esma European Securities and Markets Authority

Final Report

Draft technical standards under EMIR on contracts with a direct, substantial and foreseeable effect within the Union and non-evasion

15 November 2013 | ESMA/2013/ 1657

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Acronyms Used

BCBS	Basel Committee on Banking Supervision
CCPs	Central Counterparties
CP	Consultation Paper
DP	Discussion Paper
EMIR	European Market Infrastructures Regulation – Regulation (EU) 648/2012 of the European Parliament and Council on OTC derivatives, central counterparties and trade repositories – also referred to as "the Regulation".
EBA	European Banking Authority
EIOPA	European Insurance and Occupational Pension Authority
ESAs	European Supervisory Authorities
ESMA	European Securities and Markets Authority
IOSCO	International Organisation of Securities Commissions

ODRG	OTC Derivatives Regulators Group
OTC	Over the Counter
RTS	Regulatory Technical Standards
TRs	Trade Repositories

I. Executive Summary

Reasons for publication

Regulation (EU) No 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC Derivatives, Central Counterparties (CCPs) and Trade Repositories (EMIR) requires ESMA to develop draft regulatory technical standards (RTS) in relation to 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 this Regulation as provided in Article 11 paragraph 12 and in Article 4 paragraph 1(a)(v) of EMIR.

In relation to the draft technical standards, ESMA consulted stakeholders on two occasions. The first consultation on a Discussion Paper (DP) was conducted from 16 February to 19 March 2012. The second consultation which included the proposed draft RTS was conducted from 17 July to 16 September 2013. The Securities and Markets Stakeholder Group (SMSG) established under the Regulation (EU) No 1095/2010 establishing the European Supervisory Authority (ESMA Regulation) was also requested to provide an opinion in accordance with Articles 10 and 15 of that Regulation.

Contents

This final report includes the feedback from the second consultation and the proposed changes made by ESMA to the draft RTS. The first section focuses on contracts with a direct, substantial and foreseeable effect within the Union. The second part focuses on cases where it is necessary or appropriate to prevent the evasion of rules or obligations provided for in EMIR.

Next steps

This final report will be submitted to the European Commission by 15 November 2013. The Commission has three months to decide whether to endorse ESMA's draft regulatory technical standards.

II. Introduction

1. On 27 July 2012, the Regulation (EU) No 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives, central counterparties (CCPs) and trade repositories (TRs) (EMIR) was published in the Official Journal of the European Union. EMIR entered into force on 16 August 2012, however a number of provisions in EMIR require ESMA to develop draft regulatory technical standards (RTS) and implementing technical standards (ITS). Therefore these provisions only fully apply following the entry into force of the Commission Regulations endorsing the draft RTS and ITS developed by ESMA.

2. ESMA delivered a first set of RTS and ITS in September 2012 that the Commission endorsed through Implementing or Delegated Regulation of 19 December 2012.

3. This report covers a subsequent set of RTS related to the OTC derivative contracts that are considered to have a direct, substantial and foreseeable effect within the Union and the cases where it is necessary or appropriate to prevent the evasion of any provision of EMIR (see Annex I for the legal mandate).

4. The Regulation aims at preventing that risks resulting from OTC derivative contracts entered into by counterparties outside of the Union being imported in the Union. It also aims at preventing evasion of rules and obligations provided by EMIR.

5. Before the submission of this final report to the Commission, ESMA publicly consulted on two occasions:

    a. from 16 February to 19 March 2012. On the basis of the political agreement on EMIR reached on 9 February 2012, ESMA released a discussion paper[1] (DP) asking for views on the development of the draft technical standards ESMA is required to develop. ESMA received 135 responses, 28 of which were confidential. On 6 March, ESMA also hosted a public hearing on the DP which was well attended with around 100 participants physically present and around 80 connected via conference call. Responses related to the topic of these RTS were mostly of general nature and are referred to in the CP.

    b. from 17 July to 16 September 2013, ESMA published a consultation paper[2] (CP), which included the actual draft technical standards. ESMA received 20 responses, 1 of which was confidential. Those answers are analysed in the scope of this Final Report.

6. There has been a period of more than 15 months between the end of the first consultation and the publication of the second consultation in order to allow time for discussions with regulators of third countries to progress. Indeed, as stressed by respondents to the DP, in view of the global nature of the OTC derivative markets and the interactions between market stakeholders, a strong cooperation between regulators and understanding of the regulatory and supervisory frameworks is needed in order to develop RTS that adequately address risks and grant sufficient certainty to market stakeholders.

7. In addition to the consultations above, ESMA consulted: i) the Post-Trading Consultative Working Group (CWG) which was asked in September 2011 to respond to a general call for input on all EMIR technical standards and more recently was informed about the outcome of the public consultation on the CP; ii) the Securities and Markets Stakeholder Group (SMSG) which was consulted on the CP.

8. Besides the draft included in this final report, ESMA together with European Banking Authority (EBA) and European Insurance and Occupational Pensions Authority (EIOPA), is also required under EMIR to develop joint regulatory technical standards on risk mitigation techniques for OTC derivatives that are not cleared by a CCP, notably on exchange of collateral (margins for bilateral transactions) to cover the exposures arising from those transactions and on operational processes for the exchange of collateral, minimum transfer

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

[2] http://www.esma.europa.eu/system/files/2012-379.pdf

amount and certain details on intra-group exemptions. These measures are not included in this final report.

9. One important element for the drafting of the RTS is the analysis of the costs and benefits that the proposed measures might entail. This final report includes an impact assessment in Annex III. The limited amount of information available and collected on the basis of the responses to the DP and CP did not allow ESMA to perform a quantitative cost-benefit analysis on the technical standards. In the determination of the thresholds established in this report, ESMA however relied upon the studies and work developed by international standard setters on related matters.

10. Another important element signalled by stakeholders is linked to the time needed for market participants to adapt to the new requirements for contracts that are considered to have a direct, substantial and foreseeable effect within the Union. ESMA has considered these concerns and proposes a 6 months delay from the entry into force of the Regulation to the date of application of that relevant article of the draft technical standards.

11. This final report contains a summary of responses to the CP received by ESMA and the rationale for keeping or changing the draft regulatory technical standards following the consultation process.

Feedback from stakeholders and changes to the draft regulatory technical standards

12. Stakeholders' answers to the consultations allowed ESMA to gather information to refine the development of the draft RTS. ESMA has analysed answers received and revised the draft RTS taking into account the comments provided by stakeholders.

III. Contracts with a direct, substantial and foreseeable effect within the Union

13. EMIR stipulates that two entities established in one or more third countries that would be subject to the clearing obligation if they were established in the Union shall clear their OTC derivative contracts provided they have a direct, substantial and foreseeable effect within the Union. In addition, Article 11(12) of EMIR stipulates that risk mitigation techniques established in paragraphs 1 to 11 of Article 11 of EMIR shall apply to OTC derivatives between third country entities that would be subject to those obligations if they were established in the Union provided those contracts have a direct, substantial and foreseeable effect within the Union.

14. In the CP, ESMA specifies that the OTC derivative contracts meet those criteria when they are covered by a guarantee issued by a financial counterparty established in the Union subject to some quantitative thresholds, and when they are concluded between Union branches of third countries entities.

15. Respondents generally welcome the approach adopted by ESMA in the development of the draft RTS related to contracts that are considered to have a direct, substantial and foreseeable effect within the Union. They stress the need to adopt a pragmatic and global approach in

order to prevent conflicts between rules applicable in the third country and EMIR rules as well as in view of the difficulty to apply rules and obligations to third country entities. Stakeholders generally encourage an approach that maximises certainty.

Equivalence

16. Most respondents recognise progress made in the international discussions between regulators including the "European Commission and the CFTC Common Path Forward" reached in July 2013. However some stakeholders stress that the commitment to address risks stemming from the OTC derivative markets has been undertaken by all the G20 members. As a result, they consider that regulators from these countries should rely on each others more broadly instead of multiplying the set of rules applicable to an OTC derivative contract. They consider that compliance with third country regulation should be deemed compliance with EMIR and ask ESMA to consider this framework when developing the draft RTS.

17. ESMA understands the need for certainty that stakeholders have expressed and has drafted rules with the objective to provide a clear framework to market participants. ESMA is committed to favour cooperation with third countries supervisors. That cooperation aims at avoiding the application of several sets of rules to an OTC derivative contract while ensuring that risks are adequately managed in a level playing field. For this purpose, ESMA has engaged in discussions with third countries regulators in multilateral forum in the scope of the ODRG and on a bilateral basis.

18. In this respect, it is important to give due consideration to the mechanism to avoid duplicative or conflicting rules[3] provided by EMIR and which is based on equivalence of the legal, supervisory and enforcement arrangements of third countries. Other jurisdictions also have that type of mechanism, such as substituted compliance in the US. However, the scope and application of the mechanisms are not identical and a close cooperation between supervisors is required to apply them in an efficient and adequate manner allowing addressing risks while preventing duplication and overlaps of regulation or gaps. The set-up of these mechanisms recognises the fact that although third countries are committed to address risks resulting from the OTC derivative markets, the timing and scope of the answer may differ and an analysis is required before the equivalence can be granted.

19. The mechanism of equivalence is very relevant in the framework of these RTS as the equivalence will allow counterparties to be deemed to have fulfilled EMIR obligations, including those related to the clearing obligation and the risk mitigation techniques. As a result, when one of the third country counterparties to an OTC derivative contracts is established in an equivalent country, both counterparties will be deemed to have fulfilled obligations under EMIR, including those related to the clearing obligation and the risk mitigation techniques as the case may be, by applying the equivalent rules of the third country.

20. As it duly considers the structure and organisation of the global market when drafting the RTS aiming at addressing risks, ESMA has adopted a pragmatic approach in order to specify the relevant contracts having a direct, substantial and foreseeable effect in the Union.

[3] See Article 13 of EMIR

III.

III.I OTC derivative contracts guaranteed by a financial counterparty (Article 4(4) and Article 11(14)(e) of EMIR)

21. In the CP, ESMA indicates that OTC derivative contracts between third country counterparties that are covered by a guarantee issued by a Union financial counterparty shall be considered as having a direct, substantial and foreseeable effect within the Union when some quantitative thresholds are met.

22. In their responses, most of the stakeholders agree that the existence of a guarantee is an appropriate criterion to consider that an OTC derivative contract shall be considered as having a direct, substantial and foreseeable effect within the Union. Some respondents raise comments on the definition of the guarantee and on the quantitative thresholds to be applied.

Definition of the guarantee

23. In their responses, some stakeholders seek clarification as to how the term "guarantee" should be defined. They ask for guidance as to what would actually constitute a guarantee, and whether implicit guarantee, letters of comfort, insurance contracts and CDS would constitute a guarantee for the purpose of this provision.

24. Some respondents raise concerns about the reference to a "legally enforceable" guarantee. They consider that this reference would force counterparties to conduct due diligence on contracts and would create operational difficulties. Furthermore, a few stakeholders argue that only courts could determine legal enforceability.

25. ESMA considers that the concern expressed by stakeholders related to the use of the term "legally enforceable" is legitimate. Indeed, it is in the interest of the parties to ensure that their contracts are legally enforceable. Due diligence to this effect should not be required for the purpose of these RTS. The term "legally enforceable" is therefore removed from the characteristics of the guarantee in the draft RTS.

26. On the definition of the term guarantee, ESMA understands the uncertainty stemming from the use of a term that is not defined and may encompass different types of contract. A definition is therefore introduced in the draft RTS that aims at providing legal certainty. This definition refers to explicitly documented legal obligations, thereby excluding implicit guarantees and in general letters of comfort, unless they are drafted as a legal obligation of the issuer. Credit derivatives, i.e. credit protection sold in the form of an OTC derivative, and contracts of insurance are also out of the scope of the definition of guarantee as resulting risks are addressed through different instruments. Indeed, the risk involved in OTC credit derivatives is already addressed by EMIR and risks of insurance contracts by the EU Solvency regime.

A guarantee issued by a financial counterparty

27. In order to be considered within the scope of the RTS, the guarantee shall be issued by a financial counterparty. In this respect, a few respondents suggested limiting the guarantees to the ones issued by a financial counterparty which is also the parent company of the guaranteed entity as counterparties to the OTC derivative would otherwise have no link of affiliation in the Union.

28. ESMA believes that the key criterion does not lie with the affiliation of the guaranteed counterparty and the issuing party. Instead, the risk that shall be addressed results from the guarantee irrespective of the affiliation relationship that may exist between the guarantor and the guaranteed counterparty. For this purpose, the RTS proposed in the CP provides that the guarantee shall be issued by a financial counterparty but does not require any affiliation between the guarantor and the guaranteed entity. The RTS is maintained without amendment in this respect.

29. In their response, some stakeholders asked for clarification of the term "established". This term refers to the guarantor that shall be a financial counterparty established in the Union in order for the guarantee to be considered in the scope of the RTS. This term is used in EMIR and shall be understood with the same meaning with reference to the RTS.

Quantitative thresholds

30. In order for the OTC derivative contracts to be considered, the guarantee that covers them shall meet some cumulative quantitative thresholds. It shall cover OTC derivatives for an aggregated notional amount of at least 8 billion euro equivalent or a proportion of this amount when the guarantee covers a percentage of the liability resulting from the OTC derivative contracts, and be at least equal to 5% of the sum of current exposure in OTC derivatives of the guarantor.

31. The reference to the 8 billion euro equivalent threshold was praised by stakeholders in their responses for being consistent with the thresholds for exemption for initial margin requirements set out in the final report on margin requirements for non-centrally cleared derivatives issued by BCBS IOSCO. Indeed, the minimum level below which non-centrally cleared OTC derivatives would not be subject to initial margin requirements is set to 8 bn of gross notional outstanding. However, stakeholders express a preference for this threshold to be calculated on a net rather than a gross basis.

32. ESMA notes that the threshold set by the working group on margin requirement in its final report refers to a gross value. This is a strong argument to keep on referring to the gross value given the consistency between the two approaches. Furthermore, allowing netting would introduce uncertainty about precisely which contracts would be deemed offsetting and that approach would not answer to the need for certainty expressed by stakeholders. As a result, ESMA does not propose changes in the RTS in this respect.

33. On the threshold based on the current exposure of the issuing financial counterparty on OTC derivatives, some respondents welcome its inclusion as a genuinely risk sensitive measure. Other stakeholders point to the difficulty of calculating it. One respondent considers that the 5% threshold related to the sum of current exposure in OTC derivatives of the issuing financial

counterparty is too low and requires that it be increased to 10% in order to be more representative.

34. The threshold related to current exposure applies to financial counterparties only and is expressed by reference to the Regulation on prudential requirements for credit institutions and investment firms (Regulation (EU) No 575/2013 of the European Parliament and of the Council), ESMA therefore does not propose modification in the calculation of the current exposure. On the level of the threshold, in view of the low number of comments requesting an increase and in the absence of data to support the request, ESMA does not propose a modification.

35. Stakeholders seek clarity as to how often the thresholds would have to be monitored. Respondents stressed that constant monitoring of the thresholds would be excessively burdensome. Some proposed that the checks be performed when the contract is concluded.

36. ESMA understands that clarity should be given on the moment when the monitoring shall be performed against the thresholds as it will enhance certainty that stakeholders are asking for. For this purpose, the RTS has been amended to introduce clarity on the monitoring of the relevant conditions by the guarantor. In particular, for guarantees below 8 billion, the monitoring should occur on the day the amount of the guarantee is increased. When the amount of the guarantee is above 8 billion, but the liabilities resulting from the OTC derivatives contracts covered by the guarantee are below 8bn or 5%, the conditions should be monitored on the day of the increase of the liability for the 8bn threshold and on the month of the decrease of the sum of current exposures for the 5% threshold.

37. Some respondents also asked whether the notional amount and current exposure set for the thresholds should be calculated at the level of the group or of the legal entity. Given the fact that the purpose of the provision is to capture risks imported from a transaction between third country counterparties, it is appropriate to concentrate on the legal entity. In this respect, ESMA is aware of the possibility to split the amount of a guarantee among several guarantors. To address this situation and avoid that, because the risk would be split, it would not be covered, ESMA applies a proportional value of the threshold when the guaranty covers only a part of the liability resulting from the OTC derivative contracts.

38. In order to answer to the need for clarity expressed by stakeholders in their response, ESMA considers appropriate to clarify that OTC derivative contracts concluded after the date of application of the Regulation but before a guarantee that meets the cumulative quantitative thresholds covers them, are considered to have a direct, substantial and foreseeable effect within the Union. The draft RTS have been amended to introduce a provision to this effect.

39. In the answers to the CP, stakeholders made a number of comments on the practicalities of dealing with the changes required when OTC derivatives are considered to have a direct, substantial and foreseeable effect within the Union. For example, the third country counterparty will need time in order to inform its counterparties that OTC derivative contracts they conclude together will have to comply with some EMIR requirements.

40. ESMA understands that third country counterparties need time to prepare for compliance with the RTS and believes that a six month transition period would be appropriate. The RTS are therefore amended to reflect that the provisions related to the contracts that have a direct,

substantial and foreseeable effect within the Union would apply six months after the date of entry into force of the Regulation adopting the draft RTS.

III.II OTC derivative contracts between Union branches of third countries entities

41. In the CP, ESMA proposes that an OTC derivative contract shall be considered as having a direct, substantial and foreseeable effect within the Union when the two counterparties enter into the OTC derivative contract via their branches in the Union.

42. The majority of respondents agree and support that approach. They consider that it ensures a level playing field. Some stakeholders propose to extend the scope of the provision to capture OTC derivative contracts concluded between the EU branch of a third country entity and a third country entity, even though this entity would have no branch within the EU. They consider that the market footprint justifies the inclusion of such transactions. However, others propose narrowing the scope of the provision by introducing a de minimis threshold below which branches would not be covered. The introduction of such a threshold is opposed by others. Some respondents also propose an opt-in framework, whereby EU branches could deem their transactions to have a direct, substantial and foreseeable effect within the Union. This approach would allow them to demonstrate that they are subject to EMIR and therefore can benefit from substituted compliance in other jurisdictions.

43. In view of the support received for the approach proposed in the CP, of the different and sometimes opposed views expressed by stakeholders on this topic and, in the absence of data supporting views expressed, ESMA considers it is appropriate to keep this provision of the RTS unchanged.

III.III Scope of application to OTC derivative contracts

44. In order to answer to the need for certainty expressed by respondents, ESMA clarifies in the RTS that the OTC derivative contracts concluded before the date of application of the relevant part of the Regulation shall not be considered as having a direct, substantial and foreseeable effect within the Union. This approach is justified by the fact that time is needed to ensure compliance and that, for some contracts, at the time when they were concluded, the application of some provisions of EMIR could not have been anticipated and were therefore not considered when setting the terms of the transactions. Furthermore, this approach is in line with that adopted in EMIR for the application of the clearing obligation (article 4(1) (b) of EMIR).

45. This approach means that those contracts concluded before the date of application of the technical standards will not be subject to the application of the relevant provisions of EMIR. However, for the calculation of the 8 bn and 5% thresholds all the relevant outstanding contracts should be considered, even if concluded before the date of application of the RTS.

III.IV Other cases considered by ESMA

46. In the CP, ESMA indicates the other cases it considered in order to determine contracts considered to have a direct, substantial and foreseeable effect within the Union. These cases refer to the currency and the underlying of the OTC derivative contract, the relationship as a subsidiary, and contractual provisions affecting other entities such as acceleration of obligations.

47. The vast majority of respondents agrees with ESMA's approach. They consider that the currency or the underlying of the OTC derivative contract should not be considered as it would entail an inappropriate broad definition of the direct effect of the contract, that subsidiaries should not be considered in the absence of a guarantee by the parent, and that contractual provisions should not be considered as they do not affect the obligation but its timing.

IV Cases where it is necessary or appropriate to prevent the evasion of rules or obligations

48. ESMA proposes in the CP to determine cases where it is necessary or appropriate to prevent the evasion of any provision of EMIR by adopting a criteria based approach. In the first part of the article, it provides a general definition and, in the second and third parts of the article, further refines the criteria including reference to artificial arrangements. Finally, in the fourth part of the article, ESMA indicates that the applicable rule should be compared to the EMIR rules that would apply if the OTC derivative contract would be subject to EMIR.

49. The large majority of respondents welcomes the approach adopted by ESMA and agrees that ESMA should not develop a prescriptive list of cases or circumstances to determine cases where it is necessary or appropriate to prevent the evasion of provisions of EMIR. Most respondents agree that a criteria based approach is the most appropriate way. However, for some other stakeholders, a principles-based approach for determining whether an arrangement is designed to evade the provisions of EMIR would be more appropriate than a criteria-based approach.

50. Some stakeholders consider that the examples of situations that would give rise to the application of the anti-evasion rule provided by ESMA in the RTS may create the risk that ESMA adopts an approach that it wishes to avoid, i.e. setting up a prescriptive list of transactions or circumstances. Stakeholders note that the introduction of lists which may be subject to interpretation create legal uncertainty.

51. Respondents do not believe there should be an automatic assumption that an arrangement that meets one or more of the criteria set to characterise artificial arrangements (Article 3(3) of the draft RTS) is designed to evade EMIR and request ESMA to clarify that the mere existence of the situations specified in the articles should not automatically constitute an avoidance, abuse or circumvention of EMIR. For this purpose, they propose to remove the reference to "regardless of any subjective intentions of the entities involved".

52. Other stakeholders suggest that ESMA explicitly includes an acknowledgment that if an arrangement is established because of a business, commercial reason or economic justification, it would be legitimate and would not constitute evasion. In the same logic, a respondent asks that some cases be explicitly excluded from the anti-evasion rule, such as

cases where those transactions/arrangements are market practice, form part of the risk or tax management policy of an entity or, in general, obey to an internal policy establish before EMIR entered into force.

53. Finally a respondent notes that mutual recognition or equivalence should be a priority for ESMA to negotiate and achieve as it would allow getting some certainty including in respect of evasion.

54. ESMA understands that the examples of situations that characterise an artificial arrangement may create confusion and lead to an in-appropriate reading of the article. The text of this Article is therefore amended to withdraw example of such situations and is streamlined to maintain the criteria based approach.

55. Because it also agrees that there should be no automatic qualification of evasion, ESMA amends the text of the RTS to withdraw the reference to "regardless of the subjective intention of the entities involved". Indeed, each situation will have to be taken into consideration in order to determine whether it falls within the RTS or not.

56. Furthermore, given that the RTS provides that the arrangement shall have as primary purpose the avoidance of application of EMIR in order to be covered by the evasion provision, ESMA believes that the recognition that arrangement established "because of a business, commercial reason or economic justification, would be legitimate" is not necessary. Indeed, when a contract is concluded for commercial reasons it will not have the evasion of EMIR as primary purpose.

57. Regarding equivalence, it is indeed an important mechanism as it allows considering that counterparties entering into an OTC derivative contract which is subject to rules that are considered equivalent are complying with EMIR requirements. It means that when an arrangement is subject to equivalent rules there would be no evasion of EMIR requirements as rules equivalent to EMIR would apply. In this respect, it is worth noting that ESMA has delivered to the Commission a Technical Advice on equivalence on 9 countries i.e. US, Japan, Australia, Canada, Hong Kong, India, Singapore, South Korea and Switzerland, which can be used by the Commission in order to adopt its decisions on equivalence through implementing acts.

ANNEX I - Legislative mandate to develop draft technical standards

Article 4 (4)

ESMA shall develop draft regulatory technical standards specifying 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 to in paragraph 1(a)(v) of article 4.

Article 11 (14) (e)
ESMA shall draft regulatory technical standards specifying 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 to in paragraph 12 of this article.

ANNEX II - Draft regulatory technical standards

COMMISSION DELEGATED REGULATION (EU) No .../..

of [date]

supplementing Regulation (EU) No 648/2012 of the European Parliament and of the Council of 4 July 2012 with regard to regulatory technical standards on direct, substantial and foreseeable effect of contracts within the Union and to prevent the evasion of rules and obligations

(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 on OTC derivatives, central counterpaties and trade repositories[4], and in particular Article 4(4) and point (e) of Article 11(14) thereof,

Whereas:

(1) Given the broad variety of OTC derivative contracts, in order 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 necessary or appropriate to prevent the evasion of rules and obligations arising from any provision of Regulation (EU) No 648/2012, a criteria based approach should be adopted.

(2) Given that pursuant to Article 13(3) of Regulation (EU) No 648/2012, the provisions of that Regulation would be deemed fulfilled when at least one of the counterparties is established in a country for which the Commission has adopted an implementing act declaring equivalence in accordance with Article 13(2) of Regulation (EU) No 648/2012, regulatory technical standards would mainly benefit contracts where both counterparties are established in a third country whose legal, supervisory and enforcement arrangements have not yet been declared equivalent.

(3) Certain information on contracts concluded by third country entities would still only be available to third country competent authorities. Therefore Union competent

4 OJ L 201, 27,7,2012, p.1.

authorities should closely cooperate with those authorities in order to ensure that the relevant provisions are applied and enforced

(4) Given that a technical term is necessary for a comprehensive understanding of the appropriate technical standards, this term should be defined.

(5) OTC derivative contracts concluded by counterparties established in third countries covered by a guarantee provided by entities established in the Union create a financial risk for the guarantor established in the Union. Furthermore, given that the risk would depend on the size of the guarantee granted by financial counterparties in order to cover OTC derivative contracts and given the interconnections between financial counterparties compared to non-financial counterparties, only OTC derivative contracts concluded by counterparties established in third countries that are covered by a guarantee which exceeds quantitative thresholds and is provided by financial counterparties established in the Union should be considered as having a direct, substantial and foreseeable effect in the Union.

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

(7) OTC derivative contracts that are entered into by specific counterparties with the primary purpose of avoiding the application of the clearing obligation or of the risk mitigation techniques applicable to entities that would have been the natural counterparties to the contract, should be considered as evading the rules and obligations laid down in Regulation (EU) No 648/2012 as they hinder the achievement of a purpose of the Regulation, namely mitigating counterparty credit risk.

(8) OTC derivative contracts that are part of an arrangement whose characteristics are not supported by a business rationale or commercial substance and has as its primary purpose the circumvention of the application of Regulation (EU) No 648/2012, including rules relating to the conditions of an exemption, should be considered as evading the rules and obligations laid down in that Regulation.

(9) Situations where the individual components of the arrangement are inconsistent with the legal substance of the arrangement as a whole, where the arrangement is carried out in a manner which would not ordinarily be used in what is expected to be reasonable business conduct, where the arrangement or series of arrangements includes elements that have the effect of offsetting or nullifying their reciprocal economic substance, where transactions are circular in nature, should be considered as indicators of an artificial arrangement or an artificial series of arrangements.

(10) It is desirable to provide technical standards related to contracts that have a direct, substantial and foreseeable effect within the Union as well as technical standards related to the prevention of evasion of rules and obligations provided for in Regulation (EU) No 648/2012 in a single instrument since both sets of technical standards relate to the clearing obligation and the risk mitigation techniques.

Furthermore, they share common features such as their application to a contract whose counterparties would not be subject to the clearing obligation or to the risk mitigation techniques if the conditions of Article4(1)(a)(v) and Article 11(14)(e) of Regulation (EU) No 648/2012 specified further by this Regulation were not met.

(11) Given that third country counterparties require time in order to arrange for compliance with the requirements of Regulation (EU) No 648/2012 when their OTC derivative contracts are considered to have a direct, substantial and foreseeable effect within the Union, it is appropriate to delay the application of that provision by six months.

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

(13) In accordance with Article 10 of Regulation (EU) No 1095/2010 of the European Parliament and of the Council[5], the European Securities and Markets Authority 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 that Regulation.

HAS ADOPTED THIS REGULATION:

Article 1

Definitions

For the purpose of this Regulation the following definition shall apply:

(a) "guarantee" means an explicitly documented legal obligation by a guarantor to cover payments of the amounts due or that may become due pursuant to the OTC derivative contracts covered by that guarantee and entered into by the guaranteed entity to the beneficiary where there is a default as defined in the guarantee or where no payment has been effected by the guaranteed entity.

Article 2

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

5 Regulation (EU) No 1095/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Securities and Markets Authority) (OJ L 331, 15,12,2010, p.84).

1. An OTC derivative contract shall be considered as having a direct, substantial and foreseeable effect within the Union when at least one third country counterparty benefits from a guarantee provided by a financial counterparty established in the Union which covers all or part of its liability resulting from that OTC derivative contract, to the extent that the guarantee meets both following conditions:

   (a) it covers the entire liability of a third country counterparty resulting from one or more OTC derivative contracts for an aggregated notional amount of at least EUR 8 billion or the equivalent amount in the relevant foreign currency, or it covers only a part of the liability of a third country counterparty resulting from one or more OTC derivative contracts for an aggregated notional amount of at least EUR 8 billion or the equivalent amount in the relevant foreign currency divided by the percentage of the liability covered;

   (b) it is at least equal to 5 per cent of the sum of current exposures, 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.

When the guarantee is issued for a maximum amount which is below the threshold set out in point (a) of the first sub-paragraph, the contracts covered by that guarantee shall not have a direct, substantial and foreseeable effect within the Union unless the amount of the guarantee is increased in which case the direct, substantial and foreseeable effect of the contracts within the Union shall be re-assessed by the guarantor against the conditions set out in points (a) and (b) of the first sub-paragraph on the day of the increase.

Where the liability resulting from one or more OTC derivative contracts is below the threshold set out in point (a) of the first sub-paragraph, such contracts shall not have a direct, substantial and foreseeable effect within the Union even where the maximum amount of the guarantee covering such liability is equal to or above the threshold set out in point (a) of the first sub-paragraph and even where the condition set out in point (b) of the first sub-paragraph has been met.

In the event of an increase in the liability resulting from the OTC derivative contracts or of a decrease of the current exposure, the guarantor shall re-assess whether the conditions set out in points (a) and (b) of the first sub-paragraph are met. Such assessment shall be done respectively on the day of the increase of liability for the condition set out in point (a) of the first sub-paragraph and on a monthly basis for the condition set out in point (b)of the first sub-paragraph.

OTC derivative contracts for an aggregate notional amount of at least EUR 8 billion or the equivalent amount in the relevant foreign currency concluded before a guarantee is issued or increased, and subsequently covered by a guarantee that meets the conditions set out in points (a) and (b) of the first sub-paragraph, shall be considered as having a direct, substantial and foreseeable effect within the Union.

2. An OTC derivative contract shall be considered as having a direct, substantial and foreseeable effect within the Union where the two counterparties established in a third country enter into the OTC derivative contract through their branches in the Union and would qualify as financial counterparties if they were established in the Union.

Article 3

Cases where it is necessary or appropriate to prevent the evasion of rules or obligations provided for in Regulation (EU) No 648/2012

1. An OTC derivative contract shall be deemed to have been designed to circumvent the application of any provision of Regulation (EU) No 648/2012 if the way in which that contract has been concluded is considered, when viewed as a whole and having regard to all the circumstances, to have as its primary purpose the avoidance of the application of any provision of that Regulation.
2. For the purposes of paragraph 1, a contract shall be considered as having for primary purpose the avoidance of the application of any provision of Regulation (EU) No 648/2012 if the primary purpose of an arrangement or series of arrangements related to the OTC derivative contract, is to defeat the object, spirit and purpose of any provision of Regulation (EU) No 648/2012 that would otherwise apply including when it is part of an artificial arrangement or artificial series of arrangements.

   An arrangement that intrinsically lacks business rationale, commercial substance or relevant economic justification and consists of any contract, transaction, scheme, action, operation, agreement, grant, understanding, promise, undertaking or event shall be considered an artificial arrangement. The arrangement may comprise more than one step or part.

Article 4

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.

Article 2 shall apply six months after its date of entry into force.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 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. However no data was provided by respondents or was available to allow performing a quantitative impact assessment. As a result, ESMA uses a qualitative analysis in this impact assessment.

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 Union?

Specific objective	Ensuring that when a Union guarantor provides a guarantee to a third country entity for its OTC derivative contracts, the direct and foreseeable effect within the Union 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 Union 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 Union 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 capturing all the direct substantial and foreseeable effect of a contract within the Union.
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 Union 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 OTC derivative contracts of third country counterparties that are guaranteed and have a substantial effect within the Union?

Specific objective	Ensuring that only those guaranteed OTC derivative contracts that have a substantial effect within the Union are covered in the definition.
Policy option 1	Use a criteria based option to determine the substantial effect of the OTC derivative contracts covered by the guarantee.
How would achieving the objective alleviate/eliminate the problem?	By using criteria to determine the substantial effect of the OTC derivative contracts covered by the guarantee, we limit the substantial OTC derivative contracts covered by the guarantees to those that will meet such criteria.
Policy option 2	Use a quantitative approach to determine the substantial effect of the OTC derivative contracts covered by the guarantee.
How would achieving the objective alleviate/eliminate the problem?	By including quantitative thresholds, OTC derivative contracts covered by the guarantee 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 Union branches of entities established in third countries and that would qualify as financial counterparties if they were established in the Union?

Specific objective	Ensuring that the direct, substantial and foreseeable effect within the Union of OTC derivative contracts between Union branches of entities established in third countries and that would qualify as financial counterparties if they were established in the Union are covered as appropriate.
Policy option 1	Consider that all OTC derivative contracts between Union branches of entities established in third countries and that would qualify as financial

	counterparties if they were established in the Union are covered.
How would achieving the objective alleviate/eliminate the problem?	By defining the OTC derivative contracts without quantitative thresholds, all of them are covered when concluded between Union branches.
Policy option 2	Consider that all OTC derivative contracts above a quantitative threshold between Union branches of entities established in third countries and that would qualify as financial counterparties if they were established in the Union 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 as they are branches of the third countries entities, which would qualify as financial counterparty if they were established in the Union and they are established in the Union.
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 Union as they are concluded through Union branches.
Regulator's costs	The costs for regulators will be slightly higher in option 1 as it will cover a larger number of OTC derivative contracts.
Compliance costs	The costs will be slightly higher in option 1 as it will cover a larger number of OTC derivative contracts.
Indirect costs	There should not be differences in the two options.
Policy option 2	
Benefits	It will only focus on the biggest OTC derivative contracts.
Regulator's costs	The costs for regulators will be slightly lower in option 2, as they would

	focus on a lower number of OTC derivative contracts.
Compliance costs	The costs will be slightly lower in option 2 as it will cover a lower number of OTC derivative contracts.
Indirect costs	There should not be differences in the two options.

CASES WHERE IT IS NECESSARY OR APPROPRIATE TO PREVENT THE EVASION OF RULES OR OBLIGATIONS PROVIDED FOR IN EMIR

Technical options:

(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 clear situations.
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.