10 January 2011

ISDA (International Swaps and Derivatives Association)

Comments on *Belgian Presidency* compromise text of *7 December 2010* on EMIR

Territorial Scope Issues and proposals for amendments therein

The proposed compromise text does not resolve many of the issues regarding the **territorial scope** of the proposed Regulation. We attach suggested wording dealing with each of the points discussed below.

Article 2(6): The proposed **definition of "financial counterparty"** currently applies to investment firms, credit institutions, etc. "as defined in" the various sectoral directives, which could have extraterritorial effect as well as covering some non-financial and other entities that benefit from exclusions from the scope of those directives. The definition of financial counterparty should be amended so that it is clearly limited to undertakings established in the EU that are subject to the requirements of the relevant sectoral directives.

The definitions of "investment firms", "credit institutions", etc. in the relevant directives are not limited to investment firms, credit institutions, etc. that are established in or do business in the EU. For example, the definition of "investment firm" in article 4(1) of the Markets in Financial Instruments Directive (MiFID) covers any legal person (including non-EU entities) whose regular occupation or business is providing investment services or performing investment activities. It is article 5 of MiFID which limits the requirements of MiFID to entities which are incorporated in a Member State (which is their "home state"). Therefore, referring to the definitions in the sectoral directives could result in the definition of "financial counterparty" in EMIR having extraterritorial effect, covering non-EU firms that do not have a branch in or otherwise do business in the EU.

In addition, the proposed definition of "financial counterparty" would have the clearly unintended result that many (both EU and non-EU) non-financial and other entities would be treated as "financial counterparties" because they fall within the general definitions of investment firms, credit institutions, etc. in the sectoral directives even though they might benefit from other exemptions in those directives. For example, the very broad definition of "investment firm" in article 4(1) of MiFID covers many non-financial entities, such as non-financial corporations that provide investment services or perform investment activities on a limited or incidental basis, although these entities are not subject to the authorisation or other requirements imposed by MiFID because they can benefit from one or other of the exemptions that are separately provided in article 2 of MiFID.

In addition, the proposed compromise definition has the result that non-EU alternative investment funds will be within the scope of EMIR merely because they are managed by an

EU alternative investment fund manager covered by the Alternative Investment Fund Managers Directive (AIFMD).

Definition of "established" and "branch". The definition of non-financial counterparty and our proposed amendments to the definition of "financial counterparty" refer to **undertakings "established" in the EU** but the proposed compromise text does not define what this means. Therefore, it is unclear whether this term is restricted to undertakings incorporated in the EU or whether it is also extends to undertakings incorporated outside the EU that have a branch in the EU. If it covers non-EU entities with an EU branch, it would also be unclear whether the requirements of EMIR apply only to activities carried on through the EU branch or whether they have extraterritorial effect with respect to activities carried on outside the EU by the non-EU entity (simply because it has an EU branch). We consider that EMIR should include a definition of "established" based on the corresponding provisions of the AIFMD combined with specific provisions dealing with the treatment of non-EU entities that have a branch in the EU.

For these purposes, we also recommend including a **definition of "branch"** in EMIR modelled on the definition in the Banking Consolidation Directive and MiFID.

Treatment of EU branches of non-EU entities: We recommend the inclusion of specific provisions explicitly addressing how the rules in Title II of EMIR apply to non-EU entities which have a branch in the EU. Those rules should apply to EU branches of non-EU entities to ensure competitive equality with EU firms. However, it should be made clear that those rules only apply to transactions entered into through the EU branch and do not apply extraterritorially to transactions entered into outside the EU by the non-EU entity, simply because it has a branch in the EU. (See below for the application of article 23(1) in relation to non-EU CCPs providing services to EU branches of non-EU entities)

Treatment of non-EU branches of EU entities: The Regulation should also make clear that it does not apply to activities conducted by EU financial or non-financial counterparties through branches in non-EU jurisdictions (at least if those activities are conducted with persons outside the EU). In particular, non-EU branches of EU firms should not be subject to the clearing or reporting obligations. Otherwise, there is a risk that non-EU branches of EU firms will be subject to incompatible obligations deriving from the Regulation and local law in a way that would adversely affect the ability of EU banks and other firms to operate in non-EU markets through local branches. (See below for the application of article 23(1) in relation to non-EU CCPs providing services to non-EU branches of EU entities).

Application of rules where EU firm acts as agent: It is also not clear how the rules in Title II of EMIR apply where an EU financial counterparty acts as a fund manager or agent (or otherwise arranges the transaction). This is particularly important where EU fund managers or intermediaries act on behalf of non-EU clients, where the client would otherwise be outside the scope of EMIR. The proposals could have the effect of encouraging non-EU clients not to appoint EU firms to act on their behalf as it could bring the clients within the scope of rules that are not designed to apply to them. It should be made clear that the rules in Title II only apply where the counterparty to the trade (as a principal) is a financial counterparty or non-financial counterparty as defined in EMIR.

Application of clearing obligation in relation to contracts with third country entities: Article 3(1) of the proposed compromise text indicates that when a financial counterparty in the EU (or a non-financial counterparty in the EU that is subject to the clearing obligation)

deals with third country entities, the clearing obligation only applies if the third country entity would be subject to the clearing obligation if it were established in the EU.

However, it will be necessary to address the issue of how EU based financial counterparties will establish whether or not a particular non-EU counterparty is or is not an entity to which the clearing obligation is relevant. In many cases, it may be necessary to have a detailed knowledge of the legal entity's business in order to determine whether it would fall within a relevant category if it were established in the EU. In addition, many of the exemptions from the relevant EU directives refer to specific EU legal situations which may not be capable of being applied in relation to a non-EU entity, for example, those in article 2 Banking Consolidation Directive.

In particular, it will be very difficult for EU firms to ascertain whether third country entities that are non financial entities would fall within Article 7(2) if they were established in the EU. Non EU entities will be under no obligation to calculate their positions in accordance with the methodology prescribed by Article 7 and EU firms competing to do business with them will be at a disadvantage if they ask for representations about compliance with those calculations.

Similar issues will arise in relation to EU counterparties as in many cases it will not be readily apparent whether an EU counterparty is in fact an entity within the definitions (e.g. there is no official register in the UK of whether a particular entity is a "credit institution" within the meaning of the directives and the official register does not make it possible to distinguish investment firms authorised under MiFID from other firms authorised under national provisions). There is also currently no proposal to require the publication of a list of non-financial counterparties falling within article 7(2).

EU counterparties should not be liable for a breach of the Regulation if they take reasonable steps to establish whether or not an EU or non-EU counterparty is an entity of a kind triggering the clearing obligation. In particular they should be able (but not be required) to rely on representations from their counterparty.

Ability to exempt transactions from the clearing obligation: Requiring EU financial counterparties to clear transactions with non-EU entities will place EU counterparties at a competitive disadvantage if local laws do not impose similar restrictions on local dealers. This will encourage groups to book non-EU business in entities located outside the EU. Therefore, it may be appropriate to allow for exemptions from the clearing requirement in cases where the local law would not require local dealers to clear the transaction. However, there may be other unintended consequences where it will be necessary to create exceptions to address cases where there is no realistic threat to the orderly functioning and integrity of financial markets or the stability of the whole or part of the financial system in the Union.

Application of article 23 in relation to branches: It should also be made clear that the restrictions on non-EU CCPs:

- ***Do apply*** where a non-EU CCP provides clearing services to an EU branch of an undertaking established outside the EU;

- ***Do not apply*** where a non-EU CCP provides clearing services to a non-EU branch of an EU entity (otherwise EU banks would be at a competitive disadvantage where they

operate in third countries through branches and have to participate in local clearing arrangements).

Addressing legal certainty issues: There will be cases where it will be difficult to establish whether or not the Regulation applies or where there may be inadvertent non-compliance with the provisions of the Regulation. This is a particular concern in the cross-border context. The Regulation should include provisions making clear that non-compliance does not invalidate contracts or give rise to damages claims. Otherwise there is a risk that the Regulation could create significant adverse prudential risks for firms.

Annex

Proposed amendments addressing territorial scope:

Article 2(6) – definition of "financial counterparty"

'financial counterparty' means **undertakings established in the Union that are** investment firms **subject to the requirements of** Directive 2004/39/EC, credit institutions **subject to the requirements of** Directive 2006/48/EC, insurance undertakings **subject to the requirements of** Directive 73/239/EEC, assurance undertakings **subject to the requirements of** Directive 2002/83/EC, reinsurance undertakings **subject to the requirements of** Directive 2005/68/EC, undertakings for collective investments in transferable securities (UCITS) **subject to the requirements of** Directive 2009/65/EC, an institution for occupational retirement provision **subject to the requirements of** Directive 2003/41/EC or alternative investment funds managed by alternative investment funds managers **subject to the requirements of** Directive 2010/.../.

Proposed new Article 2(6a) and (6b)– definitions of "established" and "branch"

(6a) 'established' means:

(i) for undertakings for collective investments in transferable securities authorised under Directive 2009/65/EC or alternative investment funds within the meaning of Directive 2010/.../, 'being authorised or registered in' or, as the case may be if it is not authorised or registered, 'having its registered office in';

(ii) for institutions for occupational retirement provision subject to the requirements of Directive 2003/41/EC, 'having its registered office or main administration in';

(iii) for other undertakings, 'having its registered office in' (or, if the undertaking does not have a registered office, 'having its head office in');

(6b) 'branch' means a place of business which is a part of an undertaking, other than the head office, which has no legal personality and which carries on the activities of that undertaking;

Proposed new article 2a(1) – treatment of third country firms with branches in the EU

Article 2a

Application of Title II

(1) The obligations under the rules in Title II shall apply in relation to OTC derivative contracts concluded by branches in the Union of undertakings established in third countries which would fall within the definition of a financial counterparty or a non-financial counterparty referred to in Article 7 if the branch were a separate undertaking established in the Union as if the undertaking were a financial counterparty within the meaning of this Directive or a non-financial counterparty referred to in Article 7.

Proposed new article 2a(2) – treatment of non-EU branches of EU entities

(2) The obligations under the rules in Title II shall not apply in relation to OTC derivative contracts concluded by branches in third countries of financial counterparties or of non-financial counterparties referred to in Article 7 where those contracts are concluded with counterparties that are not established in the Union or with branches outside the Union of counterparties that are established in the Union.

Proposed new article 2a(3) – Application of rules where EU firm acts as agent

(3) The obligations under the rules in Title II apply to financial counterparties and non-financial counterparties referred to in Article 7 that conclude OTC derivative contracts or on whose behalf OTC derivative contracts are concluded and not to a fund manager or other person acting on behalf of a counterparty in relation to the conclusion of those contracts (or arranging for a counterparty to conclude those contracts).

Proposed new article 3(3) – Difficulties of identifying relevant counterparties

(3) Financial counterparties and non-financial counterparties referred to in Article 7(2) shall establish, implement and maintain adequate internal arrangements designed to secure compliance with the clearing obligation under paragraph 1. However, they shall not be liable for an infringement of that clearing obligation where, notwithstanding the implementation of such arrangements, they were not aware that their counterparty in relation to an OTC derivatives contract was a counterparty falling within paragraph 1. In particular, they may rely on a representation from their counterparty that it is not a counterparty falling within paragraph 1.

Proposed new Article 3(4) - Third country competitive issues

(4) The clearing obligation referred to in Article 3(1) shall not apply to derivative contracts entered into with entities established or operating through branches in a third country where the law of that third country does not require other persons entering comparable derivative contracts with those entities to clear those contracts with a CCP or does not allow those contracts to be cleared with a CCP listed in the register referred to in Article 4(4).

Proposed new article 3(5) – Powers to address unintended consequences

The clearing obligation referred to in Article 3(1) shall not apply to a counterparty or group of counterparties or an OTC derivative contract or a class of OTC derivative contracts (either generally or in particular circumstances) where the Commission determines that the non-application of the clearing obligation would be unlikely to present a threat to the orderly functioning and integrity of financial markets or the stability of the whole or part of the financial system in the Union.

Powers are delegated to the Commission to adopt regulatory technical standards specifying where the clearing obligation does not apply in accordance with the previous sub-paragraph.

The draft regulatory technical standards shall be adopted in accordance with Articles [7 to 7d] of Regulation .../... [ESMA Regulation].

Amendments to article 23(1) – treatment of branches

A CCP established in a third country may provide clearing services to clearing members and their clients established in the Union **(or acting through a branch in the Union)** only where the CCP is recognised by ESMA. **However, this restriction shall not apply to a third country CCP where it provides clearing services to an undertaking established in the Union which is acting through a branch outside the Union**.

New article 69a – legal certainty

An infringement of the rules in this Regulation shall not, of itself, result in the invalidity of any OTC derivative contract or impair the ability of the parties to enforce the provisions of an OTC derivative contract. No-one shall have a right to claim damages from a party to an OTC derivative contract solely as a result of an infringement of those rules.