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COVER NOTE

From:	Secretary-General of the European Commission, signed by Mr Jordi AYET PUIGARNAU, Director
date of receipt:	13 February 2014
To:	Mr Uwe CORSEPIUS, Secretary-General of the Council of the European Union
No. Cion doc.:	C(2014) 792 final
Subject:	COMMISSION DELEGATED REGULATION (EU) No .../.. of 13.2.2014 supplementing Regulation (EU) No 648/2012 of the European Parliament and of the Council 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

Delegations will find attached document C(2014) 792 final.

Encl.: C(2014) 792 final



Brussels, 13.2.2014
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COMMISSION DELEGATED REGULATION (EU) No .../..

of 13.2.2014

supplementing Regulation (EU) No 648/2012 of the European Parliament and of the Council 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)

EXPLANATORY MEMORANDUM

1. CONTEXT OF THE DELEGATED ACT

Article 4(4) and Article 11(14) of Regulation (EU) No 648/2012 empower the Commission to adopt, following submission of draft standards by the European Securities and Markets Authority (ESMA), and in accordance with Article 10 of Regulation (EU) No 1095/2010, delegated acts on regulatory technical standards 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 Regulation (EU) No 648/2012.

In accordance with Articles 10 to 14 of Regulation (EU) No 1095/2010 establishing ESMA, the Commission shall decide within three months of receipt of the draft standards whether to endorse the drafts submitted. The Commission may also endorse the draft standards in part only, or with amendments, where the Union's interests so require, having regard to the specific procedure laid down in those Articles.

1. CONSULTATIONS PRIOR TO THE ADOPTION OF THE ACT

In accordance with the third subparagraph of Article 10(1) of Regulation (EU) No 1095/2010, ESMA has carried out a public consultation on the draft regulatory technical standards submitted to the Commission in accordance with Articles 4(4) and 11(14) of Regulation (EU) No 648/2012. 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 asking for views on the development of the draft technical standards.
- b. from 17 July to 16 September 2013, ESMA published a consultation paper (CP), which included the actual draft technical standards.

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.

3. LEGAL ELEMENTS OF THE DELEGATED ACT

Article 1 defines the notion of a guarantee, which is relevant for the application of Article 2.

Article 2 details the circumstances under which a contract executed between two third country counterparties shall be considered as having a direct, substantial and foreseeable effect within the Union.

Article 3 details the cases where it is necessary or appropriate to prevent the evasion of rules or obligations provided for in Regulation (EU) No 648/2012

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(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 counterparties and trade repositories¹, 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, these regulatory technical standards should apply to contracts where both counterparties are established in a third country whose legal, supervisory and enforcement arrangements have not yet been declared equivalent to the requirements laid down in that Regulation.
- (3) Certain information on contracts concluded by third country entities would still only be available to third country competent authorities. Therefore Union competent 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.

¹ OJ L 201, 27.7.2012, p.1.

- (5) OTC derivative contracts concluded by entities 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 entities established in third countries that are covered by a guarantee which exceeds certain 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 concluded 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 that 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 Article 4(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 entities affected by these regulatory technical standards require time in order to arrange for compliance with the requirements of Regulation (EU) No 648/2012 when their OTC derivative contracts fulfil the conditions set out in

these regulatory technical standards for being considered to have a direct, substantial and foreseeable effect within the Union, it is appropriate to delay the application of the provision containing those conditions 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 Council², 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 purposes 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

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 entity 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 entity 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 entity 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.

² 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).

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 be considered to 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 entities 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 from xxx [PO to insert date 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, 13.2.2014

For the Commission
The President
José Manuel BARROSO