

## Obligations Under EMIR Imminent

*Law360, New York (September 12, 2013, 5:31 PM ET)* -- On September 15, certain obligations under the European Market Infrastructure Regulation take effect.

EMIR entered into force in 2012 and introduced provisions to improve transparency, establish common rules for central counterparties (CCPs) and trade repositories (TRs), reduce the risks associated with the over-the-counter (OTC) derivatives market by providing for central clearing of OTC derivative contracts or, in lieu of clearing, the application of risk mitigation techniques, and require the reporting of all derivatives (whether OTC or exchange traded) to a TR. Notwithstanding that EMIR is an EU law, U.S. and other non-EU counterparties will be affected.

The obligations require EU banks and their counterparties to agree on processes and procedures for portfolio reconciliation and dispute resolution of derivatives executed in the OTC market by September 15. By that date, nonfinancial counterparties (NFCs) must also identify their status as such to their EU banks in order to enable the banks to apply the correct standards for portfolio reconciliation and for purposes of the upcoming clearing rules (currently anticipated to come into effect in the EU in 2014).

Additionally, transaction reporting for OTC derivatives is scheduled to begin on Jan. 1, 2014, and on Jan. 1, 2015, for exchange-traded derivatives. Although both parties are obliged to report, one party may report on behalf of both by prior arrangement.

EMIR follows swap regulation in the United States under the Dodd-Frank Wall Street Reform and Consumer Protection Act that generally started taking effect on Jan. 1, 2013. To date, participants in the U.S. swap and foreign exchange (FX) forward and options markets have had to (1) comply with new entity registration requirements, (2) comply with business conduct rules, (3) commence swap and FX forward reporting, and (4) submit limited types of credit default swaps and interest rate swaps to central clearing.

Mandatory trading on exchanges or swap execution facilities (SEFs) and margining of bilateral, noncentrally cleared swaps have not yet taken effect but are pending.

Given the global nature of the derivative market, it is vital for counterparties to know which sets of rules will apply to their OTC derivative transactions, which timetables apply and what actions must be taken to ensure compliance.

## September Obligations

By way of background, EMIR classifies counterparties to OTC derivatives contracts into the following two main categories:

- Financial counterparties (FCs)
- NFCs

NFCs are subdivided into the following categories:

- NFCs+, which are higher-volume users of OTC derivatives and have exceeded a clearing threshold
- NFCs-, which are subthreshold users of OTC derivatives

NFCs- have fewer obligations under EMIR.

EU banks will need to know the correct classification of their counterparties in order to apply the correct EMIR standards. To facilitate this diligence requirement, the International Swaps and Derivatives Association developed the NFC Representation Protocol.

In order to complete the representation, the counterparty must determine (1) whether it is an NFC or an FC and, (2) if it is an NFC, whether designated swap activity thresholds have been surpassed. The first question that a non-EU entity must answer in analyzing its status is whether it would be deemed to be an FC if it were located in the EU.

FCs include the following: EU-authorized investment firms (e.g., asset managers and broker-dealers), banks, insurers, assurers, reinsurers, the Undertakings for Collective Investment in Transferable Securities, UCITS management companies, EU institutions for occupational retirement provision, and alternative investment funds (in short, investment funds that are not UCITS), irrespective of their location, that are managed by an EU person authorized under the Alternative Investment Fund Managers Directive (or, when this possibility is allowed in the future, a non-EU person authorized under AIFMD).

If the entity would be regulated as an FC if it were resident in the EU, then the non-EU entity is deemed to be an FC. If the entity would be deemed to be an NFC if resident in the EU, then it would be an NFC.

Under the NFC Representation Protocol, once the entity has determined that it is an NFC, the entity must then determine whether it qualifies as an NFC+ or an NFC-. If it is an NFC-, the OTC derivatives that it enters into will not be subject to the central clearing requirements and certain risk mitigation requirements will be disappplied.

The thresholds for determining whether an NFC is an NFC+ or an NFC- are a “gross notional value” of €1 billion for credit derivatives and equity derivatives and €3 billion for FX derivatives, interest rate derivatives, commodity derivatives and other OTC derivatives.

Transactions are calculated over a rolling 30-business day period and are based on the average. Transactions entered into for hedging purposes are excluded from the calculation. For these purposes, “hedging” is broadly defined to include substantially all trades designed to mitigate risks associated with assets or an investment portfolio.

For purposes of calculating the thresholds, OTC transactions entered into by NFCs within an affiliated group do count towards the total, regardless of whether the entities are EU or non-EU residents. We understand that the European Securities and Markets Authority[1] takes the view that, when a clearing threshold for one asset class is reached, the counterparty will be treated as exceeding the thresholds for all classes of OTC derivative contracts.

Under EMIR generally, as well as for the purposes of those thresholds, the types of transactions that qualify as “derivatives” are those financial instruments set out in points (4) to (10) of Section C of Annex I to the Markets in Financial Instruments Directive (MiFID).

Broadly, MiFID incorporates substantially all types of derivatives traded for investment or trading purposes but excludes spot transactions and forwards entered into for commercial purposes. The definition has a number of nuances, which are beyond the scope of this article.[2]

As a general matter, the EMIR definition of a “hedging transaction” is broader than the definition provided by U.S. regulators under Dodd-Frank, and although the types of derivatives included for purposes of EMIR do not distinguish (as Dodd-Frank does) between security-based swaps and other swaps, the transaction class is otherwise similar to the one provided under Dodd-Frank in that it excludes physically settled forwards entered into for commercial purposes and includes substantially all OTC derivatives entered into for investment or financial trading purposes.

For risk mitigation, EMIR requires that counterparties transacting in noncentrally cleared OTC derivatives enter into an agreement, on or before Sept. 15, 2013, that addresses how the parties will reconcile their derivative portfolios and resolve valuation and other transactional disputes.

Unlike the Dodd-Frank rules, under which portfolio reconciliation is the responsibility of the swap dealer but not the end user, under EMIR, both parties to OTC derivatives — including both FCs and NFCs — have an obligation to reconcile their portfolios or to engage a third party to do so on the counterparty’s behalf.

The industry has facilitated compliance through the use of the ISDA Portfolio Reconciliation, Dispute Resolution and Disclosure Protocol, under which, amongst other things, counterparties elect to be either a “portfolio data receiving entity” or a “portfolio data delivering entity.”

As a portfolio data receiving entity, the entity will be obliged to carry out the reconciliation and to bring to the attention of the other counterparty all material discrepancies within five business days. Any failure to report discrepancies results in affirmation.

Under the protocol, each adhering party also consents to the disclosure of information to the extent required by EMIR and the disclosure of information to and between the other party's head office, branches or affiliates, or any persons or entities that provide services under EMIR.

Third-country counterparties that have trading relationships with EU banks will be required to adhere to the ISDA protocol or enter into a bilateral agreement with the EU bank regarding reconciliation and dispute resolution in order to continue trading with the EU counterparty after the deadline.

Under EMIR, the EU has adopted risk mitigation rules similar to those adopted by the U.S. Commodity Futures Trading Commission (CFTC) in the internal and external standards applicable to swap dealers and major swap participants (MSPs). Those EMIR rules cover timely confirmations, marking to market, portfolio reconciliation, portfolio compression, valuation and dispute resolution.

The rules require FCs to send confirmations for each transaction within a range of deadlines dependent on the status of the counterparties, the type of derivative and the date of execution (the timing requirements are phased in).

### **Application of EMIR to Transactions with an EU Counterparty**

EMIR applies directly to any entity incorporated or otherwise formed in the EU that has entered into an OTC derivatives transaction and indirectly to any non-EU counterparty that trades with an EU counterparty. In the case of an EU entity contracting with a non-EU counterparty, EMIR obligations will apply as a result of the application of EMIR to the EU entity.

Clearing obligations, which are not currently scheduled to take effect until 2014, will not apply to non-EU NFCs that trade with an EU FC, provided that the volume of trades effected by the NFC remains below the €1 billion or €3 billion thresholds described above.

Clearing thresholds are not applied to FCs; EU FCs and non-EU FCs trading with an EU counterparty must comply with the clearing requirements for all derivative transactions.

EMIR is not clear on its application to non-EU branches of EU entities or non-EU entities that have branches in the EU. Broadly, the principle is that a branch should be treated as being its parent. Thus, a non-EU branch of an EU entity and an EU branch of a non-EU entity would be subject to EMIR to the extent and in the same way that its parent would be.

However, the position is more complex than that depending on the particular EMIR obligation at issue. For example, an EU branch of a non-EU entity will not be subject to the trade-reporting obligation. But, to the extent it deals with an EU counterparty, the clearing obligation, which is inherently two-way, will apply.

Application of this principle means that an EU entity (including its third-country branches) may only use CCPs for clearing purposes that are either established in the EU and authorized under EMIR or, in the case of third-country CCPs, are recognized by ESMA under EMIR. One of the conditions of such recognition is that the European Commission has determined the third country's legal and supervisory framework regarding CCPs as equivalent to that of EMIR.

Trade reporting of OTC derivatives transactions to an authorized TR is scheduled to commence on Jan. 1, 2014. There is some doubt regarding whether this deadline will be possible given the fact that there is currently no authorized TR.

Reporting obligations under EMIR apply to both counterparties to an OTC derivatives transaction, including the non-EU resident in the case of a transaction between an EU resident and a non-EU resident. EMIR does not provide relief from reporting, as is available under Dodd-Frank, for transactions between affiliated entities.

### **Application of EMIR to Transactions Between Non-EU Counterparties**

EMIR applies to OTC derivative transactions carried out outside the EU between third-country counterparties in two circumstances.

First, a non-EU transaction that has a “direct, substantial and foreseeable effect” in the EU is subject to EMIR. Second, a transaction carried out outside the EU will be subject to EMIR where it is necessary or appropriate to prevent the evasion of EMIR. EMIR requires that ESMA develop regulatory technical standards that clarify the practical application of those circumstances.

On July 17, ESMA launched a consultation aimed at developing the provisions of EMIR related to OTC derivative transactions by non-EU counterparties that have a direct, substantial and foreseeable effect in the EU and aimed at preventing attempts by non-EU counterparties to evade EMIR. An important consideration in applying these proposals is the doctrine of third-country equivalence under EMIR.

Equivalence standards effectively define when the two circumstances triggering extraterritorial application of EMIR will apply since the circumstances are only applicable where both counterparties are established in a third country that has not been declared equivalent to EMIR by the European Commission.

### ***Equivalence***

The commitment to address risks posed by derivative contracts was made by the G20 in 2009. Given the existence of legislation with a similar aim in different countries and the global nature of the derivative markets, EMIR recognizes the need to avoid application of duplicative or conflicting rules to the same OTC derivative contract, providing for the recognition of “equivalence” in Article 13.

EMIR has relevant provisions that allow (1) the use by EU counterparties of third-country CCPs or TRs when complying with EU rules and (2) the application by EU counterparties of third-country rules (instead of the EU rules) to derivatives transactions.

This is subject to an overarching condition that those rules and infrastructures have similar results and bear similar protections to the EU rules. The process by which the EU determines this similarity is the equivalence assessment, which will take the form of a regulation adopted by the European Commission.

ESMA's role in this process is twofold: (1) to advise the EC on the equivalence and (2) to recognize third-country CCPs and TRs that might apply to ESMA for recognition.

On September 3, ESMA published its advice to the EC on the equivalence of the regulatory regimes for OTC derivatives clearing, CCPs and TRs of Australia, Hong Kong, Japan, Singapore, Switzerland and the United States with EMIR.

The third-country rules were compared with EMIR requirements for central clearing, reporting, CCPs, TRs, NFCs and risk mitigation techniques for uncleared trades. ESMA considers third-country regimes equivalent where the legal provisions and the level of supervision and enforcement are similar to that of EMIR.

ESMA advises that the regulatory regimes of Australia and Switzerland for CCPs are equivalent to EU rules and proposes conditional equivalence for the following regimes:

- Hong Kong, Japan, Singapore and the United States for CCPs
- The United States and Japan for central clearing, requirements for NFCs and risk mitigation techniques for uncleared trades
- The United States for TRs

The EC is expected to use ESMA's technical advice to prepare possible equivalence decisions. Where it adopts such a decision, certain provisions of EMIR may be disapplied in favor of equivalent third-country rules and, depending on the specific area determined to be equivalent, ESMA may:

- recognize within the EU a CCP that is authorized outside the EU; or
- recognize within the EU a TR that is authorized outside the EU.

Under Dodd-Frank, regulators and private parties can apply to the CFTC to seek an equivalency determination. In contrast, EMIR does not provide a procedure for a market participant or foreign regulator to request the EC to make an equivalency determination.

The adoption of an implementing act declaring a third country's equivalence means that the related requirements in that country would allow for a similar outcome as would the application of EMIR. Put simply, when at least one counterparty to the transaction is located in a third country that is declared equivalent, EMIR can be disapplied.

In other words, EMIR requirements can be substituted by equivalent requirements in third countries for cross-border transactions (transactions between EU entities and third-country entities) and transactions exclusively between third-country entities. Therefore, if one of the two counterparties to a transaction is established in a third country declared as equivalent by the EC, EMIR may be disapplied even if the transaction would have a direct, substantial and foreseeable effect in the EU.

The CFTC adopted a similar concept in its Cross-Border Guidance and its Exemptive Order, both issued in July 2013.[3] Under the CFTC's "substituted compliance" concept, which was described in the Cross-Border Guidance, regulators or private parties that are subject to regulations governing derivative transactions in a non-U.S. jurisdiction may apply to the CFTC for a comparability determination regarding the regulatory scheme in place for the applicable jurisdiction.

If the CFTC makes a comparability finding, an entity or transaction conducted in the foreign jurisdiction that is subject to the category of U.S. laws and regulations for which comparability is found will be deemed to be in compliance with the U.S. regulations so long as the entity or transaction complies with the corresponding foreign laws and regulations.[4]

Comparability determinations, once given, apply to all entities and transactions occurring in that jurisdiction (unless otherwise provided in the determination). In the Exemptive Order, the CFTC granted certain types of foreign entities an extension on the compliance deadlines under Dodd-Frank.

Relief granted under the Exemptive Order included relief for non-U.S. swap dealers and MSPs from swap reporting requirements, relief for all non-U.S. persons from swap dealer registration due to changes in the definition of "U.S. person" made in the Cross-Border Guidance, and relief allowing non-U.S. swap dealers and MSPs to comply with local capital adequacy, compliance officer, risk management and recordkeeping requirements.

The Exemptive Order relief terminates upon the earlier of Dec. 21, 2013, and the issuance of a substituted compliance determination by the CFTC. The EC has requested that the CFTC determine that EMIR is a comparable regime to Dodd-Frank.

### ***Transactions That Have a Direct, Substantial and Foreseeable Effect in the EU***

ESMA has proposed that EMIR would apply when two counterparties to the same transaction are established outside the EU, their jurisdictions' rules are not considered equivalent to EMIR, and where one of the following conditions are met:

- One of the two non-EU counterparties is guaranteed by an EU FC for at least €8 billion of the gross notional amount of OTC derivatives entered into and for an amount of at least 5 percent of the OTC derivatives exposures of the EU guarantor.
- The two non-EU counterparties execute their transactions via their EU branches.

By contrast, ESMA considers 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 since the contracts would not have a direct effect in the EU.

Similarly, ESMA considers that contracts entered into by third-country subsidiaries of an EU parent should not be considered to have a direct, substantial and foreseeable effect in the EU (unless explicitly guaranteed within the scope of the standards set by ESMA).

These standards are similar to those established by the CFTC. Under the Cross-Border Guidance, U.S. swap regulations generally apply to any entity that is registered or required to register with the CFTC as a swap dealer or MSP, or to any transaction in which one of the counterparties is a “U.S. person”.

Under this guidance, non-U.S. branches of a U.S. person (e.g., the London branch of a U.S. bank) are still considered to be U.S. persons, and swap dealers and MSPs located outside the United States are required to comply with most of the U.S. swap regulations.

The Cross-Border Guidance also provides that U.S. swap regulations may apply to market participants that are neither CFTC registrants nor U.S. persons if their swap activities have an impact on U.S. markets by virtue of being guaranteed by a U.S. person or because the foreign person is acting as a “conduit affiliate”[5] for a U.S. person.

### ***Transactions That Are Designed to Evade EMIR***

Similar to the anti-evasion principles contained in Dodd-Frank,[7] EMIR recognizes the need to “prevent the evasion of EMIR” and requires ESMA to develop standards related to that principle. ESMA’s proposed focus is on the substance or effect of OTC derivative transactions that would ordinarily have been subject to EMIR but that are not (leaving aside the anti-evasion principle).

Any arrangement that is set up because of a business, commercial or economic reason would be legitimate and not be brought back into scope. An example of a likely nonlegitimate arrangement would be where it is decided within a group that an OTC derivative be entered into by an entity that is not involved in the business to which the derivative relates in order to avoid EMIR (e.g., hedging of a risk incurred by another entity).

The proposals are aimed at preventing the evasion of the EMIR requirements, such as would be the case if derivatives contracts between non-EU counterparties were being concluded without any business substance or economic justification and effected with an intention of evading EMIR.

ESMA’s proposals give the industry some comfort that commercial decisions by EMIR-regulated firms to enter into derivatives contracts outside the EU by means of non-EU branches or affiliates will not be interpreted as “evasion,” provided the arrangements are legitimate.



## **Dodd-Frank and CFTC's Cross-Border Guidance**

Under the Cross-Border Guidance, the CFTC distinguished between “entity-level requirements” and “transaction-level requirements” that are applicable to swap dealers and MSPs.

Entity-level requirements include capital adequacy, risk management, recordkeeping, special drawing rights (SDR) reporting, large-trader reporting and appointment of a chief compliance officer.

Transaction-level requirements include central clearing, margining and segregation for noncentrally cleared swaps, exchange and SEF trade execution, documentation, portfolio reconciliation and compression, real-time reporting, confirmations, trading records, and external business conduct standards. Based on these classifications, the CFTC confirmed that the below applications would subsist.

### ***Transactions Where the Counterparty is a U.S. Person***

- U.S. swap dealers and MSPs: All entity-level and transaction-level requirements apply; substituted compliance is not available.
- Non-U.S. swap dealers or non-U.S. MSPs: All entity-level and transaction-level requirements apply.
- Substituted compliance is available for entity-level requirements other than large-trader reporting, SDR reporting and certain recordkeeping requirements. These entities may follow substituted compliance for reporting and other entity-level requirements until termination of the Exemptive Order.
- Branch of a U.S. swap dealer or MSP located outside the United States: All entity-level and transaction-level requirements apply; substituted compliance is not available.
- Entities that are not required to register as swap dealers or MSPs but are U.S. persons where the counterparty is not required to register: Clearing, trade execution, large-trade reporting, real-time reporting, SDR reporting and recordkeeping (nonregistrant requirements) apply. (The nonregistrant requirements apply if either counterparty is a U.S. person.)

### ***Transactions Where the Counterparty Is a Non-U.S. Person***

- Non-U.S. swap dealers or non-U.S. MSPs where the counterparty is not a swap dealer or MSP, is not guaranteed by a U.S. person, and is not a conduit affiliate: All entity-level requirements apply, but substituted compliance is available for entity-level requirements other than large-trader reporting. These entities currently have the benefit of the Exemptive Order. Transaction-level requirements do not apply.

- Foreign branches of a U.S. swap dealer or non-U.S. MSPs where the counterparty is not a swap dealer or MSP, is not guaranteed by a U.S. person, and is not a conduit affiliate: All entity-level requirements apply, but substituted compliance is available for entity-level requirements other than large-trader reporting. These entities currently have the benefit of the Exemptive Order other than with respect to clearing. Transaction-level requirements other than external business conduct standards apply, but substituted compliance is available. Transactions in designated-rate swaps and credit swaps are subject to mandatory central clearing on Oct. 9, 2013.
- U.S. swap dealers and MSPs: All entity-level and transaction-level requirements apply; substituted compliance is not available.
- Entities that are not required to register as swap dealers or MSPs and are non-U.S. persons where the counterparty is not required to register and is not guaranteed by a U.S. person or a conduit affiliate: Other than large-trader reporting, non-registrant requirements do not apply.

### ***CFTC Relief Granted for Interaffiliate Swaps***

Under no-action relief adopted by the CFTC in April 2013 for entities other than swap dealers or MSPs, both new and “legacy” swaps between affiliated entities are exempt from the requirement that they be reported to SDRs, provided that any swap with a third party that is related to the interaffiliate swap is trade reported.

“Legacy” swaps that must otherwise be reported under Dodd-Frank include all swap transactions in effect for an entity between July 2010 and the present. Interaffiliate transactions are also exempt from real-time reporting to the extent they are not deemed to be “arm’s-length transactions”.

Related third-party transactions would be subject to real-time reporting and reporting to an SDR if conducted with a U.S. person. EMIR recognizes that intra-group transactions may be necessary for aggregating risks within a group structure and therefore excludes certain intra-group transactions from the clearing obligation but not from the transaction reporting obligation or the risk mitigation requirements.

However, the intra-group exemption does not automatically apply. The relevant regulators must be notified in advance and, in the case of transactions with third-country entities, grant authorization to apply it.

### **Future Collaboration Between the EU and the United States**

The EU has applied to the CFTC for a comparability determination, and the EC and ESMA are conducting an equivalence assessment of CFTC requirements. The CFTC and EC have also indicated that they are working together to establish similar approaches to straight-through processing and harmonized international rules on margins for uncleared swaps.

In addition, the EC, ESMA and the CFTC have emphasized the importance of jurisdictions and regulators deferring to each other where the respective quality and enforcement of regulations justifies such deferral. They have agreed to continue to work together and to consider any unforeseen effects of the implementation of their respective rules. They have also stated that they will continue to work with other international partners with a view to establishing a more generalized system that would extend to third countries the treatment the EU and CFTC grant to each other.

--By William Yonge and P. Georgia Bullitt, Morgan Lewis & Bockius LLP

*William Yonge is a partner in the firm's London office. Georgia Bullitt is a partner in its New York office.*

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[1] ESMA, which was established on Jan. 1, 2011, is an independent EU authority that works closely with the other European supervisory authorities responsible for banking (European Banking Authority) and insurance and occupational pensions (European Insurance and Occupational Pensions Authority) and with the European Systemic Risk Board. ESMA's mission is to enhance the protection of investors and promote stable and well-functioning financial markets in the EU. As an independent institution, ESMA achieves this aim by building a single rulebook for EU financial markets and ensuring the rulebook's consistent application across the EU. ESMA contributes to the regulation of financial services firms with a pan-European reach, either through direct supervision or through the active coordination of national supervisory activity.

[2] Under Dodd-Frank, the definition of "swap" includes physically settled FX forwards, but such FX forwards were exempted by the U.S. Secretary of the Treasury from all requirements of Dodd-Frank other than reporting to a swap data repository (SDR), business conduct standards and antifraud laws.

[3] CFTC, Interpretive Guidance and Policy Statement Regarding Compliance with Certain Swap Regulations (July 12, 2013), available at <http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/federalregister071213b.pdf> [hereinafter Cross-Border Guidance]. See also CFTC, Exemptive Order Regarding Compliance With Certain Swap Regulations, 78 Fed. Reg. 43,785 (22 July 2013), available at <http://www.gpo.gov/fdsys/pkg/FR-2013-07-22/pdf/2013-17467.pdf> [hereinafter Exemptive Order].

[4] Cross-Border Guidance, *supra* note 3, at 185.

[5] As described in the Cross-Border Guidance, a "conduit affiliate" is a non-U.S. person that is under common control with a U.S. person and, in the regular course of its business, enters into swaps with foreign market participants on behalf of the U.S. affiliate and transfers the economics of those third-party swaps to the U.S. affiliate through back-to-back arrangements.

[6] See Section 722(d) of Dodd-Frank (providing that the CFTC may issue regulations with respect to activities outside of the United States that are necessary to prevent evasion of Dodd-Frank).