EMIR and its extraterritorial applicability


LAW (EUROPE)

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European legislation can often impact Islamic financial institutions, irrespective of whether or not they operate in the EU. The European Market Infrastructure Regulation (EMIR) is one such piece of legislation which Islamic financial institutions should be particularly aware of.

EMIR obliges certain market participants to centrally clear over-the-counter derivative contracts (OTC contracts), which may, depending on their terms, also include Shariah compliant derivatives, or to apply risk mitigation techniques with respect to OTC contracts.

These obligations can extend to OTC contracts where both counterparties are established outside the EU if:

- the OTC contract has 'a direct, substantial and foreseeable effect' within the EU, or
- it is 'necessary or appropriate' to prevent the evasion of any provisions of the EMIR.

These obligations only attach to third country entities (TCEs) that would be subject to the relevant obligation if established in the EU. The extent to which these obligations apply to a TCE will depend on its status under the EMIR.

If at least one of the counterparties to an OTC contract is established in a jurisdiction declared by the EU Commission as equivalent, the provisions of the EMIR could be misapplied. Only TCEs located in non-equivalent jurisdictions would need to ensure compliance with the EMIR.

Applicable rules

The EMIR provides that an OTC contract will have a 'direct, substantial and foreseeable effect' within the EU if:

- at least one TCE has (with respect to such an OTC contract) the benefit of a guarantee provided by an EU guarantor who is a financial counterparty (FC). Such guarantee must:

  1) cover the liability under one or more contracts for an aggregated notional amount of at least GBP8 billion (US$9.77 billion), and

  2) be at least equal to 5% of the EU guarantor's total 'current exposures' under OTC contracts.

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- The liability that arises from these OTC contracts must itself at least reach the threshold. If not, such OTC contracts would not be considered to have a 'direct, substantial and foreseeable effect' within the EU even where both the aforementioned thresholds are met. Both thresholds are assessed at the time such an OTC contract is entered into and on an ongoing basis, and

- it has been entered into by two TCEs through their branches located in the EU and these TCEs would be FCs if established in the EU.

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Indirect impact

The EMIR also 'bites' where a TCE is transacting with an EU counterparty. The clearing obligation applies with respect to OTC contracts between an EU counterparty (which is an FC or an NFC+) and a TCE which would be subject to this obligation if it were established in the EU.

There is no such express provision under the EMIR with respect to the risk mitigation obligation. However, TCEs will be required by their EU counterparties to agree with arrangements ensuring compliance with the EMIR.

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