The extraterritorial effect of the EU regulation of OTC derivatives

1. On 10 April 2014 some of the legislation that provides for the extraterritorial effect of the European Markets Infrastructure Regulation (“EMIR”) came into force. The remaining legislation will come into force on 10 October 2014. This legal update considers this legislation and the counterparties to which it applies. It also considers whether some counterparties might be able to avoid the extraterritorial effect as a result of the European Commission making an equivalence decision in respect of third country jurisdictions. It considers the European Securities and Market Authority (“ESMA”) advice to date on the equivalence of the regulatory regimes in the US, Japan, Australia, Canada, Hong Kong, India, Singapore, South Korea and Switzerland and notes that even in the US ESMA did not find full equivalence. Finally this legal update also considers the requirements that third country central counterparties (“CCPs”) and trade repositories must meet in order respectively to provide clearing services to their EU clearing members and to provide reporting services to EU counterparties which enable those counterparties to satisfy their clearing reporting requirements under EMIR.

2. There are real risks that the extraterritorial effect of the EU legislation, particularly when combined with the extraterritorial effects of third country legislation, will disrupt cross-border trades. There is an urgent need for regulators to agree, in particular, on how counterparties established in different jurisdictions are expected to comply with duplicative clearing obligations. This legal update, therefore, also considers the consequences of the application of EMIR to cross-border transactions.

3. We have sought to address all points that are relevant as regards non-EU counterparties. The index below will assist those readers who wish to focus only on specific areas:

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June 2014
The extraterritorial effect of EMIR

4. EMIR was considered in our legal update entitled “A Quick Start Guide to EMIR”. This legal update focuses on the extraterritorial reach of EMIR. EMIR explicitly states that it has extraterritorial effect in two situations:

   (a) The clearing obligation applies to contracts entered into by a ‘financial counterparty’ or a ‘non-financial counterparty’ in the EU and a third country entity provided that the third country entity would be subject to the clearing obligation if it were established in the EU. Only non-EU entities that would be categorised as financial counterparties or qualifying non-financial counterparties were they established in the EU would be subject to the clearing obligation in these circumstances.

   (b) Both the clearing obligation and the risk mitigation requirements apply to contracts between third country entities that would be subject to the clearing obligation if they were established in the EU, provided that the contract has a “direct, substantial and foreseeable effect within the EU” or where such an obligation is necessary or appropriate to prevent the evasion of any provisions of EMIR. Again this provision only captures non-EU entities that would be categorised as financial counterparties or qualifying non-financial counterparties under EMIR.

In addition, market developments are creating an indirect extraterritorial effect as EU counterparties already bound to comply with the reporting obligation and the EMIR risk mitigation requirements that apply to uncleared trades are encouraging their non-EU counterparties to comply also so as to facilitate their own compliance.

5. These direct and indirect extraterritorial effects and their consequences are considered in detail at paragraphs 19 - 30 below. The possibility of complying with third country regimes that have been declared equivalent to the EU regime as opposed to complying with EMIR is considered at paragraphs 31 - 65 below. Before considering the extraterritorial effects and the concept of equivalence further, however, it is necessary to summarise the general scope and application of EMIR so as to put into context the terms and concepts used in the EU legislation.

Scope of EMIR:

6. EMIR applies to any legal or natural person established in the EU that is a legal counterparty to a derivative contract, including interest rate, foreign exchange, equity, credit and commodity derivatives. EMIR identifies two main categories of counterparty to a derivatives contract:

   (a) ‘financial counterparties’ ("FC"), which includes EU authorised financial institutions such as banks, insurers, MiFID investment firms, UCITS funds and, where appropriate, their management companies, occupational pension schemes and alternative investment funds managed by a manager authorised or registered under AIFMD; and

   (b) ‘non-financial counterparties’ ("NFC"), which means an undertaking established in the EU which is not classified as a FC, including entities not involved in financial services.

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1 See our legal update of January 2013 entitled “A Quick Start Guide to EMIR: What you need to do and when.”
2 See Article 4(1)(a)(iv) EMIR.
3 See Articles 4(1)(a)(v) and 11(12) EMIR.
4 While this note predominantly references the application of EMIR in the EU, EMIR will eventually apply across the entire European Economic Area ("EEA") as well. The EEA consists of the 28 Member States of the EU plus Iceland, Liechtenstein and Norway. All relevant EU legislation in the field of the Single Market is integrated into the EEA Agreement so that it applies in Iceland, Liechtenstein and Norway as well as the EU. EMIR is currently under consideration for incorporation into the EEA Agreement but, until such incorporation has taken place, EMIR will not apply in Iceland, Liechtenstein and Norway.
5 Defined as a financial instrument set out in points (4) to (10) of Section C of Annex I to Directive 2004/39 (MiFID).
6 See Article 2(6) EMIR.
7 See Article 2(9) EMIR.
7. The Commission has made clear in its FAQ on EMIR that the concept of ‘undertaking’ in the definition of a NFC covers any entity engaged in an economic activity, regardless of the legal status of the entity or the way in which it is financed. Case law of the European Court of Justice is consistent with this approach and has made clear that any activity consisting in offering goods and services on a market is an economic activity. Accordingly, individuals and non-profit entities carrying out an economic activity are considered to be undertakings and thus capable of being NFCs, provided they offer goods and services in the market. The concept does not extend to include public authorities.

8. A NFC whose positions in OTC derivatives exceeds a clearing threshold is known as a ‘qualifying non-financial counterparty’ (“NFC+”). In general, NFCs+ are treated in the same way as FCs. It is the responsibility of the NFC to determine whether or not its positions exceed the clearing threshold and to notify ESMA and the relevant national regulator if this is the case.

9. In essence, for the purpose of determining whether a NFC exceeds the thresholds so as to become a NFC+, hedging transactions are excluded from the calculation of positions in OTC derivative contracts. The calculation of positions must include all OTC derivative contracts entered into by the NFC itself or other NFCs within its group which are not objectively measurable as reducing risks directly related to the commercial activity or treasury financing activity of the counterparty or of its group. The thresholds differ according to the type of derivative contract and are determined by taking into account the systemic relevance of the sum of the net positions and exposures per counterparty and per class of OTC derivative. The thresholds, and the criteria for establishing which contracts can be deemed to be for hedging purposes, are set out in the subordinate legislation adopted by the Commission on 19 December 2012.

How does EMIR categorise non-EU counterparties?

10. Given the cross-reference to regulatory authorisation, it is straight-forward to establish whether an EU counterparty is a FC. It is also relatively easy to establish whether a non-EU counterparty is a FC as ESMA’s Q & A directs that consideration should be given to the nature of the activities the non-EU entity undertakes. It is less easy to establish whether any counterparty is a NFC+ and the appropriate categorisation of non-EU NFCs.

11. It is first worth considering when an entity is a non-EU entity. Entities without any physical presence in the EU are clearly non-EU entities but further consideration needs to be given to non-EU entities that have EU subsidiaries and branches. In its FAQ the Commission summarises that for the purpose of the application of EMIR, a NFC refers to an undertaking established in the EU but points out that ‘undertaking’ and ‘established’ are not further defined.

12. We have explained the concept of ‘undertaking’ at paragraph 7 above but the concept of establishment is crucial to the treatment of branches and subsidiaries in the EU. This concept is an EU construct that is not set out in any one place in particular but is the subject of legal definition based on EU primary legislation dealing with the right of establishment (Articles 49 – 55 of the Treaty on the Functioning of the EU) and subsequent case law. The concept does not include branches: establishment refers to the establishment of solo entities with individual legal identity which are incorporated (or are domiciled or have their registered office) in a Member State in the EU. As a result, subsidiaries are included within the concept but branches are not capable of being established in their own right. Thus a subsidiary of a non-EU entity can be established in the EU but a branch cannot. To summarise, if bank A is a bank headquartered and regulated in the US and has a branch (“B”) in Dublin and a subsidiary (“S”) in London, A and B are non-EU entities but S is an EU entity.

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8 “EMIR: Frequently Asked Questions” Updated: 18 December 2013
9 See Article 10(2) EMIR
10 See Article 10(1) – (3) EMIR.
11 A distinction is drawn between credit and equity derivatives on the one hand and interest rate, foreign exchange, commodity derivatives and all other derivatives on the other.
12 See Articles 10 and 11 of the Commission Delegated Regulation No.149/2013/EU with regard to regulatory technical standards on indirect clearing arrangements, the clearing obligation, the public register, access to a trading venue, non-financial counterparties, risk mitigation techniques for OTC derivative contracts not cleared by a CCP.
13. We have already commented that it is relatively straight-forward to assess whether a non-EU entity would be regarded as an FC if it were established in the EU. In the example given in the above paragraph, as A is regulated as a bank in the US, it would be a non-EU FC. It is more difficult in the case of non-EU NFCs and NFCs+. ESMA’s Q&A provides that if the non-EU entity is part of a group which also includes NFCs established in the EU, its status as either an NFC+ or NFC should be assumed to be the same as that of the EU NFCs. If the non-EU entity is not part of such a group, but benefits from a similar but limited exemption in its own jurisdiction, it can be assumed that the entity would be NFC were it established in the EU.

14. If neither of the above applies, however, then there is only one way to determine conclusively whether a non-EU entity is a NFC or NFC+: it would have to calculate its group-level position against the EMIR clearing threshold.

15. EU counterparties should obtain representations from their non-EU counterparties detailing their status. The EU counterparty is not expected to conduct verifications of the representations and may rely on such representations unless they are in possession of information which clearly demonstrates that those representations are incorrect. If it is not possible to obtain such representations and assess what the counterparty’s status would be under EMIR, firms should assume that their counterparty status is NFC+ and apply the EMIR requirements accordingly.

16. Seemingly, when non-EU counterparties are themselves directly bound by EMIR, the onus is on them to establish their appropriate categorisation under EMIR.

**Application of EMIR to different counterparties**

17. The provisions in EMIR apply differently to NFCs+ than to NFCs. In general, NFCs+ are treated in the same way as FCs. The provisions applicable to the different types of counterparty are as follows:

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<thead>
<tr>
<th></th>
<th>Clearing obligation</th>
<th>Reporting obligation</th>
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<tbody>
<tr>
<td><strong>FC</strong></td>
<td>Clearing obligation</td>
<td></td>
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<td></td>
<td>All risk mitigation techniques:</td>
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<td></td>
<td>• timely confirmation;</td>
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<td>• portfolio reconciliation and compression;</td>
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<td>• dispute resolution;</td>
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<td>• marking-to-market or marking-to-model;</td>
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<td>• the exchange of collateral to cover the exposures arising from OTC derivatives not cleared by a CCP;</td>
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<td></td>
<td>• increased capital requirements; and</td>
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<td></td>
<td>• the reporting of unconfirmed trades.</td>
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<tr>
<td><strong>NFC+</strong></td>
<td>Clearing obligation</td>
<td></td>
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<tr>
<td></td>
<td>Risk mitigation techniques as above for FC (save in relation to the increased capital requirements and the reporting of unconfirmed trades)</td>
<td></td>
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<tr>
<td><strong>NFC</strong></td>
<td>Certain risk mitigation techniques (timely confirmation, portfolio reconciliation and compression, dispute resolution)</td>
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</table>

18. Non-EU counterparties are not, however, treated in the same way as their EU counterparts.

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14 The ISDA 2013 EMIR NFC Representation Protocol enables parties to amend the terms of their ISDA Master Agreements to reflect certain known your counterparty requirements, and the consequences of transacting on the basis of an incorrect classification, imposed by EMIR.
Contracts between an EU counterparty and a non-EU counterparty

19. This extraterritorial effect, summarised in paragraph 4(a) above, only applies when an EU FC or NFC+ is transacting with a non-EU FC or NFC+ (as the EMIR clearing obligation does not apply when a NFC is party to a transaction). The application will not come into effect until the clearing obligation is operative and that is unlikely to be until 2015. ESMA still needs to develop subordinate legislation known as Regulatory Technical Standards (“RTS”) to determine the classes of OTC derivatives that will be subject to the clearing obligation. A first notification that an EU CCP (Nasdaq OMX) had been authorised to clear certain classes of OTC interest rate swaps and equity derivatives was made to ESMA on 18 March 2014 and this triggered the clearing obligation procedure described in Article 5(2) EMIR under which ESMA considers whether the class of derivatives currently cleared by Nasdaq OMX should be subject to the clearing obligation. If it considers that the asset classes cleared by Nasdaq OMX should be subject to the clearing obligation, ESMA must draft RTS and submit them to the Commission within 6 months of the authorisation of the CCP. Thus ESMA has until 18 September 2014 to submit the first set of draft RTS. Different deadlines will apply for each class of OTC derivatives cleared by authorised CCPs, the deadline being triggered by the date on which the CCP was authorised.

20. The first clearing obligations were originally expected to take effect in summer 2014, subject to phase-in periods, but this timetable is now clearly impossible. Following the submission by ESMA of the draft RTS, the draft RTS must be endorsed by the European Commission (which has between one and 3 months to do so) and not be subject to objection by the European Parliament and the Council (which also have between one and 3 months to consider their position) before the legislation can be adopted. The actual date of application of a clearing obligation will depend on the date of entry into force of the RTS and the expected phase-in period per type of counterparty, to be defined in the RTS. In these circumstances, the first clearing obligation is unlikely to take effect before early 2015.

21. As a result of the need to determine the clearing obligation as described above, EMIR does not currently expressly apply to a non-EU counterparty transacting (within the scope of EMIR) with an EU counterparty but this does not mean that non-EU counterparties in such transactions are not affected by EMIR. Article 11 EMIR prescribes the risk mitigation requirements that apply to uncleared trades and already applies whenever at least one counterparty is established within the EU. Accordingly, when an EU counterparty is transacting with a non-EU entity, the EU counterparty must (by negotiating appropriate obligations in the master agreement) ensure that the EMIR requirements for portfolio reconciliation, dispute resolution, timely confirmation and portfolio compression are met for the relevant portfolio and/or transactions even though the non-EU counterparty is not itself subject to EMIR. It is for these reasons that EU counterparties have been increasingly encouraging their non-EU counterparts to comply voluntarily with the requirements of EMIR and to sign the relevant ISDA protocols. Although there is no legal obligation on the non-EU counterparty to comply, market pressures may give them little option.

22. The EMIR reporting obligation does not (and will not apply to non-EU counterparties) but EU counterparties transacting with non-EU counterparties are still requesting information from their counterparties in order to comply with the reporting obligation themselves. Article 9(5) EMIR provides that at least the identities of the parties to the derivative contracts should be reported to trade repositories. It is this information that EU counterparties may seek from their non-EU counterparts but confidentiality and data protection legislation in third countries may prevent some non-EU counterparties providing this information. This causes a problem for the EU counterparty as, as ESMA points out in its Q & A, the Article 9(5) requirement

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15 It ought to be noted that the concept of ‘front-loading’ creates a requirement to clear OTC derivative contracts entered into after a CCP has been authorised under EMIR and before the date of application of the clearing obligation if the remaining maturity of those contracts exceeds a limit defined by ESMA in the RTS. ESMA wrote to the Commission on 8 May 2014 requesting that the extent of the front-loading period be limited to the period between the entry into force of the RTS and the date of application of the clearing obligation. At present, however, the front-loading window is open due to the notification made to ESMA in respect of Nasdaq OMX on 18 March. The extent of the front-loading period may, therefore, impact the date on which the clearing obligation comes into force.

16 The ISDA 2013 EMIR Portfolio Reconciliation, Dispute Resolution and Disclosure Protocol enables parties to amend the terms of their Protocol Covered Agreements to reflect the portfolio reconciliation and dispute resolution requirements imposed by EMIR as well as to include a disclosure waiver to help ensure parties can meet the various reporting and record keeping requirements under EMIR without breaching confidentiality restrictions.
cannot be waived. Accordingly, an EU counterparty dealing with counterparties that cannot be identified because of legal, regulatory or contractual impediments, would not be deemed compliant with Article 9(5) of EMIR. There is no legal obligation on the non-EU counterparty to supply the requested information, but EU counterparties may choose not to do business with non-EU counterparties who will cause them to be non-compliant with EMIR.

23. Irrespective of the fact that the EMIR risk mitigation requirements do not apply to contracts between EU and non-EU counterparties, these developments are causing counterparties dealing in cross-border transactions to face conflicting and duplicative requirements. When the clearing obligation comes into force, it is to be hoped that there will be clarity as to where cross-border transactions should be cleared as it will not be possible to have duplicative requirements that mandate that the trade be cleared in more than one location. Without this clarity, if an EU and a US entity, for example, enter into a trade that is subject to a clearing obligation under EMIR and Title VII of Dodd-Frank respectively both parties will not be able to comply with their respective obligations. This could discourage cross-border trades.

24. In the future, if the non-EU entity is established in a jurisdiction which the Commission has found has an equivalent regime to that in EMIR, the counterparties could comply with the equivalent rules in the third country. The concept of ‘equivalence’ is considered at paragraphs 3 to 6 below.

Contracts between non-EU counterparties

25. As described in paragraph 4(b) above, there are some circumstances under which EMIR obligations will apply when both counterparties are outside the EU and established in third countries that have not been declared equivalent to EMIR. Both the clearing obligation and the risk mitigation requirements apply to contracts between non-EU entities that would be subject to the clearing obligation if they were established in the EU, provided that the contract has a “direct, substantial and foreseeable effect within the” EU “or where such an obligation is necessary or appropriate to prevent the evasion of any provisions of” EMIR. This provision mirrors similar language in Article 722(d) of the US Dodd-Frank Wall Street Reform and Consumer Protection Act 2010 leaving globally active financial market participants facing the spectre of duplicative and even conflicting regulation. To some extent this duplication was inevitable as G20 nations made a joint decision in September 2009 to regulate OTC derivative transactions. Accordingly, international regulators have been seeking to address the problem.

26. On Friday 21 March 2014, the Official Journal of the EU published the RTS specifying the contracts that are considered to have “direct, substantial and foreseeable” effect within the EU and the cases where it is necessary to prevent the evasion of rules and obligations for the purposes of EMIR. These RTS develop Article 4(4) and 11(4)(e) EMIR that specify the circumstances by which clearing and risk mitigation techniques would apply to OTC derivatives contracts entered into between two counterparties established in third countries (provided that they would be subject to the EMIR clearing requirement if they were established in the EU). The clearing obligation in EMIR does not apply when a NFC is party to a transaction. Thus these RTS only apply when any combination of non-EU FCs or NFCs+ are transacting. The RTS entered into force on 10 April 2014 but Article 2 (Contracts with a direct, substantial and foreseeable effect within the Union) does not apply until 10 October 2014.

27. The legislation states that a contract has a “direct, substantial and foreseeable effect within the” EU when either sub-paragraph (a) or (b) below applies:

(a) At least one of the counterparties benefits from a legally enforceable guarantee provided by a FC established in the EU and covering all or part of its liability resulting from the OTC derivative contract, to the extent that the guarantee meets the following conditions:

(i) Where it is a guarantee which covers all such liability, it covers OTC derivatives transactions entered into by the third country counterparty for an aggregated notional amount that is at least 8 billion euro equivalent or where it is a guarantee which covers only a percentage of such liability, it covers OTC derivatives transactions entered into by the third country counterparty for an aggregated notional amount of at least 8 billion euro equivalent divided by the percentage of the liability covered; and
(ii) It is at least equal to 5% of the sum of current exposures in OTC derivative contracts of the FC established in the Union issuing the guarantee.\(^\text{17}\)

(b) The two counterparties enter into the OTC derivative contract via their branches in the EU\(^\text{18}\).

28. Additionally, the legislation provides that it is necessary or appropriate to prevent the evasion of EMIR where OTC derivative contracts would have been subject to the clearing obligation or the risk mitigation techniques but have been concluded in a way which is contrived to evade application of the clearing obligation or of the risk mitigation techniques. The legislation provides that an OTC derivative contract shall be deemed to have been so contrived 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 its primary purpose the avoidance of the application of EMIR\(^\text{19}\).

29. The legislation also makes clear that it shall be considered that an OTC derivative contract has been contrived to circumvent EMIR when it is part of an arrangement which has been put into place for the essential purpose of avoidance of EMIR including when it is part of an artificial arrangement. The legislation states an arrangement is artificial where it lacks commercial substance or relevant economic justification in itself.\(^\text{20}\)

30. As pointed out in paragraph 25 above, the RTS only apply if neither counterparty to a OTC derivative contract is established in a third country whose legal, supervisory and enforcement regime has been declared equivalent to EMIR. This is because when one counterparty is established in an equivalent third country, Article 13(3) EMIR provides that there shall be deemed compliance with the clearing obligation, the reporting obligation, the rules on NFCs+ and the risk mitigation requirements for uncleared trades set out in EMIR. The following diagrams developed by ESMA make this point clear:

**Diagram A**

Both counterparties are established in a third country A

Third country A is declared equivalent for the purpose of EMIR

Counterparties are deemed to comply with the clearing obligation/ reporting obligation/ rules on NFCs+/ risk mitigation requirements in EMIR

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\(^{17}\) See Article 2(1)(a) and (b) RTS.

\(^{18}\) See Article 2(2) RTS.

\(^{19}\) See Article 3(1) RTS.

\(^{20}\) See Article 3 (2) RTS.
What is an equivalence decision?

31. The purpose of the RTS is to set out when EMIR has extraterritorial effect but EMIR itself already foresaw the possibility of duplicative and conflicting requirements. It, as referenced above, contains a mechanism in Article 13 which is intended to avoid duplicative or conflicting rules on clearing, reporting and risk mitigation requirements. The mechanism involves the European Commission making an “equivalence decision” in respect of a third country jurisdiction. This means that the Commission is satisfied that:

(a) the rules on clearing, reporting, the clearing thresholds and risk mitigation in that third country are equivalent to those in EMIR;

(b) the third country has equivalent provisions on professional secrecy; and

(c) the rules are effectively applied and enforced so as to ensure effective supervision and enforcement.

32. Once (or if) the Commission has decided that a third country jurisdiction is equivalent, counterparties entering into transactions within the scope of EMIR shall be deemed to have complied with the provisions of EMIR if at least one of the counterparties is established in that third country. The following tables set out the scope of application of EMIR to third country entities pursuant to the RTS and Article 13 of EMIR. In addition to the points raised in the tables (and as explained at paragraphs 28 and 29 above), EMIR will also apply to 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 requirements set out in EMIR.

21 See Article 13(3) EMIR and recital 2 RTS.
<table>
<thead>
<tr>
<th>EU Firm (including branches established in Third Countries)</th>
<th>Equivalent Third Country</th>
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<tbody>
<tr>
<td>EU Firm (including branches established in Third Countries)</td>
<td>EMIR applies.</td>
</tr>
<tr>
<td>Non Equivalent Third Country</td>
<td>EU Branch</td>
</tr>
<tr>
<td>Non Equivalent Third Country</td>
<td>EMIR applies to EU firm. * Clearing obligation may apply to both counterparties depending on their EMIR categorisation.</td>
</tr>
<tr>
<td>Third Country Firm</td>
<td>EMIR applies to EU firm. * Clearing obligation may apply to both counterparties depending on their EMIR categorisation.</td>
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<tr>
<th>EU Firm (including branches established in Third Countries)</th>
<th>Non-Equivalent Third Country</th>
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<tr>
<td>EU Firm (including branches established in Third Countries)</td>
<td>EMIR applies.</td>
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<tr>
<td>Non Equivalent Third Country</td>
<td>EU Branch</td>
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<tr>
<td>Non Equivalent Third Country</td>
<td>EMIR applies to EU firm. * Clearing obligation may apply to both counterparties depending on their EMIR categorisation.</td>
</tr>
<tr>
<td>Third Country Firm</td>
<td>EMIR applies to EU firm. * Clearing obligation may apply to both counterparties depending on their EMIR categorisation.</td>
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</table>

* May be pressure from EU counterparty on non-EU counterparty to comply with EMIR so as to facilitate its own compliance.
Third country CCPs and trade repositories

33. An equivalence decision is also necessary before third country CCPs can provide clearing services to clearing members which are established in the EU\(^{22}\) and before EU counterparties are able to satisfy their reporting obligation under EMIR by reporting to a third country trade repository\(^{23}\). ESMA must "recognise" the CCPs and trade repositories. A CCP will only be recognised if all the following criteria are met:

(a) the CCP is authorised in the third country and subject to effective supervision and enforcement;
(b) there is a cooperation agreement in place between ESMA and the relevant regulator in the third country;
(c) there are equivalent rules on anti-money laundering and financing of terrorism in the third country;
(d) the Commission has made an equivalence decision;
   (i) determining that the legal and supervisory arrangements for CCPs in the third country are equivalent to EMIR;
   (ii) that the CCPs are subject to effective supervision and enforcement; and
   (iii) that the third country provides for an effective equivalent system for the recognition of CCPs in third countries.

34. There has been ongoing debate about whether the EU equivalence process is as nuanced as the SEC’s substituted compliance mechanism, which has been described as an outcomes-based approach. The EU Commissioner for financial services, Michel Barnier, has made clear a number of times that, in his opinion, the equivalence mechanism also involves an outcomes-based approach and, in the context of EMIR, the Commission recently confirmed that the assessment is outcome-focused and will, as much as possible, take account of the specificities of the regulatory context in the third country. Yet the reciprocity provision in (d)(iii) above could prevent a recognition decision from being made and appears to be a move away from an outcomes-based approach in the context of the recognition of CCPs at least. Such reciprocity provisions are becoming an increasing feature of EU equivalence decisions.

35. Similar requirements are imposed on trade repositories before they can be recognised by ESMA, although there is not the same reciprocity provision. Non-EU trade repositories will still be permitted to provide services to EU members even if they are not recognised under EMIR but importantly those EU members will not be able to satisfy their reporting obligation under EMIR by reporting to that trade repository.

What did ESMA advise the Commission?

36. ESMA has compared certain third country rules with EMIR requirements including those relating to NFCs central clearing, reporting, CCPs, trade repositories and clearing thresholds as well as risk mitigation techniques for uncleared trades. It has not, however, considered all these aspects in respect of all the third countries whose regimes it has assessed.

37. On 3 September 2013 ESMA published its first set of advice to the European Commission on the equivalence of the regulatory regimes for OTC derivatives clearing, CCPs, and trade repositories of non-EU countries with EMIR. ESMA assessed the equivalence of the regulatory regimes of Australia, Hong Kong, Japan, Singapore, Switzerland and the US but, somewhat surprisingly, did not find complete equivalence even in the US.

38. On 2 October 2013 ESMA supplemented its technical advice with complete equivalence findings on Australia, Canada, Hong Kong, India, Singapore, South Korea and Switzerland. On 30 January 2014 ESMA gave advice to the European Commission in respect of the equivalence between the Japanese regulatory regime for commodity CCPs and the regulatory regime for CCPs under EMIR.

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22 See Article 25 EMIR.
23 See Article 77 EMIR.
Table outlining what ESMA has considered to date:

<table>
<thead>
<tr>
<th>Country</th>
<th>CCPs</th>
<th>TRs</th>
<th>Conflicting/duplicative rules</th>
</tr>
</thead>
<tbody>
<tr>
<td>US</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>Japan</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>Australia</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>Canada</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>Hong Kong</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>India</td>
<td>✓</td>
<td>✓</td>
<td>TBD</td>
</tr>
<tr>
<td>Singapore</td>
<td>✓</td>
<td>✓</td>
<td>TBD</td>
</tr>
<tr>
<td>South Korea</td>
<td>✓</td>
<td>✓</td>
<td>TBD</td>
</tr>
<tr>
<td>Switzerland</td>
<td>✓</td>
<td>TBD</td>
<td>✓</td>
</tr>
<tr>
<td>Rest of World</td>
<td>✓</td>
<td>TBD</td>
<td>✓</td>
</tr>
</tbody>
</table>

40. ESMA found the regulatory regimes of Australia and Switzerland for CCPs equivalent to EU rules. If the Commission adopted ESMA’s advice in this regard, only Australian and Swiss CCPs would be able to satisfy ESMA’s requirements for recognition so that they could remain globally active and continue to provide services to their clearing members established in the EU. ESMA also found the regime for Australian trade repositories equivalent to that in the EU. If this advice were accepted, EU counterparties could only satisfy their reporting requirements under EMIR by reporting to EU and Australian trade repositories.

41. ESMA’s lack of equivalence findings, save as detailed above, is significant and concerning, particularly in respect of the clearing obligation. As noted at paragraph 23 above, if two counterparties established in different jurisdictions enter into a trade that is subject to a clearing obligation under their respective legislation, it will not be possible for both parties to comply with their obligations without an equivalence decision in respect of their respective CCPs: a trade cannot be cleared twice. The lack of equivalence in respect of CCPs and the clearing obligation could, therefore, discourage cross-border trades. ESMA’s findings in respect of the other EMIR requirements are of less immediate concern as, for example, it would be possible – if onerous, time-consuming, costly and potentially confusing – for a trade to be reported twice to different trade repositories and for the parties to comply with two sets of risk mitigation requirements.

42. It is worth noting that, at the time of the last update on 29 April 2014, 33 CCPs have applied to ESMA for recognition under Article 25 EMIR and agreed to have the fact of their application made public. On the basis of ESMA’s advice to date, only the Australian and Swiss applicants are likely to satisfy ESMA’s requirements for recognition without adopting additional legally binding internal policies, procedures, rules, models and methodologies. Some applicant CCPs are established in jurisdictions, such as Mexico, Brazil, Dubai, New Zealand, Malaysia and South Africa, the equivalence of which ESMA has not considered and so in relation to which a recognition decision is not possible in the near future. Other applicant CCPs are established in countries such as Canada and India which ESMA has advised will not, at present, satisfy the requirements necessary for recognition.

24 Although ESMA did not find equivalence in respect of the ASX listed equities market.
In summary, on 1 September 2013 ESMA advised that CCPs authorised in the US are subject to effective supervision and enforcement on an on-going basis. It went on to find, however, that US legal and supervisory arrangements themselves do not ensure that US CCPs comply with legally binding requirements which are equivalent to the requirements laid down in EMIR and ESMA would only consider those requirements to be met if those CCPs themselves adopted additional legally binding internal policies, procedures, rules, models and methodologies which are equivalent. This means that US CCPs will not automatically meet the criteria that ESMA requires before they can be recognised to provide services to EU counterparties.

ESMA seemed to find that the US satisfied the reciprocity requirement. It advised the Commission to consider that the US does have an equivalent system for the recognition of third country CCPs but it noted that the US authorities do not use the equivalent system on a long-term basis. ESMA pointed out that in practice the US authorities require that CCPs authorised outside of the US become subject to the direct jurisdiction of the SEC and CFTC and the application of two sets of rules and noted that this represents a departure from the third country CCP regime prescribed in EMIR. There is thus a possibility that the Commission will not find the reciprocity condition satisfied in respect of the US.

ESMA made the same sort of conditional finding of equivalence regarding the US regime for the regulation of trade repositories, the clearing obligation, timely confirmations and portfolio reconciliation. For example, ESMA advised the Commission to find that the regime is equivalent only if the product subject to the clearing obligation in the EU is also subject to the clearing obligation in the US and the counterparty in the US is a non-exempted entity or, if exempted, it would benefit from an equivalent exemption if established in the EU. ESMA placed similar conditions on an equivalence decision in respect of timely confirmation and portfolio reconciliation. It did find equivalence regarding portfolio compression.

There are, however, a number of areas where ESMA simply found that the US regime is not equivalent. It found that the US legal, supervisory and enforcement arrangements are not equivalent to the requirements laid down in EMIR in respect of the reporting obligation. This finding, if adopted by the Commission, would not prevent EU counterparties from using US trade repositories but it would mean that they could not satisfy their reporting obligation under EMIR by reporting to them.

ESMA also found that the US regime for dispute resolution is not equivalent to that of EMIR and so EU counterparties transacting with US counterparties would not satisfy all the risk mitigation requirements of EMIR by complying with US law. It did not consider it possible to make an equivalence decision regarding NFCs given the different application of the EU and US regimes.

In its advice of 1 September 2013 ESMA did not consider the Japanese regime for trade repositories because Japanese trade repositories do not intend to apply for recognition which means that there is no possibility of EU counterparties being able to satisfy the reporting obligation in EMIR by using Japanese trade repositories. As with the US, ESMA’s findings in respect of CCPs were of ‘conditional equivalence’. It also advised that Japan satisfied the reciprocity requirement. It made a similar conditional finding to the US in respect of the Japanese regime in respect of the clearing obligation.

In the absence of Japanese requirements equivalent to the risk mitigation obligations in EMIR, ESMA advised the Commission that it was not possible to make an equivalence decision that would allow EU counterparties to satisfy the requirements of Article 11 EMIR by complying with Japanese law.

In its September 2013 advice, ESMA advised only in respect of the regulatory regime in Japan for CCPs which clear derivatives transactions conducted on Financial Instruments Exchanges and OTC derivatives transactions relating to securities, currencies, interest rates, credit, weather, GDP and other indices. Subsequent to delivering this advice, ESMA became aware that there is a separate regulatory regime in Japan for CCPs which clear commodities derivatives transactions and OTC commodities derivatives transactions. This regulatory regime is governed by different legislation and the CCPs are subject to supervision by different regulatory authorities. Thus ESMA considered it necessary to deliver supplemental advice to the Commission in respect of commodities CCPs. ESMA delivered its advice on 30 January 2014 and made the same finding of conditional equivalence in respect of the Japanese commodities CCPs as it did in respect of the other Japanese CCPs in September 2013.
Australia

51. ESMA found that the regulation of CCPs in Australia was equivalent to EMIR standards, save for the ASX listed equities market, on 1 September 2013. It also advised the Commission to consider the reciprocity requirement satisfied: Australia has an effective equivalent system for the recognition of third country CCPs in respect of the Australian derivative markets (including both exchange-traded and OTC derivative markets), the Australian debt markets, and the Australian cash-equity markets but not the ASX listed equities market. This finding, should the Commission endorse it, would enable Australian CCPs, save in respect of the ASX listed equities market, to satisfy ESMA’s requirements for recognition and enable them to continue to remain globally active and service EU clearing members.

52. On 2 October 2013 ESMA gave the Commission further advice in respect of whether the Australian regime is equivalent to the EMIR provisions relating to the clearing obligation, risk mitigation requirements for uncleared trades and trade repositories.

53. In relation to trade repositories, ESMA advised that the Commission decide that trade repositories authorised in Australia do comply with legally binding requirements which are equivalent to those set out in EMIR. It also advised the Commission to consider the Australian legal, supervisory and enforcement arrangements for trade repositories and the guarantees of professional secrecy in Australia equivalent to the EU regime. If the Commission agrees with this advice, this would mean that EU counterparties can satisfy their reporting requirements under EMIR by reporting to Australian trade repositories.

54. ESMA’s findings in relation to whether the Australian regime is equivalent to the EMIR clearing obligation and risk mitigation requirements for uncleared trades were less positive.

55. As with Japan and the US, ESMA advised that the Commission only find the Australian regime equivalent as respects the clearing obligation if the product subject to the clearing obligation in the EU is also subject to the clearing obligation in Australia and the counterparty in Australia is a non-exempted entity or, if exempted, it would benefit from an equivalent exemption if established in the EU.

56. Due to the absence of legally binding requirements equivalent to the risk mitigation techniques foreseen in EMIR in the Australian regime, ESMA did not consider it possible to make an equivalence decision that would permit the EMIR risk mitigation requirements for uncleared trades to be disapplied.

Canada

57. ESMA delivered a report to the Commission on 2 October 2013 in which it said that it was not in a position to perform a conclusive analysis and deliver advice as to whether the Canadian regime is equivalent to the EU requirements relating to the clearing obligation, NFCs and risk mitigation techniques for uncleared trades as Canada is still in the process of finalising its regulatory regime. ESMA is ready to assess the Canadian regime once further progress has been.

Hong Kong

58. ESMA considered the equivalence of the regulation of CCPs in Hong Kong and made the same conditional finding as in the US and Japan in its advice of 1 September 2013. It also found that Hong Kong satisfied the reciprocity requirement. ESMA delivered a further report to the European Commission on 2 October 2013. It concluded that it was not in a position to perform a conclusive analysis and deliver advice in respect of the clearing obligation, NFCs, risk mitigation techniques for uncleared trades and trade repositories as Hong Kong is still in the process of finalising its regulatory regime. ESMA said that it is ready to receive a new mandate from the Commission to provide advice once further progress has been made towards the adoption of the relevant Hong Kong regulatory regime.
India

59. On 1 October 2013 ESMA made the same finding of conditional equivalence as regards Indian CCPs as it did in respect of US and Japanese CCPs: ESMA advised that it would only grant recognition to a CCP authorised in India if it had adopted legally binding internal policies, procedures, rules, models and methodologies which incorporate provisions that are broadly equivalent to the legally binding requirements for CCPs under EMIR. ESMA, however, advised the Commission to consider that India does not meet the reciprocity requirement: it does not have a specific regime for the recognition of CCPs authorised under the legal regime of a third country. If the Commission agrees with ESMA’s findings in both respects, Indian CCPs would not be able to satisfy ESMA’s requirements for recognition and so would not be able to provide clearing services to EU clearing members.

Singapore

60. In September 2013 ESMA considered the equivalence of the regulation of CCPs in Singapore and made the same conditional finding as in the US, Japan and India. ESMA also concluded that Singapore satisfied the reciprocity requirement.

61. ESMA delivered further advice to the Commission in relation to trade repositories on 2 October 2013 and made another finding of conditional equivalence. ESMA advised the Commission to consider that trade repositories authorised in Singapore are subject to effective supervision and enforcement on an on-going basis. ESMA also advised the Commission to consider that the legal and supervisory arrangements of Singapore ensure that trade repositories authorised in Singapore comply with legally binding requirements which are equivalent to the requirements laid down in Title VII of EMIR but only in respect of those trade repositories that have adopted additional legally binding internal policies, procedures and rules that equate to the EMIR requirements for trade repositories.

South Korea

62. In a report dated 1 October 2013 ESMA made another finding of conditional equivalence regarding South Korean CCPs. It also advised the Commission to consider that South Korea satisfied the reciprocity requirement in respect of CCPs providing clearing services to the OTC derivative markets of South Korea but not for CCPs providing clearing services in respect of financial instruments that are not OTC derivatives. This means that, if the Commission accepts ESMA’s advice, South Korean CCPs which adopt additional legally binding internal policies, procedures, rules, models or methodology which are equivalent to the requirements set out in EMIR could satisfy ESMA’s requirements for recognition. They would then be able to provide clearing services to EU counterparties.

Switzerland

63. On 1 September 2013 ESMA found that the regulation of CCPs in Switzerland was equivalent to EMIR standards. It also found that Switzerland satisfied the reciprocity requirement. If the Commission endorsed these findings, this would enable Swiss CCPs to satisfy ESMA’s requirements for recognition and enable them to continue to remain globally active and service EU clearing members.

64. In a supplemental report dated 1 October 2013 ESMA concluded that it was not in a position to perform a conclusive analysis and deliver advice as to whether the Swiss regime is equivalent to the requirements in EMIR relating to the clearing obligation, NFCs and risk mitigation techniques for uncleared trades as Switzerland is still in the process of finalising its regulatory regime in these areas. ESMA said that it is ready to receive a new mandate from the Commission to advice when progress has been towards the adoption of the relevant Swiss regulatory regime.
65. On 12 September 2013 the OTC Derivatives Regulators Group (“ODRG”) published a report on “Agreed Understandings to Resolving Cross-Border Conflicts, Inconsistencies, Gaps and Duplicative Requirements”. The report represents the understandings of the authorities with responsibility for the regulation of the OTC derivatives markets in Australia, Brazil, the European Union, Hong Kong, Japan, Ontario, Quebec, Singapore, Switzerland and the United States.

66. The report’s conclusions include the following which are intended to improve the cross-border implementation of OTC derivatives reforms:

   (a) Early and comprehensive consultation among the relevant authorities when equivalence or substituted compliance assessments are being undertaken is essential;

   (b) A flexible, outcomes-based approach should form the basis of final assessments regarding equivalence or substituted compliance;

   (c) A stricter rule approach would apply to address gaps in mandatory trading or clearing obligations;

   (d) There is an IOSCO framework for consultation on mandatory clearing determinations25;

   (e) Jurisdictions should remove barriers to reporting to trade repositories by market participants and to access to trade repository data by authorities; and

   (f) There should be appropriate intermediary measures and a reasonable but limited transition period for foreign entities to implement OTC derivatives reforms.

67. Under the report the authorities agreed to deal pragmatically through the ODRG, other multilateral groups, and/or on bilateral bases, as needed, with a view to ensuring that G20 goals are met while also aiming to minimise disruption and legal uncertainty. ESMA’s findings on equivalence, however, suggest that the EU has not paid much heed to the report to date, although it has certainly consulted with the third country authorities, but it remains to see whether the Commission will take a different approach.

Next steps

68. The extraterritorial reach of EMIR has some logic to it: the focus is on transactions or counterparties which have a degree of nexus to the EU. The approach to equivalence is, however, concerning. It is surprising that ESMA has not found that any jurisdiction, even those of other G20 countries which are implementing the same 2009 G20 commitment as the EU, is wholly equivalent to EMIR. Perhaps, despite Barnier’s claims to the contrary, the EU approach to equivalence is more rule-than outcome-based. Such an approach fails to have regard to the fact that different approaches tailored to different markets can still have, and meet, the same objective.

69. ESMA’s advice to the Commission is not binding and so should not be regarded as definitive. On the other hand, it is unlikely that the Commission would wholly countermand ESMA’s advice as it will not have undertaken the same detailed assessment as ESMA nor have the same experts upon which to rely. The Commission could ask ESMA to reconsider some of its findings or to investigate further. This would, however, take more time and increase the uncertainty that globally active financial market participants are already experiencing as they face duplicative and conflicting rules which ironically seek to implement the same supranational obligation. Actual coordination amongst global regulators is still urgently needed, particularly to address the real risk that cross-border trades subject to duplicative clearing obligations will be discouraged without agreement on how the counterparties subject to those obligations are expected to comply.

25 IOSCO Report on Requirements for Mandatory Clearing (February 2012).
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## EMIR: Timeline for Implementation

<table>
<thead>
<tr>
<th>Date</th>
<th>Event</th>
</tr>
</thead>
<tbody>
<tr>
<td>16.08.2012</td>
<td>EMIR entered into force but most provisions only apply at a later date.</td>
</tr>
<tr>
<td>16.08.12</td>
<td>Reporting obligation backdated to derivative contracts which were entered into before 16 August 2012 and remained outstanding at that date and to derivative contracts entered into on or after 16 August 2012.</td>
</tr>
<tr>
<td>15.03.2013</td>
<td>The following requirements apply:</td>
</tr>
<tr>
<td></td>
<td>• Non-financial counterparty must notify NCA and ESMA if exceeding (and no longer exceeding) the clearing threshold;</td>
</tr>
<tr>
<td></td>
<td>• Timely confirmations;</td>
</tr>
<tr>
<td></td>
<td>• Mark to market or mark to model requirements; and</td>
</tr>
<tr>
<td></td>
<td>• Reporting of unconfirmed trades.</td>
</tr>
<tr>
<td></td>
<td>In addition:</td>
</tr>
<tr>
<td></td>
<td>• Trade repositories can start applying for registration to ESMA;</td>
</tr>
<tr>
<td></td>
<td>• Third country trade repositories can start applying for recognition to ESMA.</td>
</tr>
<tr>
<td>15.09.2012</td>
<td>The following requirements apply.</td>
</tr>
<tr>
<td></td>
<td>• Portfolio reconciliation;</td>
</tr>
<tr>
<td></td>
<td>• Portfolio compression; and</td>
</tr>
<tr>
<td></td>
<td>• Dispute resolution.</td>
</tr>
<tr>
<td>15.09.2013</td>
<td>Previously existing EU CCPs authorisation and third country CCPs recognition application deadline.</td>
</tr>
<tr>
<td>September 2013</td>
<td>Publication of the final report by IOSCO and BCBS defining common international requirements on margin requirements for non-centrally cleared derivatives.</td>
</tr>
<tr>
<td>07.11.2013</td>
<td>Adoption of the registration decision of the first trade repositories.</td>
</tr>
<tr>
<td>12.02.2014</td>
<td>Reporting start date for all asset classes.</td>
</tr>
<tr>
<td>18.03.2014</td>
<td>First EU CCP authorised (NASDAQ-OMX) – start of the frontloading window.</td>
</tr>
<tr>
<td></td>
<td>First notification for the clearing obligation under Article 5.</td>
</tr>
<tr>
<td>21.03.2014</td>
<td>The Regulatory Technical Standards (“extraterritorial RTS”) specifying the contracts that are considered to have “direct, substantial and foreseeable” effect within the EU or which are necessary to prevent evasion of rules and obligations for the purposes of EMIR are published.</td>
</tr>
<tr>
<td>10.04.2014</td>
<td>Extraterritorial RTS applies (save for Article 2).</td>
</tr>
<tr>
<td>18.09.2014</td>
<td>ESMA to submit first draft RTS on the clearing obligation.</td>
</tr>
<tr>
<td>10.10.2014</td>
<td>Article 2 of extraterritorial RTS (Contracts with a direct, substantial and foreseeable effect within the Union) applies.</td>
</tr>
<tr>
<td>Q4 2014</td>
<td>ESMA expects to submit draft legislation on margin requirements for non-centrally cleared OTC derivatives.</td>
</tr>
<tr>
<td>Possible date</td>
<td>Applications for exemptions from clearing for intragroup transactions (Art. 4) and pension scheme arrangements (Art 89(2)).</td>
</tr>
<tr>
<td>? before application of clearing obligation</td>
<td>Clearing obligation expected to come into force.</td>
</tr>
<tr>
<td>Early 2015</td>
<td>Possible date</td>
</tr>
<tr>
<td>15.08.2015</td>
<td>Pension scheme arrangements exemption from clearing obligation ends.</td>
</tr>
<tr>
<td>01.12.2015 – 01.12.2019</td>
<td>Proposed that margin requirements on non-centrally cleared OTC derivatives will come into force:</td>
</tr>
<tr>
<td></td>
<td>• phased-in over 4 years depending on counterparties’ aggregate month-end average notional amount of non-centrally cleared derivatives.</td>
</tr>
</tbody>
</table>
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