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EMIR – IMPACT FOR CAYMAN FUNDS – UPDATE FOLLOWING ESMA PUBLICATION

Take Care – EMIR Impacts Cayman Funds

In our bulletin of October 2013 we highlighted the impact that EMIR will have on Cayman Funds, explaining briefly what EMIR is and how it will have to be navigated by Cayman Funds trading derivatives both with European Union counterparties, and in certain circumstances, even when trading with non-European Union counterparties.

See October bulletin:

<http://www.dilloneustace.ie/download/1/Publications/Cayman/EMIR%20Impact%20for%20Cayman%20Funds.pdf>

ESMA Publishes Final Draft Technical Standards on the Cross Border Application of EMIR

As mentioned in the October bulletin, EMIR provides that the clearing obligation and the obligations relating to the risk mitigation techniques for non-centrally cleared OTC derivatives may apply to OTC derivative contracts entered into between non-EU counterparties. Where third country entities (“TCE’s”), including Cayman Funds, that would be subject to EMIR if they were established in the EU, enter into OTC derivative contracts, the EMIR

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clearing obligation and the EMIR obligations relating to the risk mitigation will apply both:

- (a) where the contract has a direct, substantial and foreseeable effect within the EU; and
- (b) where such an obligation is necessary or appropriate to prevent the evasion of any provisions of EMIR.

In light of this requirement, the European Securities and Markets Authority (“**ESMA**”) has now published its final draft Regulatory Technical Standards (“**RTS**”) specifying both the contracts that are considered to have a direct, substantial and foreseeable effect within the EU and the cases where it is necessary or appropriate to prevent the evasion of any provision of EMIR.

The RTS will be of particular importance to Cayman Funds as they provide more detail on the application of EMIR to transactions between non-EU counterparties with a direct, substantial and foreseeable effect with in the Union and in relation to non-evasion.

The RTS can be found here:

<http://www.esma.europa.eu/content/Draft-technical-standards-under-EMIR-contracts-direct-substantial-and-foreseeable-effect-wit>

Contracts that are Considered to have a Direct, Substantial and Foreseeable Effect Within the EU

The RTS clarify that an OTC derivative contract shall be considered as having a direct, substantial and foreseeable effect within the Union when “at least one third country counterparty benefits from a guaranteeⁱ provided by a financial counterpartyⁱⁱ established in the Union which covers all or part of its liability resulting from that OTC derivative contract” to the extent that both of the following conditions are met by the guarantee:

- (a) It covers the entire liability of a third country counterparty resulting from one or more OTC derivative contracts for an aggregated notional amount of at least EUR 8 billionⁱⁱⁱ, or it covers only a part of the liability of a third country counterparty resulting from one or more OTC derivative contracts for an aggregated notional amount of at least EUR 8 billion^{iv}, divided by the percentage of the liability covered; and
- (b) It is at least equal to 5 per cent of current exposures in OTC derivative contracts of the financial counterparty established in the EU issuing the guarantee.

The RTS also clarify that OTC derivative contracts for an aggregate notional amount of at least EUR 8 billion or the equivalent amount in the relevant foreign currency concluded before a guarantee is issued or increased, and subsequently covered by a guarantee that meets the

conditions set out in (a) and (b) above, shall be considered as having a direct, substantial and foreseeable effect within the Union.

Cases Where It is Necessary or Appropriate to Prevent the Evasion of Rules or Obligations Provided for in EMIR

In accordance with the RTS, an OTC derivative contract will be deemed to have been designed to circumvent the application of EMIR if the way in which it has been concluded is considered, when viewed as a whole, to have as its primary purpose the avoidance of the application of any provision of EMIR.

An OTC derivative contract will be considered as having for primary purpose the avoidance of any provision of EMIR if the primary purpose of an arrangement related to the contract is to defeat the “object, spirit and purpose of” any provision of EMIR that would otherwise apply including when it is part of an artificial arrangement or artificial series of arrangements. An arrangement that intrinsically lacks business rationale, commercial substance or relevant economic justification and consists of any contract, transaction, scheme, action, operation, agreement, grant, understanding, promise, undertaking or event shall be considered an artificial arrangement.

Implementation of Final Draft Technical Standards on the Cross Border Application of EMIR

The final draft RTS were submitted to the European Commission on 15 November 2013 who have three months to decide whether to endorse ESMA’s draft regulatory technical standards. Assuming no further changes, the RTS will enter into force on the twentieth day following that of its publication in the Official Journal of the European Union.

The provision of the RTS containing detail on which contracts are considered to have a “direct, substantial and foreseeable effect with the EU” will apply six months after the date of entry into force of the RTS. The provision of the RTS containing detail on case where it is necessary or appropriate to prevent the evasion of rules or obligations provided for in EMIR will come into force with the main RTS.

How Dillon Eustace Can Help

Leveraging off its European team, Dillon Eustace Cayman offers a unique perspective for its Cayman clients on EMIR.

Dillon Eustace will keep its clients and contacts up to date on EMIR developments and how they will affect Cayman funds as the consultation process is finalised. Please don’t hesitate to contact Derbhil O’Riordan or Matt Mulry with any queries you might have on this or other legislative

developments, Cayman, European or otherwise, where you have any concerns on the impact on your Cayman funds^v.

ⁱ A guarantee is defined in the RTS as “an explicitly documented legal obligation by a guarantor to cover payments of the amounts due or that may become due pursuant to the OTC derivative contracts covered by that guarantee and entered into by the guaranteed entity to the beneficiary where there is a default as defined in the guarantee or where no payment has been effected by the guaranteed entity”.

ⁱⁱ The term financial counterparty is broadly defined in EMIR as a person *authorised under one of the EU’s financial services directives*, thereby excluding Cayman Funds.

ⁱⁱⁱ Or currency equivalent.

^{iv} Or currency equivalent.

^v Further publications on EMIR can be found at:

<http://www.dilloneustace.ie/download/1/EMIR%20-%20Key%20Points%20and%20Dates.pdf>

<http://www.dilloneustace.ie/download/1/EMIR%20-%20Update%20and%20Next%20Steps.pdf> .

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