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ESMA Advice on Third-Country Equivalence Under EMIR

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Clarity to market participants on the equivalence of derivatives rules to European requirements has been much anticipated. On 3 September, ESMA published its technical advice to the European Commission on the equivalence of the US and Japanese derivatives frameworks to the EU rules. The advice is not the final EU statement on the equivalence of these regimes, because the European Commission is charged with adopting legislative acts on equivalence. Once it has considered ESMA's advice, the Commission has the discretion (not apparently limited to concerns about financial services) to declare equivalence. Broadly speaking, several US and Japanese rules on derivatives have been considered equivalent, but this is subject to market participants agreeing to apply European standards, where higher.

Equivalence

Under the European Market Infrastructure Regulation ("EMIR")¹ the European Commission may adopt implementing acts declaring that the legal, supervisory and enforcement arrangements of a non-EU country are equivalent to the requirements in EMIR. For a central counterparty ("CCP") or trade repository ("TR") established in a non-EU country to provide their services in the EU, an equivalence decision is one of the requirements that must be fulfilled before the European Securities and Markets Authority ("ESMA") will grant access of the CCP or TR to EU investors. Equivalence decisions on other obligations under EMIR have the effect that if one party to a derivative trade is established in a non-EU country and the contract is subject to EMIR, the counterparties may choose to follow the non-EU country's equivalent regime instead of EMIR.

¹ Regulation (EU) No 648/2012 on OTC derivatives, central counterparties and trade repositories.

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The European Commission requested ESMA to provide its technical advice on the equivalence of certain non-EU countries which host large derivatives markets, to assist the Commission in formulating its equivalence decisions, starting with the US and Japan. The scope of the advice covers the recognition of non-EU CCPs and TRs, the clearing obligation, reporting obligation, non-financial counterparties (“NFCs”), portfolio reconciliation, dispute resolution, portfolio compression and margin requirements. Advice on the regimes for CCPs and TRs has also been provided for Australia, Hong Kong, Singapore and Switzerland, despite the deadline for that advice being 1 October 2013. ESMA confirms that it continues to work on the advice on other areas for these jurisdictions. ESMA is also working on technical advice for the regimes in Canada, India and South Korea. Advice relating to Dubai has been postponed.

Both the Commission and ESMA have stated that ESMA’s technical advice should not be construed as “prejudging” the European Commission’s final decision on equivalence. The advice is, nevertheless, a clear indication of those areas where equivalence decisions are likely to be forthcoming. ESMA’s advice is that all of the countries studied have effective supervisory regimes for the derivatives markets. Stumbling blocks for more unqualified equivalence decisions remain. For example rules on margin requirements still need to be finalised in many countries and any equivalence decision will remain pending until a proper assessment is made of the final rules.

Because the ESMA advice remains to be ratified by the Commission, it does not affect the need for those who deal with European counterparties to comply with EU requirements on portfolio reconciliation and dispute resolution procedures by 15 September 2013, such as by executing the new ISDA protocol on these topics.²

² For more information on the steps corporates and funds should be taking for EMIR compliance you may refer to our client publication, [Alert: Actions required in light of Derivative Reforms](#). For more information on EMIR and related legislation in other jurisdictions you may refer to the following: [Alert: ESMA consults on Extraterritoriality, OTC Derivatives Regulation and Extraterritoriality III](#), and [The Revised EU and US Regulatory Frameworks for Commodity Derivatives](#).

The table below summarises the key outcomes of ESMA’s technical advice for the jurisdictions on which ESMA has published advice.

COUNTRY	US	JAPAN	AUSTRALIA	HONG KONG	SINGAPORE	SWITZERLAND
Clearing obligation	<p>Equivalent, however the clearing obligation should be disapplied only if:</p> <p>(i) the product subject to the clearing obligation in the EU is also subject to the clearing obligation in the US; and</p> <p>(ii) the entity in the US is a non-exempted entity, or, if exempted, it would benefit from an equivalent exemption in the EU.</p> <p><u>Intragroup transactions:</u></p> <p>In view of the establishment of an equivalent regime for the clearing obligation and for risk mitigation techniques (see below requirements which are part of the EMIR risk mitigation rules), ESMA advises that transactions between EU and US entities in the same group should benefit from the intragroup exemption.</p>	<p>Equivalent, however the requirement should be disapplied only if:</p> <p>(i) the product subject to the clearing obligation in the EU is also subject to the clearing obligation in Japan; and</p> <p>(ii) the counterparty in Japan is a non-exempted entity, or, if exempted, it would benefit from an equivalent exemption in the EU.</p>	<p>ESMA's advice is due on 1 October 2013.</p>	<p>ESMA's advice is due on 1 October 2013.</p>	<p>ESMA's advice is due on 1 October 2013.</p>	<p>ESMA's advice is due on 1 October 2013.</p>
Timely confirmation	<p>Equivalent, however the requirement should be disapplied only if:</p> <p>(i) the relevant transaction is executed between a EU counterparty and a Swap Dealer ("SD") or Major Swap Participant ("MSP") subject to the Commodity Futures Trading Commission ("CFTC") jurisdiction; and</p> <p>(b) reporting of unconfirmed trades to EU competent authorities is not disapplied.</p>	<p>Not equivalent. There are no legally binding requirements on timely confirmation.</p>	<p>ESMA's advice is due on 1 October 2013.</p>	<p>ESMA's advice is due on 1 October 2013.</p>	<p>ESMA's advice is due on 1 October 2013.</p>	<p>ESMA's advice is due on 1 October 2013.</p>
Portfolio reconciliation	<p>Equivalent, however the requirement should be disapplied only if:</p> <p>(i) where the transaction is between a financial counterparty or a NFC that is above the EMIR clearing threshold ("NFC+") and a SD or MSP, the SD or MSP apply the provisions applicable to transactions between SDs and MSPs;</p>	<p>Not equivalent. There are no legally binding requirements on portfolio reconciliation.</p>	<p>ESMA's advice is due on 1 October 2013.</p>	<p>ESMA's advice is due on 1 October 2013.</p>	<p>ESMA's advice is due on 1 October 2013.</p>	<p>ESMA's advice is due on 1 October 2013.</p>

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	and (ii) where the transaction is between a NFC that is below the EMIR clearing threshold ("NFC-") and a SD or MSP, the SD or MSP apply the provisions applicable to transactions to counterparties other than SD or MSP.					
Portfolio compression	Equivalent where the entity subject to the EMIR provisions on portfolio compression in the EU enters into transactions with a SD or MSP subject to the CFTC regime.	Not equivalent. There are no legally binding requirements on portfolio compression.	ESMA's advice is due on 1 October 2013.	ESMA's advice is due on 1 October 2013.	ESMA's advice is due on 1 October 2013.	ESMA's advice is due on 1 October 2013.
Dispute resolution	Not equivalent.	Not equivalent. There are no legally binding requirements on dispute resolution.	ESMA's advice is due on 1 October 2013.	ESMA's advice is due on 1 October 2013.	ESMA's advice is due on 1 October 2013.	ESMA's advice is due on 1 October 2013.
Effective supervisory and enforcement arrangements with respect to OTC derivatives	Broadly equivalent.	Equivalent.	ESMA's advice is due on 1 October 2013.	ESMA's advice is due on 1 October 2013.	ESMA's advice is due on 1 October 2013.	ESMA's advice is due on 1 October 2013.
Bilateral margin and capital with respect to OTC derivatives	ESMA advises the Commission to suspend a decision on equivalence pending finalisation of the rules in both the EU and the US.	ESMA advises the Commission to suspend a decision on equivalence pending finalisation of the rules in the EU.	ESMA's advice is due on 1 October 2013.	ESMA's advice is due on 1 October 2013.	ESMA's advice is due on 1 October 2013.	ESMA's advice is due on 1 October 2013.
NFCs	Note, ESMA has advised the Commission not to take a specific determination on equivalence for NFCs but to analyse the clearing obligation and risk mitigation requirements (in the above rows) also with respect to NFCs.					
CCP authorisation requirements	Equivalent, provided the CCP adopts legally binding internal policies, procedures, rules, models and methodologies which comply with certain requirements for CCPs under EMIR - ESMA identifies the following specific areas of requirements: For CCPs under the CFTC Derivatives	Equivalent, provided the CCP adopts legally binding internal policies, procedures, rules, models and methodologies which comply with certain requirements for CCPs under EMIR - ESMA identifies the following specific areas of requirements:	Equivalent (however see recognition of third country CCPs below).	Equivalent, provided the CCP adopts legally binding internal policies, procedures, rules, models and methodologies which comply with certain requirements for CCPs under EMIR - ESMA identifies the following specific areas of requirements:	Equivalent, provided the CCP adopts legally binding internal policies, procedures, rules, models and methodologies which comply with certain requirements for CCPs under EMIR - ESMA identifies the following specific areas of requirements:	Equivalent.

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	<p>Clearing Organisation ("DCO") regime:</p> <ul style="list-style-type: none"> (a) Risk Committee; (b) Business continuity; (c) Margin; (d) Default fund; (e) Other financial resources; (f) Liquidity risk control; (g) Default waterfall; (h) Collateral; (i) Investment policy; and (j) Review of models, stress testing and back testing. <p>For CCPs under the Securities and Exchange Commission ("SEC") regime:</p> <ul style="list-style-type: none"> (a) Risk Committee; (b) Business continuity; (c) Outsourcing; (d) Segregation and portability; (e) Margin; (f) Default fund; (g) Other financial resources; (h) Liquidity risk control; (i) Default waterfall; (j) Collateral; (k) Investment policy; (l) Default procedure; and (m) Review of models, stress testing and back testing. <p>CCPs under the CFTC's regime for systemically important DCOs and Opt-In DCOs:</p> <ul style="list-style-type: none"> (a) Risk committee; (b) Margin; (c) Default fund; (d) Other financial resources; (e) Default waterfall; 	<ul style="list-style-type: none"> (a) Organisational; (b) Requirements for senior management and the Board; (c) Risk Committee; (d) Conflicts of interest; (e) Business continuity; (f) Participation; (g) Transparency; (h) Segregation and portability; (i) Exposure management; (j) Margin; (k) Default fund requirements; (l) Other financial resources; (m) Liquidity risk control; (n) Default waterfall; (o) Collateral; (p) Investment policy; (q) Default procedure; (r) Review of models, stress testing and back testing; and (s) Settlement. <p>The CCP must ensure that no changes are made to its internal policies, procedures, rules or methodologies in a way which would mean that it would no longer comply with the standards required by EMIR.</p>		<ul style="list-style-type: none"> (a) Organisational; (b) Requirements for senior management and the Board; (c) Risk Committee; (d) Record keeping; (e) Conflicts of interest; (f) Business continuity; (g) Outsourcing; (h) Participation; (i) Transparency; (j) Segregation and portability; (k) Exposure management; (l) Margin; (m) Default fund; (n) Other financial resources; (o) Liquidity risk control; (p) Default waterfall; (q) Collateral; (r) Investment policy; (s) Default procedure; (t) Review of models, stress testing and back testing; and (u) Settlement. <p>The CCP must ensure that no changes are made to its internal policies, procedures, rules or methodologies in a way which would mean that it would no longer comply with the standards required by EMIR.</p>	<ul style="list-style-type: none"> (a) Organisational, (including governance, compliance, audit); (b) Requirements for senior management and the Board; (c) Risk Committee; (d) Record keeping; (e) Conflict of interest; (f) Business continuity; (g) Outsourcing; (h) General conduct of business; (i) Participation; and (j) Margin. <p>The CCP must ensure that no changes are made to its internal policies, procedures, rules or methodologies in a way which would mean that it would no longer comply with the standards required by EMIR.</p>	

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	<p>(f) Collateral;</p> <p>(g) Investment policy; and</p> <p>(h) Review of models, stress testing and back testing.</p> <p>The CCP must ensure that no changes are made to its internal policies, procedures, rules or methodologies in a way which would mean that it would no longer comply with the standards required by EMIR.</p>					
Effective system for recognition of CCPs authorised under the legal regime of a third country	Equivalent, however, the US authorities do not use the equivalent system on a long-term basis. In addition, the US authorities require CCPs authorised outside of the US to be subject to the direct jurisdiction of the SEC and the CFTC and the application of two sets of rules, which represents a departure from the third country CCP regime prescribed in EMIR.	Equivalent.	Equivalent (except for CCPs providing clearing services to the ASX listed equities market).	Equivalent.	Equivalent.	Equivalent.
Trade repository requirements	<p><u>Authorisation requirements:</u></p> <p>Equivalent, provided the TR adopts legally binding internal policies, procedures, rules, models and methodologies which comply with EMIR requirements relating to operational separation and collection of data on exposures (valuation and collateral).</p> <p><u>Reporting obligation:</u></p> <p>Not equivalent. The reporting obligation of EMIR cannot be substituted with the reporting obligation of the US regime, which omits the requirement to report specific data on valuation of exposures and collateralisation of such exposures.</p> <p><u>Guarantee of professional secrecy:</u></p> <p>Equivalent.</p> <p><u>Effective on-going supervision and enforcement:</u></p> <p>Equivalent. Although the US regime</p>	ESMA's advice postponed (no Japanese TRs have yet indicated that they intend to apply for recognition under EMIR).	ESMA's advice is due on 1 October 2013.	ESMA's advice is due on 1 October 2013.	ESMA's advice is due on 1 October 2013.	ESMA's advice is due on 1 October 2013.

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	does not provide specifically for TRs, the US supervisory regime applicable to all regulated firms applies and is equivalent.					

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PARIS | ROME | SAN FRANCISCO | SÃO PAULO | SHANGHAI | SINGAPORE | TOKYO | TORONTO | WASHINGTON, DC

This memorandum is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired.

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