Global Financial Markets Association[1]

Impact of EU extraterritorial legislation on Asian markets

1. INTRODUCTION

This note sets out a summary of EU legislation which has recently been proposed or which is in the process of being implemented, and which has an extraterritorial effect which may have an impact on non-EU markets and Asian markets in particular.

Extraterritoriality arises both intentionally in EU legislation (e.g., where the legislation expressly states that it is intended to apply to non-EU entities), and also unintentionally (e.g., where the territorial scope of legislation is unclear, or where obligations which apply to an EU entity may end up having an impact on that entity's clients or counterparties). Where the extraterritoriality arises intentionally, the European authorities are generally aware that applying EU legislation extraterritorially may result in some entities becoming subject to duplicative or conflicting regulation, reducing their ability to compete with entities in the EU or in other jurisdictions.

One of the mechanisms that European authorities frequently seek to employ is equivalence or reciprocity determinations. The idea of equivalence or reciprocity determinations is that, where an entity is established in an equivalent jurisdiction or one which gives reciprocal access to EU entities, that entity is not required to comply with EU regulation (or is permitted to access EU markets on the same basis as EU entities).

The key concerns with equivalence or reciprocity determinations are discussed further below. However, these determinations are likely to have a particularly onerous effect on entities established in Asian jurisdictions. Some large Asian markets are not located in G20 jurisdictions, so they are not required to implement legislation adopting the G20 commitments. In some cases these jurisdictions may choose to implement such legislation, but they may also decide to implement only some aspects of that legislation or to tailor the G20 commitments to suit the particular requirements of their local markets. In this case, it is possible that they may not be found to have equivalent regimes to those in the EU.

1 The Global Financial Markets Association (GFMA) brings together three of the world's leading financial trade associations to address the increasingly important global regulatory agenda and to promote coordinated advocacy efforts. The Association for Financial Markets in Europe (AFME) in London and Brussels, the Asia Securities Industry & Financial Markets Association (ASIFMA) in Hong Kong and the Securities Industry and Financial Markets Association (SIFMA) in New York and Washington are, respectively, the European, Asian and North American members of GFMA. For more information, visit http://www.gfma.org.

In addition, because of the fragmented nature of Asian markets it is not practical for Asian jurisdictions to adopt the approach taken by the EU and to assess equivalence in each relevant jurisdiction. As a result, Asian jurisdictions are less likely to implement a regime which requires them to provide recognition to foreign entities or jurisdictions.

2. EU REGULATION ON OTC DERIVATIVES, CCPS AND TRADE REPOSITORIES (EMIR)

EMIR is the main piece of European legislation implementing the G20 commitments on OTC derivatives reform. It imposes three main obligations on counterparties to derivatives contracts:

- a mandatory clearing obligation for specified OTC derivative contracts;
- risk mitigation obligations in relation to uncleared OTC derivative contracts; and
- an obligation to report all derivative contracts (both OTC and exchange-traded) to a trade repository registered or recognised under EMIR.

These obligations apply primarily to "financial counterparties" and "non-financial counterparties" as defined in EMIR. Broadly, "financial counterparties" are entities authorised under one of the specified European directives, and "non-financial counterparties" are undertakings established in the EU which are not financial counterparties or central counterparties.

EMIR also introduces a harmonised Europe-wide authorisation process for EU central counterparties (**CCPs**) and EU trade repositories, and a recognition process for non-EU CCPs and trade repositories wishing to provide services in the EU.

EMIR came into force on 16 August 2012, but many of the key obligations under EMIR require further European implementing legislation before they become effective. The obligations are currently set to come into force gradually over the course of the next two years.

Although EMIR contains provisions which are intended to address problems which may arise from extraterritorial application of EMIR, these provisions present their own problems, as discussed further below.

i. Restrictions on non-EU CCPs providing services in the EU

Article 25 EMIR prohibits non-EU CCPs from providing clearing services to clearing members or trading venues established in the EU unless those non-EU CCPs are recognised by the European Securities Markets Authority (**ESMA**). This prohibition covers all clearing services provided by a non-EU CCP, in relation to any financial instrument. It is not limited to clearing services in relation to OTC derivatives. There is a transitional provision permitting non-EU CCPs which currently provide services to EU clearing members under existing national Member State laws to continue doing so until 15 September 2013, and then so long as they submit an application for recognition by 15 September 2013, to continue providing services in accordance with existing national Member State laws until their application for recognition is rejected or allowed.

Although EMIR does not provide a definition of "established", the Commission's Q&A on EMIR state that a non-EU CCP which provides clearing services to a non-EU branch of an entity incorporated in the EU will be considered to be providing clearing services to a clearing member "established" in the EU and will be required to seek recognition.

Recital 59 states that "in order not to hamper the further development of cross-border investment management business in the Union, a third-country CCP providing services to clients established in the Union through a clearing member established in a third country should not have to be recognised by ESMA". In some jurisdictions, the clearing houses or local regulatory regime requires an entity to be incorporated in the relevant jurisdiction in order to obtain authorisation or to access a CCP. The CCPs in those jurisdictions would not be required to obtain recognition under EMIR in order to continue providing services to local subsidiaries of EU entities. However, a number of banks and investment firms incorporated in the EU have branches in Asian jurisdictions such as Hong Kong and Singapore. Where the local regulatory regime permits EU entities to carry on activities through a branch and to access a local CCP through a branch, local CCPs will be required to obtain recognition and local branches of EU entities will be unable to receive clearing services from those CCPs until they obtain recognition.

We discuss the issues associated with the recognition process further below.

This restriction clearly raises concerns for Asian branches of EU entities, which will no longer be permitted to access non-EU CCPs unless those CCPs obtain recognition under EMIR. This may increase the risk to which EU entities are exposed, if they are not able to use their Asian branch to clear transactions through a local CCP. It is also likely to reduce the scope of services that those branches can provide to clients (as they will no longer be able to provide indirect clearing services, for example), reducing the choice of service provider for clients in the relevant jurisdictions. In addition, where a jurisdiction requires particular products to be cleared through a local CCP (for example, the requirement in India for particular FX transactions to be cleared through CCIL), local branches of EU entities may no longer be able to provide those products.

The restriction may also have the effect of reducing liquidity in Asian markets, if foreign banks decide to operate through local subsidiaries rather than branches of one of the main operating entities in their group, as local subsidiaries are typically less well capitalised than the main operating entity.

The restriction also raises concerns for Asian CCPs. Article 25 imposes restrictions on the non-EU CCPs themselves, rather than imposing restrictions solely on EU clearing members preventing them from clearing through unrecognised CCPs. As a result, non-EU CCPs now need to conduct a review of their clearing members to determine whether or not they may be clearing members established in the EU to whom the CCPs are no longer permitted to provide services. The Commission has clarified that it would consider a non-EU branch of an EU entity to be a clearing member established in the EU, and that non-EU CCPs providing clearing services to such a non-EU branch would be required to seek recognition. However, despite repeated requests for the Commission or ESMA to clarify the issue, the position regarding non-

EU entities with EU branches is still unclear. It seems likely that these entities should not be considered to be "established" in the EU for these purposes, but neither the Commission nor ESMA have provided any clarity on this point, which makes it difficult for non-EU CCPs to be entirely sure that they are in compliance with EMIR when they provide clearing services to non-EU entities with EU branches.

Some non-EU CCPs may not wish to obtain recognition. There are a number of provisions under EMIR which impose obligations on "CCPs". However, it is unclear whether this means only CCPs authorised under EMIR, or whether it may also mean non-EU CCPs recognised under EMIR. For example, the reporting obligation under EMIR applies to "counterparties and CCPs". It is not clear whether recognised CCPs may become subject to a reporting obligation under EMIR. In addition, EMIR imposes obligations on clearing members of "CCPs" (such as the obligation to make public disclosure of information on prices and fees of clearing services, or the obligation to offer both individual and omnibus client segregation of assets and positions held with the CCP). Non-EU CCPs may not wish to apply for recognition while the potential impact of being recognised for both the non-EU CCP and its clearing members remains unclear, particularly when the process of preparing the information and documentation required for the application is likely to be expensive and time-consuming.

It is also possible that some non-EU CCPs may not be able to obtain recognition, because the conditions for granting recognition include an assessment of the legal and supervisory arrangements in place in the jurisdiction where the non-EU CCP is established. If that jurisdiction does not meet the relevant conditions, the non-EU CCP will not be able to obtain recognition.

Similar issues arise in relation to non-EU trade repositories. However, in addition to the requirement for an equivalence determination, there is also a requirement for the jurisdiction in which the non-EU trade repository is established to negotiate a treaty with the EU. As a result, a non-EU trade repository would be reliant on its home jurisdiction being willing and able to negotiate a treaty with the EU. Although non-EU trade repositories will still be permitted to provide services to EU members even if they are not recognised under EMIR, those EU members will not be able to satisfy their reporting obligation under EMIR by reporting to that trade repository. A counterparty may only satisfy its reporting obligation under EMIR by reporting to a trade repository which is authorised or recognised under EMIR. If a non-EU trade repository is unable to obtain recognition under EMIR, this will prevent it from establishing a global trade repository as it will be unable to provide relevant services in the EU. It may also provide a competitive advantage to EU trade repositories, as they will be able to register in the EU, and could also register in the US under Dodd Frank (as Dodd Frank requires the trade repository itself to meet particular criteria for recognition, rather than imposing conditions on the jurisdiction where the trade repository is established). If other jurisdictions take the same approach to recognition as the US, an EU trade repository should be able to operate globally. However, a non-EU trade repository may be unable to operate in the EU.

ii. Cross-border provisions

Although the obligations under EMIR apply primarily to EU entities (i.e., financial counterparties and non-financial counterparties), some of the core provisions will also apply to non-EU entities which deal with EU counterparties. This is a cause for concern for non-EU entities where the scope and application of the relevant provisions remains unclear, or where they may be subject to duplicative or conflicting obligations as a result.

Article 9 EMIR requires "counterparties and CCPs" to ensure that OTC derivative contracts are reported to trade repositories. The term "counterparty" is not defined in EMIR, so it is unclear who is required to comply with this obligation.

Although "counterparty" is not a defined term in EMIR, ESMA has indicated in discussions that it considers that the term should refer only to financial counterparties and non-financial counterparties as defined in EMIR. As a result, non-EU counterparties should not be required to comply with the reporting obligation. However, ESMA has not provided any formal guidance on this issue and the UK FSA has recently indicated that it considers that if the clearing and risk mitigation obligations will apply to non-EU counterparties, the reporting obligation should also apply.

In addition, although the term "CCP" is defined in EMIR, it is not clear whether the obligations on "CCPs" in EMIR apply only to CCPs authorised under EMIR, or whether they may also apply to CCPs which are recognised under EMIR. As a result, it is unclear whether non-EU CCPs may be required to comply with the reporting obligation. This may be a further disincentive for non-EU CCPs to apply for recognition under EMIR.

The risk mitigation obligations in Article 11 EMIR state that they apply to financial counterparties and non-financial counterparties. However, it is unclear whether or not these obligations apply to transactions entered into with non-EU entities or other entities not directly subject to EMIR.

Some of the technical standards under Article 11 appear to indicate that these obligations apply only to transactions entered into with other financial counterparties or non-financial counterparties. For example:

- Article 12 of Regulation 149/2013 (Timely confirmation) sets out deadlines for timely confirmation for contracts where both counterparties are either a financial counterparty or a non-financial counterparty. As a result, the timely confirmation obligation appears not to apply to transactions between a financial counterparty or non-financial counterparty and a non-EU entity. However, ESMA has confirmed in discussions that the obligation should apply to transactions with non-EU entities, although it remains unclear which deadlines should apply to such transactions.

However, other technical standards are less clear. For example:

- Article 13 of Regulation 149/2013 (Portfolio reconciliation) states that financial counterparties and non-financial counterparties shall have in place a written agreement on portfolio reconciliation with each of their counterparties. As discussed above, "counterparties" is not a term defined in EMIR. As a result, it is not clear whether "counterparties" refers only to other financial counterparties or non-financial counterparties, or whether it refers to any counterparty to a transaction with a financial counterparty or non-financial counterparty. This may mean that, even though non-EU entities should not be subject to obligations under EMIR, they may become subject to such obligations simply by dealing with an EU counterparty.

This means that there is a lack of clarity regarding the extent of the obligations which may affect non-EU counterparties entering into OTC derivative transactions with EU counterparties.

iii. Counterparty categorisation

EMIR imposes additional obligations on non-financial counterparties who exceed the clearing threshold specified under EMIR, and also on financial counterparties dealing with such counterparties. As a result, it is important for a non-financial counterparty to be aware of whether or not it exceeds the relevant threshold, and also important for financial counterparties to be aware of the categorisation of their counterparties.

In calculating its position in OTC derivatives, a non-financial counterparty shall include all the OTC derivative contracts entered into by the non-financial counterparty or by other non-financial entities within the group to which the non-financial counterparty belongs, which are not objectively measureable as reducing risks directly relating to the commercial activity or treasury financing activity of the non-financial counterparty or of that group.

A non-financial counterparty is required to calculate its positions in OTC derivatives (for the purposes of determining whether or not it has exceeded the threshold) on a group basis, taking into account positions in OTC derivatives held by other "non-financial entities" in its group. As the definition of "group" is geographically neutral (and so includes non-EU entities within a group), and as EMIR refers to "non-financial entities" rather than "non-financial counterparties" (the term "non-financial counterparty" only covers entities established in the EU, while "non-financial entity" is undefined), it appears that a non-financial counterparty is required to aggregate all the OTC derivative positions of the EU and non-EU non-financial entities in its group.

This is a key concern for entities established in the EU who may need to make notifications to relevant regulators and to ESMA. However, because the scope of some of the obligations under EMIR varies according to the categorisation of the counterparties to the transaction, where an EU counterparty deals with a non-EU counterparty, it will be required to confirm the categorisation of that counterparty to determine whether it would have been a financial counterparty or a non-financial counterparty in excess of the relevant thresholds if it had been established in the EU. In order to ensure that they are complying with the relevant obligations, EU counterparties may ask non-EU counterparties to give representations and warranties regarding their categorisation. This would require a non-EU counterparty which would have been a non-financial counterparty if it was established in the EU to determine whether or not it is in excess of the thresholds specified under EMIR.

However, this may not be information which a non-EU counterparty is monitoring on a group-wide basis. As a result, non-EU counterparties may be unwilling to give representations that they fall within a particular category under EMIR when they cannot be certain whether this is correct or not. This may result in EU counterparties treating them as if they were non-financial counterparties over the threshold (i.e., applying the strictest set of obligations) to be certain that they meet their obligations under EMIR. For example, this may mean that non-EU counterparties are required to clear OTC derivative transactions with EU counterparties through CCPs authorised or recognised under EMIR unless they can demonstrate to that EU counterparty that they are below the thresholds specified under EMIR.

In addition, the requirement to calculate OTC derivatives positions on a global, group-wide basis may be a concern for groups which are primarily non-EU groups but which may have a small EU presence. If an Asian group has a subsidiary in the EU which would be categorised as a non-financial counterparty, but which on its own is unlikely to have sufficient OTC derivatives positions to qualify as a non-financial counterparty over the relevant thresholds, it is possible that trading activity elsewhere in the group may push that EU entity over the threshold. This may mean that, because of a single EU entity, the Asian group is required to put in place procedures to monitor group-wide OTC derivatives trading activity.

iv. Extraterritorial provisions

Articles 4(1)(a)(v) and 11(12) EMIR provide that the clearing and risk mitigation obligations shall apply to OTC derivative contracts entered into between to third country entities that would have been subject to those obligations if they were established in the EU, provided that those contracts have a direct, substantial and foreseeable effect within the EU or where such obligation is necessary or appropriate to prevent the evasion of any provision of EMIR.

As a result, it is possible that the clearing and risk mitigation obligations may apply to transactions between two non-EU entities. ESMA and the Commission are required to produce regulatory technical standards which will specify the contracts or circumstances that will trigger this requirement. However, they have not yet done so. This means that there is considerable uncertainty for non-EU entities, as they may become subject to obligations under EMIR at some point in the future but they are currently unable to prepare for compliance with EMIR.

There are no provisions requiring the Commission to specify amended phase-in periods or transitional periods for third country entities to comply, so it is possible that they may become subject to obligations under EMIR with limited notice.

This requirement also requires non-EU entities to monitor developments in the EU in order to be aware when the Commission may determine that they are subject to EMIR.

If a third country entity does become subject to these obligations in relation to its OTC derivative contracts with other third country entities, there are no available exemptions with the exception of Article 13. There is no intra-group exemption available in relation to transactions between two third country entities. In addition, Article 13 is unlikely to provide any genuine assistance for the reasons discussed above.

v. Equivalence assessments

The requirements and restrictions imposed by EMIR are only relieved for cross-border business between non-EU and EU entities where the non-EU entity is located in a jurisdiction which has in place equivalent rules and legislation to that in the EU.

The intragroup exemption from the clearing and margin requirements is only available in relation to transactions between EU and non-EU group members where the non-EU group member is established in a jurisdiction which the Commission has determined to be equivalent under Article 13 EMIR.

Article 13 EMIR provides that a counterparty will be deemed to have complied with the obligations under Articles 4, 9, 10 and 11 EMIR where it enters into a transaction subject to EMIR and at least one of the counterparties to that transaction is established in a jurisdiction which has been determined to be equivalent.

A third country CCP will only be able to obtain recognition under EMIR if the Commission has determined that the legal and supervisory arrangements in the jurisdiction where it is established impose legally binding requirements which are equivalent to those under Title IV EMIR.

A third country trade repository will only be able to obtain recognition under EMIR if the Commission has determined that the legal and supervisory arrangements in the jurisdiction where it is established impose legally binding requirements which are equivalent to those under EMIR, and where the jurisdiction where the trade repository is established has entered into an international agreement with the EU in relation to exchange of information and mutual access to information on derivative contracts held in trade repositories in that third country jurisdiction.

This approach to equivalence determinations is likely to result in comparatively few jurisdictions being considered to be equivalent, and may have a disproportionate effect on Asian markets.

Basis for equivalence determination: It is currently unclear whether the Commission will make an equivalence determination where the legal and supervisory arrangements of a third country aim to achieve the same results as those under EMIR, or only where there are exact analogies for obligations under EMIR. For example, if a jurisdiction imposes risk mitigation obligations on counterparties to OTC derivatives contracts, but these obligations do not include a portfolio compression obligation, it is not clear whether the Commission might determine that that jurisdiction is not equivalent.

It is also unclear whether the Commission may be able to make a partial equivalence determination for a jurisdiction which has in place a reporting obligation that the Commission determines to be equivalent, but no clearing or risk mitigation obligations.

If the Commission will only grant an equivalence determination where the legal and supervisory arrangements in a third country are exactly equivalent to those in the EU, this is likely to reduce significantly the number of jurisdictions which are considered to be equivalent.

The requirement that the legal and supervisory arrangements in a third country must be equivalent to those under EMIR, rather than equivalent to those recommended by international standards, may have the effect that even other G20 jurisdictions will not be considered to be equivalent, even though all G20 jurisdictions are in the process of implementing the same recommendations on OTC derivatives reform. For example, G20 jurisdictions require their CCPs to ensure that they meet the CPSS-IOSCO Principles for financial market infrastructures. As a result, all these CCPs will meet the same core standards. However, EMIR imposes additional requirements on CCPs in addition to those in the CPSS-IOSCO Principles. As a result, even if a CCP meets the CPSS-IOSCO Principles, and so complies with international best practice, it will not be considered to be equivalent unless the jurisdiction where it is established has imposed additional obligations similar to those under EMIR.

However, the impact of this approach is likely to be more significant in non-G20 jurisdictions. Some of the largest and most sophisticated Asian markets are not in G20 jurisdictions (e.g., Singapore). Many of these jurisdictions have been waiting to monitor developments in the US and EU following implementation of Dodd Frank and EMIR before developing their own OTC derivatives regulation. Each jurisdiction will introduce obligations in relation to OTC derivative transactions which it considers are appropriate for its markets. Jurisdictions which are not part of the G20 are not required to implement the reforms recommended by the G20, and may not consider it appropriate to impose all of these reforms. Where a jurisdiction has only a small OTC derivatives market or where there is no local CCP which might provide clearing services in relation to OTC derivatives, the regulator in that jurisdiction may not consider it appropriate to impose a clearing obligation or all of the risk mitigation obligations set out in the G20 commitments. The EU has tailored the G20 commitments to meet the requirements of European derivatives markets, but the requirements for equivalence do not appear to envisage that other jurisdictions may also wish to tailor the requirements for their own jurisdictions.

Requirement for reciprocal access: EMIR also provides that the Commission may only adopt an equivalence determination in relation to a third country's regulation and supervision of CCPs where the legal framework of that third country provides for "an effective equivalent system for the recognition of CCPs authorised under third-country legal regimes".

This means that, if a third country has equivalent regulation and supervision of local CCPs, but does not recognise foreign CCPs, that jurisdiction cannot be determined to be equivalent. This is likely to be a particularly onerous condition because authorisation and recognition of CCPs under EMIR covers clearing services in relation to any financial instrument, not just OTC derivatives. As a result, even if a jurisdiction provides an equivalent system for recognition of foreign CCPs clearing OTC derivatives, if it does not provide such a system for recognition of foreign CCPs clearing locally listed shares, it would not be considered to be equivalent.

Requirement for "legally binding" requirements: In contrast to the approach taken under the Dodd Frank Act, the equivalence assessment in relation to CCPs and trade repositories is undertaken on a per jurisdiction, rather than a per CCP or per trade repository basis. This reduces the need for multiple equivalence assessments, which might potentially require regulators to conduct duplicative assessments of numerous CCPs or trade repositories in a particular jurisdiction, increasing the amount of work to be conducted by regulators and potentially also extending the timeframe for obtaining recognition.

However, CCPs and trade repositories established in non-EU jurisdictions will only be able to apply for recognition where they are subject to equivalent "legally binding" requirements in their home jurisdiction. As a result, it would not be sufficient for a third country CCP to comply voluntarily with obligations equivalent to those under EMIR, as these obligations would not be "legally binding" on the CCP. Similarly, there is no option for a third country CCP to choose to become subject to obligations under EMIR. For example, it would have been possible to develop a regime under which an entity which decided to apply for recognition would become subject to obligations under EMIR. Instead, it appears that an entity can only obtain recognition if it is already subject to equivalent obligations under another legal system. This is a much less flexible approach as, instead of simply applying obligations under EMIR to entities which choose to be subject to those obligations, EMIR requires other jurisdictions to introduce legislation equivalent to that under EMIR before it will permit entities established in those jurisdictions to provide services in the EU.

This approach appears to impose unnecessary restrictions on non-EU CCPs from providing services to EU clearing members, and means that the process for obtaining recognition is to a large extent outside the control of these non-EU CCPs. If the legal and supervisory arrangements in their jurisdiction are not considered to be equivalent, other than lobby for changes in law, there is little that these CCPs can do to obtain recognition as they are unable to rectify the problem by complying voluntarily with obligations equivalent to those under EMIR. For example, if a non-EU CCP is not required to provide individual and omnibus client segregation, but instead chooses to do so, it would not be able to apply for recognition under EMIR, as the legal framework under which it is regulated would not require it to provide individual and omnibus client segregation.

Similar issues also arise for non-EU trade repositories seeking recognition under EMIR although there is the additional requirement for an international agreement between the jurisdiction where the non-EU trade repository is established and the EU, which is a further factor outside the control of the trade repository.

Timing for equivalence determinations: A further issue which is likely to be a particular concern for Asian jurisdictions is the proposed timing for the Commission's equivalence determinations, both because these determinations may be made before the relevant jurisdictions have completed implementation of their OTC derivatives legislation, and also because the determinations may not be made in time for entities in relevant jurisdictions to benefit from the determinations before obligations under EMIR become effective.

Before the Commission can make its equivalence determinations, ESMA has been requested to provide the Commission with its technical advice on equivalence. The Commission had originally requested ESMA to provide this technical advice as follows:

- By 15 March 2013:
  - USA: in relation to CCPs, trade repositories and Article 13;
  - Japan: in relation to CCPs and Article 13;
- By 15 June 2013:
  - Australia: in relation to CCPs and Article 13;
  - Canada: in relation to Article 13;
  - Dubai: in relation to CCPs;
  - Hong Kong: in relation to CCPs, trade repositories and Article 13;
  - India: in relation to CCPs;
  - Singapore: in relation to CCPs and Article 13;
  - Switzerland: in relation to CCPs and Article 13.

However, on 27 February 2013 the Commission granted ESMA an extension of this deadline[2], to enable ESMA to take into account on-going international discussions and further developments in implementing relevant legislation in other jurisdictions, so that it is now required to provide its technical advice in relation to the US and Japan by 15 June 2013, and on the remaining jurisdictions by 15 July 2013.

While the timing of these equivalence assessments works well for jurisdictions such as the US which are already implementing OTC derivatives legislation, it may cause problems for Asian

[2] http://www.esma.europa.eu/system/files/european_commission_letter_extending_deadline_for_emir_equivalence_assessments.pdf

jurisdictions which have established OTC derivatives markets but which have not yet passed relevant legislation, or which are not in the G20 and so are not required to comply with the deadline set in the G20 commitments.

Although this extension is intended to allow ESMA to take into account further developments in OTC derivatives legislation in relevant jurisdictions when considering its advice on equivalence, the relevant jurisdictions may still not have completed implementation of their legislation by the time ESMA has completed its advice on equivalence.

In addition, there are other jurisdictions which are in the process of consulting on or implementing their own OTC derivatives regulation which are not included in the Commission's list of jurisdictions to be considered for equivalence. These jurisdictions include Korea and the People's Republic of China. There is currently no indication of when the Commission may start to consider equivalence assessments for these jurisdictions. Similarly, if the Commission determines that a jurisdiction is not equivalent at this stage, but that jurisdiction may still have further work to do on implementing relevant legislation, there is no timetable specified for reviewing that determination.

There is also a tension between the need to conduct any equivalence assessment only once a jurisdiction has completed its OTC derivative reforms, and the expiry of transitional and phase-in periods under EMIR. For example, a non-EU CCP which was providing clearing services to clearing members in the EU prior to 19 December 2012 may be able to benefit from transitional provisions which permit it to continue providing such services without being recognised under EMIR, so long as it submits its application for recognition by 15 September 2013. However, in order for ESMA to grant recognition, that non-EU CCP needs to be established in a jurisdiction which the Commission has determined to be equivalent. ESMA has recently indicated in its Practical Guidance for the recognition of Third Country CCPs by ESMA[3] that if no equivalence determination has been granted, ESMA will be unable to grant the application for recognition, and "clearing members and trading venues established in the European Union will have to cease using the clearing services of that [third country CCP] with immediate effect".

As a result, if no equivalence determination has been granted in relation to a particular third country by 15 September 2013, it is possible that a CCP established in that third country will be unable to obtain recognition, and may be required to cease providing clearing services to EU clearing members immediately. This will be a particular concern for CCPs established in jurisdictions where the Commission has not yet indicated that it is considering an equivalence determination (e.g., Korea), but may also be a concern for CCPs established in jurisdictions such as Hong Kong or Singapore, where the Commission has requested technical advice from ESMA by 15 July 2013. There is no deadline by which the Commission is required to make its equivalence determination, and although ESMA is required to provide its technical advice by 15

[3] http://www.esma.europa.eu/system/files/tc-ccp_applications.pdf

July 2013 it is possible that the Commission may grant a further extension to ESMA or may not be able to make an equivalence determination by 15 September for some other reason.

Concerns with deemed compliance under Article 13: Article 13 effectively operates as a provision requiring reciprocity. The Commission is only permitted to determine that a third country regime is equivalent if the regime in that third country is applied in an "equitable and non-distortive manner". Even if a third country has in place a regime identical to that under Articles 4, 9, 10 and 11 of EMIR, it is unlikely to be determined to be equivalent if the effect of an equivalence determination would be that an EU entity operating in that jurisdiction may be subject to more regulation than a local entity operating in that jurisdiction.

It is also unclear how the deemed compliance provision will operate in practice, as it seems possible that some counterparties could fall into legislative gaps as a result of being deemed to have complied with EMIR even though they are not required to comply with equivalent legislation in another jurisdiction. For example, if another jurisdiction also has a deeming provision similar to that under EMIR, and finds the EU equivalent, counterparties from that jurisdiction would be deemed to have complied with EMIR, and EU counterparties would be deemed to have complied with the legislation in that other jurisdiction, without either party being required to comply with any obligations.

Article 13 also does not assist in all situations where duplicative or conflicting regulation may apply, as it assumes that all jurisdictions will apply relevant legislation only to entities established in the relevant jurisdiction. For example, a Singapore branch of an EU entity may be subject to regulation under EMIR and also in Singapore. However, assuming that Singapore is determined to be equivalent, Article 13 would only assist where that Singapore branch deals with a counterparty established in Singapore (as Article 13 only assists where at least one counterparty is "established" in the equivalent jurisdiction, and the branch may not be considered to be "established" in Singapore for the purposes of Article 13). If the Singapore branch deals with a counterparty in Hong Kong, that transaction may then be subject to regulation under EMIR, Singapore law and Hong Kong law, and Article 13 would not assist.

3. EU SHORT SELLING REGULATION (SSR)

The SSR introduces restrictions on entering into uncovered short sales in shares or sovereign debt, or entering into uncovered sovereign credit default swaps. It also requires persons with net short positions in shares or sovereign debt, or positions in uncovered sovereign credit default swaps to notify the regulator if their positions exceed specified thresholds, and to make public disclosure if those positions exceed further specified thresholds.

These restrictions and obligations apply to shares admitted to trading on a regulated market or multilateral trading facility in the European Union, sovereign debt issued by an EU sovereign issuer, and credit default swaps in relation to such sovereign debt.

The SSR also introduces powers for EU regulators to introduce temporary emergency restrictions.

The SSR came into force on 1 November 2012. Since then, a number of regulators have imposed temporary emergency measures using the powers granted by the SSR.

i. Territorial scope of the SSR

The SSR expressly states that the notification and disclosure requirements apply to natural or legal persons domiciled or established in a third country. As a result, a firm or investor in an Asian jurisdiction who may have a short position in shares or sovereign debt or an uncovered position in sovereign CDS covered by the SSR will need to notify that position to a regulator in the EU or make a public disclosure in the EU, even if that Asian firm or investor has no presence or business in the EU.

However, because there is no similar express statement regarding the territorial scope of the restrictions or temporary emergency powers under the SSR, it is unclear whether the restrictions or temporary emergency powers should also apply to any person who enters into a short sale in instruments covered by the SSR. For example, Asian investors seeking to hedge exposures to European entities (for example by purchasing credit default swaps on European sovereign debt) would be prohibited from doing so unless they held the underlying sovereign debt or were able to make use of an exemption under the SSR.

ii. Scope of instruments covered

A large number of companies with a primary listing outside the EU also have shares admitted to trading on the London Stock Exchange (for example, Samsung, Mitsubishi Corporation and Air China all have shares listed on the LSE). If the provisions of the SSR applied to all shares admitted to trading on an EU regulated market or multilateral trading facility regardless of where else those shares might be traded, there would be the potential for the SSR to have a significant extraterritorial impact.

The SSR seeks to mitigate this potential extraterritorial impact through an exemption where the principal trading venue of the relevant shares is in a third country. The relevant EU competent authority for the shares of a company that are traded on a trading venue in the EU and also on a third country venue is required to determine whether the principal venue for trading of those shares is in the EU or in a third country, and ESMA is required to publish the list of shares for which the principal trading venue is in a third country.

However, competent authorities are only required to carry out this determination at least every two years. In any event, even if competent authorities carried out the determination more frequently, ESMA is only required to publish the list every two years. As a result, if shares are admitted to trading on a trading venue in the EU their principal venue for trading will be considered to be a market in the EU until ESMA updates its public list.

iii. Temporary emergency measures

The SSR was proposed in part as a response to the temporary emergency bans on short selling of shares in financial institutions which have been introduced in a number of EU jurisdictions from 2007 onwards often on little or no notice and with no prior consultation. A Europe-wide restriction on uncovered short selling should help address some of the issues raised by these temporary bans (including lack of certainty, lack of clarity in scope and overlaps in jurisdiction).

However, the SSR also acknowledges that there may be circumstances where EU regulators consider that the restrictions under the SSR are not sufficient to address problems in their jurisdiction, and may wish to take further temporary action to restrict short selling. As a result, the SSR also contains powers for competent authorities to impose temporary emergency measures, including additional notification and disclosure requirements for short selling, restrictions on entering into short positions in any financial instrument and restrictions on entering into sovereign credit default swaps.

In order to avoid some of the problems which arose in relation to the temporary bans introduced during the crisis, the SSR gives ESMA the power to act to co-ordinate the bans and requires competent authorities to notify ESMA before imposing any temporary restrictions. The SSR also requires competent authorities to obtain the consent of any other EU competent authority before imposing a ban which may have an impact on financial instruments for which the other EU competent authority is the relevant regulator.

However, while the powers to impose temporary measures are intended to provide a common framework for any temporary short selling bans, in practice there remains a great deal of uncertainty regarding the temporary bans that have been introduced under these powers. For example, because the framework for the restrictions is set out in the SSR, these temporary restrictions tend to quote the wording in the SSR verbatim in order to ensure that any restrictions are within the scope of the powers granted by the SSR. However, this still leaves questions which remain unanswered until competent authorities are able to publish guidance (often some time after the imposition of the ban).

In addition, although competent authorities are supposed to obtain the consent of other competent authorities before imposing restrictions which affect shares for which those other competent authorities are the relevant regulator, this has not occurred in a number of recent emergency bans. This appears to be because competent authorities are not aware of circumstances in which their bans may affect shares regulated by other competent authorities. For example, if the Italian regulator prohibits entering into short positions in shares admitted to trading on a regulated market in Italy, this may affect trading in index futures admitted to trading on a regulated market in another EU jurisdiction (e.g., Germany) where that index contains Italian listed shares. This results in a lack of co-ordination in introducing these measures, and a lack of clarity over the exact scope of the measures (for example, would that Italian ban prohibit trading in German listed index futures?).

These temporary restrictions are still being introduced with little or no notice, which continues to generate uncertainty. For example, the UK FSA recently introduced a restriction one day in the morning lasting until close of business the same day. The ban stated that it was intended to support a restriction imposed by the Italian regulator. However, the scope of the UK and Italian restrictions was not the same, and the short duration of the ban did not permit firms to seek guidance from the FSA on the scope of the ban.

While measures of this sort create uncertainty for EU market participants, they seem likely to create even more uncertainty for non-EU market participants who may not receive information on possible temporary measures as promptly as EU market participants or who may not have contacts with relevant regulators in order to seek prompt guidance.

4. UK FSA PROPOSED RULES IN RELATION TO NON-EEA DEPOSITOR PREFERENCE REGIMES

In September 2012 the UK FSA published a consultation paper[4] addressing the implications of non-EEA national depositor preference regimes on UK branches of non-EEA banks.

The FSA proposed that firms from non-EEA countries with national depositor preference regimes should be required either to accept deposits in the UK only through a UK-incorporated subsidiary, or to implement an alternative arrangement that ensures that persons who have placed deposits with that firm in the UK are no worse off than depositors in the firm's home jurisdiction if it fails (for example, by ring-fencing assets in the UK branch so that they are available only to UK branch depositors). At the same time that the FSA is proposing these restrictions for firms from non-EEA countries with national depositor preference regimes, the UK is also proposing to implement its own national depositor preference regime (although the effects of this are likely to be reduced by the ring-fencing requirements to be implemented under the Vickers proposal).

The FSA proposes a two-year implementation period for firms to put in place the necessary arrangements. As a result, if the proposed rules become final, firms will be required to comply by 2015.

These rules will affect banks in jurisdictions with national depositor preference regimes (such as Australia and Singapore) which have branches in the UK. These proposed rules are also part of a broader increasing reluctance on the part of the UK regulator to authorise UK branches of non-EEA banks. We are also aware that Chinese banks in particular have raised concerns with the FSA regarding the difficulties that they have experienced in establishing branches in the UK (although other EU jurisdictions have been more welcoming).

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[4] http://www.fsa.gov.uk/static/pubs/cp/cp12-23.pdf

5. REVISED AND RESTATED CAPITAL REQUIREMENTS DIRECTIVE AND REGULATION (CRD IV)

On 20 July 2011, the European Commission adopted a legislative proposal to repeal and replace the existing Capital Requirements Directives (the Banking Consolidation Directive and the Capital Adequacy Directive) with a Directive and a Regulation (CRD IV). CRD IV will implement Basel III in the EU. The European legislative bodies have reached final agreement on the text of CRD IV, which is expected to come into force on 1 January 2014.

i. Bonus cap

CRD IV requires EU banks and investment firms to implement remuneration policies, including a cap on the value of any bonuses awarded, setting a maximum ratio between the fixed and variable component of total remuneration. It also permits Member States to set stricter requirements.

Although the obligations under CRD IV apply primarily to EU banks and investment firms, the European authorities were concerned that firms might seek to avoid the restrictions and requirements in relation to remuneration using other group entities outside the EU. As a result, CRD IV states that competent authorities must ensure that the provisions in Articles 88(2) – 91 on remuneration will apply at group, parent company and subsidiary levels, including entities established in offshore financial centres. Recital 48 also indicates that the obligations should apply to branches and subsidiaries established in third countries.

It does not appear that the extension of the remuneration provisions to other group companies is restricted to other group companies within the consolidated group of the relevant EU bank or investment firm. As a result, the remuneration provisions under CRD IV (including the cap on bonuses) may apply to non-EU companies in the same group as the EU bank or investment firm, including non-EU subsidiaries. In relation to non-EU headquartered groups, the intention of CRD IV was to restrict the application of the remuneration rules to EU subsidiaries (although there are references to the rules applying to the parent company of EU subsidiaries).

This is likely to have a significant impact on the competitiveness of both EU banks or investment firms with Asian group entities, and also Asian entities which are part of a group with an EU bank or investment firm in their group, as the level of remuneration that they are permitted to award will be restricted by the remuneration provisions under CRD IV.

ii. Exposures to Qualifying CCPs

Basel III introduced proposals to promote the use of CCPs by introducing a preferential 2% risk weighting for banks' direct exposures as a clearing member to qualifying CCPs (and, subject to conditions, for banks' indirect exposures to qualifying CCPs as the client of a clearing member). Basel III envisages that a CCP will be a qualifying CCP if it satisfies the CPSS-IOSCO Principles for financial market infrastructures, and that the home state regulator of the relevant CCP should be responsible for publicly certifying that the CCP complies with the Principles.

As the legislation implementing Basel III in the EU, CRD IV also introduces a 2% risk weighting for derivative transactions cleared through a CCP. However, rather than requiring such a qualifying CCP to satisfy the CPSS-IOSCO Principles, CRD IV requires a qualifying CCP to be a CCP authorised or recognised under EMIR. This has the effect both of applying more restrictive criteria than those prescribed under Basel III (because the CCP would be required to comply not only with the CPSS-IOSCO Principles but also with any additional requirements imposed by EMIR), and also of requiring that ESMA rather than the CCP's home state regulator should perform the assessment of compliance with the Principles.

CRD IV does contain transitional provisions which allow EU firms to treat EU or non-EU CCPs as qualifying CCPs for a maximum period of 15 months from the date of entry into force of the relevant RTS referred to in Article 89(3), i.e. up to 15 June 2014 (unless an earlier decision is made on their authorisation or recognition). The Commission is given power to extend this period by a further 6 months, "in exceptional circumstances where it is necessary and proportionate to avoid disruption to international financial markets".

These rules are potentially problematic for EU firms with direct or indirect exposures to non-EU CCPs, and may also cause problems for those non-EU CCPs. As discussed above, some non-EU CCPs may not wish to apply for recognition under EMIR. However, they may need to do so in order to compete with authorised or recognised CCPs.

Even if non-EU CCPs do apply, they may be refused recognition because their home state regulatory framework is not regarded as equivalent to the more stringent EMIR requirements, their home state regulatory framework does not provide an effective equivalent framework for reciprocal recognition of CCPs from other countries or their home state regulator will not enter into a cooperation agreement with ESMA. In addition, there is a risk that even if a non-EU CCP applies for recognition before 15 September 2013, recognition will not be granted before the expiry of the CRD IV transitional period, as EMIR allows ESMA up to 180 working days (approximately 9 months) from receipt of a complete application to determine the application (the Commission might be able to extend the transitional period to address such cases, but this might be difficult if only one or two CCPs have applications pending).

In addition, groups subject to EU consolidated supervision may not be able to avoid the consequences of higher risk charges by using a non-EU subsidiary or third party as a clearing member of a non-EU CCP which has not attained EMIR recognition, because the requirement also applies to indirect exposures to the CCP (and any risks in a non-EU clearing member subsidiary may be captured on regulatory consolidation by higher EU capital charges unless the consolidating supervisor allows consolidation on aggregation basis using the solo capital requirement calculated under the subsidiary's rules – but e.g. the UK no longer allows this).

6. EU FINANCIAL TRANSACTION TAX DIRECTIVE (FTT)

On 14 February 2013 the European Commission adopted a legislative proposal for an EU Financial Transaction Tax. The FTT will apply only in eleven Member States: Austria, Belgium, Estonia, France, Germany, Greece, Italy, Portugal, Slovakia, Slovenia and Spain (the "**FTT zone**"). If the FTT is adopted, it may apply from as early as 1 January 2014.

The FTT will be charged on:

- transactions in debt securities, equities and entry into / modification of derivatives where at least one party is a financial institution and at least one party is established in the FTT zone;
- transactions in debt securities and equities where at least one party is a financial institution and the issuer of the underlying debt / equity is established in the FTT zone; and
- certain other intra-group transactions that transfer risk between entities.

The definition of "financial institution" covers entities authorised under the specified EU directives (including investment firms and regulated markets authorised under MiFID, credit institutions authorised under the Banking Directive, AIFs authorised under AIFMD). It also covers any other undertaking which carries on specified activities, including trading for own account or for the account of customers with respect to any financial instrument, acquisition of holdings in undertakings, deposit taking or lending, financial leasing, or granting guarantees or commitments. As a result, the definition of "financial institution" covers a wide range of entities, including non-EU entities and entities which are not required to seek authorisation in order to carry on their activities.

The FTT applies to all relevant transactions, whether OTC or on-exchange. The headline rate is a harmonised minimum of 0.1% of purchase price (or market value if greater) for financial instruments. For derivatives the rate is a minimum of 0.01% of notional principal. However, the effective rate will be higher. Each party which is a financial institution will be separately liable for the tax, so transactions between two financial institutions will be taxed twice. In addition, the FTT applies separately to each transaction in a chain of transactions making up a financial transaction, which creates a "cascade" effect, multiplying the impact of the tax.

There are only very limited exemptions. For example, there is no intra-group exemption, no intermediary exemption (which exacerbates the cascade effect) and no market maker exemption. There is an exemption for primary market transactions and transactions with certain public bodies (including the central banks of EU Member States). However, there is no exemption for non-EU public bodies, so non-EU central banks would be subject to the FTT, for example.

The extraterritorial impact of the FTT is significant unprecedented in scope and complexity. A financial institution incorporated or with its registered office in the FTT zone will be subject to the FTT and so will all of its branches worldwide. As a result, Hong Kong or Singapore branches of French or German banks will be fully subject to the FTT in the same way as the French or German head office. In addition, a financial institution incorporated or with its registered office outside the FTT zone but with a branch within the FTT zone (e.g., a Japanese bank with a German branch) will be subject to the FTT with respect to transactions carried out by that branch.

Financial institutions established outside of the FTT zone (for example, financial institutions established in Asian jurisdictions with no EU branches) will be taxed whenever they transact with parties in the FTT zone or a non-FTT zone branch of a party in the FTT zone (whether those parties are financial institutions or not), and whenever they deal in securities issued by an entity established in the FTT zone.

This impact is limited in principle by an exception for cases where the person liable to tax can show there is no link between the economic substance of the transaction and the territory of any FTT zone Member State. However, it is unclear when it might be possible to rely on this exception.

The Commission's explanatory note on the territorial application of the FTT gives the example of a Chinese bank and a Chinese investment firm acting in the name of a Chinese branch of a German industrial company, entering into a futures contract in China for the Chinese operations of the German industrial company. In that case, the Chinese bank and investment firm would be subject to FTT in principle (as the Chinese investment firm is considered to be established in Germany, as it is acting in the name of a German company, and the Chinese bank would also be considered to be established in Germany as it is dealing with the German company). The Chinese bank and investment firm may not be required to pay FTT if they are able to prove that there is no link between the economic substance of the transaction and the territory of Germany. However, the Commission states that "such proof is not available, however, where the operations of the German company in China have an impact on the balance sheet of the German headquarters".

The importance of the euro as an international currency means that it is likely to be difficult for a non-EU or non-FTT zone entity to avoid dealing with FTT zone financial institutions, because the large euro-zone banks are typically in the FTT zone. In addition, where an FTT zone financial institution (or a non-FTT zone branch of an FTT zone financial institution) participates in an anonymous trading system (such as a regulated market or multilateral trading facility), counterparties will deal with that FTT zone financial institution without knowing, and could become liable to FTT involuntarily. As a result, even for non-EU entities it will be difficult to avoid triggering liability to FTT, which is likely to have an impact on costs.

Though the proposed FTT may be unprecedented in scope and complexity, the experiences of many countries who have adopted securities transaction taxes are plentiful, and the data are quite conclusive. Transaction taxes achieve none of the objectives of their proponents but impose significant harm. Transaction taxes impair liquidity of markets, raise the cost of capital, and reduce economic growth. Further, they fail to reduce market volatility, as proponents claim, and they consistently fail to generate anticipated revenue. The damaging effects of an FTT throughout the FTT zone and via extraterritorial linkages discussed above would likely be substantial at a time that the global economy remains in a fragile state.

7. EU ALTERNATIVE INVESTMENT FUND MANAGERS DIRECTIVE (AIFMD)

The AIFMD creates a harmonised regulatory structure throughout the European Union for all funds which are not currently regulated under EU legislation. AIFMD requires managers of alternative investment funds to seek authorisation or registration, and imposes conduct of business and transparency obligations on those managers. It also creates an EU passport for funds managed by authorised or registered managers, which will replace existing national private placement regimes for such funds over the next few years.

AIFMD came into force on 21 July 2011, and Member States have until 22 July 2013 to transpose the directive into national legislation.

i. Territorial scope of authorisation requirement under AIFMD

AIFMD requires Member States to ensure that no alternative investment fund manager (AIFMD) manages an alternative investment fund (AIF) unless it is authorised in accordance with AIFMD. Article 2 AIFMD states that AIFMD shall apply to:

- EU AIFMs which manage one or more EU or non-EU AIFs;
- Non-EU AIFMs which manage one or more EU AIFs;
- Non-EU AIFMs which market one or more EU or non-EU AIFs in the EU.

Subject to limited transitional provisions, a non-EU AIFM which manages a non-EU AIF and intends to market that AIF to investors in the EU under the AIFMD passport is subject to the same authorisation requirements as an EU AIFM, including capital requirements.

Where compliance with AIFMD is incompatible with compliance with other laws to which a non-EU AIFM is subject, Article 37 AIFMD provides that that non-EU AIFM is not required to comply with the relevant provisions of AIFMD, so long as it can demonstrate that it is impossible to comply with both laws, that the law to which the non-EU AIFM is subject provides for an equivalent rule which has the same regulatory purpose and offers the same level of protection to investors in the relevant AIF, and that the non-EU AIFM complies with that law. However, this will not assist an AIFM which is subject to duplicative (rather than incompatible) obligations.

However, there is no exemption where a non-EU AIFM might be able to comply with both regulation in its home jurisdiction and also under AIFMD. This may lead to a competitive disadvantage in its home jurisdiction for a non-EU AIFM which is required to comply with the capital requirements and conduct of business obligations under AIFMD while other fund managers in its home jurisdiction are subject to less onerous obligations.

ii. Marketing without a passport

The AIFMD passport regime will not be available to non-EU AIFMs immediately. ESMA is required to issue advice in 2018 to the European Parliament, Council and the Commission with regard to the possible termination of the existence of national private placement regimes. If ESMA advises that these regimes should be terminated, the Commission is required to adopt a delegated act within 3 months of ESMA's advice, terminating those regimes. If these regimes are terminated, non-EU AIFMs will only be able to market their AIFs in the EU by obtaining full authorisation and access to the passport under AIFMD. However, ESMA is not obliged to recommend that the national private placement regimes be terminated, so the activation of the passport for non-EU AIFMs may not occur as early as 2018.

Until the non-EU AIFMs are able to obtain authorisation and use the passport under AIFMD, non-EU AIFMs wishing to market their AIFs to investors in the EU will continue to be able to do so in accordance with Member States' existing private placement regimes.

However, they will only be permitted to do so where there are appropriate co-operation arrangements in place between the competent authorities of the Member States where the AIFs are marketed and the supervisory authorities of the third country where the non-EU AIFM is established. The regulators in some jurisdictions are already working on establishing such co-operation arrangements. However, there is no guarantee that such arrangements will be in place by the time AIFMD is set to enter into force in July 2013 and AIFMs may be required to cease marketing to investors in the EU if the supervisory authority in their home jurisdiction has not agreed a co-operation agreement with EU regulators in time.

iii. Becoming subject to other EU regulation

A non-EU AIFM which decides to seek authorisation under AIFMD may also find that it or the funds it manages become subject to other EU regulation by virtue of its status as an authorised AIFM. For example, a non-EU fund managed by a non-EU fund manager which is an AIFM authorised under AIFMD will be a financial counterparty under EMIR, while a non-EU fund whose manager is not authorised under AIFMD will be a third country entity and subject to a much more limited range of obligations under EMIR.

8. REVISED AND RESTATED MARKETS IN FINANCIAL INSTRUMENTS REGULATION AND DIRECTIVE (MiFID 2)

The Markets in Financial Instruments Directive developed a harmonised regime across the European Union for investment firms. The original directive was required to be implemented in Member States by November 2007. Following a review of the original directive, the European Commission has proposed a revised and restated version of the original directive, split across a new directive and regulation. MiFID 2 builds on the original directive, but is intended to update its provisions to reflect recent technological and other developments.

The Commission adopted a legislative proposal for MiFID 2 in October 2011. The European Parliament has reached an agreed position on the text (on 26 October 2012), and the Council is currently in the process of agreeing its proposed amendments with its most recent compromise text published on 21 March 2013. Once the Council has reached its agreed position, the Council and the European Parliament can commence formal negotiations to agree the final text. The text is expected to be finalised later this year, and to come into force / be implemented into the national law of Member States during 2015.

This note provides a high level summary of the position under the Commission's original legislative proposal, and the most recent Council and European Parliament compromise texts. However, as the final text has not yet been agreed the outcome is not yet certain.

i. Impact of MiFID 2 on cross-border business

The Commission's legislative proposal for MiFID 2 proposed the removal of Member States' existing national exemptions for cross-border business, replacing these with a requirement for third country firms to establish a branch in the EU and obtain authorisation before providing services in the EU. A third country firm would still be permitted to provide services on a cross-border basis (i.e., without establishing a branch) to clients classified as eligible counterparties, so long as that third country firm was registered with ESMA.

The European Parliament and Council compromise texts would also require third country firms to establish a branch in the EU and obtain authorisation before providing services to retail clients or clients who have opted up to professional client status. However, the Council text proposes removing the requirement for third country firms to register with ESMA before providing services to other clients. This should permit third country firms to continue to provide cross border services to clients under existing national regimes, except where they are required to establish a local branch in order to provide services to those clients (i.e., where the clients are retail clients or have opted up to professional client status).

Third country firms would still be permitted to provide services to clients in the EU where any service is solicited at the exclusive initiative of the EU client. However, in order to rely on this approach firms need to ensure that they are always able to demonstrate that any business was undertaken at the client's request and was not solicited in any way by the third country firm. While it may be possible to do this for small numbers of clients it is not possible to build a business in this way.

The Commission legislative proposal and Council compromise text contain limited transitional provisions, permitting existing third country firms to continue to provide services in Member States in accordance with national regimes until 4 years after entry into force of MiFID 2. The Parliament compromise text would permit third country firms to continue to provide services through a branch in the EU in accordance with national regimes until one year after that Commission has adopted an equivalence determination in relation to the relevant third country.

These changes will clearly have an impact on Asian banks and investment firms providing investment services to clients or carrying on investment activities with counterparties in the EU on a cross-border basis, particularly if they are required to register with ESMA before continuing to provide services (as required under the original legislative proposal and also under the Parliament compromise text).

The changes are also likely to have an impact on Asian banks and investment firms currently operating in the EU through local branches. These local branches are currently authorised under the national law of the relevant Member State. However, following implementation of MiFID 2 the local branches will need to be authorised in accordance with the conditions set out in MiFID 2. Depending on the approach taken to implementation by the Member States, this may mean that third country firms are required to seek re-authorisation of their EU branches. If they are unable to meet the conditions for authorisation set out in MiFID 2, they will no longer be permitted to provide investment services to clients in the EU.

ii. Equivalence determinations and requirement for reciprocity

The original legislative proposal stated that a third country firm could only establish a branch in the EU if the Commission had adopted an equivalence decision, determining that the legal and supervisory arrangements of the relevant third country are equivalent to those under MiFID, and that the third country provides for equivalent reciprocal recognition of the prudential framework applicable to investment firms authorised under MiFID. The European Parliament compromise text also requires an equivalence determination and for the third country to provide for equivalent reciprocal recognition of investment firms authorised under MiFID.

The Council compromise text does not require an equivalence determination or reciprocity, but does still require other conditions to be met (for example, the firm must be from a jurisdiction which is not on the FATF list of non-cooperative countries, and cooperation arrangements must have been agreed between the supervisory authorities of the relevant third country and the competent authorities of the Member State where the branch is established).

Where a third country firm seeks to register with ESMA to provide cross-border services in the EU, the Commission legislative proposal and the Parliament compromise text both require that the Commission has adopted an equivalence determination in relation to the relevant third country before that firm may register with ESMA.

These requirements for equivalence determinations raise similar issues to those discussed above in relation to EMIR. However, the requirement for reciprocal recognition of investment firms authorised under MiFID raises additional concerns, in part because it is not clear what is intended by reciprocal "recognition". MiFID 2 does not appear to propose that EU branches of third country firms should be exempt from the requirement to comply with prudential regulation under MiFID 2. As a result, it is not clear what form of "recognition" a third country jurisdiction would be required to give to the requirements under MiFID 2, and whether it would be sufficient for a third country to permit EU banks or investment firms to establish branches in the relevant third country or whether some formal statement on equivalence or recognition is required.

iii. Other provisions

Mandatory exchange trading for derivatives: MiFID 2 will introduce requirements for financial counterparties and non-financial counterparties (as defined in EMIR) to enter into specified classes of derivative only on an EU regulated market, multilateral trading facility (**MTF**) or organised trading facility (**OTF**). Counterparties will only be permitted to enter into derivative contracts subject to the mandatory exchange trading obligation on a non-EU exchange where that exchange is located in a third country for which the Commission has adopted an equivalence determination. This raises the same concerns in relation to equivalence and reciprocity set out above.

Position management and product intervention powers: Where ESMA considers it necessary to address a threat to the orderly functioning and integrity of financial markets, and where competent authorities have not taken measures to address the threat, ESMA may take steps to limit the ability of any person to enter into a commodity derivative.

ESMA will also have the power to temporarily prohibit or restrict in the Union the marketing, distribution or sale of certain financial instruments or financial instruments with certain features, or a type of financial activity or practice. Regulators in each Member State will also have the power to introduce similar prohibitions or restrictions in their Member State.

The territorial scope of these powers is unclear, but it appears that ESMA will have the power to impose these restrictions on any person (not just persons established or authorised in the EU), where they are carrying on activities in the EU.