



The voice of banking
& financial services

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Response from the International Swaps and Derivatives Association Inc. (“ISDA”) and the British Bankers Association (“BBA”) to the ESMA consultation paper entitled “Draft Regulatory Technical Standards on contracts having a direct, substantial and foreseeable effect within the Union and non-evasion of provisions of EMIR”

The BBA¹ and ISDA² welcome the opportunity to respond to the ESMA *Draft Regulatory Technical Standards on contracts having a direct, substantial and foreseeable effect within the Union and non-evasion of provisions of EMIR*. We would be very happy to further discuss the views expressed in this response as ESMA considers appropriate.

Executive summary

We fully support the objectives of EMIR and welcome the recent progress made between the European Commission (EC) and the U.S. Commodity Futures Trading Commission (CFTC) on the question of extra-territoriality of EMIR and Dodd-Frank, as expressed in the recent joint statement on the “Common Path Forward”. We also support the work of the FSB’s OTC Derivatives Regulators Group (ODRG), and we welcome their August 16 report which affirmed that participants had reached a number of substantive understandings to address issues being raised by the cross-border implementation of OTC derivatives reforms. With both the CFTC/EC and ODRG agreements supported by the G20 (as highlighted in the 5-6 Sept G20 Leaders’ declaration), the ability of jurisdictions and regulators to defer to each other where regulations achieve similar outcomes is an important component in minimising the risk of regulatory conflicts, inconsistencies and duplicative

¹ The BBA is the UK’s leading association for the banking and financial services sector, representing the interests of more than 240 member organisations with a worldwide presence in 180 countries. Our member banks make up the world’s largest international banking cluster, operating 150 million accounts for UK customers and contributing over £50 billion annually to UK economic growth. We represent our members to policymakers, regulators, the media and all key stakeholders across the UK, Europe and beyond, working together to promote a legislative and regulatory system that works for customers and promotes economic growth.

² Since 1985, ISDA has worked to make the global over-the-counter (OTC) derivatives markets safer and more efficient. Today, ISDA has over 800 member institutions from 60 countries. These members include a broad range of OTC derivatives market participants including corporations, investment managers, government and supranational entities, insurance companies, energy and commodities firms, and international and regional banks. In addition to market participants, members also include key components of the derivatives market infrastructure including exchanges, clearinghouses and repositories, as well as law firms, accounting firms and other service providers. Information about ISDA and its activities is available on the Association’s web site: www.isda.org

requirements and reducing the potential for regulatory arbitrage. In this respect, further work and enhanced collaboration between regulators is needed to prevent the inconsistent treatment of bank branches and guaranteed subsidiaries between jurisdictions which will create further legal uncertainty and complexity for market participants as well as opportunities for regulatory arbitrage.

We acknowledge that the purpose of this consultation paper is not to set out the basis on which equivalence may be deemed pursuant to Article 13 of EMIR, nor is it to set out the circumstances in which provisions other than Articles 4 or 11 of EMIR should apply to entities established outside the EU – those queries are more properly addressed in ESMA’s Questions and Answers relating to implementation of EMIR³. Rather, the purpose of this consultation paper is to set out and delineate the circumstances in which an OTC derivative contract is to be considered to have a direct, substantial and foreseeable effect for the purposes of Articles 4(1)(a)(v) and 11(12) of EMIR, and to specify anti-evasions measures which will ensure that the clearing obligation set out in Article 4 of EMIR or the risk mitigation requirements set out in Article 11 are applicable to the counterparties to such OTC derivative contracts. Regardless, it is important to note that this consultation is occurring in the context of a broader on-going policy discussion on how jurisdictions’ regulatory regimes for derivatives should interact. As such, industry is unable to properly consider the wider ramifications of ESMA’s proposals and just how they will fit within any eventual 3rd country regulatory framework. It is thus incumbent on ESMA to ensure their proposals properly account for any developments, and not to add to industry’s already considerable burden in this space.

At the end of this response, we have set out our replies to each of the 9 questions asked by ESMA in the consultation paper. Our detailed responses are set out below.

In summary, we:

- Call on ESMA’s to provide more detailed guidance as to what would actually constitutes a guarantee for the purpose of the RTS application;;
- Call on ESMA to confirm that the guarantee threshold determination is a one-off test to be performed on the date of entry into the OTC derivative contract. If this is not the case, firms should be required to monitor their position relative to the thresholds no more frequently than on a 30 day rolling period (per the NFC+ thresholds in Article 10(1)(b) of EMIR). ;
- Ask for ESMA’s confirmation that Article 13 of EMIR is aimed at allowing the disapplication of certain parts of EMIR by the counterparties on an optional basis;
- Urge ESMA to strike a more appropriate balance between identifying genuine evasion and capturing genuine economic activity which is not evasive.
- Ask for ESMA to work with other regulators to harmonise the approach to transactions entered into by local branches of third country/foreign entities to avoid regulatory conflicts/duplication or regulatory loophole
- Request clarification from ESMA as to which regulator (ESMA or the national competent authorities of the counterparties) is to be tasked with having responsibility to determine whether an OTC derivative contract, or the arrangement(s) of which such contract forms a part, is designed to avoid, evade or circumvent EMIR; and

³ On the question of Art 9 reporting, we understand from TR Answer 15 in the latest ESMA Q&A on EMIR that the Article 9 reporting obligation only applies to counterparties incorporated in the European Union.

- Should be grateful if ESMA would clarify the extent and manner in which ESMA envision the avoidance/evasion provisions of the draft RTS interacting with similar legislation promulgated by regulators in third countries (including but not limited to Dodd-Frank).

More generally in light of the first set of ESMA technical advice on third country equivalence, we question how these draft RTS would apply in the case where a third country is the subject of a partial/conditional equivalence decision.

We note that ESMA has only permitted itself 9 calendar days between the end of the consultation period and the date on which ESMA is required to submit its final draft RTS to the European Commission. In the interests of supporting ESMA's need to comply with the timetable set by the European Commission, we affirm our desire to constructively engage with ESMA on the issues identified in this response, with the aim of ensuring that the final draft is clear as to its scope and does not risk duplication or conflict with the laws of third countries.

General Comments

1. Contracts considered to have a direct, substantial and foreseeable effect within the EU

1.1. At least one of the counterparties benefits from a “legally enforceable” guarantee provided by a financial counterparty established in the Union (Article 2(2)).

We would welcome clarification from ESMA as to why it is felt necessary to include the requirement in Article 2(2) of the draft RTS that the guarantee be “legally enforceable”.

We are concerned that it may give rise to an obligation on the counterparties to carry out some level of due diligence as to whether or not the guarantee is indeed legally enforceable. There does not appear to be any benefit to the counterparties nor to regulators in requiring such due diligence to be carried out for this purpose.

We note that paragraph 40 of the consultation paper merely states that “contracts entered into by subsidiaries established in third countries of an EU parent should not be considered to have a direct, substantial and foreseeable effect within the Union *unless explicitly* [sic] *guaranteed*”. Question 6, set out on page 15 of the consultation paper, also appears to be drawing a distinction between explicit and implicit guarantees provided by a parent to its subsidiary.

The emphasis in this consultation paper is therefore on whether or not the guarantee is explicit rather than merely implicit. Whether or not it is legally enforceable does not ultimately appear to be relevant.

We further note that in paragraph 48 of the consultation paper, ESMA refers to the fact that the parent may have “*strong incentives to pay*” and/or “*could decide to pay on a voluntary basis*”, but (per paragraph 49) you note that you “*do not consider that these effect* [sic] *would be direct and foreseeable*”. We agree with ESMA's analysis on that point.

Accordingly, we should be grateful if ESMA would consider amending the opening paragraph of Article 2(2) to read as follows:

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

1.2. At least one of the counterparties benefits from a legally enforceable “guarantee” provided by a financial counterparty established in the Union

Paragraph 30 of the consultation paper states that the guarantee “*can be concluded as a straight forward guarantee or not*” and that “*The terms should be interpreted to cover any other arrangement which operates in a substantially similar way*”. Question 1, set out on page 12 of the consultation paper, also refers to a guarantee “*whatever is its form*”.

No such qualifications to the word “guarantee” are contained within the recitals or main body of the draft RTS itself. We therefore request that ESMA clarify its intention as to what is or is not intended to be deemed a “guarantee” for the purpose of this draft RTS, and to include such guidance in the recitals.

In the absence of such guidance, there are numerous types of commercial or transactional relationships which could have a similar effect to a ‘guarantee’. Credit default swap transactions and insurance contracts (among other financial products) can all be structured so as to produce a similar economic result to a guarantee, however it must be stated that such instruments are not used by market participants in a “substantially similar way” to guarantees with respect to OTC derivative contracts. In more broad terms, a contractual legal guarantee placing an obligation on one party to provide capital to another party could also be considered a ‘guarantee’, as could any possible ‘bail-in’ provisions in a recovery and resolution regime. There are also arrangements other than a guarantee which would have the same effect in terms of what ESMA is seeking to capture (e.g. indemnities, hold harmless provisions etc.),

In view of these issues, we believe that the reference to “guarantee” in the draft RTS should only refer to arrangements in the legal form of a guarantee. We do agree with ESMA that the basis on which such guarantee is legally created and documented (whether by way of a deed or otherwise) should be irrelevant – the key question is simply “is this arrangement in the legal form of a guarantee?”

1.3. At least one of the counterparties benefits from a legally enforceable guarantee provided by a “counterparty” established in the Union

We acknowledge that the geographic scope of financial counterparties that are in scope appears to have been limited by ESMA. From a practical perspective, we would suggest restricting the **enforcement** of the guarantee criteria to guarantees granted by EU FCs to their foreign affiliates, meaning that the draft RTS would only apply to transactions between a TCE and another TCE which benefits from a guarantee provided by an EU FC parent company. Otherwise we do not see how ESMA would be to ensure the application of these draft RTS to transactions between TCEs which have no affiliation with EU entities.

1.4. At least one of the counterparties benefits from a legally enforceable guarantee provided by a financial counterparty “established” in the Union

The term “established” is used repeatedly in EMIR and other regulatory technical standards that have already been published. Unfortunately this term is not defined anywhere in such legislation, which has resulted in a lack of clarity as to how such term should be interpreted and thereby risks inconsistent application of EMIR by industry participants.

The interpretation of this wording has a fundamental bearing on the ultimate scope of the RTS. It also is a term utilised extensively in other legislation. In order to ensure consistent application across jurisdictions and to provide greater clarity for industry, we request that ESMA provide Q&A guidance as to what constitutes a firm being ‘established’ in the EU as the term ‘established’ can have different meanings depending on the context.

*1.5. At least one of the counterparties benefits from a legally enforceable guarantee provided by a financial counterparty “**established in the Union**”*

We note that these draft RTS are apparently only the second instance of ESMA expressly limiting the scope of the definition of “financial counterparty” to entities established in the Union⁴.

We also note that:

- Paragraph 25 of the consultation paper states that the OTC derivative contract would have a direct effect in the EU if the guarantor is *established in the EU*;
- Paragraph 27 of the consultation paper states that to be considered “substantial”, the entity should generate a significant risk for financial counterparties *established in the EU*; and
- Recital (3) of the draft RTS refers to an *EU established guarantor*.

We therefore understand ESMA’s intention is to limit the geographic scope of financial counterparties in this instance to those financial counterparties that are established in the Union.

2. When should benchmarking against the cumulative guarantee thresholds be carried out?

We note that the draft RTS does not state the point in time at which the guarantee referred to in Article 2(2) of the draft RTS must exist, nor whether breach of the thresholds must be considered only as of the date of entry into the OTC derivative contract or on an on-going basis.

It is industry’s position that this calculation should be a one-off test performed on the date of entry into the OTC derivative contract. If this is not the case, firms should be required to monitor their position relative to the thresholds no more frequently than on a 30 day rolling period (per the NFC+ thresholds in Article 10(1)(b) of EMIR).

Daily calculations – as required of those within scope of the CRD – would be a very onerous and costly obligation on both parties for little additional benefit. On-going tests also give rise to numerous implementation challenges, not least the following:

- How should counterparties treat trades that are at the point of entry not subject to any in scope guarantees but become so during the life of the transaction?

⁴ The other instance being in the response to TR Question 15 in the most recently published ESMA Questions & Answers paper relating to EMIR, in which ESMA confirmed that the reporting obligation under Article 9 EMIR only applies to counterparties *established in the European Union*

- The counterparties will need to put in place systems to monitor the levels of such guarantees (in both absolute terms and by reference to the applicable current exposure of the guarantor). The counterparty who may receive payment under the guarantee may have no means of verifying on an on-going basis whether or not the representation by the counterparty in respect of which the guarantee has been provided (which representation would need to be an on-going representation made on each day during which the OTC derivative contract is outstanding, rather than merely a day-1 representation given on the date of entry into the OTC derivative contract) has been breached – for example, an “all monies” guarantee provided by a guarantor in favour of all creditors of its subsidiary. Given that the counterparty who may receive payment under the guarantee could find itself in breach of its obligations under this draft RTS but has no means to independently verify the extent to which the guarantee is now in scope for Article 2(2) of the draft RTS, we strongly feel that this should be a one off test to be carried out as of the date of entry into the transaction.
- More generally, an on-going monitoring obligation would imply that, throughout its lifespan, the OTC derivative contract could be subject to EMIR on an “in and out” basis, thus raising major operational and legal complexity.

In any event, we ask that ESMA also clarify the following:

- Can a firm accept a third country entity’s representation that they are not in breach of the thresholds? There is no obvious way in which a counterparty can test such representations.
- How would regulators ensure compliance? Would the enforcement action require the involvement of the guaranteeing EU-incorporated financial counterparty?
- What is the intended approach if there is a chain of counterparties, each guaranteeing one another, with the counterparty at the top of the chain being the only one that is incorporated in the EU?
- On what basis do the Article 11 risk mitigation requirements apply in relation to third country entities in non-equivalent jurisdictions and against whom does ESMA anticipate any sanctions for non-compliance being applied? The EU-incorporated guarantor?

We welcome ESMA clarifying that the calculation of the threshold is on a per-counterparty basis, and not aggregated across the group.

3. Ability to optionally disapply certain provisions of EMIR

In three separate parts of the consultation, ESMA indicates that the ability to disapply the requirements of EMIR is *optional*, where one of the parties is located / established in a jurisdiction deemed equivalent by the Commission:

- Paragraph 20 of the consultation paper states that “Under Article 13 of EMIR, in case of OTC derivative contracts between an EU counterparty and a counterparty established in an equivalent jurisdiction, the provisions of EMIR can be disapplied and the provisions of the third country applied”;
- Paragraph 21 of the of the consultation paper states that “*when at least one counterparty to the transaction is located*” in a third country declared equivalent, EMIR can be disapplied”;

- Recital 2 of the draft RTS states that *“The entities subject to this Regulation would be able to disapply the provisions of Regulation (EU) No 648/2012 and apply the equivalent provisions in a third country, if at least one of the two counterparty [sic] is established in a jurisdiction for which the Commission adopted an implementing act on equivalence”*.

We support this interpretation of Article 13(3) of EMIR and note that it reflects the joint press statements made by the Commission and by the CFTC on 11 July 2013 specifying that parties should have a choice as to which of the two “substantially identical” regulations to comply with where there has been an positive decision has been taken on substituted compliance/equivalence. We also note that in the consultation, paragraph 22 supports this interpretation as well.

However, for the sake of legal certainty, we would welcome ESMA definitively confirming that it is their interpretation that EMIR may be *optionally* disapplied in instances where one counterparty is established in a 3rd country jurisdiction that has been the subject of a positive equivalence decision by the European Commission.

Should this assumption be correct, we would welcome ESMA amending recital (2) which would currently lead to the conclusion that TCEs should first consider whether one of them is established in an equivalent jurisdiction and, if that is the case, then no question of direct effect in the EU would arise – we do not believe it is the intention of ESMA to have TCE counterparties considering the application of the RTS in this way.

Our understanding of the sequencing of the determination of the application of the draft RTS application is the following:

- First, an entity needs to determine whether the transaction in question falls within the scope of the “transactions covered” by the RTS, i.e. transactions having a direct, substantial and foreseeable effect within the EU (the RTS foresees two types of such “covered transactions”, guaranteed TCEs and EU branches of TCEs) or transactions evading EMIR applications.
- Second, the entity needs to determine whether the covered transaction in question falls within the scope of application of Article 13 of EMIR, i.e. whether the relevant third country(ies) are equivalent and whether the counterparties wish to apply that equivalent regime or apply EMIR.

Accordingly, we believe that recital 2 should be amended to read:

Where contracts have a direct, substantial and foreseeable effect within the Union or in cases where the application of Regulation (EU) No 648/2012 is appropriate to prevent the evasion of any provision of Regulation (EU) No 648/2012, the provisions of Regulation (EU) No 648/2012 which would apply as a result are capable of disapplication pursuant to Article 13 of Regulation (EU) No 648/2012 by the relevant third country entities where at least one of the two entities is established in a jurisdiction which has been determined as equivalent by an implementing act adopted by the European Commission.

4. Two counterparties enter into the OTC derivative contact via their EU branches and consideration of other OTC derivative contracts entered into between EU branches of non-EU entities and other non-EU entities

We agree with the ESMA proposal that transactions between EU branches of non-EU entities should be subject to EMIR as proposed. We also agree that quantitative thresholds should not apply to these transactions.

To provide market participants with legal clarity and certainty, we consider that the treatment of foreign bank branches should be defined in a harmonised way at an international level, as inconsistent treatment of bank branches could result in regulatory overlap and conflicts as well as opportunities for regulatory arbitrage.

In this respect we already observe that the respective approaches of ESMA and the CFTC are not sufficiently aligned and do not create a level playing field for market participants. We note in particular that:

- Both the joint CFTC/European Commission press statement of 11 July and Commissioner Barnier's speech of 15 July referred to enabling market participants to determine their own choice of rules where substituted compliance/equivalence has been determined.
- The CFTC permits substituted compliance to foreign branches of US persons where a non-US swap regulation regime is comparable to the CFTC's rules. This approach - which considers foreign branches of US persons as US persons - is consistent with ESMA's approach. The CFTC has also granted relief to foreign branches of a US Swap Dealer or MSP in relation to certain transaction-level rules.
- The US has a strong supervisory interest in regulating the activities that occurs within its jurisdictional borders. Consistent with this principle, the CFTC cross border guidance states that a US branch of a non-US SD or MSP would be subject to transaction level requirements without substituted compliance being available because of a "strong supervisory interest" in regulating swap dealing activities occurring in the United States irrespective of the counterparty. (For further information, see footnote 513 of the CFTC cross border guidance).
- The ESMA consultation however considers a more limited supervisory scope. In contrast to the CFTC, ESMA in Paragraph 36 treats transactions between EU branches of non-EU entities and other non-EU entities as cross-border transactions between non-EU entities which are not of direct effect within the EU. Accordingly, these transactions do not fall within EMIR's scope of application.
- Hence, the CFTC and ESMA's treatment of foreign bank branches established within their jurisdiction is not consistent. ESMA would consider foreign bank branches established in the EU primarily as a TCE not subject to EMIR (except in the cases provided by the draft RTS), whereas the CFTC would consider foreign bank branches established in the US as US person for the purpose of the application of US transaction level requirements.

- Finally, we understand that ESMA proposed approach to third country equivalence assessment as set out in its technical advice to the Commission in respect of the US is to have equivalence apply on a piecemeal basis and be subject to conditions – where partial/conditional equivalence applies this could lead to circumstances where parties are subject to two sets of regulations or potentially neither depending on the rule in question and the classification of the counterparties. In this respect ESMA should clarify whether and how the technical standards would apply where a third country has not been determined as “fully equivalent” but only “partially/conditionally equivalent”.

In view of the above, we strongly urge ESMA to continue to work with key national regulators - in particular with the CFTC - in order to provide a harmonised approach to the treatment of branches.

5. Avoidance, abuse and circumvention of EMIR

Whilst we agree with the need to prevent evasion, and we support and endorse the principles and criteria based approach which ESMA has adopted, we do believe that ESMA’s proposed criteria is too broad. Their general nature, and the requirement for only “one or more” criteria to be met for the presumption of evasion to be made, will lead to a disproportionate imbalance between identifying genuine evasion and capturing genuine economic activity which is not evasive.

An example where the drafting is too broad is the statement at the end of Article (3);

"The purpose of the arrangement or series of arrangement, consists in avoiding the Regulation [EMIR].where, regardless of any subjective intentions of the entities involved, it defeats the object, spirit and purpose of the regulation [EMIR] provisions that would otherwise apply."

The statement ‘*regardless of any subjective intention of the parties involved*’ leaves open the possibility that an organisation can evade EMIR entirely unintentionally and regardless of any wider commercial or regulatory considerations factors. It also seems contradictory to define specific situations where evasion can occur linked to examples of situations where the parties have clearly intended to evade EMIR, only to adopt a catch-all position by stating that a party can commit evasion without any intention to do so.

Failure to properly account for a firm’s intentions when structuring a trade does not account for the very real commercial considerations behind such decisions. Firms that utilise the back-to-back booking model do so on the basis that is a legitimate business structure and often in response to customer request and local law reasons. This is distinguished from a situation where an institution changes its booking model on a one off basis to ensure that a trade which would usually be subject to EMIR falls outside its scope.

We do believe it would be helpful if a new paragraph could be added at the end of the list of situations Article 3(a) to (e) of the draft RTS, to clarify that the mere existence of the situations specified in such articles should not mean that such arrangements will be deemed, a priori, to constitute an avoidance, abuse or circumvention of EMIR. There may be perfectly legitimate business or commercial reasons for using some of the structures mentioned in these paragraphs, which are not in any way designed to avoid the application of EMIR or to abuse its provisions.

Finally, the current drafting of Article 3 of the draft RTS does not state which regulatory body will be expected to consider whether or not the OTC derivative contract and/or arrangement(s) of which such contract forms a part are designed to evade, abuse or circumvent EMIR. We request that ESMA clarify whether it is the responsibility of ESMA to make such determination or the responsibility of the national competent authorities of the counterparties to the OTC derivative contract. We also believe it is vital that ESMA clarifies how these proposals correlate with other similar regulatory regimes in third countries (such as, but not limited to, Dodd-Frank).

1) Other comments

We ask ESMA to clarify whether and how the reporting obligation attached to the timely confirmation and dispute resolution requirements would apply to transactions falling within the scope of application of ESMA proposed RTS given that EMIR Art 9 reporting obligations do not apply to such transactions. Should the reporting obligations attached to EMIR Art 11 apply, ESMA should also specify the competent authority to whom (ESMA, third country local authority) the report should be made.

Article 2(2)(c)

We understand that the reference to “it” at the commencement of this article is intended to refer to the aggregate notional amount of the guarantee. To remove any doubt, we would welcome ESMA making the following drafting change:

*“~~It~~ **the aggregate notional amount of such guarantee** 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...”*

Article 3(3)(e)

It is unclear to which “business risks” ESMA is referring in this Article and, accordingly, should be grateful for ESMA’s clarification. Is “business risks” intended to refer to pricing only or also other aspects? If so, which?

We would be keen to avoid any suggestion that an accidental mis-pricing of an (uncleared) OTC derivative contract as a cleared trade could be considered as a deliberate artificial arrangement to circumvent the application of EMIR. In the first instance, it should be seen for what it is – an error.

Article 3(4)

We believe that the reference to “paragraph 4” in Article 3(4) is a typographical error, and that ESMA instead intend to refer to “paragraph 3”.

Responses to questions raised by ESMA in the consultation paper

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

Answer 1: For the reasons stated by ESMA, we agree that a guarantee provided by a financial counterparty established in the EU should have a direct, substantial and foreseeable effect within the EU. See our response under heading 1 above for further details.

We do not agree that the guarantee, “whatever its form”, should be considered in scope. Further to our responses under heading 1(b) above, we query what ESMA intend by the words “whatever its form” and note that there is no reference within the RTS itself to anything other than the word “guarantee”. The intention of the RTS only appears to be to capture arrangements that are in the legal form of a guarantee, rather than, for example, credit default swap transactions, insurance contracts, letters of credit, keepwell agreements or total return swap transactions. If ESMA’s intention is to capture anything other than an arrangement in the legal form of a guarantee, this should be clearly specified in more detail, so that the boundaries of this obligation are clear – we note that recital (8) already prohibits any attempt at structuring around such boundaries.

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

Answer 2: Whilst the deadline for replies to this consultation does not facilitate our carrying out a detailed quantitative impact study on this issue, our initial review indicates that the levels of the proposed thresholds are such that only substantial guarantee arrangements will result in OTC derivative contracts falling within scope of this draft RTS.

We assume that ESMA’s intention is for counterparties to use their reasonable discretion in ascertaining which foreign exchange rate should be used in determining whether the applicable euro denominated threshold specified in Article 2(2) of the draft RTS has been exceeded, but would welcome clarification.

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

Answer 3: Yes, we agree with the ESMA proposal that transactions between EU branches of non-EU entities should be subject to EMIR as proposed. We also agree that quantitative thresholds should not apply to these transactions. More generally, we consider it crucial that ESMA work with other regulators to define a harmonised and consistent approach to the treatment of local branches of third country/foreign entities so as to ensure legal certainty and a level playing field.

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

Answer 4: Yes, for the reasons stated by ESMA in this consultation paper

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

Answer 5: Yes, we strongly agree with ESMA.

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

Answer 6: No, for the reasons explained above.

Question 7: [accidentally omitted from the consultation paper by ESMA]

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

Answer 8: Yes, for the reasons specified by ESMA.

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

Answer 9: On balance, yes. Whilst a lack of certainty as to the precise scope of the provisions does give rise to elements of doubt, we understand and appreciate the regulatory imperative to clamp down on abuse, evasion or circumvention of EMIR and consider this an appropriate approach for regulators to take. Our only drafting point is to points are to clarify in the RTS that the mere existence of the situations specified in the articles should not automatically constitute an avoidance, abuse or circumvention of EMIR and to remove the reference to “regardless of any subjective intentions of the entities involved” We would also request that ESMA clarifies who must consider that the abuse, evasion or circumvention has occurred, i.e. it is for ESMA to determine this or national competent authorities of the counterparties?

We believe that the ESMA’s proposed drafting should be amended to avoid legal uncertainty. We believe that the following sections should be modified as follows:

“2. For the purpose of this Article, an OTC derivative contract is deemed to have been contrived to evade the application of any provision of [EMIR] if the way in which the OTC derivative contract has been concluded is considered, viewed as a whole, and having regard to all the circumstances, to have as **primary sole** purpose, or to have features which would not be in the arrangement by which the contract was concluded if it did not have as its **primary sole** purpose:

(a) the avoidance of the application of any provision of [EMIR], ~~or~~

(b) the abuse of the application of any provision of [EMIR].”

The broad drafting of paragraph 2 may inadvertently bring within scope transactions which are not evasive. Although it is obvious that a transaction, when structured in a manner motivated by a legitimate business, economic or commercial purpose, is not contrived to evade EMIR, there may be

considerable divergence between authorities regarding what would constitute a transaction avoiding the Regulation. Indeed, this is a subjective criterion that can lead to a large range of interpretation among the NCAs and further could be a discriminatory provision within the EU countries, which goes against the intention of the legislators.

Like tax law on evasion for which the infringement is based on the exclusive purpose of avoiding tax provisions, and as a matter of legal certainty and uniformity across the EU, we think that arrangements avoiding EMIR provisions should be prevented when the transaction is concluded with the same exclusive purpose of avoiding the application of EMIR provisions.

Regarding the purpose of “abuse of the application of any provision of EMIR”, this provision seems too vague and its content appears unclear. Again, its interpretation and its scope would be left up at the discretion of the NCA and would result in a considerable disparity of application. It should therefore be removed.

*“3. For the purpose of paragraph 2, it shall be considered that an OTC derivative contract has been contrived to circumvent [EMIR] when it is ~~part of~~ **entered into as** an artificial arrangement or an artificial series of arrangement which has been put into place for the **essential sole** purpose of avoidance of any provision of [EMIR]. ~~or to exploit the application of [EMIR].~~”*

*An arrangement may be concluded through any contract, transaction, scheme, action, operation, agreement, grant, understanding, promise, undertaking or event and may comprise more than one step or part **which includes the trading of at least one OTC derivative contract.***

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

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

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

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

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

~~**(e) the arrangement or series of arrangements results in non-application of [EMIR] but this is not reflected in the business risks undertaken by the entities relating this activity.**~~

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

~~***The purpose of an arrangement or series of arrangements, consists in avoiding [EMIR] where, regardless of any subjective intentions of the entities involved, it defeats the object, spirit and purpose of [EMIR] provisions that would otherwise apply.***~~

Pursuant to the explanations given for paragraph 2 and with regard to the broad drafting of the criteria defining what an artificial arrangement is, the resulting uncertainty can be avoided by restraining it to the sole purpose of avoiding EMIR provisions, understood as the cases where any other purpose appears at most negligible for both parties.

Given the contradictory issues at stake, on one side an exhaustive list of cases which would not provide enough flexibility to adapt to evolving market practice and could not anticipate the entirety of situations of evasions, and on the other side, a broadly-drafted criteria-based approach that fails to provide certainty and predictability, this more adaptable and compromising solution proposed should be adopted.

~~***“4. In determining whether an arrangement or series of arrangements has led to the evasion of [EMIR] as referred to in paragraph 4, the requirements of [EMIR] applicable to the entities involved, having regard to those arrangements, shall be compared with the requirements that would be applied under the same circumstances in the absence of the arrangements.”***~~

The drafting of paragraph 4 appears unclear. It refers to “the requirements of EMIR applicable to the entities involved, having regard to those arrangements”, whereas the goal of the arrangement is specifically to avoid EMIR provisions. We do not see what this is referring to. As a result, we would appreciate that ESMA clarifies this paragraph or, if relevant, removes it.

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

Answer 10: Yes. With referring to what has been stated previously, a more flexible drafting proposes that artificial arrangements should be considered as cases where evasion of EMIR provisions should be prevented when these arrangements have been concluded with the sole purpose of avoiding EMIR provisions.