

Cross-Border Application of EMIR — What Has Changed?

Third country counterparties should take careful note of when EMIR applies, to avoid unintentionally invoking the standards.

The European Securities and Markets Authority (ESMA) has now published its Final Report¹ regarding the cross-border application of European Market Infrastructure Regulation (EMIR)² Regulatory Technical Standards (the Final Draft RTS). We summarize below what has changed since our prior Client Alert ("*ESMA Publishes Draft Regulatory Technical Standards on Cross-border Application of EMIR*" published 25 July 2013) compared with ESMA's July Consultation Paper³ regarding the cross-border application of EMIR.

Over the Counter (OTC) derivative contracts “having a direct, substantial and foreseeable effect”

Summary of current proposal

The Final Draft RTS provide in Article 2 that OTC derivative contracts concluded by third country counterparties shall be considered as having a direct, substantial and foreseeable effect within the EU (and therefore will be subject to EMIR) when either:

At least one of the third country counterparties benefits from a guarantee provided by an EU financial counterparty, covering all or part of its liability under OTC derivative contracts, and the guarantee both:

- (a) covers such liability for an aggregated notional amount of at least EUR 8 billion (divided by the percentage of liability covered where only part of the liability is covered) (the Notional Amount Threshold); and
- (b) is equal to at least 5 per cent. of current exposures in OTC derivative contracts of the guarantor (the Current Exposure Threshold, and together with the Notional Amount Threshold, the Quantitative Thresholds)

or:

The two third country counterparties enter into the OTC derivative contract through their EU branches and would qualify as financial counterparties if they were established in the EU.

For purposes of limb (a) above, the actual liability resulting from OTC derivatives counts rather than any maximum amount of the guarantee (unless such maximum guarantee amount is less than the Notional Amount Threshold). Where the liability resulting from OTC derivatives is below the Notional Amount Threshold, the criterion set out in limb (a) above will, therefore, not be met even if the maximum amount of the guarantee is equal to or above the Notional Amount Threshold.

ESMA's additional clarifications

ESMA has provided several clarifications, in response to respondents' input to the Consultation Paper.

Definition of "guarantee"

- The term "guarantee" has now been defined, such that only explicitly documented legal obligations are referred to. Implicit guarantees are therefore excluded. Letters of comfort are excluded unless the issuer drafts such letters as legal obligations. Credit derivatives and contracts of insurance will also fall outside of the scope of such definition. The term "legally enforceable", that ESMA had included in its July Consultation Paper, has been removed from the characteristics of a guarantee caught by the Final Draft RTS. ESMA recognized that parties to an OTC derivative contract should not be required to engage in any due diligence of the guarantee in order to be able to properly classify the counterparty they are dealing with for EMIR purposes.

How to monitor whether thresholds are breached

- An OTC derivative contract that involves one of the third country counterparties benefiting from a guarantee that does not satisfy the two criteria set out above has to be reassessed (i) each time the notional amount of the covered liability increases (to confirm whether the total notional amount is above the Notional Amount Threshold following such increase), and (ii) monthly with respect to any reduction in the exposure (to confirm whether the guarantee does not, as a result of such reduction, reach the Current Exposure Threshold).

Applying the Notional Amount Threshold when guarantee covers only part of the liability

- Where the guarantee covers only a part of the liability resulting from the OTC derivative contracts, ESMA applies a proportional value of the EUR 8 billion threshold. This application addresses the scenario in which several guarantors each may be guaranteeing only a percentage of the overall liability.

Scenario where guarantee is added or where guarantee reaches the Quantitative Thresholds at a later stage

- OTC derivative contracts for an aggregate notional amount of at least EUR 8 billion concluded before a guarantee is issued or increased or if the liability arising from OTC derivative contracts reaches the Quantitative Thresholds at a later stage, are considered to have a direct, substantial and foreseeable effect within the EU once they are covered by a guarantee meeting the necessary conditions.

Grandfathering provisions

- OTC derivative contracts concluded before the date of application of the rules set out in the RTS shall not be considered as having a direct, substantial and foreseeable effect within the EU (although they will count towards the Quantitative Thresholds to the extent they remain outstanding).
- A six-month transition period will follow entry into force of the regulation adopting the Final Draft RTS, before the provisions relating to contracts having a direct, substantial and foreseeable effect apply.

Anti-evasion provisions

Summary of current proposal

The Final Draft RTS provide in Article 3 that an OTC derivative contract will be deemed to have been designed to circumvent the application of EMIR (and so will nevertheless be subject to EMIR) if its primary purpose is to defeat the object, spirit and purpose of any provision of EMIR that would otherwise apply. Business rationale, commercial substance and relevant economic justification are all relevant.

ESMA's additional clarifications

Anti-evasion examples ESMA had listed in its July Consultation Paper have been removed to avoid confusion. ESMA now relies only on a criteria based approach.

The reference to "regardless of any subjective intentions of the entities involved" that ESMA had included in its July Consultation Paper has been removed to reflect that each situation will be taken into consideration.

What Next?

The European Commission (EC) has until 15 February 2014 to endorse the Final Draft RTS, or decide not to endorse. Assuming the EC endorses, the European Parliament and Council need to approve the Final Draft RTS before they take effect.

Conclusion

The appended table shows our interpretation of ESMA's proposed application of EMIR to OTC derivative contracts in the cross-border context, as previously published in our Client Alert ("*ESMA Publishes Draft Regulatory Technical Standards on Cross-border Application of EMIR*" published 25 July 2013), and updated to reflect the Final Draft RTS. Aside from the conclusions in the table, if an arrangement involving third country firms appears to regulators to evade the application of EMIR, such arrangement may be subject to EMIR as a result of the rules designed to prevent such evasion.

ESMA's proposed application of EMIR to OTC derivative contracts in the cross-border context

Derivative contract entered into between:	EU firm (including branches in third countries)	Third country firm (equivalent jurisdiction), no guarantee*	EU branch of third country financial firm (equivalent jurisdiction)	Third country firm (equivalent jurisdiction) with guarantee* from EU financial counterparty	Third country firm (non-equivalent jurisdiction), no guarantee*	EU branch of third country financial firm (non-equivalent jurisdiction)	Third country firm (non-equivalent jurisdiction) with guarantee* from EU financial counterparty
EU firm (including branches in third countries)	EMIR applies	Substituted compliance permitted	Substituted compliance permitted	Substituted compliance permitted	EMIR applies	EMIR applies	EMIR applies
Third country firm (equivalent jurisdiction), no guarantee*	Substituted compliance permitted	EMIR does not apply	EMIR does not apply	Substituted compliance permitted	EMIR does not apply	EMIR does not apply	Substituted compliance permitted
EU branch of third country financial firm (equivalent jurisdiction)	Substituted compliance permitted	EMIR does not apply	Substituted compliance permitted**	Substituted compliance permitted	EMIR does not apply	Substituted compliance permitted**	Substituted compliance permitted
Third country firm (equivalent jurisdiction) with guarantee* from EU financial counterparty	Substituted compliance permitted	Substituted compliance permitted	Substituted compliance permitted	Substituted compliance permitted	Substituted compliance permitted	Substituted compliance permitted	Substituted compliance permitted
Third country firm (non-equivalent jurisdiction), no guarantee*	EMIR applies	EMIR does not apply	EMIR does not apply	Substituted compliance permitted	EMIR does not apply	EMIR does not apply	EMIR applies
EU branch of third country financial firm (non-equivalent jurisdiction)	EMIR applies	EMIR does not apply	Substituted compliance permitted**	Substituted compliance permitted	EMIR does not apply	EMIR applies**	EMIR applies
Third country firm (non-equivalent jurisdiction) with guarantee* from EU financial counterparty	EMIR applies	Substituted compliance permitted	Substituted compliance permitted	Substituted compliance permitted	EMIR applies	EMIR applies	EMIR applies

*References in the table above to "a guarantee" mean a guarantee that meets the Quantitative Thresholds and is given by an EU financial counterparty.

**If either third country counterparty would not qualify as a financial counterparty if it were established in the EU, then EMIR will not apply.

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Endnotes

¹ "Draft technical standards under EMIR on contracts with a direct, substantial and foreseeable effect within the Union and non-evasion" dated 15 November 2013

² Regulation (EU) No 648/2012 of the European Parliament and Council on OTC derivatives, central counterparties and trade repositories

³ "Draft Regulatory Technical Standards on contracts having a direct, substantial and foreseeable effect within the Union and non-evasion of provisions of EMIR" dated 17 July 2013