Consultation Paper

Draft Regulatory Technical Standards on contracts having a direct, substantial and foreseeable effect within the Union and non-evasion of provisions of EMIR

17 July 2013 | ESMA/2013/892

Date: 17 July 2013

ESMA/2013/892

Responding to this paper

ESMA invites comments on all matters in this paper. Comments are most helpful if they:

- contain a clear rationale;
- include quantitative elements to support any concern; and
- describe any alternatives ESMA should consider, including alternative drafts.

ESMA will consider all comments received by **16 September 2013**.

All contributions should be submitted online at www.esma.europa.eu under the heading 'Consultations'.

Publication of responses

All contributions received will be published following the close of the consultation period, unless you request otherwise. Please clearly and prominently indicate in your submission any part you do not wish to be publically disclosed. A standard confidentiality statement in an email message will not be treated as a request for non-disclosure. A confidential response may be requested from us in accordance with ESMA's rules on access to documents. We may consult you if we receive such a request. Any decision we make is reviewable by ESMA's Board of Appeal and the European Ombudsman.

Data protection

Information on data protection can be found at www.esma.europa.eu under the heading 'Disclaimer'.

Who should read this paper

All interested stakeholders are invited to respond to this discussion paper. In particular, responses are sought from financial and non-financial counterparties of OTC derivatives transactions.

Table of Contents

Acronyms Used

CP	Consultation Paper
DP	Discussion Paper
EMIR	Regulation (EU) N. 648/2012 on OTC derivatives, central counterparties and trade repositories – also referred to as "the Regulation".
ESMA	European Securities and Markets Authority
RTS	Regulatory Technical Standards

I. Executive Summary

Reasons for publication

This consultation paper seeks stakeholders' views on Regulatory Technical Standards (RTS) ESMA is required to draft under Regulation (EU) No 648/2012 of the European Parliament and Council on OTC derivatives, central counterparties and trade repositories. Under Articles 10 and 15 of Regulation (EU) No 1095/2010 of the European Parliament and Council establishing ESMA (ESMA Regulation), ESMA needs to conduct a public consultation before submitting draft RTS or ITS to the Commission.

The input from stakeholders will help ESMA in finalising the relevant draft technical standards. As highlighted in the ESMA discussion paper[1] on these draft technical standards, one essential element in the development of draft technical standards is the analysis of the costs and benefits that these legal provisions will imply. Respondents to this consultation are encouraged to provide the relevant data to support their arguments or proposals.

Contents

This consultation paper follows the structure of the articles 4(4) and 11 (14) (e) of EMIR, with the first section focusing on specifying contracts that are considered to have a direct, substantial and foreseeable effect within the Union and the second part focuses on cases where it is necessary or appropriate to prevent the evasion of any provision of EMIR.

Next steps

On the basis of the responses to this consultation paper, ESMA will update the draft technical standards and the impact assessment and send the final report to the European Commission for endorsement.

II. Introduction

1. EMIR[2] was adopted on 4 July 2012 and entered into force on 16 August 2012. However, the provisions of EMIR that need to be specified via technical standard will take effect when the relevant technical standard will enter into force. Therefore, the provisions of EMIR related to contracts that are considered to have a direct, substantial and foreseeable effect within the Union and to cases where it is necessary or appropriate to prevent the evasion of any provision of EMIR, will enter into force when the relevant technical standards will themselves enter into force.

2. EMIR introduces provisions to improve transparency, establish common rules for central counterparties (CCPs) and for trade repositories (TRs) and to reduce the risks associated with the OTC derivatives market. In this respect, it provides for the obligation to centrally clear OTC derivative contracts or to apply risk mitigation techniques such as the exchange of collateral. This obligation applies to OTC derivative contracts when counterparties are established in the Union[3].

[1] ESMA/2012/95 of 16 February 2012

[2] http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2012:201:0001:0059:EN:PDF

[3] Article (4)(1)(a) (i) to (iii): „(i) between two financial counterparties;(ii) between a financial counterparty and a non-financial counterparty that meets the conditions referred to in Article 10(1)(b); (iii) between two non-financial counterparties that meet the conditions referred to in Article 10(1)(b);"

When one counterparty is established in the Union and the other counterparty is established in a third country[4] (cross-border transaction), the clearing obligation or risk mitigation requirements would apply subject to the mechanisms to avoid duplicative or conflicting rules[5]. When the two counterparties are established in third countries, EMIR would only apply under certain conditions developed under the draft RTS presented in this consultation paper. The mechanisms to avoid duplicative or conflicting rules would also apply in such case.

3. The conditions under which the clearing obligation or the risk mitigation techniques should apply to a contract entered into by two third country counterparties relate to the direct, substantial and foreseeable effects of the contract within the Union or to the necessity or appropriateness to prevent the evasion of provisions of EMIR. These conditions shall be specified by ESMA via regulatory technical standard.

4. The draft RTS were initially expected to be developed by 30 September 2012. However, in view of the importance of the topic it was necessary to consider discussions with competent authorities of third countries, in particular in the framework of the OTC Derivatives Regulators Group. As a result, the development of these RTS was postponed. On 22 April 2013, the European Commission has set a new date to 25 September 2013 for the delivery of these RTS.

5. This consultation paper covers the draft RTS that ESMA is required to draft and that specify the contracts that are considered to have a direct, substantial and foreseeable effect within the Union or cases where it is necessary or appropriate to prevent the evasion of any provision of EMIR as referred to in paragraph 12 of the article related to risk mitigation techniques for OTC derivative contracts that are not cleared.

6. ESMA has already consulted on the development of these draft RTS. In its discussion paper[6] (DP) related to EMIR and issued on 16 February 2012, ESMA called for the view of stakeholders on how ESMA should specify contracts that are considered to have a direct, substantial and foreseeable effect within the EU and, cases where it is necessary or appropriate to prevent the evasion of any provision of EMIR for contracts entered into between third country counterparties.

7. One essential element for the drafting of technical standards is the analysis of the cost and benefits that the proposed measures might entail. This consultation paper includes in Annex III an impact assessment. In order to help ESMA to perform a quantitative based cost-benefit analysis and base it on objective figures, respondents to this consultation paper are invited to accompany their responses with quantitative evidence supporting their arguments.

8. Comments are welcome on all the sections and annexes of this consultation paper. Respondents are invited to clearly highlight the section and provisions which their comments refer to and provide supporting data whenever possible.

III. Consultation Paper

9. The OTC derivative contracts that are considered in the scope of this consultation paper are those entered into between two counterparties that are established in third countries. This consultation

[4] Article 4(1)(a)(iv) of EMIR: "between a financial counterparty or a non-financial counterparty meeting the conditions referred to in Article 10(1)(b) and an entity established in a third country that would be subject to the clearing obligation if it were established in the Union"

[5] See Article 13 of EMIR.

[6] http://www.esma.europa.eu/system/files/2012-95.pdf

does not relate to OTC derivative contracts entered into by counterparties that are both established in the EU, nor to those between a counterparty established in the EU and another counterparty established in a third country.

10. Under some specific circumstances, provisions of EMIR related to the clearing obligation and the risk mitigation techniques apply to contracts concluded by counterparties that are both established in one third country or in different third countries, provided they would be subject to the EMIR requirements if they were established in the EU. The first circumstance relates to the direct, substantial and foreseeable effect of the contract in the Union. The second circumstance addresses the situations where it is necessary or appropriate to prevent the evasion of any provision of EMIR.

11. In their answer to the DP, stakeholders recognised that the approach to draft these RTS is not straightforward and stressed the importance of international regulatory cooperation in this respect. They noted the need to avoid overlaps which would create burdens and difficulties for the market participants but also gaps that would open the door to potential evasion was pointed out.

12. Stakeholders called for clarity on the determination of what would constitute direct, substantial and foreseeable effect. Certainty is necessary to prevent legal risks and decisions that could be detrimental to the efficiency of markets. Some responses suggested considering only OTC derivative contracts above a certain level, others to take into account obligations applicable in third countries. Stakeholders also note that evasion should not be presumed as many companies enter into transactions with third country entities or branches in third countries for legitimate business reasons.

13. Responses noted the global nature of the OTC derivatives market and stressed the significant implications that the scope of application of EMIR would have on the way counterparties structure their business models to carry out their activity in this market.

14. Stakeholders considered that a good regulatory outcome would need to ensure that counterparties could carry out their business in the most safe and efficient way, allowing them to properly manage the risks they face. It would also need to prevent any possibility to leverage potential loopholes in any jurisdiction and any possibility of circumventions of European requirements.

15. ESMA gives due consideration to the global nature of the OTC derivative markets and recognises the need to rely on equivalent regimes and the benefits that mutual recognition and substituted compliance can bring to ensure safe, efficient and global OTC derivative markets. For this purpose, ESMA engaged in discussions with third country supervisors on the most appropriate way to ensure that possible gaps, overlaps and duplications on the scope of application of EMIR and other third country legislations do not result in a disruption of the global nature of the OTC derivatives market or in the impossibility for certain counterparties to enter into OTC derivative transactions with each other, while ensuring that risks arising from these markets are adequately managed in a level playing field. In developing the draft RTS, ESMA has considered answers it received to the Discussion Paper (DP) as well as the discussions it held with third countries regulators within the OTC Derivative Regulators Group[7].

[7] See Statement of Leaders on the Operating Principles and Areas of Exploration in the Regulation of the Cross-Border Derivative Market of 4 December 2012 http://www.esma.europa.eu/system/files/2012-802.pdf

III.I Contract considered to have a direct, substantial and foreseeable effect within the Union

Need for certainty

16. When an OTC derivative contract has direct, substantial and foreseeable effect in the Union, although counterparties are established in non-EU jurisdiction, under some specific conditions, the clearing obligation or the risk mitigation techniques provided for in EMIR would apply. It is therefore very important for counterparties to be in a position to know what set of rules will apply to their OTC derivative transactions.

17. This need for certainty was raised by several respondents to the DP. They stressed the impact uncertainty could have on OTC derivative activities that would have a nexus with the Union. They recommend that the draft technical standards do not discourage counterparties to enter into OTC derivatives contemplated for legitimate commercial reasons.

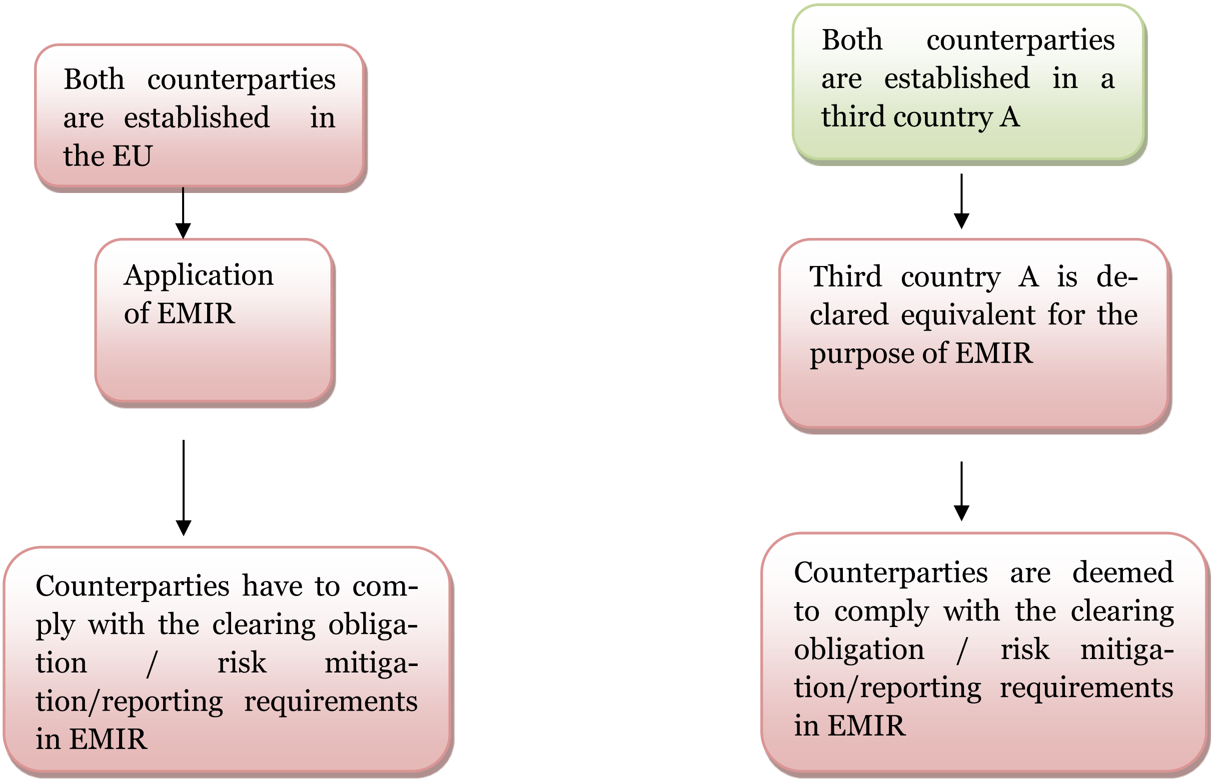
18. ESMA understands the need for counterparties to get certainty and, through the draft technical standards, aims at providing a clear framework allowing determination of whether EMIR rules would apply to OTC derivative contracts entered into by counterparties established in a third country. Considering the objectives of the relevant provisions of EMIR, ESMA is cautious not to discourage international activity with a European nexus where no significant risk would be posed within the Union. Consistently, ESMA is cautious that EMIR applies when the OTC derivative contracts meet the cumulative conditions of having a direct, substantial and foreseeable effect within the Union. For this purpose, the framework determining the conditions should be clear and detailed in order for counterparties to derive certainty from it.

Equivalent third countries

19. The commitment to address risks posed by derivative contracts was made by the G20. It means that other countries are likely to adopt legislation with a goal similar to that of EMIR. For instance, the Dodd Franck Act was adopted in the USA. Given the existence of legislation with a similar aim in different countries and the global nature of the derivative markets, EMIR does recognise the need to avoid application of duplicative or conflicting rules to the same OTC derivative contract. For this purpose, it provides in its Article 13 for a mechanism to avoid duplicative or conflicting rules i.e. the recognition of equivalence.

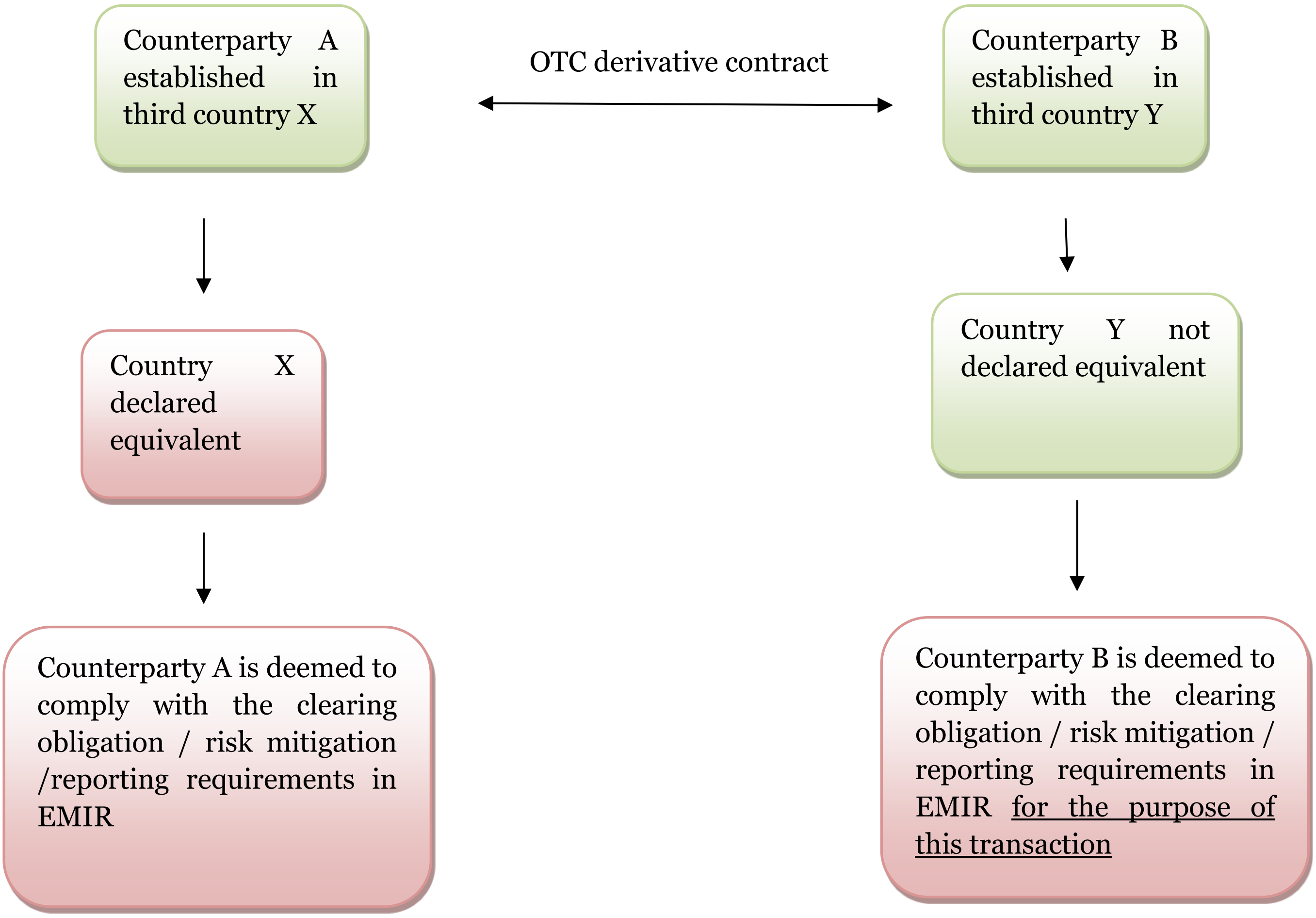
20. Under Article 13 of EMIR, in case of OTC derivative contracts between an EU counterparty and a counterparty established in an equivalent jurisdiction, the provisions of EMIR can be disapplied and the provisions of the third country applied. This mechanism provided by Article 13 also applies to transactions between counterparties in one or several third countries. As a result, when contracts between counterparties established in third countries are considered to have a direct substantial and foreseeable effect within the Union, it is necessary to consider Article 13 of EMIR and in particular paragraphs 2 and 3.

21. The adoption of an implementing act declaring a third country's equivalence means that the related requirements in that country would allow reaching a similar outcome as with the application of EMIR. As a result, and in order to avoid duplication, when at least one counterparty to the transaction is located in a third country declared equivalent, EMIR can be disapplied as the third country framework allows reaching an outcome equivalent to that of EMIR.



22. EMIR requirements can be substituted by equivalent requirements in third countries for cross-border transactions and transactions between third country entities. Therefore, if one of the two counterparties of a transaction is established in a third country for which the Commission has adopted an implementing act declaring it equivalent, although the transaction would have a direct, substantial and foreseeable effect in the EU, EMIR could be disapplied.

23. Against this background, the draft RTS included in this consultation paper should be read in conjuction with Article 13 of EMIR. Therefore the cases analysed below and included in the scope of the draft RTS (guaranteed entities and branches) only refer to the cases where both counterparties are established in non-equivalent jurisdictions.

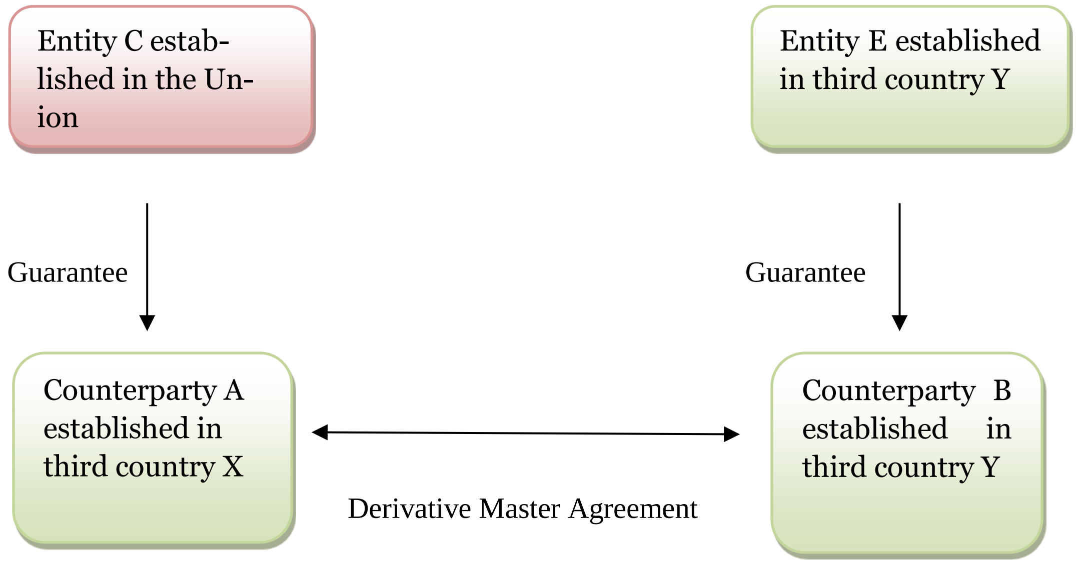


Scope of application of the draft RTS

Guarantee

24. Counterparties may benefit from a guarantee of another entity. The scope of the guarantee may vary and be of general nature e.g. covering all liabilities of that entities up to a certain amount, or of specific nature e.g. covering liabilities resulting from a specified activity or contract. When the liabilities are covered by a guarantee, the default of the guaranteed counterparty would have a direct effect on the guarantor which would be obliged to assume the resulting liability.

25. When an OTC derivative contract is entered into by a third country counterparty benefiting from a guarantee issued by an EU guarantor, the OTC derivative contract would have a direct effect in the EU, i.e. where is established the guarantor.



26. Although guarantees provided by any EU entity might result in a direct effect in the EU, ESMA decided to limit the scope of this provision to guarantees issued by financial counterparties for the following reasons:

   a. Guarantees issued by entities other than financial counterparties are not expected to be substantial;

   b. Competent authorities have less information on guarantees issued by entities other than financial counterparties;

   c. Competent authorities should have the appropriate powers to enforce the provisions of these draft RTS and these powers are well developed for financial counterparties[8].

27. In order to be considered substantial the effect of the guarantee should reach or exceed a significant monetary value and it should be significant considering the overall activity on OTC derivatives of the EU established financial counterparty. In addition, to be considered substantial the entity should generate a significant risk for financial counterparties established in the EU i.e. the default of the non-EU entity benefiting from the guarantee could create a risk of default for the EU entity. For this purpose, it is proposed that the amount of the guarantee should exceed two cumulative thresholds related to the value of the OTC derivative contracts guaranteed and the value of the guarantee compared to the OTC derivative activity of the EU financial counterparty providing the guarantee.

28. The second consultative document related to Margin Requirements for Non-centrally Cleared Derivatives[9] issued by the Basel Committee on Banking Supervision and the Board of the International Organization of Securities Commissions proposes to set a minimum level below which non-centrally cleared OTC derivatives would not be subject to initial margin

[8] Although competent authorities will extend their powers on non-financial counterparties above the clearing threshold to enforce the provisions of EMIR. Most of the national competent authorities would not have a broad range of powers to check all the activitites of non-financial counterparties, including their relationships with foreign entities.

[9] http://www.bis.org/publ/bcbs242.pdf

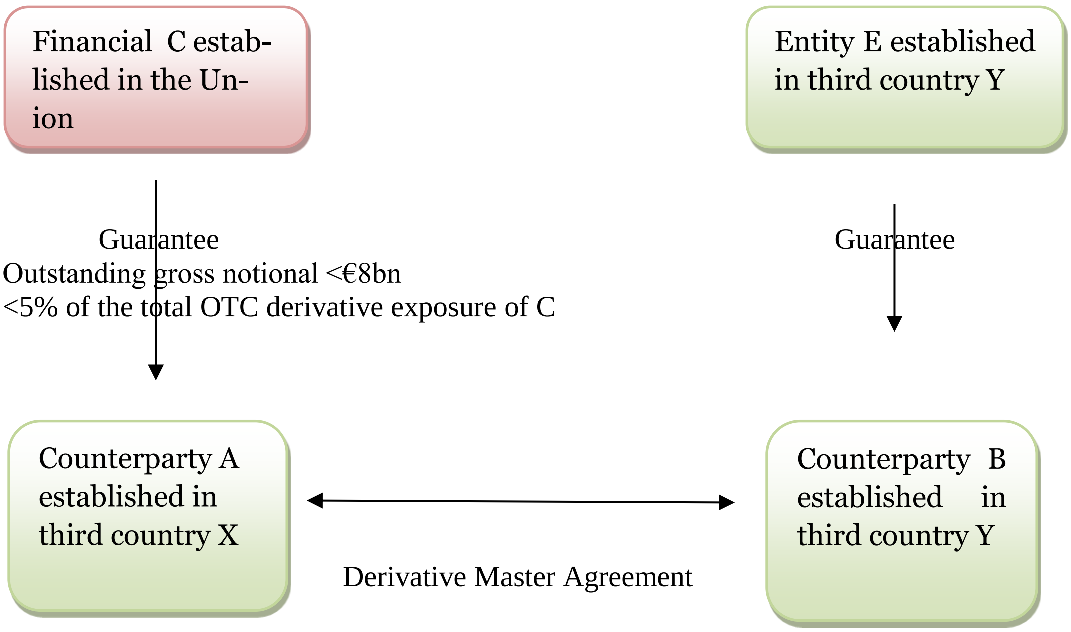
requirements. This minimum threshold was set at €8bn of gross notional outstanding. In view of international consistency and in order to facilitate the application of this provision, notional amounts are considered for an amount equivalent to the current exemption for initial margin requirements for non-CCP cleared OTC derivatives. ESMA therefore proposes to use the same level for the threshold related to the significant value of the OTC derivative contracts guaranteed.

29. Considering the high value of this threshold in absolute value (notional amount), ESMA considers that the relative threshold on the activity of the EU financial counterparty should be on the lower side. Therefore, for the threshold related to the activity of the guarantor, ESMA proposes to consider 5 percent of the total OTC derivatives exposures that the financial counterparty established in the EU faces. However, it should be noted that there is no common methodology to calculate exposures. Therefore, further indication should be provided in this respect. For this purpose, and considering that the provision is addressed to financial counterparties in general not only to banks, ESMA considers that a more straight forward approach to calculate exposures should be considered. For this purpose, it is proposed to use the definition of current exposure as provided for in Article 272(17) of the Capital Requirement Directive (CRD).

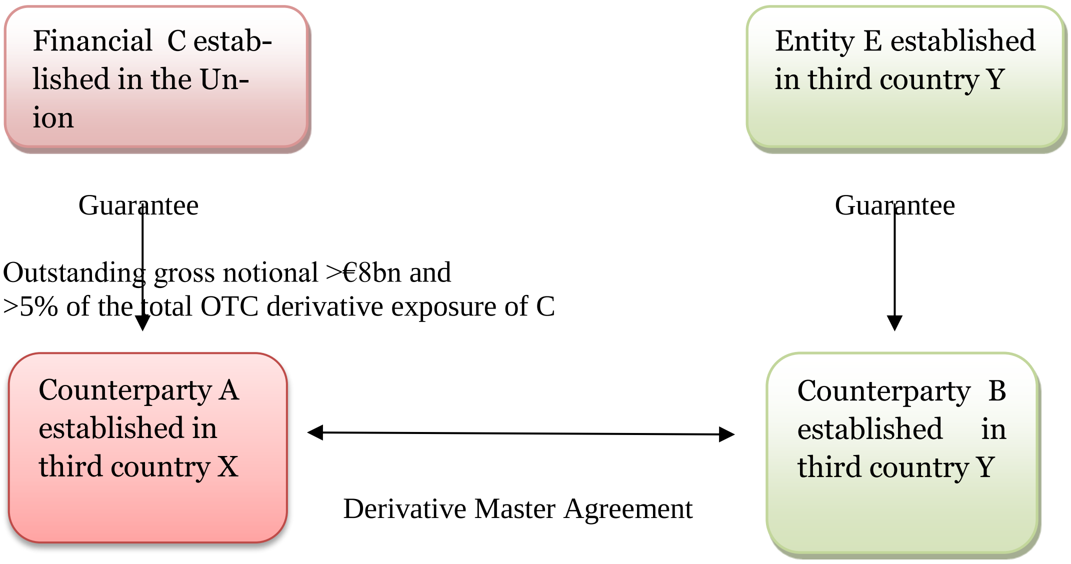
30. The guarantee can be concluded under different forms and have different labels. It can be concluded as a straight forward guarantee or not. ESMA proposes not to differentiate between the different forms of guarantees as long as they cover the OTC derivative contracts of the counterparty and are valid and enforceable guarantees. The term should be interpreted to cover any other arrangement which operates in a substantially similar way.

31. With reference to the foreseeable effects, ESMA considers that the combination of the limited and clearly defined personal scope of application (only guarantees issued by financial counterparties to entities in non-equivalent third countries) and the quantitative thresholds would allow the entities subject to this provisions to reasonably envision the effect resulting from the OTC derivative contracts they enter into and the associated risks.

<u>OTC derivative contracts covered by a guarantee of an EU financial below the thresholds – Outside the scope of the RTS</u>



OTC derivative contracts covered by a guarantee of an EU financial above the thresholds – within the scope of the RTS



Q.1 Do you agree that a full or partial guarantee issued to the benefit of a third country counterparty by an EU guarantor, whatever is its form, be considered in order to specify the direct, substantial and foreseeable effect of the contract?

Q.2 Do you agree with the 2 cumulative thresholds proposed in the draft RTS? Do you consider that the proposed value of the thresholds is set at an appropriate level in order to specify the direct, substantial and foreseeable effect of the contract? Please provide relevant data to justify your answer.

EU Branches of third countries entities

32. Third country entities may establish branches within the Union. Branches are usually established in order to better serve the market where they are established and for this purpose will likely be active in the European market. These branches may be significant players in the European market and participate in the provision of liquidity on this market.

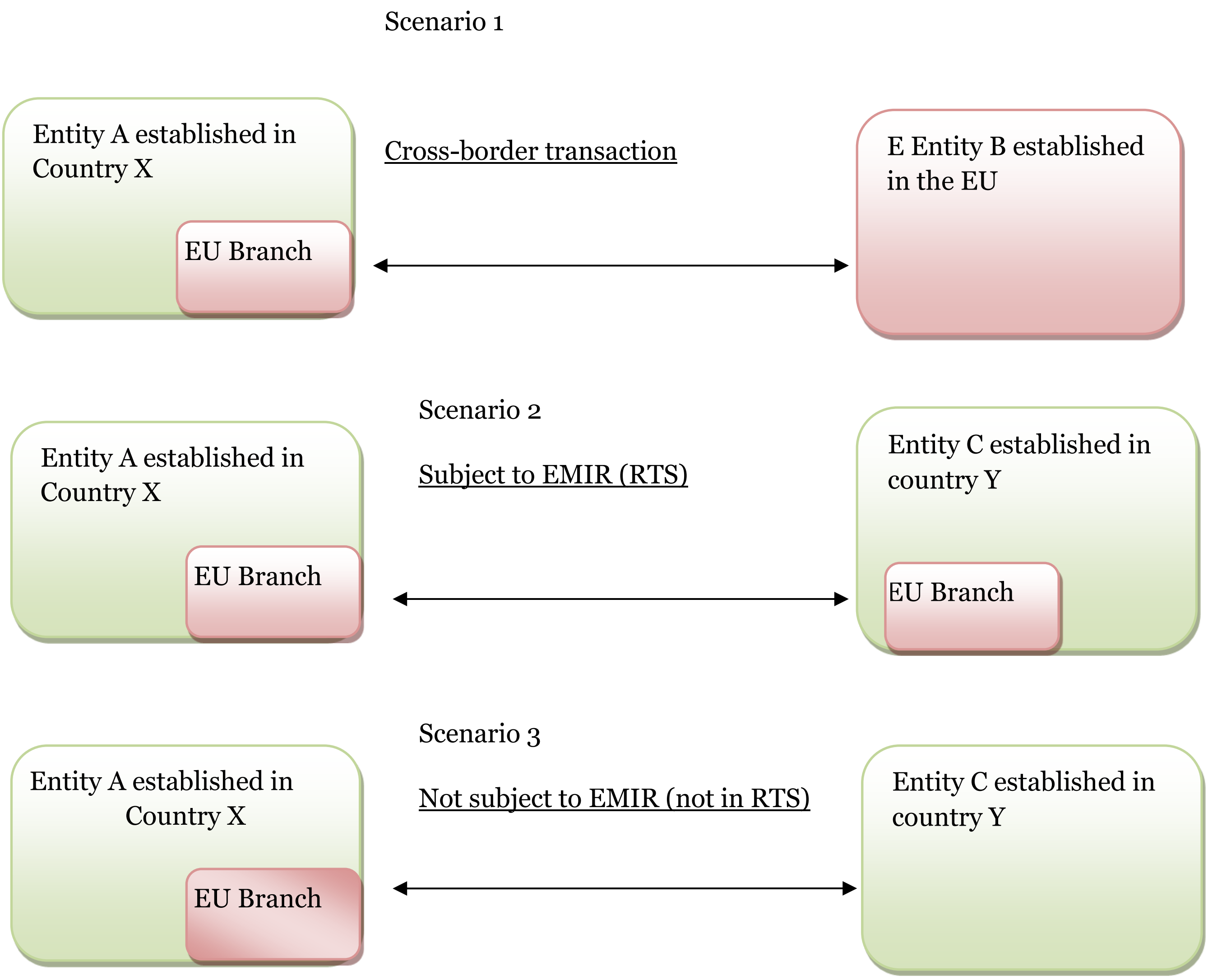
33. The transactions of such EU branches would have a direct effect on the European markets if they are concluded with an EU counterparty or with the EU branch of a non-EU entity. The first scenario, involves an EU entity and would be of cross-border nature. It is therefore not addressed under these draft RTS.

34. The second scenario involves two non EU entities operating through EU branches. These branches operate in the same markets as European firms. In addition, they might not be captured by foreign regimes given that they operate in a foreign jurisdiction and the third countries of establishment may not be equivalent to Europe. Therefore if the transactions between these branches are not captured, this might potentially lead to a loophole, with a consequential direct effect within the Union. This non-application of rules equivalent to EMIR for transactions concluded by two EU branches of non-equivalent third country entities might

result in potential market disruptions, with a direct substantial and foreseeable effect in the Union. For example, market liquidity may be wholly or partially dependent on the activities of EU branches of non-EU entities. Therefore any disruption to these entities could have systemic consequences.

35. Given that the potential impact for the Union derives from the failure of an entity with such significant interconnectedness with EU counterparties and markets, all transactions concluded between EU branches of non-equivalent third country entities should be captured by the draft RTS. Excluding some of these transactions might still result in a substantial effect for the Union in terms of potential systemic risk. Therefore quantitative thresholds should not apply to these transactions.

36. Differently, ESMA believes that OTC derivative contracts between the EU branch of a non-EU entity and another non-EU entity, should be left to the regimes of the third countries involved, as that transaction would be a cross-border transaction between two non-EU entities, whereas in the previous case the transaction would be solely executed within the Union by two non-EU entities. For this purpose, ESMA believes that in this third scenario the transaction does not have a direct effect in the EU.



Q.3 Do you agree that OTC derivative contracts entered into between two EU branches of third country entities would have direct effect within the Union?

Other cases considered by ESMA

Currency and underlying of the OTC derivative contracts

37. ESMA has contemplated using the currency of the OTC derivative contracts, as well as the underlying of the OTC derivative contracts in order to identify the direct, substantial and foreseeable effect of a contract within the Union. However, ESMA considers that using this type of criteria would entail using a broad definition of the "direct" nature of the effect of the contract within the Union. Indeed capturing the currency or the underlying of the contract would relate to the risk of the instrument and would use a broad identification of nexus between the OTC derivative contract and the Union. As a result, it is proposed not to consider criteria, such as the currency or the underlying of the contract in order to determine the direct effect of the contract within the EU.

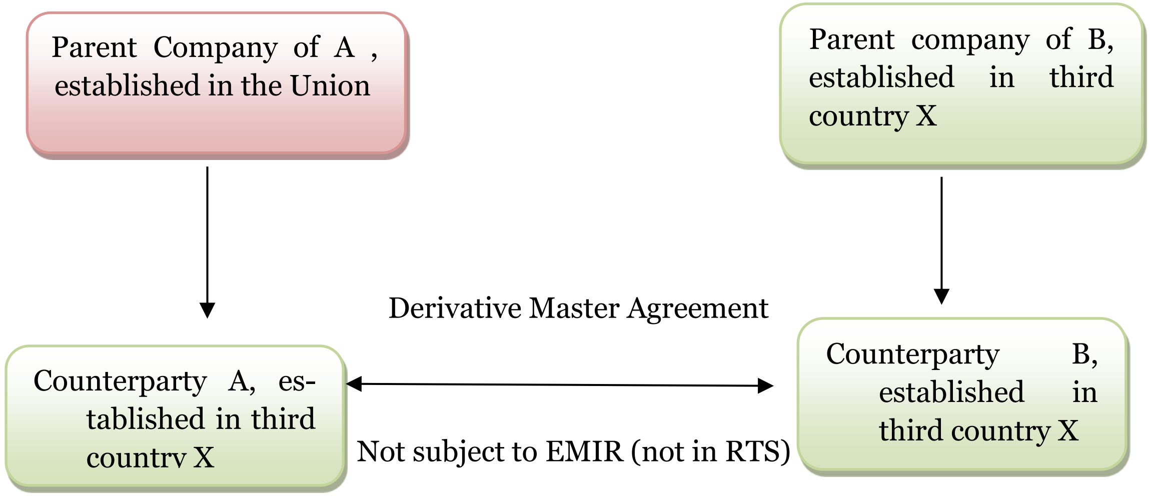
Q.4 Do you agree that criteria related to the currency or underlying of the OTC derivative contracts should not be used to specify the direct effect of the contract within the Union?

Subsidiaries

38. Entities within a group may have strong interrelations. This is particularly true between parent and subsidiaries. For the purpose of the direct effect of the contracts, ESMA has considered whether the OTC derivative contracts entered into by the third country subsidiary of an entity established in the Union should be considered as having a direct effect within the EU. Indeed, although the subsidiary is a different legal entity, and the parent may not be legally bound to assume financial losses of the subsidiary, it may have strong incentives to pay. It may also decide to pay on a voluntary basis. The subsidiary can also operate on the assumption that the parent would rescue it in case of default. This would create an implicit backing by the parent with possible risks to be imported in the EU. Finally, the parent company's reputation could be hurt in case of default of the subsidiary pursuant to the derivative contracts. This damage to the reputation of the parent company may lead to strong difficulties for the EU parent.

39. Although ESMA considers that the OTC derivative contracts entered into by the subsidiaries established in a third country of an EU parent, could have some effect on the EU entity, it does not consider that these effect would be direct and foreseeable. Indeed, the parent would not be legally bound by the OTC derivative contracts of its subsidiaries, unless it has issued guarantees in this respect (case already covered above). Furthermore, it would be difficult to predict the effect of the contract on the reputation of the EU entity or on the basis of an implicit backing.

40. As a result ESMA considers that the contracts entered into by subsidiaries established in third countries of EU parent should not be considered to have a direct, substantial and foreseeable effect within the Union unless explicitely guaranteed.



Q.5 Do you agree that contracts of third country subsidiaries of EU entities would not have a direct substantial and foreseeable effect within the EU?

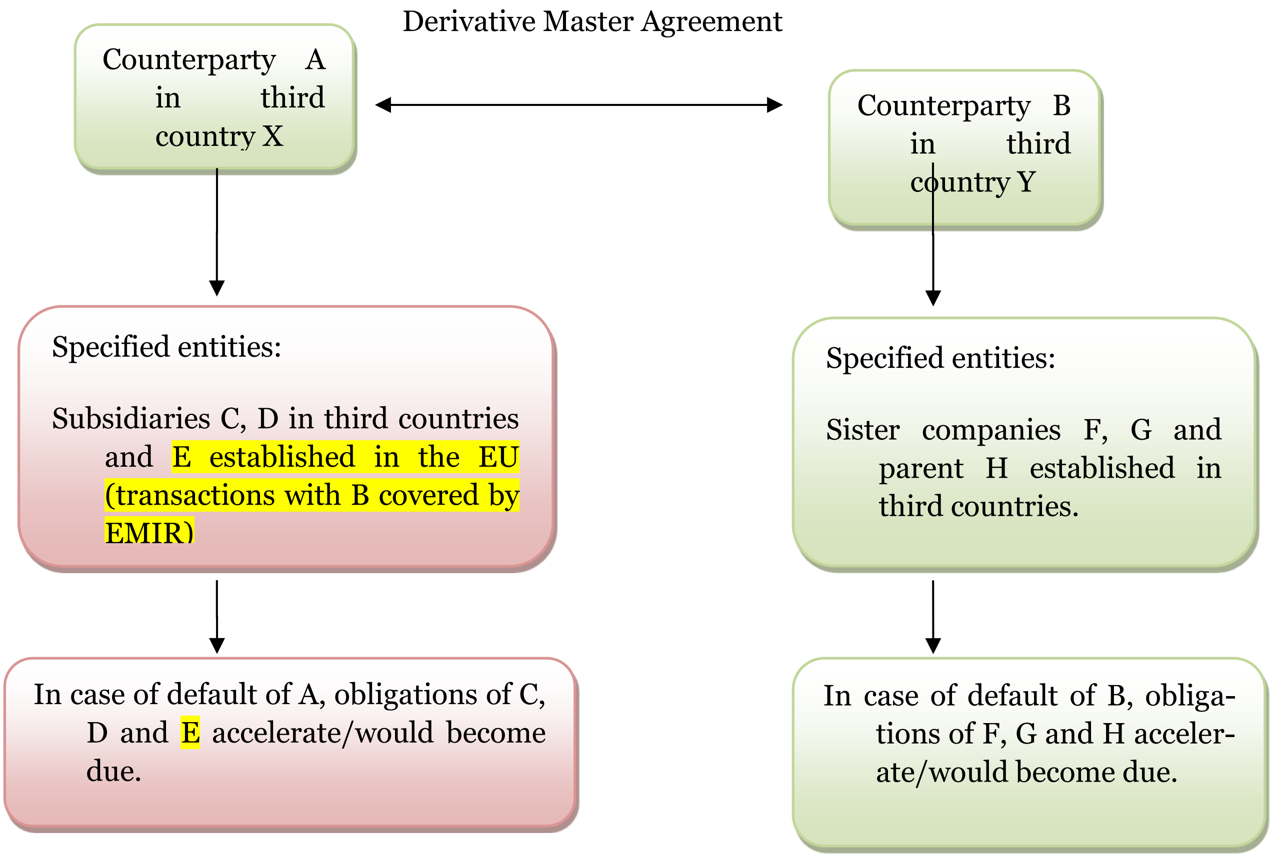
Q.6 Do you believe that in absence of a guarantee, there is limited implicit backing by the EU parent of a third country subsidiary that can result in a direct, substantial and foreseeable effect in the EU?

<u>Contractual effect</u>

41. Derivative master agreements usually consider the relationship between counterparties globally i.e. including due regard to other entities of the group. For instance, master agreements provide for the determination of lists of entities[10] whose obligation would become immediately due[11] in case of default of the counterparty. That list is usually made up of entities belonging to the group of the counterparties. Indeed, the creditworthiness of one entity of the group could impact or reflect on the creditworthiness of other entities of the group. For example, bank A established in third country A could have listed in its master agreement with counterparty B, subsidiaries X, Y and Z and counterparty B could have listed sister companies F and G and parent company H. As a result of being listed, in case of default of the counterparty under the OTC derivative contract, the listed entities would be subject to an acceleration of their obligations that would become immediately due vis a vis the counterparty.

[10] For instance, "Specified Entities" under the ISDA Master Agreement.

[11] The so called acceleration of the obligation.



42. When counterparties established in a third country have listed for the purpose of acceleration or cross default in their master agreement a financial counterparty or a non-financial counterparty established in the Union, their derivative contracts may have an effect within the Union. In our example, if E is established in the Union, the derivative contract between A and B could have an effect in the Union.

43. However, the effect of the acceleration does not impact the parties to the obligation or the obligation itself but only the timing of the obligation. Indeed, the transaction and resulting liabilities remain between the counterparties. The only change relate to the moment when the obligations become due. Furthermore, it should be noted that transactions between EU specified entities (subsidiary E) and its counterparties are already covered by EMIR. ESMA, therefore, considers that it would be disproportionate to include in the scope of EMIR the transactions between A and B. ESMA therefore does not consider that this effect of the contract should be taken into account in order to specify the direct, substantial and foreseeable effect of the contract within the Union.

Q.8 Do you agree that the acceleration of the obligation of listed entities resulting from the OTC derivative contract should not be considered to specify the direct, substantial and foreseeable effect of the contract?

<u>Summary of the scope of application of EMIR to third country entities pursuant to the draft RTS and Article 13 of EMIR:</u>

<table>
<tr><th colspan="2" rowspan="2"></th><th rowspan="2">EU Firm (including Branches established in 3rd Countries)</th><th colspan="2">Equivalent third Country</th></tr>
<tr><th>EU Branch</th><th>3rd Country Firm</th></tr>
<tr><td colspan="2">EU Firm (including Branches established in 3C)</td><td>EMIR applies</td><td>EMIR can be disapplied</td><td>EMIR can be disapplied</td></tr>
<tr><td rowspan="2">Non-Equivalent third Country</td><td>EU Branch</td><td>EMIR applies</td><td>RTS (Not apply)</td><td>RTS (Not apply)</td></tr>
<tr><td>3C Firm</td><td>EMIR applies</td><td>RTS (Not apply)</td><td>RTS (Not apply)</td></tr>
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<tr><td rowspan="2">Non-Equivalent third Country</td><td>EU Branch</td><td>EMIR applies</td><td>RTS (Apply)</td><td>RTS (Not covered unless substantial guarantees from EU FC)</td></tr>
<tr><td>3C Firm</td><td>EMIR applies</td><td>RTS (Not covered unless substantial guarantees from EU FC)</td><td>RTS (Not covered unless substantial guarantees from EU FC)</td></tr>
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III.II Prevention of Evasion

44. In order to develop the draft technical standard related to the prevention of evasion of EMIR Regulation, it is useful to refer to recital 23 of Regulation (EU) N.648/2012. This recital clarifies that in order to foster financial stability within the Union, it might be necessary to submit transactions entered into by counterparties established in third countries to the clearing and risk mitigation techniques where such obligations are necessary or appropriate to prevent the evasion of any of the provisions of EMIR.

45. The provisions of Article 4(1)(a)(v) and recital 23 of EMIR that refer to the need to "prevent the evasion of any of the provisions of EMIR", indicate that ESMA should aim at capturing transactions which would have ordinarily been subject to the provisions of EMIR but which have been deliberately structured so as to avoid its application.

<u>The approach</u>

46. Anti-evasion rules such as that one provided for in EMIR are common in the area of tax legislation. They are usually referred to as anti-avoidance rules. In that field, they are typically drafted to consider the substance or economic effect of a transaction as opposed to its legal form. For example, these rules seek to prevent tax avoidance where the main object or purpose, or one of the main objects or purposes, of a transaction is to avoid tax as opposed to listing specific circumstances in which avoidance has been identified. Such rules are suggested to have a positive deterrence and compliance effect. However, the drafting should be carefully developed in order to avoid introducing uncertainty on the application of the provision.

47. ESMA proposes to develop a set of criteria regarding the substance or effect of OTC derivative transactions which would ordinarily have been subject to the provisions of EMIR but which by application of different means are not. This approach is favoured over the development of a prescriptive list of transactions types or circumstances in which such transactions might occur. Such a prescriptive list would not be flexible and would leave room for gaps in view of the evolution of practices. Furthermore, the approach based on criteria is in line with the approach adopted in other technical standards under EMIR.

Q.9 Do you agree with a criteria based approach in order to determine cases where it is necessary or appropriate to prevent the evasion of any of the provisions of EMIR?

<u>The primary purpose of the arrangement</u>

48. In order to determine whether the OTC derivative contracts should be captured under EMIR, ESMA proposes to consider the global form of the arrangement or arrangements instead of focusing only on the OTC derivative contracts on their own. Indeed, each individual step of the transaction may not allow to identify the primary purpose of the arrangement.

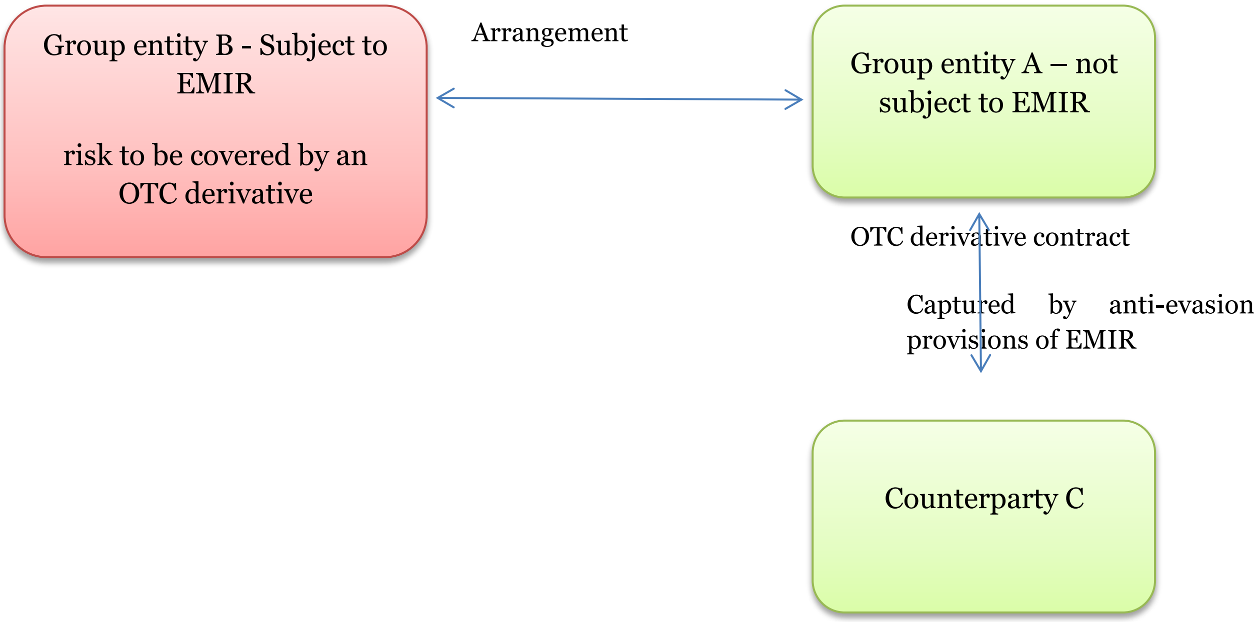
49. The primary purpose of the arrangement to consider is the main reason for which the OTC derivative contracts are part of a more global arrangement. Indeed, if the arrangement is set up because of a business, commercial reason or economic justification, it is would be legitimate. However, in the absence of such commercial, business or economic rationale supporting the arrangement, it would be considered as artificial and may give rise to characterisation as a case where evasion should be prevented.

50. In order to provide a clear definition and understanding of situations where an arrangement would be considered artificial ESMA proposes to provide an non-exhaustive list of situations that would be particularly relevant.

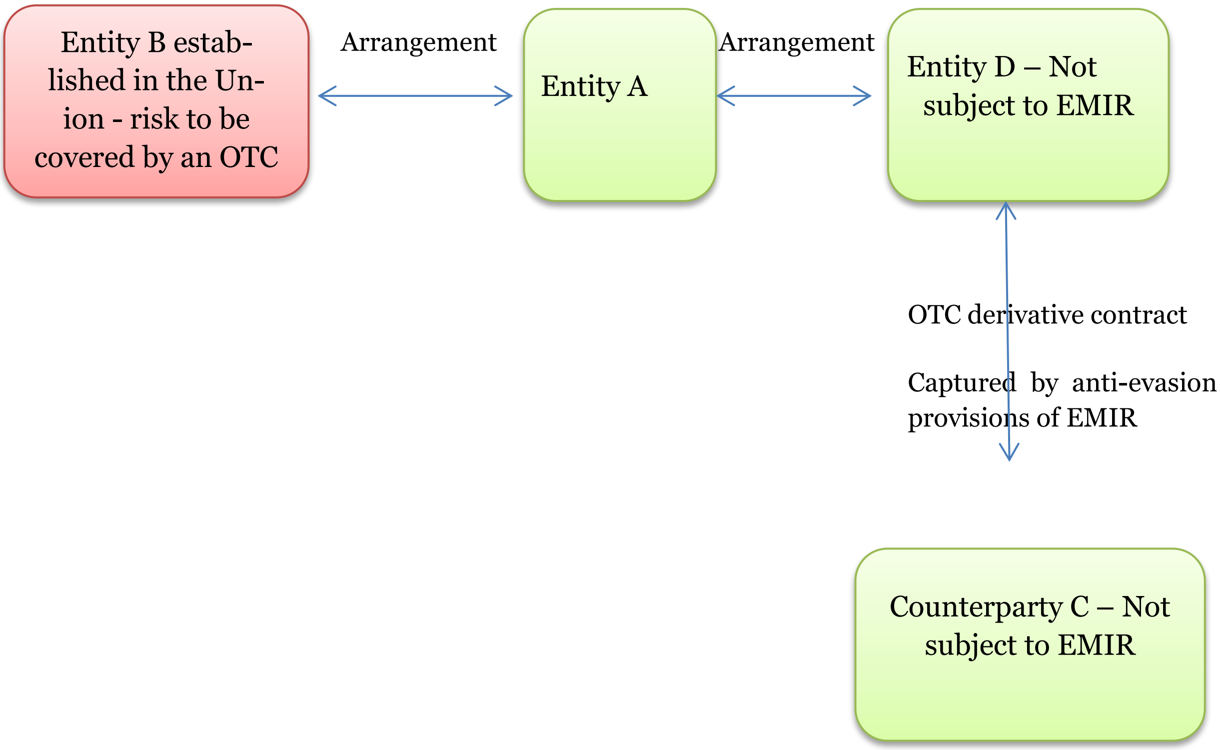
The evasion of any provisions of EMIR

51. Within a group, it may be decided that an OTC derivative contract should be entered into by an entity A that is not involved in the business to which the derivative relates e.g. hedging of a risk incurred by entity B, or the risk management of the group in order to avoid application of the clearing obligation or risk mitigation techniques. The OTC derivative contract would necessitate arrangements between the entity of the group that is directly involved in the business, B, and the entity A entering into the OTC derivative contract. In such case, the arrangement would not be supported by a commercial, business or economic reason. ESMA considers that it is clear that this arrangement would be considered as an artificial arrangement and should be captured.

OTC derivative contract concluded by a group entity which does not incur risk



52. An arrangement aiming at avoiding application of EMIR could also be concluded by unrelated parties. An entity B incuring a risk to be protected by an OTC derivative may agree with a non related party A that a party D, that is not subject to EMIR, for instance because it is established in a third country, will enter into that OTC derivative contract. Through the arrangement concluded between B, A and D, the profits and losses of the OTC derivative contract would be beared by and distributed to B. If the avoidance of EMIR is the primary purpose of the arrangement, ESMA considers this arrangement should be captured by the anti-evasion provision of EMIR.



Q.10 Do you agree that artificial arrangements that would have for primary purpose to avoid or abuse of any provision of EMIR should be considered as cases where evasion of provision of EMIR should be prevented?

Annex I - Legislative mandate to develop draft technical standards

Articles 4 (4) and 11 (14) (e)

ESMA shall develop draft regulatory technical standards specifying the contracts that are considered to have a direct, substantial and foreseeable effect within the EU or the cases where it is necessary or appropriate to prevent the evasion of any provision of this Regulation as referred to in respectively paragraph 1(a)(v) of Article 4 and paragraph 12 of Article 11.

ANNEX II - Draft regulatory technical standards on OTC derivatives

COMMISSION DELEGATED REGULATION (EU) No …/..

of [date]

supplementing Regulation (EU) No 648/2012 of the European Parliament and of the Council with regard to regulatory technical standards on direct, substantial and foresseable effect of contracts within the Union and prevention of evasion

(Text with EEA relevance)

THE EUROPEAN COMMISSION,

Having regard to the Treaty on the Functioning of the European Union,

Having regard to Regulation (EU) No 648/2012 of the European Parliament and of the Council of 4 July 2012 OTC derivatives, central counterpaties and trade repositories[12], and in particular Articles 4(4) and 11(14)(e) thereof.

Whereas:

(1) This Regulation specifies the criteria to determine when an OTC derivative contract may be considered to have a direct, substantial and foreseeable effect within the Union and cases where it is appropriate to prevent the evasion of any provision of Regulation (EU) No 648/2012.

(2) Given that pursuant to Article 13 of Regulation (EU) No 648/2012, the provisions of Regulation (EU) No 648/2012 would be deemed fulfilled as a result of the adoption of an implementing act declaring equivalence, such an implementing act should be taken into account to determine the contracts that would have a direct, substantial and foreseeable effect within the Union. Therefore, the enties subject to this Regulation would be able to disapply the provisions of Regulation (EU) No 648/2012 and apply the equivalent provisions in a third country, if at least one of the two counterparty is established in a jurisdiction for which the Commission adopted an implementing act on equivalence.

(3) Guarantees provided by EU entities to cover OTC derivative contracts concluded by counterparties established in third countries create a financial risk for the EU established guarantor, such guarantees should be considered as having a direct and foreseeable effect within the Union. The substantial effect of these guarantees should be determined by specific quantitative threshold.

(4) Competent authorities should be able to enforce the provisions included in this Regulation. Therefore, only guarantees provided by financial counterparties are relevant for the purpose of determining the contracts with a direct, substantial and foreseeable effect in the EU, given the size of these guarantees and the powers and the information available to competent authorities to apply and enforce these provisions.

(5) Certain information on the contracts concluded by third country entities subject to the provisions of this Regulation are available only to third country competent authorities, the European competent authorities would need to closely cooperate with these authorities in order to ensure that the provisions in this Regulation are applied and enforced.

(6) Financial firms established in non-equivalent countries can enter into OTC derivatives through their EU branches. Given the impact of the activity of the EU branches on the EU market, OTC derivative contracts between EU branches of non-equivalent third countries should be considered to have a direct, substantial and foreseeable effect within the Union.

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[12] OJ…….

(7) OTC derivative contracts may be entered into by specific counterparties with the primary purpose to avoid application of the clearing obligation or of the risk mitigation techniques that would have applied to entities that would have been the natural counterparties to the contract, or to abuse their application. Such contracts should be considered as an evasion as they defeat the object, spirit and purpose of Regulation (EU) No 648/2012.

(8) OTC derivative contracts that are part of an arrangement whose feature is not supported by a business or commercial rationale and which demonstrate that the primary purpose of the arrangement is to prevent application of Regulation (EU) No 648/2012, or to abuse the application of the Regulation such as the benefit of an exemption, should be considered an evasion of the Regulation (EU) No 648/2012

(9) It is desirable to include the technical standards related to the contracts that have a direct, substantial and foreseeable effect within the Union as well as the technical standards related to the non-evasion of provisions of EMIR in a single instrument since both technical standards relate to the clearing obligation and the risk mitigation techniques or are closely related to them.

(10) This Regulation is based on the draft regulatory technical standards submitted by the European Securities and Markets Authority to the Commission.

(11) In accordance with Article 10 of Regulation (EU) No 1095/2010, ESMA has conducted open public consultations on the draft regulatory technical standards, analysed the potential related costs and benefits and requested the opinion of the Securities and Markets Stakeholder Group established in accordance with Article 37 of Regulation (EU) No 1095/2010.

HAS ADOPTED THIS REGULATION:

Article 1

Subject matter and scope

This regulation lays down the detailed rules supplementing the part of Articles 4(4) and 11(14)(e) of Regulation (EU) No 648/2012 related to the contracts that are considered to have a direct, substantial and foreseeable effect within the Union or the cases where it is necessary or appropriate to prevent the evasion of any provision of this Regulation as referred in respectively Article 4(4) paragraph 1(a)(v) and Article 11(12) of the that same Regulation.

Article 2

Contracts with a direct, substantial or foreseeable effect within the Union

1. An OTC derivative contract shall be considered to have a direct, substantial and foreseeable effect within the Union when either paragraph 2 or 3 apply.

2. At least one of the counterparties benefits from a legally enforceable guarantee provided by a financial counterparty established in the Union and covering all or part of its liability resulting from the OTC derivative contract, to the extent that the guarantee meets the following conditions:

(a) Where it is a guarantee which covers all such liability, it covers OTC derivatives transactions entered into by the third country counterparty for an aggregated notional amount that is at least 8 billion euro equivalent;

(b) Where it is a guaranteewhich covers only a percentage of such liability, it covers OTC derivatives transactions entered into by the third country counterparty for an aggregated notional amount of at least 8 billion euro equivalent divided by the percentage of the liability covered;

and

(c) *It is at least equal to 5 percent of the sum of currentexposures, as defined in Article 272 (17) of Regulation (EU)No 575/2013, in OTC derivative contracts of the financial counterparty established in the Union issuing the guarantee.*

3. *The two counterparties enter into the OTC derivative contract via their branches in the Union.*

Article 3

Cases where it is necessary or appropriate to prevent the evasion of any provision of Regulation (EU) No 648/2012

1. *It is necessary or appropriate to prevent the evasion of any provision of Regulation (EU) No 648/2012 where OTC derivative contracts would have been subject to the clearing obligation or the risk mitigation techniques but have been concluded in a way which is contrived to evade application of the clearing obligation or of the risk mitigation techniques.*

2. *For the purposes of this Article, an OTC derivative contract is deemed to have been contrived to evade the application of any provision of Regulation (EU) N.648/2012 if the way in which the OTC derivative contract has been concluded is considered, viewed as a whole, and having regard to all the circumstances, to have as primary purpose, or to have features which would not be in the arrangement by which the contract was concluded if it did not have as its primary purpose:*

   (a) the avoidance of the application of any provision of Regulation (EU) N.648/2012, or

   (b) the abuse of the application of any provision of Regulation (EU) N.648/2012.

3. *For the purposes of paragraph 2, it shall be considered that an OTC derivative contract has been contrived to circumvent Regulation (EU) N.648/2012 when it is part of an artificial arrangement or an artificial series of arrangements which has been put into place for the essential purpose of avoidance of any provision of Regulation (EU) N.648/2012 or to exploit the application of Regulation (EU) N.648/2012.*

   An arrangement may be concluded through any contract, transaction, scheme, action, operation, agreement, grant, understanding, promise, undertaking or event and may comprise more than one step or part.

   An arrangement, or a series of arrangements is artificial where it lacks commercial substance or relevant economic justification in itself. In determining whether the arrangement or series of arrangements is artificial, it shall be considered, in particular, whether they involve one or more of the following situations:

   (a) *the legal characterization of the individual steps of an arrangement is inconsistent with the legal substance of the arrangement as a whole;*

(b) *the arrangement or series of arrangements is carried out in a manner which would not ordinarily be employed in what is expected to be a reasonable business conduct;*

(c) *the arrangement or series of arrangements includes elements which have the effect of offsetting or cancelling the economic meaning of each other;*

(d) *transactions concluded are circular in nature;*

(e) *the arrangement or series of arrangements results in non-application of Regulation (EU) No 648/2012 but this is not reflected in the business risks undertaken by the entities relating this activity.*

The purpose of the arrangement is considered essential where any other purpose of this arrangement or series of arrangements appears at most negligible, in view of all the circumstances of the case.

The purpose of an arrangement or series of arrangements, consists in avoiding the Regulation (EU) N.648/2012 where, regardless of any subjective intentions of the entities involved, it defeats the object, spirit and purpose of the Regulation (EU) No 648/2012 provisions that would otherwise apply.

4. *In determining whether an arrangement or series of arrangements has led to the evasion of Regulation (EU) No 648/2012 as referred to in paragraph 4, the requirements of Regulation (EU) No 648/2012 applicable to the entities involved, having regard to those arrangements, shall be compared with the requirements that would be applied under the same circumstances in the absence of the arrangements.*

Entry into force

This Regulation shall enter into force on the twentieth day following that of its publication in the *Official Journal of the European Union*.

This Regulation shall be binding in its entirety and directly applicable in all Member States.

Done at Brussels,

[For the Commission
The President]

[For the Commission
On behalf of the President]

[Position]

ANNEX III

IMPACT ASSESSMENT

INTRODUCTION

In carrying out a cost benefit analysis on draft regulatory technical standards it should be noted that:

- The main policy decisions has already been taken under the primary legislation (EMIR) and the impact of such policy decisions have already been analysed and published by the European Commission;
- ESMA does not have the ability to deviate from its specific mandate set out in the primary legislation;
- ESMA policy choices should be of a pure technical nature and not contain issues of a political nature;
- In most circumstances ESMA's policy options are limited to the approach it takes to drafting a particular regulatory or implementing technical standard.

With reference to the monetary value attached to the identified costs and benefits, it should be noted that in the DP and CP, ESMA explicitly asked respondents to provide data to support this cost benefit analysis. Data was provided by a few respondents but this did not prove sufficient to perform a cost-benefit analysis of a quantitative nature. Respondents to this consultation paper are therefore invited to justify their answers by providing supporting evidences of a quantitative nature and to provide relevant information to complement this qualitative analysis.

CONTRACTS WITH A DIRECT, SUBSTANTIAL AND FORESEEABLE EFFECT WITHIN THE UNION

Technical options:

(a): What is the most appropriate approach to determine the third country guaranteed entities that have a direct and foreseeable effect within the EU?

Specific objective	Ensuring that when an EU guarantor provides a guarantee to a third country entity, the direct and foreseeable effect within the EU is covered in the definition.
Policy option 1	Only full guarantees should be included.
How would achieving the objective alleviate/eliminate the problem?	By including only fully guaranteed liabilities, liabilities assumed by a single EU entity would be included.
Policy option 2	Full or partial guarantees should be included
How would achieving the objective alleviate/eliminate the problem?	By including full and partial guarantee, all EU entities assuming liabilities, be it in full or for a part, will be

	included.
Which policy option is the preferred one? Explain briefly.	Policy option 2, given that option 1 would not allow to capture all the direct substantial and foreseeable effect of a contract within the EU.
Is the policy chosen within the sole responsibility of ESMA? If not, what other body is concerned / needs to be informed or consulted?	Yes

Impacts of the proposed policies:

Policy option 1	QUALITATIVE DESCRIPTION
Benefits	It will ensure that EU entities with full exposure be included.
Regulator's costs	The costs for regulators will be slightly lower in option 1, as the check will be limited to full guarantees.
Compliance costs	The costs for the third country entities should not be different in the 2 options.
Indirect costs	There should not be differences in the two options although the scope of application would be broader under option 2.
Policy option 2	
Benefits	It will ensure that all contracts that have a direct effect within the Union be captured.
Regulator's costs	The costs for regulators will be slightly higher in option 2, as the check will include both full and partial guarantees.
Compliance costs	The costs for the third country entities should not be different in the 2 options.
Indirect costs	There should not be differences in the two options although the scope of application would be broader under option 2.

(b): What is the most appropriate approach to determine the third country guaranteed entities that have a substantial effect within the EU?

Specific objective	Ensuring that only those guarantees that have a substantial effect within the Union is covered in the definition.

Policy option 1	Use a criteria based option to determine the substantial effect of the guarantee.
How would achieving the objective alleviate/eliminate the problem?	By criteria to determine the substantial effect of the guaranty, we limit the substantial guarantees to those that will meet these criteria.
Policy option 2	Use a quantitative approach to determine the substantial effect of the guarantee.
How would achieving the objective alleviate/eliminate the problem?	By including quantitative thresholds, guarantees that are covered will be clearly defined.
Which policy option is the preferred one? Explain briefly.	Policy option 2, given that option 1 would not provide sufficient certainty and would leave too much room for interpretation.
Is the policy chosen within the sole responsibility of ESMA? If not, what other body is concerned / needs to be informed or consulted?	Yes

Impacts of the proposed policies:

Policy option 1	QUALITATIVE DESCRIPTION
Benefits	It will ensure that the substantial effect of a contract be assessed in a flexible manner.
Regulator's costs	The costs for regulators will be slightly higher in option 1, as the check will include assessment of criteria.
Compliance costs	The costs for the third country entities should not be different in the 2 options.
Indirect costs	There should not be differences in the two options although the scope of application would be clearer under option 2.
Policy option 2	
Benefits	It will ensure that there is no room for interpretation and provide legal certainty.
Regulator's costs	The costs for regulators will be slightly lower in option 2, as the check will be on data.
Compliance costs	The costs for the third country entities should not be different in the 2 options.
Indirect costs	There should not be differences in the two options although the scope of application would be clearer under option 2.

(c): What is the most appropriate approach to consider the direct, substantial and foreseeable effect within the Union of the contracts concluded between EU branches of entities established in third countries?

Specific objective	Ensuring that the direct, substantial and foreseeable effect within the Union of contracts between EU branches of entities established in third countries are covered as appropriate.
Policy option 1	Consider that all contracts between EU branches of entities established in third countries are covered.
How would achieving the objective alleviate/eliminate the problem?	By defining the contracts without quantitative thresholds, all of them are covered when concluded between EU branches.
Policy option 2	Consider that all contracts above a quantitative threshold between EU branches of entities established in third countries are covered
How would achieving the objective alleviate/eliminate the problem?	By using a quantitative threshold, we cover only the biggest contracts.
Which policy option is the preferred one? Explain briefly.	Policy option 1 is the preferred one
Is the policy chosen within the sole responsibility of ESMA? If not, what other body is concerned / needs to be informed or consulted?	Yes

Impacts of the proposed policies:

Policy option 1	QUALITATIVE DESCRIPTION.
Benefits	It will allow covering all contracts that have a particular strong nexus with the EU as they are concluded through EU branches.
Regulator's costs	The costs for regulators will be slightly higher in option 1 as it will cover a larger number of contracts.
Compliance costs	The costs will be slightly higher in option 1 as it will cover a larger number of contracts.
Indirect costs	There should not be differences in the two options.
Policy option 2	
Benefits	It will only focus on the biggest contracts.

Regulator's costs	The costs for regulators will be slightly lower in option 2, as they would focus on a lower number of contracts.
Compliance costs	The costs will be slightly lower in option 2 as it will cover a lower number of contracts.
Indirect costs	There should not be differences in the two options.

NON EVASION

<u>Technical options:</u>

(a): What is the most appropriate way for ESMA to specify cases where it is necessary to prevent evasion of provision of Regulation (EU) No 648/2012?

Specific objective	To prevent evasion of any provision of EMIR.
Policy option 1	Adopt a criteria based approach.
How would achieving the objective alleviate/eliminate the problem?	Criteria would allow determining the cases of evasion.
Policy option 2	Adopt an approach based on a list of defined cases.
How would achieving the objective alleviate/eliminate the problem?	The list of defined cases of evasion would allow capturing situations where the cases are taking place.
Which policy option is the preferred one? Explain briefly.	The first option is preferred as it allows flexibility to adapt to market evolution in the determination of cases of evasion.
Is the policy chosen within the sole responsibility of ESA? If not, what other body is concerned / needs to be informed or consulted?	The option is the sole responsibility of ESMA.

Impacts of the proposed policies:

Policy option 1	QUALITATIVE DESCRIPTION
Benefits	It will allow adapting to evolving market practice.
Regulator's costs	The costs for regulators will be broadly identical in both options

Compliance costs	The costs for the third country entities would be broadly identical in both options.
Indirect costs	There should not be differences in the two options.
Policy option 2	
Benefits	It will ensure clarity and certainty to determine contracts that have a substantial effect.
Regulator's costs	The costs for regulators will be broadly identical in both options.
Compliance costs	The costs for the third country entities would be broadly identical in both options.
Indirect costs	There should not be differences in the two options.