

# Assessing the Impact of the Extraterritorial Provisions of the European Markets Infrastructure Regulation (EMIR) on Emerging Economies' OTC Derivatives Markets: A Doctrine of Proportionality Perspective Challenges and Unresolved Issues

By  
Jeremmy Okonjo\*

## ABSTRACT

*The enactment of extraterritorial national legislation has traditionally elicited debate on its legitimacy, efficacy and enforceability. Since the 2007-2009 global financial crisis, some legislative jurisdictions, including the EU and the US, have increasingly enacted extraterritorial financial markets regulations to contain global systemic risk. More specifically, in response to the G20 Council of Ministers' resolve to reform national and international over-the-counter (OTC) derivatives markets regulations, the EU has enacted the European Market Infrastructure Regulations (EMIR), which seeks to contain systemic risk, counterparty risk, and make the OTC derivatives markets more transparent. EMIR is extraterritorial to the extent that it imposes obligations on non- EU (third country) contract counter-parties, central counterparties (CCPs), trade repositories, and OTC derivatives market regulators.*

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\* Jeremmy Okonjo is a practicing Advocate of the High Court of Kenya and a Partner at Mwangambo & Okonjo Advocates (Kenya). He is currently a PhD Law Candidate at Kent Law School, and holds an LLM in International Banking and Finance Law (2014) from University College London, an LLM in Law, Governance and Democracy (2013) from the University of Nairobi, and an LLB (2008) from the University of Nairobi. Mr Okonjo's current practice and research interests include International Banking and Finance Law, derivatives law and regulation, constitutional and election law, and technology law. Mr Okonjo also teaches Public Law seminars at Kent Law School.

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*The extraterritoriality of EMIR, alongside the US enactment of the US Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), has drawn contradictory commentaries. EU policy makers and legislators justify extraterritoriality on the basis of the need to protect EU derivatives markets from systemic risk and regulatory arbitrage. On the other hand, third country derivatives markets regulators, policy makers and market players, especially in emerging markets, argue that EMIR will have adverse effects on the stability and development of their derivatives markets.*

*This paper explores three closely-related research questions. First, what is the regulatory logic and methodology of EMIR's extraterritorial provisions? Secondly, is the regulatory impact of these provisions proportionate as against third country emerging markets? Lastly, how can extraterritorial financial legislation by the EU be adapted to ensure both financial stability and the development of OTC derivatives markets in emerging economies? In exploring the above questions, this paper examines the extraterritorial provisions of EMIR from the perspective of the international law doctrine of proportionality.*

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## I. INTRODUCTION

The enactment of extraterritorial national legislation has traditionally elicited debate on its legitimacy, efficacy and enforceability.<sup>1</sup> Since the 2007-2009 global financial crisis, some legislative jurisdictions, including the EU and the US, have increasingly enacted extraterritorial financial markets regulations to contain global systemic risk.<sup>2</sup> More specifically, in response to the G20 Council of Ministers' resolve to reform national and international over-the-counter (OTC) derivatives markets regulations, the EU has enacted the European Market Infrastructure Regulations (EMIR), which seeks to contain systemic risk, counterparty risk, and make the OTC derivatives markets more transparent.<sup>3</sup> EMIR is extraterritorial to the extent that it imposes obligations on non- EU (third country) contract counter-parties, central counterparties (CCPs), trade repositories, and OTC derivatives market regulators.<sup>4</sup>

The extraterritoriality of EMIR, alongside the US enactment of the US Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), has drawn contradictory commentaries.<sup>5</sup> EU policy makers and legislators justify extraterritoriality on the basis of the need to protect EU derivatives markets from systemic risk and regulatory arbitrage.<sup>6</sup> On the other hand, third country derivatives

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- 1 Kenneth W Dam, 'Extraterritoriality and Conflicts of Jurisdiction' (1983) 77 *American Society of International Law Proceedings* 370; Karl Matthias Meessen, *Extraterritorial Jurisdiction in Theory and Practice* (Martinus Nijhoff Publishers 1996).
  - 2 CH Dallara, 'Containing Extraterritoriality to Promote Financial Stability' [2013] *Financial Stability Review* 47; Jan D Lüttringhaus, 'Regulating Over-The-Counter Derivatives In The European Union-Transatlantic (Dis) Harmony After Emir And Dodd-Frank: The Impact On (Re) Insurance Companies And Occupational Pension Funds' (2012) 18 *Colum. J. Eur. L.* Online 19..
  - 3 Council Regulation (EU) No 648/2012 of the European Parliament and of the Council on OTC derivatives, central counterparties, and trade repositories of 4 July 2012, O.J. 2012 L 201/1 (hereafter "EMIR").
  - 4 *Ibid*; Dallara (n 2).
  - 5 Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub.L. 111-203, H.R. 4173 (hereafter "the Dodd-Frank Act"); Lüttringhaus (n 2).
  - 6 European Commission, 'Impact Assessment Accompanying Document to the Proposal for a Regulation of the European Parliament and of the Council on OTC Derivatives, Central Counterparties, and Trade Repositories' (European Commission) Staff Working Document COM (2010) 484; European Commission, 'Commission Staff Working Paper Accompanying the Commission Communication - Ensuring Efficient, Safe and Sound Derivatives Markets' (European Commission 2009) Staff Working Paper COM (2009) 332 final.

markets regulators, policy makers and market players, especially in emerging markets<sup>7</sup>, argue that EMIR will have adverse effects on the stability and development of their derivatives markets.<sup>8</sup>

This paper explores three closely-related research questions. First, what is the regulatory logic and methodology of EMIR's extraterritorial provisions? Secondly, is the regulatory impact of these provisions proportionate as against third country emerging markets? Lastly, how can extraterritorial financial legislation by the EU be adapted to ensure both financial stability and the development of OTC derivatives markets in emerging economies? In exploring the above questions, this paper examines the extraterritorial provisions of EMIR from the perspective of the international law doctrine of proportionality.<sup>9</sup>

## II. THE ROLE OF OTC DERIVATIVES IN THE 2007-2009 GLOBAL FINANCIAL CRISIS AND THE REGULATORY REFORM AGENDA

Derivatives are financial instruments which derive their value from the price of an underlying asset or market variable.<sup>10</sup> They include forwards, futures, options swaps, and can take form as various asset classes, such as equity, interest rate, foreign exchange, credit, equity, and commodity derivatives.<sup>11</sup> These instruments are used by various transaction counterparties, including financial firms, investors,

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7 This paper uses the terms "emerging markets", "emerging economies" and "emerging market economies" interchangeably, for phonetic rather than conceptual reasons.

8 See generally, Eswar Prasad, 'Financial Sector Regulation and Reforms in Emerging Markets: An Overview' in Eswar Prasad and Masahiro Kawai (eds), *Financial Market Regulation and Reforms in Emerging Markets* (Brookings Institution 2011)..

9 The paper relies on Vranes' conception of the doctrine of proportionality, as outlined in Erich Vranes, *Trade and the Environment* (Oxford University Press 2009).

10 Robert W Kolb and James A Overdahl, *Financial Derivatives* (3rd ed, John Wiley 2003); Dick Bryan and Michael Rafferty, *Capitalism with Derivatives: A Political Economy of Financial Derivatives, Capital and Class* (Palgrave Macmillan 2006); Ahmad Ali Ghouri, 'The Law and Regulation of OTC Derivatives: An Anglo-American Comparison and Lessons for Developing Countries' (Social Science Research Network 2010) SSRN Scholarly Paper ID 1968319; Lynn A Stout, 'Derivatives and the Legal Origin of the 2008 Credit Crisis' (2011) 1 Harvard business law review 1.

11 *Ibid*; Alan N Rechtschaffen, *Capital Markets, Derivatives and the Law* (Oxford University Press 2009).

farmers and corporates, for hedging risks against, speculating on, and arbitraging in, changes in prices, rates, indices, or events such as credit defaults.<sup>12</sup>

Derivatives also play an integral role in the wider global and national economies, including price discovery, risk pricing, and liquidity provision.<sup>13</sup> Derivatives are of two types: exchange-traded derivatives, which are standardized contracts listed on securities exchanges and multilateral trading facilities (MTFs), and over-the-counter (OTC) derivatives, which are traded off-exchange.<sup>14</sup> OTC derivatives carry the advantages of being flexible and tailor-made to the needs of contract counterparties.<sup>15</sup>

After the 2008 global financial crisis, various industry, academic and high-level government inquiries, including the US Financial Crisis Inquiry Commission, and the EU De Larosiere High Level Group, concluded that OTC derivatives markets significantly contributed to the financial meltdown.<sup>16</sup> This was due to, at least, four fundamental characteristics of OTC derivatives contracts and their market structures. First, most derivatives contracts were traded bilaterally thereby making them opaque to unexposed third parties and potential liquidity providers who withheld credit support, exacerbating the credit crunch.<sup>17</sup> Secondly, most

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12 *Ibid*; John J Stephens, *Managing Currency Risk: Using Financial Derivatives* (Wiley 2001); Kolb and Overdahl (n 10). However, users have developed creative use of derivatives to achieve other objectives, including circumventing financial regulations such as bank leverage limits, money laundering, and hiding of illicitly acquired wealth. See generally, Dominika Paula Ga<sup>3</sup>kiewicz, 'Similarities and Differences between U.S. and German Regulation of the Use of Derivatives and Leverage by Mutual Funds' 2 <<http://edoc.hu-berlin.de/docviews/abstract.php?id=40940>> accessed 18 June 2015.

13 James K Jackson and Rena S Miller, *Comparing G-20 Reform of the Over-the-Counter Derivatives Markets* (CreateSpace Independent Publishing Platform 2013).

14 *Ibid*.

15 Norman Menachem Feder, 'Deconstructing Over-the-Counter Derivatives' [2002] Colum. Bus. L. Rev. 677, 731.

16 Jackson and Miller (n 13); The de Larosière Group, 'Report of the High Level Group on Financial Supervision in the EU' (European Commission 2009); Janis Sarra, 'Financial Market Destabilization and the Role of Credit Default Swaps: An International Perspective on the SEC's Role Going Forward' (2009) 78 U. Cin. L. Rev. 629; Thorsten V Koepl, C.D. Howe Institute, *Time for Stability in Derivatives Markets a New Look at Central Counterparty Clearing for Securities Markets* (CD Howe Institute 2011).

17 'COM (2009) 332 Final' (n 6) 6; Koepl, C.D. Howe Institute (n 16); Robert P Bartlett, 'Inefficiencies in the Information Thicket: A Case Study of Derivative Disclosures During the Financial Crisis' (Social Science Research Network 2010) SSRN Scholarly Paper ID 1585953 <<http://papers.ssrn.com/abstract=1585953>> accessed 7 May 2015.

counterparty exposures to OTC derivatives markets were non-collateralized, increasing counterparty risk.<sup>18</sup> Thirdly, there was a high level of concentration, and therefore led to concentration of risk, in particular market segments.<sup>19</sup> Lastly, the prices formed in derivatives markets determined the prices of other instruments,<sup>20</sup> thereby increased the contagion risks between market segments.<sup>21</sup>

The inquiries precipitated financial regulatory reforms at the international, regional and national levels.<sup>22</sup> In November 2008, in response to this crisis, the G20 Council of Ministers resolved to reform the OTC derivatives markets regulations. They agreed that:

*“All standardised OTC derivative contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties by end-2012 at the latest. OTC derivative contracts should be reported to trade repositories. Non-centrally cleared contracts should be subject to higher capital requirements.”*<sup>23</sup>

In response to these G20 commitments, various countries, including the EU and the US, embarked on various OTC derivatives regulatory reforms. On August 16, 2012, the EU Parliament enacted EMIR, which seeks to contain systemic risk, counterparty risk, and make the OTC derivatives markets more transparent.<sup>24</sup> EMIR imposes three main obligations on counterparties to derivatives contracts:

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- 18 Jackson and Miller (n 12) 3; Manmohan Singh, *Collateral, Netting and Systemic Risk in the OTC Derivatives Market* (International Monetary Fund 2010); Yuji Sakurai and Yoshihiko Uchida, ‘Rehypothecation Dilemma: Impact of Collateral Rehypothecation on Derivative Prices under Bilateral Counterparty Credit Risk’ (2014) 48 *Journal of Banking & Finance* 361.
- 19 Jackson and Miller (n 13); Adam Tickell, ‘Dangerous Derivatives: Controlling and Creating Risks in International Money’ (2000) 31 *Geoforum* 87.
- 20 *Ibid.*
- 21 ‘COM (2010) 484’ (n 6); ‘COM (2009) 332 Final’ (n 6) 6.
- 22 Financial Stability Board, The World Bank and International Monetary Fund, ‘Identifying the Effects of Regulatory Reforms on Emerging Market and Developing Economies: A Review of Potential Unintended Consequences’ (Financial Stability Board 2012) <[www.financialstabilityboard.org/wp-content/uploads/r\\_120619e.pdf](http://www.financialstabilityboard.org/wp-content/uploads/r_120619e.pdf)> accessed 8 July 2015.
- 23 ‘COM (2009) 332 Final’ (n 6) 6; Eric Helleiner and Stefano Pagliari, ‘Towards a New Bretton Woods? The First G20 Leaders Summit and the Regulation of Global Finance’ (2009) 14 *New Political Economy* 275.
- 24 EMIR (n 3).

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.<sup>25</sup>

More significantly, while the obligations under EMIR apply primarily to EU entities, some of the core provisions will also apply to non-EU entities (third countries) which deal with EU counterparties, or between two non-EU counterparties, where the transaction has a “direct, substantial and foreseeable effect” within the EU, or “where necessary or appropriate to prevent the evasion of EMIR”.<sup>26</sup> This essentially brings all the non-EU OTC derivatives markets, including developed and emerging markets, under EMIR’s jurisdiction.<sup>27</sup>

EMIR’s blanket extraterritoriality has raised concern regarding the negative impacts that the regulation may have on emerging economies’ OTC derivatives market growth and development.<sup>28</sup> This is because of the unique market challenges faced by these markets, such as poor market infrastructure, low liquidity, poor legal and regulatory frameworks, and limited product diversity, which may not have been taken into account by EMIR.<sup>29</sup> This concern necessitates an analysis of EMIR, for a justification of its extraterritoriality, its impact on emerging markets, and how these impacts can be mitigated.<sup>30</sup>

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25 *Ibid.*

26 *Ibid.*; European Securities and Markets Authority, ‘Draft technical standards under EMIR on contracts with a direct, substantial and foreseeable effect within the Union and non-evasion’ Report ESMA 2013/1657 dated 15th November 2013, final <[http://www.esma.europa.eu/system/files/2013-1657\\_final\\_report\\_on\\_emir\\_application\\_to\\_third\\_country\\_entities\\_and\\_non-evasion.pdf](http://www.esma.europa.eu/system/files/2013-1657_final_report_on_emir_application_to_third_country_entities_and_non-evasion.pdf)> accessed 8 August 2014.

27 *Ibid.* The paper uses the term “emerging markets” and “emerging economies” interchangeably, for phonetic rather than conceptual reasons.

28 Prasad (n 8); ‘Identifying the Effects of Regulatory Reforms on Emerging Market and Developing Economies: A Review of Potential Unintended Consequences’ (n 22).

29 Financial Stability Board, The World Bank and International Monetary Fund, ‘Financial Stability Issues in Emerging Market and Developing Economies’ (International Monetary Fund 2011) Report to the G-20 Finance Ministers and Central Bank Governors <[www.imf.org/external/np/g20/pdf/110211.pdf](http://www.imf.org/external/np/g20/pdf/110211.pdf)> accessed 8 July 2015.

30 Edward F Greene and Ilona Potiha, ‘Examining the Extraterritorial Reach of Dodd-Frank’s Volcker Rule and Margin Rules for Uncleared Swaps—a Call for Regulatory Coordination and Cooperation’ (2012) 7 *Capital Markets Law Journal* 271, 316.

Section 3 below lays down the theoretical and juridical framework for extraterritorial legislation in a globalized financial services sector, and then assesses the logic and methodology of EMIR's extraterritoriality with respect to emerging markets.

### III. THE EXTRATERRITORIALITY OF EMIR AND ITS APPLICATION TO OTC DERIVATIVES MARKETS IN EMERGING ECONOMIES

#### 3.1. THEORETICAL AND JURIDICAL FOUNDATIONS OF EU'S EXTRATERRITORIAL LEGISLATION

The justification for extraterritorial OTC derivatives regulations, in regulatory theory, falls under at least two main (and related) theories of regulation: the "public goods" theory<sup>31</sup> and the "tragedy of the commons" theory.<sup>32</sup> The "public goods" theory posits that systemic risk is a "public goods" problem.<sup>33</sup> Financial stability is a public good; it is non-excludable, and does not get exhausted or depleted by over-enjoyment.<sup>34</sup> Therefore, most states will want to free-ride on the benefits of global financial stability, and leave a few states (argued by some as the EU and US taxpayers) to pick up the regulatory costs. Therefore, according to this view, the free-riders must be taxed by way of extraterritorial regulations.<sup>35</sup> The "tragedy of the commons" problem is also seen in the context that the free-riding states fail to assume the costs that they impose on other states when they benefit from regulatory arbitrage, by creating regulatory safe havens.<sup>36</sup>

These two theories are mirrored by the concerns of EU and US regulators, regarding maintenance of systemically stable global financial markets, and the problem of alleged lack of initiative by other jurisdictions, especially non-EU emerging markets which were not as adversely affected (as the US and EU) by the

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31 William H Oakland, 'Theory of Public Goods', *Handbook of Public Economics*, vol 2 (Elsevier 1987).

32 Garrett Hardin, 'The Tragedy of the Commons' (1968) 162 *Science* 1243; Steven L Schwarcz, 'Systemic Risk' (2008) 97 *Georgetown Law Journal*.

33 John C Coffee, 'Extraterritorial Financial Regulation: Why ET Can't Come Home' (2014) 99 *Cornell Law Review* 1259.

34 *Ibid.*

35 *Ibid.*

36 *Ibid.*; Hardin (n 32); Schwarcz (n 32).

2008 global financial crisis, in reforming their financial markets.<sup>37</sup> EU and US regulators have therefore justified their use of extraterritorial OTC derivatives regulations to force regulatory reform on third countries. This is to ensure that EU and US taxpayers alone do not have to, once again, shoulder the burden of future bailouts.<sup>38</sup>

The juridical difficulties of extraterritoriality are best understood against the backdrop of the international law concepts of sovereignty and non-interference.<sup>39</sup> From a legislative perspective, the Treaty of Westphalia<sup>40</sup> and Articles 2(1) and 78 of the UN Charter of the United Nations<sup>41</sup> (hereinafter “UN Charter”) have entrenched sovereignty as a norm of international law, implying that a State has exclusive jurisdiction to exercise legislative authority and enforcement

of laws within its territory.<sup>42</sup> In addition, in the regulatory sphere, international comity requires national and international regulators to respect the jurisdiction of a country’s domestic regulators over its markets. While the State is subject to international law, it is not subject to the national law of another State.<sup>43</sup>

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37 Greene and Potiha (n 30) 272; Coffee (n 33).

38 *Ibid*; Michael Greenberger, ‘The Extraterritorial Provisions of the Dodd-Frank Act Protects U.S. Taxpayers from Worldwide Bailouts’ (2012) 80 University of Maryland Francis King Carey Law Review 965.

39 Auten L Parrish, ‘Reclaiming International Law from Extraterritoriality’ (2008) 93 Minnesota Law Review 815; Douglas E Rosenthal, ‘Jurisdictional Conflicts Between Sovereign Nations’ [1985] *The International Lawyer* 487; Alan Hudson, ‘Beyond the Borders: Globalisation, Sovereignty and Extra territoriality’ (1998) 3 *Geopolitics* 89; Andreas F Lowenfeld, ‘Sovereignty, Jurisdiction, and Reasonableness: A Reply to A. V. Lowe’ (1981) 75 *The American Journal of International Law* 629.

40 Ronald Asch, *The Thirty Years War: The Holy Roman Empire and Europe, 1618-48* (St Martin’s Press 1997).

41 United Nations, *Charter of the United Nations*, 24 October 1945, 1 UNTS XVI, <<http://www.refworld.org/docid/3ae6b3930.html>> accessed 8 August 2014.

42 Joan Fitzpatrick, ‘Sovereignty, Territoriality, and the Rule of Law’ (2001) 25 *Hastings Int’l & Comp. L. Rev.* 303; Greene and Potiha (n 30).

43 Harold G Maier, ‘Interest Balancing and Extraterritorial Jurisdiction’ [1983] *The American Journal of Comparative Law* 579, 594, 585; Harold G Maier, ‘Extraterritorial Jurisdiction at a Crossroads: An Intersection between Public and Private International Law’ (1982) 76 *The American Journal of International Law* 280, 281. However, international comity is not a robust defence against extraterritorial encroachment, as it is not a legal principle, is not binding, and is criticized for its uncertainty of origins, content and method of application. See AV Lowe, ‘Blocking Extraterritorial Jurisdiction: The British Protection of Trading Interests Act, 1980’ (1981) 75 *The American Journal of International Law* 257, 281; Lowenfeld (n 39) 629.

However, a State's sovereignty is not absolute. With the increase in immigration, transnational corporations, global cross-border trade, transnational crime, and borderless information technologies driven by globalization, international law has evolved certain exceptions whereby a State may enact a law and exercise legal jurisdiction over a person or activity outside of its territorial jurisdiction, or within the jurisdiction of another State. Such a law is extraterritorial.<sup>44</sup>

One such judicial exception was first pronounced in 1927 in the *Lotus* case<sup>45</sup> by the Permanent Court of International Justice (PCIJ), which held that international law grants "a wide measure of discretion" to states, to apply national legislation to "persons, properties and acts outside their territory".<sup>46</sup> The Court added that the only limit to its discretion is that it should "not overstep the limits" placed by international law upon its exercise of extraterritorial jurisdiction.<sup>47</sup> Since the PCIJ did not provide any delimiting guidelines on the exercise of the extraterritoriality discretion, its successor, the International Court of Justice, has in subsequent cases, clawed back the wide discretion.<sup>48</sup>

Since *Lotus*,<sup>49</sup> international law has evolved certain principles to guide the exercise of extraterritorial jurisdiction.<sup>50</sup> The most significant principle holds that there

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44 ILC, 'Report of the International Law Commission on the Work of Its 58th Session (1 May-9 June and 3 July-11 August 2006) UN Doc A/61/10' (2006). See generally, Jay Lawrence Westbrook, 'Extraterritoriality, Conflict of Laws, and the Regulation of Transnational Business' (1990) 25 *Tex. Int'l LJ* 71; Franklin A Gevurtz, 'Determining Extraterritoriality' (2014) 56 *William & Mary Law Review* 341.

45 *The Case of the SS 'Lotus' (France v Turkey)* (1927) 1928 PCIJ Rep Ser No 10 18 (Permanent Court of International Justice).

46 *Ibid.*

47 Rosalyn Higgins, President of the ICJ, has argued that this finding was obiter dicta, and that the case did not resolve the question whether there is need to show specific basis for jurisdiction. See Dame Rosalyn Higgins, *Themes and Theories: Selected Essays, Speeches, and Writings in International Law* (Oxford University Press 2009); Olivier De Schutter, 'Sovereignty-plus in the Era of Interdependence: Towards an International Convention on Combating Human Rights Violations by Transnational Corporations' [2010] CRIDHO WP <[http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2448107](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2448107)> accessed 8 May 2015.

48 Tomasz Koziel, 'Extraterritorial Application of EU Environmental Law - Implications of the ECJ's Judgment in *Air Transportation Association of America*' (2012) 19 *The Columbia Journal of European Law*.

49 *The Lotus Case* (n 45).

50 *Ibid.*; Meessen (n 1); De Schutter (n 46).

must be a connection between the regulated entity and the state exercising extraterritorial jurisdiction (enacting State).<sup>51</sup> This connection can be established on the basis of at least 6 principles: objective territoriality; the effects doctrine; the protective principle; nationality; passive nationality; and universal jurisdiction.<sup>52</sup>

These principles are, arguably, increasingly taking the shape of customary international law.<sup>53</sup> This is because they have been adopted by the highest courts in the two jurisdictions that have increasingly made use of extraterritorial legislation, especially in financial services regulation – the European Court of Justice (ECJ) and the US Supreme Court. In addition, third countries are increasingly complying especially with US extraterritorial legislation, with little resistance.<sup>54</sup> In the case of *Air transport Association of America and Others*,<sup>55</sup> the ECJ adopted the effects test to assert the legality of the extraterritorial application of the Emissions Trading Scheme (ETS) Directive to non-EU airlines.<sup>56</sup> Similarly, the US Supreme Court, in *NAB v Morrison*,<sup>57</sup> while rejecting the effects test, introduced the “transactional test” which reflected aspects of the effects doctrine, protective principle, and the concept of objective territoriality.<sup>58</sup>

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51 ‘UN Doc A/61/10’ (n 44) 521.

52 *Ibid*; Koziel (n 47); De Schutter (n 46) 253. For an elaboration of these principles, see ‘UN Doc A/61/10’ (n 44); International Bar Association, *Report of the Task Force on Extraterritorial Jurisdiction* (International Bar Association 2008).

53 *Report of the Task Force on Extraterritorial Jurisdiction* (n 51) 17.

54 *Ibid*; Koziel (n 47) 2521; ‘UN Doc A/61/10’ (n 44) 521.

55 *Case C-366/10, Air Transport Association of America and Others v Secretary of State for Energy and Climate Change* (2011) 49 Common Mark Law Rev 2012 1113 (European Court of Justice).

56 *IBID*. OTHER EARLIER CASES INCLUDE CJEC, *IMPERIAL CHEMICAL INDUSTRIES V. COMMISSION OF THE EUROPEAN COMMUNITY*, CASE 48/69, 14 JULY 1972; *EUROPEMBALLAGE CORP. AND CONTINENTAL CAN CO. V. COMMISSION OF THE EUROPEAN COMMUNITY*, CASE 6/72, 21 FEBRUARY 1973; *ISTITUTO CHEMIOTERAPICO ITALIANO SPA AND COMMERCIAL SOLVENTS CORPORATION V. COMMISSION OF THE EUROPEAN COMMUNITY*, JOINED CASES 6 ET 7/73, 6 MARCH 1974. SEE GENERALLY, DAVID J FEENEY, ‘EUROPEAN COMMISSION’S EXTRATERRITORIAL JURISDICTION OVER CORPORATE MERGERS, THE’ (2002) 19 GEORGIA STATE UNIVERSITY LAW REVIEW 425; JOSEPH JUDE NORTON, ‘EUROPEAN COURT OF JUSTICE JUDGEMENT IN UNITED BRANDS: EXTRATERRITORIAL JURISDICTION AND ABUSE OF DOMINANT POSITION, THE’ (1979) 8 DENV. J. INT’L L. & POL’Y 379.

57 *Morrison v. National Australia. Bank Ltd.*, 130 S. Ct. 2869 (2010)

58 See generally, Dan E Stigall, ‘International Law and Limitations on the Exercise of Extraterritorial Jurisdiction in US Domestic Law’ (2012) 35 Hastings International and Comparative Law Review 323; Greene and Potiha (n 30).

The presence of extraterritorial jurisdiction, however, does not necessarily mean that an enacting State can legitimately and validly assert extraterritorial jurisdiction.<sup>59</sup> Extraterritorial legitimacy and validity depends on how it measures up to various principles proposed by international, regional and national courts, international law jurists, and soft law.<sup>60</sup> These include the closely-related principles of proportionality, reasonableness, balancing, *abus de droit*, international comity, and subsidiarity<sup>61</sup>. Expectedly, there are varied formulations and expectations of these principles. However, the common thread that runs through them is that, since extraterritorial legislation such as EMIR distributes varying costs and benefits to the enacting State, and third countries, the enacting state has a duty to measure and balance its interests against third countries' interests.<sup>62</sup>

The above principles of legitimating extraterritoriality, it has been argued, are entrenched by various sources of international law. The doctrines of proportionality and balancing have been recognized in resolutions of the International Law Institute (ILI),<sup>63</sup> general principles of national and international law,<sup>64</sup> international customary law,<sup>65</sup> international treaties<sup>66</sup> and decisions of the ICJ.<sup>67</sup> However, critics contend that it is not clear whether these doctrines are principles or rules of international law, and what the elements of the doctrines

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59 *Report of the Task Force on Extraterritorial Jurisdiction* (n 51) 50; 'UN Doc A/61/10' (n 44) 529.

60 *Ibid*; Vranes (n 9) 95.

61 *Ibid* 295; *Report of the Task Force on Extraterritorial Jurisdiction* (n 51) 6; 'UN Doc A/61/10' (n 44) 529. See also, generally, Cedric Ryngaert, *Jurisdiction in International Law* (Oxford University Press 2015) 146; Friedl Weiss, Erik MG Denters and Paul JIM de Waart, *International Economic Law With a Human Face* (Martinus Nijhoff Publishers 1998) 175; Alina Kaczorowska, *Public International Law 4/e* (Routledge 2010) 350.

62 Vranes (n 9) 95.

63 International Law Institute, 'Draft Resolution of the International Law Institute' in *65 Yearbook of the Institute of International Law*, (1993).

64 M Hilf and S Puth, 'The Principle of Proportionality on Its Way into WTO/GATT Law' in Arnim von Bogdandy, Petros C Mavroidis and Yves Mény (eds), *European integration and international co-ordination: Studies in transnational economic law in honour of Claus-Dieter Ehlermann* (Kluwer Law International 2002), cited in Vranes (n 9) 95.

65 *Ibid*.

66 *Ibid*.

67 Vranes (n 9) 95.

are.<sup>68</sup> They argue that this makes it difficult to justify these doctrines as international law.<sup>69</sup> However, a review of the sources of these doctrines reveals an emerging pattern of understanding and assertion of the doctrines.

Vranes (2009) argues that the above doctrines can more or less fall under an umbrella doctrine of proportionality. He adapts the “three-tier test” emanating from legal theory, and EU and German judicial jurisprudence, comprising of the concepts of suitability, necessity and balancing, to constitute the umbrella doctrine of proportionality.<sup>70</sup>

According to Vranes, extraterritorial legislation must, first, be *suitable* to promote or achieve the regulatory goal. If the regulatory policy option is in fact unsuitable for achieving the desired goal, extraterritoriality cannot be justified.<sup>71</sup> In addition, the extraterritorial regulatory measures must be *necessary* to achieve the regulatory goal. Where a less arduous alternative regulatory policy can be adopted, the requirement of necessity is negated.<sup>72</sup> Thirdly, the benefits of the extraterritoriality of the legislation to the third country must be fairly balanced against the cost of the extraterritoriality to the state whose jurisdiction is encroached. Where the costs exceed the benefits to the third country, extraterritoriality is illegitimated.<sup>73</sup> The enacting state therefore has a duty to ensure that the extraterritorial legislation satisfies the three-tier proportionality doctrine.<sup>74</sup>

Vranes’ doctrine of proportionality is susceptible to various criticisms, including that it is subjective, and difficult to measure, especially in relation to the interests of States.<sup>75</sup> Nevertheless, it offers a neater legal theory from which related juridical

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68 FA Mann, *The Doctrine of International Jurisdiction Revisited after Twenty Years* (M Nijhoff 1985) 116. cited in Vranes (n 9) 95.; Ryngaert (n 60); Karl M Meessen, ‘Antitrust Jurisdiction under Customary International Law’ (1984) 78 *The American Journal of International Law* 783.

69 Jacques HJ Bourgeois, ‘EEC Control over International Mergers’ (1990) 10 *Yearbook of European Law* 103, 127; Meessen (n 67).

70 Vranes (n 9) 95.

71 *Ibid.*

72 *Ibid.*

73 *Ibid.*

74 *Ibid.*

75 *Ibid.*

and theoretical pronouncements of valid assertion of extraterritorial legislation can begin to be packaged by international and national courts, policy makers, regulators and industry groups.

This paper adopts Vranes' doctrine of proportionality as the conceptual framework for examining the extraterritorial provisions of EMIR, their impact on emerging economies' OTC derivatives markets, and whether or not they impede the development of stable OTC derivatives markets. Section 3.2 below examines the effectiveness of EMIR in increasing transparency and ensuring financial stability in third country (emerging economies') OTC derivatives markets

### 3.2. EXAMINING THE EXTENT OF EXTRATERRITORIALITY OF EMIR

EMIR imposes three main obligations on EU and non-EU counterparties to derivatives contracts: a mandatory CCP 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.<sup>76</sup> It also imposes certain registration, compliance, and conduct of business obligations on non-EU CCPs and trade repositories that wish to provide clearing and reporting services, respectively, to EU entities, and third country branches of EU entities.<sup>77</sup> EMIR also provides for certain equivalence provisions that third country regulators need to comply with, for the CCPs and trade repositories in their jurisdictions to be recognized under EMIR and be allowed to provide regulatory compliance services to counterparties under the regulation.<sup>78</sup>

The extent of EMIR's application to counterparties is determined by whether a counterparty is established in the EU, whether it is a Financial Counterparty (FC), or a Non-financial Counterparty (NFC), and, if it is an NFC, whether the amount of its derivative trade exceed a designated financial threshold.<sup>79</sup> NFCs with trading volume of over £1 billion in gross notional value for OTC equity

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<sup>76</sup> Articles 4(1), 9, and 11 of EMIR (n 3).

<sup>77</sup> Articles 25 and 77 of EMIR (n 3).

<sup>78</sup> Article 13(2) of EMIR (n 3).

<sup>79</sup> Article 2 of EMIR (n 3).

and credit derivatives, or £ 3 billion in gross notional value for foreign exchange, interest rate and commodities derivatives are classified as “NFC + Counterparties”.<sup>80</sup>

This section examines the logic and methodology of EMIR’s extraterritorial obligations. This includes: reporting, clearing and risk mitigation obligations vested on third country counterparties, registration and compliance obligations of third country CCPs and trade repositories, and equivalence provisions for third country regulators.

### 3.2.1. APPLICATION OF EMIR REPORTING OBLIGATIONS TO THIRD COUNTRY EMERGING MARKET COUNTERPARTIES

In financial regulation, the Efficient Capital Markets Hypothesis (ECMH) holds that financial markets are information-efficient. This means that the capital markets are extremely efficient in reflecting incorporating and reflecting new information about securities and markets, in their respective prices.<sup>81</sup> Hence, markets with information asymmetry are considered to be un-optimally priced.<sup>82</sup> Consequently, the ECMH has provided the strongest regulatory rationale for not only market-based economic models, but also information disclosure regulations for augmenting market efficiency.<sup>83</sup>

However, since originally posited by Eugene Fama in 1970, the ECMH has faced a lot of critique: behavioural economists describe markets as irrational, and driven by fear and greed<sup>84</sup>; others blame the ECMH for the formation of the real estate

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80 *Ibid.*

81 Eugene F Fama, ‘Efficient Capital Markets: A Review of Theory and Empirical Work’ (1970) 25 *The Journal of Finance* 383; Eugene F Fama, ‘Efficient Capital Markets: II’ (1991) 46 *The Journal of Finance* 1575.

82 *Ibid.*

83 Ronald J Gilson and Reinier H Kraakman, ‘Mechanisms of Market Efficiency, The’ (1984) 70 *Virginia Law Review* 549; Ronald J Gilson and Reinier Kraakman, ‘Mechanisms of Market Efficiency Twenty Years Later: The Hindsight Bias, The’ (2002) 28 *J. Corp. L.* 715; Ronald J Gilson and Reinier Kraakman, ‘Market Efficiency after the Financial Crisis: It’s Still a Matter of Information Costs’.

84 Andrew W Lo, ‘Reconciling Efficient Markets with Behavioral Finance: The Adaptive Markets Hypothesis’ (Social Science Research Network 2005) SSRN Scholarly Paper ID 1702447; Lawrence A Cunningham, ‘From Random Walks to Chaotic Crashes: The Linear Genealogy of the Efficient Capital Market Hypothesis’ (1993) 62 *George Washington Law Review* 546; Frank Shostak, ‘In Defense of Fundamental Analysis: A Critique of the Efficient Market Hypothesis’ (1997) 10 *The Review of Austrian Economics* 27.

and stock market bubbles<sup>85</sup>; yet others argue that the increasingly automated markets such as algorithmic-driven, high-frequency trading, do not operate on information disclosure.<sup>86</sup> Most especially, the failure of the sub-prime mortgage markets to detect the inherent systemic risks prior to the global financial crisis, despite the litany of US, EU and other jurisdictions' disclosure regulations, pointed to the weaknesses of the ECMH.<sup>87</sup> Nonetheless, despite these criticisms, the ECMH has continued to provide the regulatory rationale for market-based economic models, and also information disclosure regulations for augmenting market efficiency.<sup>88</sup> Corporate and securities disclosure regulations have therefore been considered by regulators as a critical element for efficient capital markets, and consequently, critical to the OTC derivatives markets.<sup>89</sup>

The global OTC derivatives markets are largely opaque, exacerbating counterparty risk.<sup>90</sup> Since OTC derivatives contracts are privately negotiated, information on the terms of the contract, and the extent of exposure of the counterparties, is available only to the counterparties.<sup>91</sup> This has certain negative implications on risk management.

First, regulators are unable to assess risk profiles of market segments, regulated firms, and counterparties, impairing their ability to detect systemic risk issues

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85 Joseph Atangan Tanega, 'Some Principles of Disclosure for Asset Backed Securities Under the EU Prospectus Regulation 2004' (Social Science Research Network 2008) SSRN Scholarly Paper ID 1150157; Ray Ball, 'The Global Financial Crisis and the Efficient Market Hypothesis: What Have We Learned?' (2009) 21 *Journal of Applied Corporate Finance* 8.

86 Henry TC Hu, 'Efficient Markets and the Law: A Predictable Past and an Uncertain Future' (Social Science Research Network 2012) SSRN Scholarly Paper ID 2144432; Yesha Yadav, 'Beyond Efficiency in Securities Regulation' [2014] *Vanderbilt Law and Economics Research Paper*.

87 Tanega (n 84).

88 Gilson and Kraakman, 'Market Efficiency after the Financial Crisis' (n 82); Ball (n 84); Lo (n 83).

89 Tanega (n 84); Donald C Langevoort, 'Theories, Assumptions, and Securities Regulation: Market Efficiency Revisited' (1992) 140 *University of Pennsylvania Law Review* 851; Paul M Healy and Krishna G Palepu, 'Information Asymmetry, Corporate Disclosure, and the Capital Markets: A Review of the Empirical Disclosure Literature' (2001) 31 *Journal of accounting and economics* 405.

90 Jackson and Miller (n 13) 12; Koepl, C.D. Howe Institute (n 16); Bartlett (n 17).

91 *Ibid*; 'COM (2009) 332 Final' (n 6) 15.

and apply regulatory responses.<sup>92</sup> The failure of Lehman Brothers is a classic case.<sup>93</sup> Secondly, counterparties are unable to assess the accurate exposure of their counterparties, and therefore do not contract based on true credit worthiness or risk exposure.<sup>94</sup> This results in less collateral being set aside to secure exposure.<sup>95</sup> In addition, in distressed markets, liquidity providers are reluctant to provide credit to counterparties whose credit exposure is unknown.<sup>96</sup> It is this scenario that unfolded in the case of American International Group (AIG), the seller of Credit Default Swaps (CDSs), which, unknown to the market, was over-exposed to the US sub-prime mortgage market.<sup>97</sup>

After the 2007 global financial crisis, mandatory reporting obligations emerged as a significant pillar of the efforts to increase the transparency of the OTC derivatives market.<sup>98</sup> Article 9 of EMIR requires EU Counterparties transacting with either EU or non-EU Counterparties to report details of any derivatives contracts “concluded, modified or terminated”, to a trade repository registered or recognized under EMIR.<sup>99</sup> The details include the parties to, and the main characteristics of, the derivatives contracts.

Whereas the reporting obligations do not apply to non-EU Counterparties, they are indirectly bound by the obligations when they transact with EU Counterparties.<sup>100</sup> This is because the EU Counterparties request for the outlined information, in order to comply with their reporting obligations. Non-EU entities will have to comply with the reporting obligations if they are to continue transacting with EU Counterparties, regardless of the illegality of the reporting exercise under the respective third country’s data protection and confidentiality laws.<sup>101</sup>

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92 ‘COM (2010) 484’ (n 6) 15.

93 *Ibid.*

94 *Ibid.*

95 Jackson and Miller (n 13) 3.

96 *Ibid.*; ‘COM (2009) 332 Final’ (n 6) 6.

97 Coffee (n 33) 6, 7.

98 ‘COM (2010) 484’ (n 6) 15.

99 Article 9 of EMIR (n 3).

100 *Ibid.*

101 *Ibid.*

Most emerging market regulators agree that trade reporting will increase market transparency, but caution that trade repositories and related infrastructure should only be mandated if “economically affordable and functionally useful”.<sup>102</sup> Based on emerging markets’ limited involvement in the global, US and EU Credit Default Swaps (CDS) OTC derivatives markets, which fuelled the crisis, and poor infrastructure and liquidity problems, implementation of reporting obligations in their markets may not have any immediate benefits for the stability of EU markets.<sup>103</sup> However, it will certainly constrain emerging markets, as discussed in section 4 below.<sup>104</sup>

### 3.2.2. APPLICATION OF EMIR CCP CLEARING OBLIGATIONS TO THIRD COUNTRY COUNTERPARTIES FROM EMERGING MARKET

In OTC markets, counterparty risk is mitigated through, among other mechanisms, bilateral clearing or CCP clearing.<sup>105</sup> According to the International Swaps and Derivatives Association (ISDA) 2010 Margin Survey, about 70% of OTC derivatives transactions were cleared bilaterally.<sup>106</sup> This entails the counterparties entering a Master Confirmation Agreement which provides for how the counterparties manage their respective credit exposures, including through exchange of collateral, which varies based on varying credit exposures.<sup>107</sup>

However, bilateral clearing is costly and time-consuming to small dealers, due to daily valuation and re-collateralization requirements. It is also fraught with valuation methodology disputes that delay collateralization. In addition, on average, collateral covers only about 66% of credit exposure.<sup>108</sup> Lastly, it is costly and

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102 IOSCO Emerging Markets Committee, ‘OTC Markets and Derivatives Trading in Emerging Markets’ (International Organization of Securities Commissions 2010) FR07/10 <<http://www.iosco.org/library/pubdocs/pdf/IOSCOPD330.pdf>> accessed 7 August 2015.

103 *Ibid*; ‘The de Larosière Report’ (n 16) 7.

104 See section 4 below.

105 Jon Gregory, *Counterparty Credit Risk and Credit Value Adjustment: A Continuing Challenge for Global Financial Markets* (2nd Edition edition, John Wiley & Sons 2012) 41. Other counterparty risk mitigation techniques include netting, collateral and credit quality monitoring.

106 ISDA, ‘ISDA Margin Survey 2010’ (International Swaps and Derivatives Association) <[http://www.isda.org/c\\_and\\_a/pdf/isda-margin-survey-2010.pdf](http://www.isda.org/c_and_a/pdf/isda-margin-survey-2010.pdf)> accessed 7 August 2015.

107 See generally, Paul Harding, *Mastering the ISDA Master Agreements: A Practical Guide for Negotiation* (3 edition, Financial Times/ Prentice Hall 2010); Gregory (n 104).

108 EU Committee of the House of Lords, *The Future Regulation of Derivatives Market: Is the EU on the Right Track?*, 10th Report of Session 2009-10, Report with Evidence (The Stationery Office 2010).

inefficient to assess credit exposures in a complex web of bilateral counterparty credit exposures. The implication of all these shortcomings is that in distressed markets, when a counterparty receives a margin call, it may not have sufficient liquidity to meet the call, or even borrow, and will therefore default, as was the case with AIG.<sup>109</sup>

The weaknesses of bilateral clearing were exposed in the credit crisis, precipitating calls by national, regional and international regulators for mandatory CCP clearing of OTC derivatives trades.<sup>110</sup> A CCP mitigates the shortcomings of bilateral clearing by netting counterparty exposures multilaterally, and guaranteeing that a counterparty will not default on its contractual obligations.<sup>111</sup> In addition, it provides a framework for mark-to-market valuation, collateralization, daily monitoring of positions, mutualisation of risk, and a default fund.<sup>112</sup> The CCP achieves this function by the legal mechanism of novation, whereby it interposes itself between counterparties to a derivatives contract, thereby becoming the counterparty to both the buyer and seller, separately.<sup>113</sup> In this way, all clearing counterparties have rights and obligations against the CCP, which is then in a position to efficiently value each contract and exposure on a daily basis, and extract additional collateral from the counterparties.<sup>114</sup>

However, the logic and effectiveness of CCP clearing as a solution to counterparty risk has also been questioned. It has been argued that CCPs do not extinguish credit risk; they only reallocate it.<sup>115</sup> In addition, CCPs introduce other risks by

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109 See generally, Phil Angelides and Bill Thomas, others, *The Financial Crisis Inquiry Report: Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States (revised Corrected Copy)* (Government Printing Office 2011).

110 *The Future Regulation of Derivatives Market* (n 107) 82.

111 Kern Alexander and Rahul Dhumale, 'The European Regulation of Central Counterparties: Some International Challenges', *Research Handbook on International Financial Regulation* (Edward Elgar Publishing 2012) 252.

112 *Ibid.*

113 Jiabin Huang, *The Law and Regulation of Central Counterparties* (Bloomsbury Publishing 2010) 75; Christian Chamorro-Courtland, 'Counterparty Substitution in Central Counterparty (CCP) Systems' (Social Science Research Network 2010) SSRN Scholarly Paper ID 1710485 <<http://papers.ssrn.com/abstract=1710485>> accessed 14 June 2015.

114 See generally, Craig Pirrong, *The Economics of Central Clearing: Theory and Practice* (International Swaps and Derivatives Association 2011); Gregory (n 104) 97.

115 Gregory (n 104) 118.

stripping the counterparties of the bilateral incentive to properly price and manage counterparty risk.<sup>116</sup> The regulation of CCPs may create other risks, including a regulatory risk whereby one or a few CCPs are unduly favoured, resulting in sub-optimal outcomes and market instability, and operational risks occasioned by interoperability requirements (discussed further below).<sup>117</sup> Indeed, there are concerns that the concentration of risks in the CCPs, and the increasing trend of CCP mergers across Europe and the US, will recreate “too-big-to-fail” financial institutions, thereby exacerbating systemic risk in the OTC derivatives markets.<sup>118</sup>

Nevertheless, for the functionalities outlined earlier above, EMIR extends CCP requirements to third countries, including emerging markets.<sup>119</sup> Article 4(1) of EMIR requires the clearing of all standardized OTC derivatives contracts between:

- (i) EU Financial Counterparties and/or NFC+ Counterparties;
- (ii) Either an EU financial counterparty or an NFC+ Counterparty and a non-EU Counterparty that would be deemed a Financial Counterparty or an NFC+ if it were established in the EU; and
- (iii) Two non-EU Counterparties that would each be either a Financial Counterparty or an NFC+ Counterparty if they were established in the EU, provided the contract has a “direct, substantial and foreseeable effect” within the EU or if it is necessary or appropriate to prevent the evasion of EMIR.<sup>120</sup>

The Regulatory Technical Standards (RTS) published by ESMA in November 18, 2013, clarifies that a contract has “direct, substantial and foreseeable effect”

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116 Jon Gregory, *Central Counterparties: Mandatory Central Clearing and Initial Margin Requirements for OTC Derivatives* (John Wiley & Sons 2014).

117 David Murphy, *OTC Derivatives: Bilateral Trading and Central Clearing: An Introduction to Regulatory Policy, Market Impact and Systemic Risk* (Palgrave Macmillan 2013) 262. This is significant, since CCPs concentrate counterparty and operational risk, thereby magnifying systemic risk associated with their failure.

118 *Ibid.*

119 *EMIR* (n 3).

120 *Ibid.*

121 ESMA (n 25). The use of the terms “direct, substantial and foreseeable effect” could be deemed as a legislative attempt at ensuring that the extraterritoriality of the provision falls within the effects test discussed in section 3.1 above.

where either of the two conditions are satisfied: either, the contract is guaranteed by an EU Financial Counterparty; or both counterparties are EU branches of respective non-EU entities.<sup>121</sup>

Emerging markets regulators acknowledge the utility of CCP clearing in reducing counterparty credit risk. However, they are concerned that establishing CCPs in small OTC markets will be too costly, and should only be mandated where the benefits exceed the costs.<sup>122</sup> In addition, they warn that it will lead to risk concentration in the CCPs.<sup>123</sup> Another concern is that CCPs are essentially a private law contracting device, and mandating it in legislation will create implementation problems, since the law will have to import the entire corpus of private law of CCP transacting, requiring very detailed and technical regulations.<sup>124</sup> Section 4 below discusses these implications in further detail.

### 3.2.3. APPLICATION OF EMIR RISK MITIGATION REQUIREMENTS TO THIRD COUNTRY EMERGING MARKET COUNTERPARTIES

The earlier discussion above has highlighted the inefficiencies of bilateral clearing and how CCP clearing can mitigate counterparty credit risk that stems from these inefficiencies.<sup>125</sup> By providing for clearing thresholds, EMIR acknowledges that not all OTC derivatives trades can be centrally cleared, and will therefore be vulnerable to counterparty credit risk and operational risk.<sup>126</sup> To mitigate counterparty credit risk in bilaterally cleared contracts, there is need for mandated risk-mitigation measures such as exchange of collateral, since in unregulated trades, the Counterparties sometimes waive the exchange of collateral if the other Counterparty has good credit rating.<sup>127</sup>

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122 'IOSCO Emerging Markets Committee Report FR07/10' (n 101) 33. *See also*, Alexander and Dhumale (n 110) 252.

123 *Ibid.*

124 Joanne P Braithwaite, 'Private Law and the Public Sector's Central Counterparty Prescription for the Derivatives Markets' <[http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1791740](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1791740)> accessed 7 May 2015.

125 See section 3.2.2 above. *See also*, 'COM (2009) 332 Final' (n 6).

126 Recital 24 of EMIR (n 3). *See generally*, Che Sidanius and Anne Wetheril, 'Thoughts on Determining Central Clearing Eligibility of OTC Derivatives'. The authors argue that derivatives contracts should only be eligible for CCP clearing where the contracts are standardized and liquid, and also where the operational aspects of clearing the specific contracts are automated.

127 *Ibid*; Jackson and Miller (n 13) 3.

Another typology of risks - operational risk - in OTC derivatives trades, arises from, among other reasons, inefficient and low levels of standardization in contract specifications and transaction processes.<sup>128</sup> Operational failures limit transparency, and give way to legal risks, credit risks, and other risks. An example is where non-confirmation of trades results in unenforceable contracts, and therefore, Counterparty credit risk.<sup>129</sup> These operational risks can be mitigated by the automation of trade processes, and the standardization of contracts and contract processes and infrastructure.<sup>130</sup> These processes include contract confirmation,<sup>131</sup> valuation,<sup>132</sup> dispute resolution,<sup>133</sup> portfolio reconciliation<sup>134</sup> and portfolio compression.<sup>135</sup>

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128 See Gregory (n 104). The author lists operational risk as “human error (such as trade entry mistakes), failed processes (such as settlement of trades or posting collateral), model risk (inaccurate or badly calibrated models), fraud (such as rogue traders) and legal risk (such as the inability to enforce legal agreements such as those covering netting or collateral terms)”. See also, ‘COM (2010) 484’ (n 6) 484.

129 *Ibid*; Ghouri (n 10).

130 ‘COM (2010) 484’ (n 6) 15.

131 Contract confirmations refers to both the documentation, and the process of reducing into writing, the economic terms of a particular trade agreed orally by dealers over the telephone. Confirmations are concluded within a previously agreed framework of a Master Agreement. See Philip R Wood, *Set-off and Netting, Derivatives, Clearing Systems: V. 4* (2nd Revised edition, Sweet & Maxwell 2007) 252.

132 Valuation refers to the process of determining a contract’s current market value, by averaging the value of similar contracts from various trading venues such as exchanges and trading platforms. This value determines the counterparties’ further trading decisions. Aside from the contracts, the collateral posted by the Counterparties are also valued periodically to determine whether their market value sufficiently covers a party’s credit risk at a particular time. See Khader Shaik, *Managing Derivatives Contracts: A Guide to Derivatives Market Structure, Contract Life Cycle, Operations, and Systems* (Apress 2014) 237.

133 Trade counterparties may dispute contract and collateral valuations, including trade population, trade valuation methodology, and the application of netting rules by either counterparties or valuation agents. The contracts usually make provision for dispute resolution mechanisms in the event of such disputes. See Gregory (n 104).

134 Portfolio reconciliation refers to the process of reconciling the positions between organizations in order to minimize operation risk created by discrepancies between counterparties and other sources. Reconciliation service providers operate platforms on which participants load contracts. The service providers reconcile the positions, and sends the results to participants for confirmation. This process helps reduce collateral mismatches. See Shaik (n 131) 139.

135 Trade compression refers to the process of multilateral netting of various bilateral contracts, without a CCP, and without changing the risk profile, due to redundancies created by certain trades such as unwinds. Dealers with substantial opposite positions terminate off-setting contracts before they expire. In this process, various contract counterparties submit their relevant trades for compression, which are matched according to the counterparty to the trade, and cross-referenced against a trade-reporting warehouse. Some trades are terminated and replaced, and these changes become legally binding. See *ibid*; Gregory (n 104) 55.

Article 11 of EMIR requires uncleared OTC derivatives contracts concluded between the following parties, to be subject to risk mitigation techniques:

- (i) EU Financial Counterparties and/or Non-financial Counterparties; or
- (ii) A non-EU Counterparty and either an EU Financial Counterparty or EU Non-financial Counterparty, where the EU Counterparty is subject to the EMIR risk mitigation techniques obligations; or
- (iii) Two non-EU Counterparties that would each be either a Financial Counterparty or a Non-financial Counterparty if they were established in the EU, provided the contract has a “direct, substantial and foreseeable effect within the EU or otherwise “where necessary or appropriate to prevent the evasion of EMIR”.<sup>136</sup>

The risk mitigation techniques include timely confirmations, portfolio reconciliation and compression, dispute resolution, marking-to-market<sup>137</sup> and marking-to-model,<sup>138</sup> collateralization, increased capital requirements, and reporting of unconfirmed trades.<sup>139</sup> Notably, there has been debate regarding the use of marking-to-market accounting/valuation (or fair value accounting), and how this technique can spread financial crisis, considering its role in the reduction to junk status of financial instruments of many US financial institutions, in the run-up to the 2008 global financial crisis.<sup>140</sup> Since the debate is not settled, it is

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136 Article 11 of EMIR (n 9); ESMA (n 25).

137 Marking-to-market (MtM) refers to the process of calculating or valuing what could be lost in a trade on a particular date, by reference to market movements and funding liquidity, so as to determine the margin call (cash or collateral) required to be made by a counterparty. It is also known as fair value accounting. See Thomas S Coleman, *Quantitative Risk Management: A Practical Guide to Financial Risk* (Wiley 2012) 509; Gregory (n 104) 33.

138 Marking-to-Model refers to the process of pricing trade positions, similarly to Marking-to-Market, but based on internal assumptions or financial models, such as analytically derived expectations of future cash flows, rather than market prices for identical trades/assets. This approach is used for illiquid contracts, or in conditions where markets are illiquid. See generally, Anthony Meder and others, ‘Structured Finance and Mark-to-Model Accounting: A Few Simple Illustrations’ (2011) 25 *Accounting Horizons* 559, 559.

139 Article 11 of EMIR (n 9); ESMA (n 103).

140 See generally, Christian Laux and Christian Leuz, ‘The Crisis of Fair-Value Accounting: Making Sense of the Recent Debate’ (2009) 34 *Accounting, Organizations and Society* 826; Christian Laux and Christian Leuz, ‘Did Fair-Value Accounting Contribute to the Financial Crisis?’ (2010) 24 *Journal of Economic Perspectives* 93; RA Rayman, ‘Fair Value Accounting and the Present Value Fallacy: The Need for an Alternative Conceptual Framework’ (2007) 39 *The British Accounting Review* 211

therefore necessary to examine further the utility of this technique in making OTC derivatives markets safer.

Nevertheless, there seems to be consensus that these standardization and risk mitigation measures would make OTC derivatives markets, including emerging markets, safer. However, the effectiveness of these measures in emerging markets would have to be assessed in context of their level of development.<sup>141</sup> The impact of the risk mitigation obligations on third country emerging economies' derivatives markets has been discussed in detail in Section 4.

#### 3.2.4. APPLICATION OF EMIR ORGANIZATIONAL, CONDUCT OF BUSINESS AND PRUDENTIAL REGULATIONS ON THIRD COUNTRY EMERGING MARKET CCPs

The discussion in section 3.2.2 above has shown how, by virtue of their clearing role, CCPs attain a significant systemic role in the financial sector.<sup>142</sup> In addition, since they attain regulatory status from the legislative requirement for CCP clearing, CCPs also attain a regulatory agency role in the containing of systemic risk in the OTC derivatives sector.<sup>143</sup> This new status magnifies certain regulatory concerns related to CCPs.

First, before EMIR, there was no passporting regime, hence the need for multiple regulatory compliance for cross-border clearing.<sup>144</sup> Secondly, there was no EU-wide competition regulatory framework, undermining efforts at realizing

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141 Prasad (n 8); Ghouri (n 10) 11; 'Identifying the Effects of Regulatory Reforms on Emerging Market and Developing Economies: A Review of Potential Unintended Consequences' (n 22).

142 Murphy (n 116); 'COM (2010) 484' (n 6).

143 This regulatory agency role emerged by virtue of the introduction of regulation mandating CCP clearing. Before EMIR, CCPs were a private market innovation for regulating systemic risk. See generally, Randall S Kroszner, 'Role of Private Regulation in Maintaining Global Financial Stability, The' (1998) 18 *Cato J.* 355; Randall S Kroszner, 'Central Counterparty Clearing: History, Innovation, and Regulation' (Social Science Research Network 2006) SSRN Scholarly Paper ID 948773.

144 The clearing and settlement costs of cross-border transactions across the EU were estimated at between 10-12 times that of domestic transactions. See Huang (n 112) 193. See also, Cynthia Hirata de Carvalho, 'Cross-Border Securities Clearing and Settlement Infrastructure in the European Union as a Prerequisite to Financial Markets Integration/ : Challenges and Perspectives' (Hamburg Institute of International Economics (HWWA) 2004) HWWA Discussion Paper 287; Torsten Schaper, 'Trends in European Clearing and Settlement Industry - The European Code of Conduct and Target2-Securities' (Social Science Research Network 2007) SSRN Scholarly Paper ID 965407.

interconnection and interoperability among CCPs in different EU states.<sup>145</sup> These two factors undermined provision of cross-border clearing services.<sup>146</sup> Thirdly, increased competition in the CCP sector, occasioned by MIFID's promotion of multi-lateral trading facilities (MTFs) has also resulted in a risk-management "race to the bottom", where CCPs have had to compromise high risk management standards in a bid to reduce clearing fees and remain competitive.<sup>147</sup> This exacerbated systemic risk concerns in the OTC derivatives sector. Lastly, the legal and operational framework for CCPs did not provide for the transfer or portability of positions and collateral from a defaulting clearing member to another clearing member.<sup>148</sup> The consequences were that in the event of default by a clearing member, market participants would have to close their positions, and then replace the contract.<sup>149</sup> This process left a counterparty vulnerable to market risk.<sup>150</sup>

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145 Before MiFID, the regulatory lacunae was filled by various voluntary industry standard initiatives: the 2006 European Code of Conduct for Clearing and Settlement, championed by the European Commission; Eurosystem's TARGET2-Securities (T2S); Euroclear Group's Single Settlement Engine (SSE); and Link Up Markets, a joint venture by 9 CSDs. See generally, Ruud Sleenhoff and Carlo de Meijer, 'The European Code of Conduct for Clearing and Settlement: Towards More Interoperability?' (2008) 1 *Journal of Securities Operations & Custody* 271, 271; Torsten Schaper and Michael Chlistalla, 'The Impact of Information Technology on European Post-Trading', *Sustainable e-Business Management* (Springer 2010) 51.

146 Interoperability refers to standard unilateral access between CCPs, which promotes freedom of choice among contract counterparties, and competition between CCPs. This can have the effect of reducing the cost of cross-border clearing services. See generally, Xiaobing Feng and Matthew Pritsker, 'The Structural Comparison of Central Counterparty Interoperability' (2014) 25 *International Journal of Modern Physics C* 1450049.

147 The Market in Financial Instruments Directive (MiFID) was enacted by the EU Parliament in 2004, with the aim of abolishing concentration rules, and increasing competition and consumer protection in investment services. The effect was the promotion of new alternative trading platforms, which rivalled established exchanges and clearing and settlement industry. See Schaper and Chlistalla (n 144) 51; Nadia Linciano, Giovanni Siciliano and Gianfranco Trovatore, 'The Clearing and Settlement Industry: Structure, Competition and Regulatory Issues' [2005] *Competition and Regulatory Issues* (May 2005).

148 Gregory (n 115) 213. The main legal and operational frameworks that ensure efficient porting following a clearing member's default are: identification of positions and margins, transferability of unencumbered margin and positions, and legal segregation of client margin from clearing member's margin.

149 'COM (2010) 484' (n 6). Since then, the Bank for International Settlements and IOSCO have issued regulatory standards known as Principles for Financial Market Infrastructures, outlining necessary legal frameworks for portability. Principle 14 on segregation and portability provides that CCPs should have rules and procedures that effectively protect participants' customers' positions and collateral from the default or insolvency of that participant, ensure establishment of client trust accounts by clearing members, and ensure the portability of positions and collateral of defaulting participants' customers to other clearing members. See Group of Ten and others, *Principles for Financial Market Infrastructures* (Bank for International Settlements 2012) 82.

150 Gregory (n 115).

These regulatory concerns called for regulation of CCPs not only by the EU but also by third country CCPs, so as to ensure a systemically sound CCP clearing framework, and to promote cross-border provision of clearing and other financial services.<sup>151</sup> Article 25 of EMIR prohibits third country CCPs from providing clearing services to clearing members or trading venues established in the EU unless the CCP is recognized by ESMA.<sup>152</sup> Remarkably, this restriction is not limited to OTC derivatives clearing, and in fact covers all clearing services in relation to all financial instruments.<sup>153</sup> In addition, the restriction covers provision of clearing services to non-EU branches of EU entities.<sup>154</sup>

Third country CCPs have to comply with four conditions to be recognized by ESMA.<sup>155</sup> First, the CCP must be authorized in the third country, and subject to effective supervision and enforcement.<sup>156</sup> Secondly, ESMA must have established cooperation arrangements with the respective third country regulator.<sup>157</sup> Thirdly, the CCP must be established or authorized in a third country with equivalent “anti-money laundering and financing of terrorism” laws.<sup>158</sup> Lastly, the EU

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151 de Carvalho (n 143); Linciano, Siciliano and Trovatore (n 146); Schaper (n 143).

152 Article 25 of EMIR (n 3).

153 *Ibid.*

154 *Ibid.*

155 By September 15, 2013, up to 30 third country CCPs had applied for recognition under Article 25 of EMIR. By April 2015, ESMA had recognized only ten third country CCPs established in Australia, Hong Kong, Japan, and Singapore.

156 This requirement is satisfied by the making of an equivalence decision by the European Commission regarding a third country’s regulatory regime.

157 By April 2015, ESMA had entered cooperation arrangements with regulators in 4 countries: Australia, Hong Kong, Japan, and Singapore.

158 The inclusion of anti-money laundering and financing of terrorism (AML-FT) laws as part of the recognition criteria begs the question what this has to do with systemic risk in OTC derivatives. This could point back to the critique of international AML-FT standards as attempts by major international financial centres e.g. in the EU, to ease offshore competitive pressures. See Eleni Tsingou, ‘Global Financial Governance and the Developing Anti-Money Laundering Regime: What Lessons for International Political Economy?’ (2010) 47 *International Politics* 617. Some authors have tried to tie AML-FT agenda to systemic risk, by arguing that financial instability presents opportunities for money laundering. See Navin Beekarry, ‘International Anti-Money Laundering and Combating the Financing of Terrorism Regulatory Strategy: A Critical Analysis of Compliance Determinants in International Law’ (2011) 31 *Northwestern Journal of International Law & Business* 137, 137. However, this still doesn’t make sense in the context of using extraterritorial legislation to make OTC derivatives markets safer, especially considering the Western-oriented discourse on AML-FT that discredits any non-Western banking system e.g. the Hawalla network, as “underground banking”. See Marieke de Goede, ‘Hawala Discourses and the War on Terrorist Finance’ (2003) 21 *Environment and Planning D: Society and Space* 513.

Commission must have made an equivalence decision under article 25(6) declaring that the third country regulatory framework for the CCPs is equivalent to EMIR, the regulatory frameworks for supervision of the CCPs and enforcement are effective, and the third country regulatory framework provides for an effective equivalent system for the recognition of CCPs in third countries.<sup>159</sup>

These conditions are beyond the control of emerging market CCPs (especially in third countries that are not members of the G20), which are, therefore, likely to not fulfil the conditions. This is because the fulfilment of the conditions lies in the hands of the third country legislators, policy makers and regulators, and EC and ESMA.<sup>160</sup> In addition, the equivalence provisions, discussed below, are difficult for third country emerging market regulators to comply with.<sup>161</sup> This means that EU entities may withdraw from third country emerging markets, since they cannot find compliant CCPs to transact with. These consequences have been discussed in further detail in Section 4.

### 3.2.5. APPLICATION OF EMIR DATA PROVISION REQUIREMENTS ON THIRD COUNTRY EMERGING MARKET TRADE REPOSITORIES

Section 3.2.1 above discussed the problem of transparency in erstwhile opaque OTC derivatives markets, and how mandatory reporting mitigates systemic risk.<sup>162</sup>

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159 The increasing use of “equivalence” provisions by the EU has been labelled regulatory imperialism, especially considering the increased regulatory capacity of the EU. See Kristina St Charles, ‘Regulatory Imperialism: The Worldwide Export of European Regulatory Principles on Credit Rating Agencies’ (2010) 19 *Minn. J. Int’l L.* 399; Niamh Moloney, ‘The Legacy Effects of the Financial Crisis on Regulatory Design in the EU’ in Eilís Ferran and others (eds), *The Regulatory Aftermath of the Global Financial Crisis* (Cambridge University Press 2012). In addition, it is also seen as the EU’s effort to maintain international competitiveness against “offshore” financial centres taking advantage of regulatory arbitrage. See Lucia Quaglia, ‘The Politics of “Third Country Equivalence” in Post-Crisis Financial Services Regulation in the European Union’ (2015) 38 *West European Politics* 167, 168.

160 For example, the disagreements between the EU and US regulators regarding the differences between EMIR and Dodd-Frank extraterritorial provisions led to the delay in making of equivalence decisions by ESMA and the EC, leaving CCPs in more than 30 countries in limbo as they awaited resolution of the issues. See generally, Lüttringhaus (n 2).

161 Alexander and Dhumale (n 110) 252.

162 Trade repositories improve trade and market transparency, hence aiding risk assessment and management by market participants. See generally, Christian Noyer, ‘Redesigning OTC Derivatives Markets to Ensure Financial Stability’ [2010] FSR FINANCIAL 10; Bank for International Settlements and International Organization of Securities Commissions (eds), *Report on OTC Derivatives Data Reporting and Aggregation Requirements: Final Report* (Bank for International Settlements 2012).

In addition to the reporting requirement that applies to Counterparties, EMIR also applies certain regulatory compliance obligations to trade repositories.<sup>163</sup>

Before the enactment of EMIR, there were few unregulated trade repositories, including TriOptima and the Warehouse Trust.<sup>164</sup> The problems with the unregulated nature of trade repositories were at least three-fold. First, since the trade repositories were under no legal obligation to provide data requested by regulators, they would only furnish information for regulatory purposes upon compulsion by a court order.<sup>165</sup> This took time and was inefficient in instances where regulators were required to take quick action during a financial crisis.<sup>166</sup>

Secondly, the unregulated warehouses were under no obligation to operate in the best interests of the various parties in the OTC derivatives market such as regulators and market participants, on issues such as data confidentiality, quality and accuracy, reliability, and the bundling of services.<sup>167</sup> Thirdly, since, with the anticipated requirement for trade reporting, the trade repositories would acquire a

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163 Article 77 of EMIR (n 3).

164 Trade repositories, as unregulated market innovations, served the function of receiving and maintaining data on credit derivatives, for purposes of other post-trade processes, including electronic confirmation, portfolio reconciliation, trade compression and multilateral netting. See Gregory (n 104) 56. For example, from 2006, all major dealers voluntarily submitted data on credit derivatives to the Warehouse Trust via an electronic matching and confirmation platform – Deriv/SERV. See Bank for International Settlements and International Organization of Securities Commissions (n 161) 44.

165 COM (2010) 484 (n 6) 15. Article 63 of EMIR now gives ESMA, with the cooperation of a national competent authority, the power to carry out on-site inspections at any business premises or land of a trade repository, except over information or documents subject to legal privilege. For a judicial opinion on the exercise of these powers in the UK, see the UK High Court's judgment in *European Securities and Markets Authority v DTCC Derivatives Repository Limited* [2015] EWHC 1085 (Ch), in which the High Court clarified the process that the European Securities and Markets Authority (ESMA) will need to follow in order to obtain authorisation to carry out an inspection of a trade repository in England.

166 COM (2010) 484 (n 6) 15. For the policy justification for regulator access, see Group of Twenty and others, *Authorities' Access to Trade Repository Data* (Bank For International Settlements/ ; IOSCO 2013).

167 COM (2010) 484 (n 6) 15.

regulatory agency role, there was a need to ensure that their infrastructure embodied safety and integrity.<sup>168</sup>

EMIR therefore seeks to regulate trade repositories to which OTC derivatives trade counterparties report their contracts. Article 77 of EMIR requires that third country trade repositories providing regulatory reporting services to EU entities under Article 9 should be recognized under EMIR.<sup>169</sup> For a trade repository to be recognized, it must submit an application for recognition to ESMA, showing that it is authorized and subject to effective supervision in a third country which satisfies three conditions. First, the third country must have been declared to have legal and supervisory arrangements equivalent to EMIR under the equivalence provisions under article 75(1).<sup>170</sup> Secondly, it must have entered into a treaty with the EU under Article 75(2) for mutual access to, and exchange of, derivatives contracts held in the third country trade repositories.<sup>171</sup> Thirdly, the third country must have entered into cooperation arrangements with the EU under Article 75(3) for immediate and continuous access to all necessary information from the relevant third country regulatory authority.<sup>172</sup>

As in the case of regulatory compliance mandated for CCPs, most of these conditions are beyond the control of emerging market trade repositories, which are therefore likely to not fulfil the conditions. In addition, the equivalence provisions, discussed below, are difficult for third country emerging market regulators to comply with.<sup>173</sup> This has been discussed in further detail in section 4.

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168 *Ibid.* Some of the risks inherent in Trade Repositories include: legal risk (e.g. that the TR's novation or trade compression processes will have no legal effect); operational risk (caused by unreliable and insecure systems, controls and procedures); and, data inaccuracy, loss and leakage. See International Organization of Securities Commissions Bank for International Settlements (ed), *Considerations for Trade Repositories in OTC Derivatives Markets - Consultative Report* (Bank for International Settlements 2010).

169 Article 77 of EMIR (n 3).

170 *Ibid.*

171 *Ibid.*

172 *Ibid.*

173 Article 13(2) of EMIR (n 3).

### 3.3. APPLICATION OF EMIR EQUIVALENCE PROVISIONS TO THIRD COUNTRY DERIVATIVES REGULATORY REGIMES

As indicated in the respective provisions covering third country CCPs and trade repositories, EMIR creates certain obligations that third country legislators, policy makers and regulatory authorities are bound to effect, if the third country CCPs and trade repositories are to provide regulated services to EU-regulated entities.<sup>174</sup> EMIR acknowledges that the effect of its extraterritoriality is to create duplicative and conflicting rules in third country regulatory frameworks, which may hamper cross-border business between EU and non-EU entities.<sup>175</sup>

Article 13(2) of EMIR therefore provides that the Commission may make an “equivalence decision”, by declaring that the “legal, supervisory, and enforcement arrangements” of a third country: are equivalent to the clearing, reporting, clearing thresholds, and risk mitigation requirements under EMIR; are equivalent to the rules on protection of professional secrecy under EMIR; and are “being effectively applied and enforced in an equitable and non-distortive manner so as to ensure effective supervision and enforcement in that third country”.<sup>176</sup>

According to the EC, the main aim of the equivalence provisions is to push third country policy makers and regulators to reform their OTC derivatives regulations, and to delegate EU regulators’ responsibilities over third country regulated entities to third country regulators, thereby containing regulatory arbitrage and risk contagion to EU derivatives markets.<sup>177</sup> However, other commentators argue that the extraterritoriality of EMIR is a new effort at regulatory imperialism, spurred by the EU’s increased regulatory capacity, and aimed at easing competition with offshore financial centres capitalizing on regulatory arbitrage.<sup>178</sup>

Aside from the ideological problems with regulatory unilateralism especially by the US and EU, considering their respective economies’ role in the 2008 global

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174 See Articles 13 (2), 25 and 77 of EMIR (n 3). See also, COM (2010) 484 (n 6) 15; ‘COM (2010) 484’ (n 6) 15; Alexander and Dhumale (n 110).

175 Recital 6 of EMIR (n 3).

176 Article 31 of EMIR (n 3).

177 COM (2010) 484 (n 6) 15.

178 Charles (n 158); Moloney (n 158); Quaglia (n 158).

financial crisis, the main issue with this type of legal transplantation is its disruptive effect on third country emerging economies' development policies and regulatory programmes and priorities.<sup>179</sup> A significant question (discussed further below) is whether systemic risk and compliance with EMIR is as pressing a regulatory concern for emerging market regulators, as is the building of liquid and vibrant OTC derivatives markets, which is currently their main regulatory concern.<sup>180</sup>

#### IV. THE IMPACT OF EXTRATERRITORIALITY OF EMIR ON DERIVATIVES MARKETS IN THIRD COUNTRY EMERGING MARKETS

##### 4.1. THE CONDITIONS OF DERIVATIVES MARKETS IN EMERGING ECONOMIES

To appreciate the impact of EMIR on third country emerging markets, and the relevance of the three-tier proportionality test, their OTC derivatives markets should be placed in context. There is no common definition of emerging markets, even though they share at least five common attributes: they are transitional market economies, with a lower level of development than developed countries, and which exhibit high volatility, high growth rate, and a big capacity for future growth into developed economy status.<sup>181</sup> Emerging market derivatives sectors are relatively underdeveloped, due to poorly developed spot markets, fragmented agricultural markets, and low, untradeable product volumes.<sup>182</sup>

In addition, since these markets are predominantly domestic markets, there is lower demand for hedging instruments.<sup>183</sup> This, coupled with low investor awareness, market expertise and technical capacity, has resulted in low liquidity for contracts issued to the market.<sup>184</sup> The lack of homogenous products that are also compatible with global OTC market standards has also prevented emerging

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179 Ghouri (n 10).

180 *Ibid.*

181 Aziz Sunje and Civi Emin, 'Emerging Markets: a Review of Conceptual Frameworks' in *Proceedings of the First International Joint Symposium of Business Administrator: Challenges for Business Administrators in the New Millennium* (Canakkale Onsekiz Mart Universitz, Silesian University, 2008).

182 George Tsetsekos and Panayotis N Varangis, *The Structure of Derivatives Exchanges: Lessons from Developed and Emerging Markets* (World Bank Publications 1998).

183 *Ibid.*

184 *Ibid.*

markets from growing the size of their OTC derivatives markets.<sup>185</sup> In addition, there are sub-optimal legal and regulatory frameworks for derivatives trading, and a lack of market infrastructures which further undermine the development of the derivatives sector in general.<sup>186</sup>

The resurgence of emerging markets over the last decade, and their increased participation in global, cross-border financial services, has encouraged efforts by various local and international partners to set up formal derivatives markets in these emerging markets.<sup>187</sup> In view of their novel challenges amid global competition, experts have repeatedly proposed novel approaches to setting up sustainable derivatives trading in emerging markets. These approaches include linkages with developed derivatives markets to increase market liquidity, designing and issuing of bespoke contracts that serve the unique needs of specific markets, and establishment of a cost-effective legal and market infrastructure.<sup>188</sup>

Whether the national, international or extraterritorial legal and regulatory frameworks applicable to these emerging markets allows for or inhibits these novel approaches will therefore determine the extent of growth of these emerging market OTC derivatives markets.<sup>189</sup>

The International Organization of Securities Commissions (IOSCO) recognizes at least 26 countries with OTC derivatives markets at various levels of development, as emerging markets.<sup>190</sup> They include EU countries such as Romania, Macedonia, Poland, Czech Republic, Turkey and Slovenia. Latin America is represented by Colombia, Brazil, Argentina, Panama, Costa Rica, Chile, and Barbados. Asian

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185 Saif Rahman and M Kabir Hassan, 'The Potential of Derivatives Market in Bangladesh' (2011) 32 *Journal of Economic Cooperation and Development* 97.

186 *Ibid.*

187 Dubravko Mihajek and Frank Packer, 'Derivatives in Emerging Markets' [2010] *BIS Quarterly Review*, December; Torsten Ehlers and Frank Packer, 'FX and Derivatives Markets in Emerging Economies and the Internationalisation of Their Currencies' [2013] *BIS Quarterly Review*, December <[http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2404448](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2404448)> accessed 10 May 2015.

188 Olatundun Janet Adelegan, 'The Derivatives Market in South Africa; Lessons for Sub-Saharan African Countries' (International Monetary Fund 2009) IMF Working Paper 09/196.

189 *Ibid.*

190 'IOSCO Emerging Markets Committee Report FR07/10' (n 101).

emerging markets include India, Pakistan, Korea, China, Chinese Taipei, Malaysia and Bangladesh. Africa is represented by South Africa and Kenya.<sup>191</sup>

It is important, however, to take note of the wide differences between economically and politically dominant emerging market countries such as Brazil, Russia, India, China, and South Africa (touted as the BRICS countries), and smaller emerging market countries such as Kenya, Nigeria, Pakistan, Colombia, among others. The arguments explored here are more relevant to the latter set of emerging market countries, than the BRICS countries.

The size of the global OTC derivatives market, as of 2013, was about 693 trillion dollars in outstanding notional amounts.<sup>192</sup> Most of the trades are based in London and New York, while the rest are based in the EU, Asia Pacific and Latin America.<sup>193</sup> Emerging markets account for only about 3.588 trillion dollars out of the global total, representing less than 0.5% of the global OTC derivatives markets.<sup>194</sup> With these figures in mind, it is worth considering whether or not this OTC market size is systemically significant in terms of contagion or systemic risk threatening the EU OTC derivative market, to warrant extraterritorial OTC derivatives markets regulations such as EMIR.

Majority of the OTC derivatives contracts traded globally, especially in the US and the EU, are interest rate derivatives and Credit Default Swaps (CDS).<sup>195</sup> It is these CDS contracts that were largely blamed for aggravating the global financial crisis in 2008.<sup>196</sup> On the other hand, most of the contracts traded in emerging markets are foreign exchange contracts (41%), interest rate derivatives (30%) and commodity derivatives (29%), all of which are used predominantly for hedging purposes. CDS contracts account for less than 5%.<sup>197</sup> It is for this reason that emerging markets were hardly affected by the credit crisis that spread from the

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191 *Ibid.*

192 BIS, 'OTC Derivatives Statistics as at End-June 2013' (Bank for International Settlements 2013) <[http://www.bis.org/publ/otc\\_hy1311.pdf](http://www.bis.org/publ/otc_hy1311.pdf)> accessed 7 August 2015.

193 'IOSCO Emerging Markets Committee Report FR07/10' (n 101) 8.

194 *Ibid.*

195 'BIS OTC Derivatives Statistics Report 2013' (n 191).

196 Jackson and Miller (n 13) 3.

197 'IOSCO Emerging Markets Committee Report FR07/10' (n 101) 8; Ehlers and Packer (n 186).

US sub-prime mortgage sector into Europe.<sup>198</sup> Indeed, there were no reported cases of the collapse of systemically important financial institutions (SIFIs) in emerging markets.<sup>199</sup>

An argument can be advanced that, considering the comparatively smaller size and place of the third country emerging economies' OTC derivatives markets within the global OTC derivatives market, any attempts by the EU to regulate these third country markets must be grounded on sound regulatory rationale based on a cost-benefit analysis that reveals surplus regulatory welfare in favour of these emerging markets.<sup>200</sup> The EU, in its impact assessment, disagrees with this view on three fronts. First, since the OTC derivatives market is inter-connected, all derivatives played a role. Secondly, issues affecting the CDS sector can equally crop up in other derivatives sectors. Lastly, regulation should be futuristic rather than reactionary, and should aim to fix both current and future anticipated regulatory problems.<sup>201</sup>

While this rebuttal may be compelling for EU and developed third country OTC derivatives markets, it does not make a good case for assertion of extraterritorial jurisdiction in emerging markets, from the perspective of the proportionality doctrine. This is especially the case where EMIR does not sufficiently balance the benefits of extraterritorial regulation with the costs to these third countries.<sup>202</sup> With the benefit of the above context, the following section briefly examines the impact of EMIR on third country emerging economies' OTC derivatives markets.

#### 4.2. THE IMPACT OF EMIR ON THIRD COUNTRY EMERGING ECONOMIES' OTC DERIVATIVES MARKETS

In most national and regional legislative processes, any legislative project must take into account a cost-benefit analysis of the proposed regulation, and weigh the costs of regulation against anticipated benefits.<sup>203</sup> For extraterritorial legislations such as EMIR, the discussion under section 3.1 has laid a legal case for the assessment

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198 *Ibid.*

199 *Ibid.*

200 Vranes (n 9) 96; Greene and Potiha (n 30) 293.

201 'COM (2010) 484' (n 6) 60.

202 Vranes (n 9) 96; Greene and Potiha (n 30) 293.

203 *Ibid.*

of the suitability, necessity and balance achieved by a law, as between the enacting state and the third countries.

In the case of EMIR, various impact assessments by the European Commission, EU national regulators, international and third country regulators and market participants, have highlighted varying degrees of impacts of its extraterritoriality on third country emerging markets.<sup>204</sup> These include regulatory conflicts, increased regulatory compliance costs, increased regulatory reform, supervision and enforcement costs, decreased market liquidity, market disruption, increased concentration risk and systemic risk, and stifled development of emerging economies' OTC derivatives markets.<sup>205</sup> I discuss each of these impacts below.

While these impact assessments provide valuable reference points, it is necessary to bear in mind the potential for the promotion of self-serving agenda by way of information dissemination campaigns, as is common with a polycentric sphere of regulatory activity.<sup>206</sup> Hence this discussions attempts a conscious aggregation of the views of various competing constituencies: the European Commission, EU

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204 'COM (2010) 484' (n 6); 'Identifying the Effects of Regulatory Reforms on Emerging Market and Developing Economies: A Review of Potential Unintended Consequences' (n 22); Bert Tieben, Marco Kerste and Illan Akker, 'Curtailling Commodity Derivative Markets: What Are the Consequences for the Energy Sector? SEO-Report Nr. 2011-62' (SEO Economic Research 2011); Karen Pottker, 'What Does It Really Mean? The Impact of EMIR, REMIT and MIFID II on Banks and Energy Companies' (Masters Thesis, University of Twente 2013); KPMG, 'The Cumulative Impact of Regulation: An Analysis of the Increase in and Accumulation of Regulations on the Services Provided by the Dutch Banking Sector' (KPMG 2012) <<https://www.kpmg.com/NL/en/Issues-And-Insights/ArticlesPublications/Documents/PDF/Banking-and-Leasing/The-cumulative-impact-of-regulation.pdf>> accessed 7 August 2015; Financial Stability Board, 'Peer Review of South Africa' (Financial Stability Board 2013) Review Report <[www.financialstabilityboard.org/wp-content/uploads/r\\_130205.pdf](http://www.financialstabilityboard.org/wp-content/uploads/r_130205.pdf)> accessed 7 August 2015; Financial Stability Board, 'Monitoring the Effects of Agreed Regulatory Reforms on Emerging Market and Developing Economies (Emerging Markets)' (Financial Stability Board 2013) <[http://www.financialstabilityboard.org/publications/r\\_130912.pdf](http://www.financialstabilityboard.org/publications/r_130912.pdf)> accessed 7 August 2015; Global Financial Markets Association, 'Impact of EU Extraterritorial Legislation on Asian Markets' (Global Financial Markets Association Undated) Impact Assessment <<http://www.gfma.org/Initiatives/Consistency-of-Implementation/GFMA-Views-on-the-Impact-of-EU-Extraterritorial-Legislation-on-the-Asian-Markets/>> accessed 7 August 2015.

205 *Ibid.*

206 On the political economy of polycentric regulatory activity, see generally, Julia Black, 'Critical Reflections on Regulation' (2002) 27 *Austl. J. Leg. Phil.* 1; Julia Black, 'Constructing and Contesting Legitimacy and Accountability in Polycentric Regulatory Regimes' (2008) 2 *Regulation & Governance* 137.

national regulators, international and third country regulators, and market participants.

#### 4.2.1. CONFLICT BETWEEN EMIR, US DODD-FRANK ACT AND THIRD COUNTRY LEGISLATION

A major concern of EMIR's extraterritoriality is its conflict with existing third country OTC derivatives and general securities regulations. CCPs, trade repositories and trade counterparties are subjected to at least two conflicting sets of regulations.<sup>207</sup> For example, the data protection laws of China and Korea restrict transmission or reporting of derivatives trades particulars, in conflict with EMIR reporting obligations.<sup>208</sup> This problem is exacerbated by the fact that the US has also enacted the Dodd-Frank Act, whose Title VII provisions on regulation of swap counterparties and CCPs are also extraterritorial, and which conflict with EMIR.<sup>209</sup> This includes the application of the clearing obligation to certain derivatives contracts and non-financial Counterparties, margin and collateral risk mitigation rules, registration of dealers and CCPs, and reporting requirements.<sup>210</sup>

There is concern from regulators (including the FSB), industry groups (such as GFMA and ISDA), and other observers, that duplicative and conflicting legislation will make third country market participants less competitive than EU market participants, create uncertainty and regulatory anxiety, and undermine business confidence.<sup>211</sup> This is detrimental to developing OTC derivatives markets. In addition, third country regulators will be constrained to supervise and enforce compliance with both EMIR and local legislation, to enable third country market participants to access EU markets. This undermines the third countries' sovereignty

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207 Mauricio Salazar, 'Swapping More than Regulations: Reexamining the Goals of the Dodd-Frank Act and the European Market Infrastructure Regulation on Over-the-Counter Derivative Markets' (2014) 21 *Southwestern Journal of International Law* 217, 232; Greene and Potiha (n 30); Lüttringhaus (n 2).

208 'GFMA, Impact of EU Extraterritorial Legislation on Asian Markets' (n 203).

209 Greene and Potiha (n 30); Lüttringhaus (n 2); Coffee (n 33); Salazar (n 206).

210 *Ibid.* See also, Karel Janda and Gordon Rausser, 'American and European Regulation of Over-the-Counter Derivative Securities' <<http://mpira.ub.uni-muenchen.de/35036/>> accessed 16 June 2015.

211 'GFMA, Impact of EU Extraterritorial Legislation on Asian Markets' (n 203); 'Identifying the Effects of Regulatory Reforms on Emerging Market and Developing Economies: A Review of Potential Unintended Consequences' (n 22).

and derails their economic and regulatory policies and goals.<sup>212</sup> While it is necessary to keep in mind the industry groups' narrow interests and motivations in lesser regulation of financial markets, these critiques of EMIR have exposed regulatory concerns that have been echoed by emerging market regulators, but perhaps less concertedly.<sup>213</sup>

In response to this criticism, EU policy makers, regulators and various commentators have argued that these effects are inevitable and necessary to push third countries to reform their OTC derivatives laws, prevent regulatory arbitrage, and arrest risk contagion from the third countries.<sup>214</sup> They also argue that the equivalence provisions under Article 13 resolve the regulatory conflict problem.<sup>215</sup> Since 2011, as a result of calls by industry players and EU regulators, there have been various consultations between EU and US regulators, to reconcile the differences between EMIR and Title VII. The proposed principal methods of resolving the extraterritoriality difficulties are equivalence and mutual recognition frameworks.<sup>216</sup>

The equivalence provisions hardly mitigate the problem and effects of regulatory conflict, since they require a third country to duplicate EMIR to the letter. For example, in the first equivalence evaluation of the US OTC derivatives regime, ESMA found the Dodd-Frank Act to be non-compliant, despite the latter being more stringent.<sup>217</sup> In addition, Article 13 provides that third country legislation should be "equitable and non-distortive" to EU firms by not saddling them with regulatory obligations in conflict with or more onerous than EMIR.<sup>218</sup>

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212 'FSB Peer Review of South Africa, February 2013' (n 203).

213 'IOSCO Emerging Markets Committee Report FR07/10' (n 101) 33.

214 'COM (2010) 484' (n 6); Quaglia (n 158); Moloney (n 158).

215 'COM (2010) 484' (n 6); 'GFMA, Impact of EU Extraterritorial Legislation on Asian Markets' (n 203).

216 In July 2013, the US and EU entered negotiations on the TransAtlantic Trade and Investment Partnership (TTIP), the largest Free Trade agreement in the world, including in financial services, thereby becoming a global regulatory standard-setter. See Brett Bickel, 'Harmonizing Regulations in the Financial Services Industry through the Transatlantic Trade and Investment Partnership' (2014) 29 *Emory International Law Review* 557, 558.

217 Global Financial Markets Association, 'Regulatory Reform Programme: Extraterritoriality Issues in US and EU' (Global Financial Markets Association Undated) Impact Assessment <<http://www.gfma.org/Initiatives/Consistency-of-Implementation/GFMA-Paper-Detailing-Extraterritoriality-Issues-in-US-and-EU/>> accessed 7 August 2015.

218 Article 13 of EMIR (n 3).

Moreover, equivalence decisions are dependent on treaty negotiations and subsequent equivalence assessments, which are outside of the influence of market players.<sup>219</sup> In addition, even where EU and US regulators agree on a common mutuality framework for non-EU and non-US third countries, the problems posed by EMIR's extraterritoriality persist: intrusive conflicting regulations that undermine national regulatory goals, duplicative and costly regulations, and unnecessarily onerous regulatory burdens on less risky emerging markets.<sup>220</sup>

It is also instructive to note that the EC's official impact assessment report for EMIR does not consider or discuss the conflicts between EMIR and third country legislation.<sup>221</sup> To this extent, it is questionable whether EMIR can be deemed to have fulfilled expectations of the proportionality doctrine.

#### 4.2.2. UNDULY ONEROUS REGULATORY COMPLIANCE COSTS

EMIR has significantly increased the cost of regulatory compliance for both EU and third country derivatives market players, but with more detrimental impacts for emerging markets. These include costs of installing new, automated operational systems, especially for risk mitigation and standardization of trade processes for uncleared trades, costs of complying with multiple derivatives regulations, clearing costs, and capital costs incurred in additional collateral requirements.<sup>222</sup> According to one study by Deloitte UK, which made use of, among others, BIS, IOSCO, and ESMA impact assessments, the estimated additional cost for centrally cleared OTC derivatives transactions (per Euros 1 million notional amount traded, basis

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219 Cynthia Tang, Bryan Ng and Eric Chan, 'Bumps on the Path Forward - Does the Transatlantic OTC Derivatives Debate Need a New Direction' (2013) 32 *International Financial Law Review* 39; Bickel (n 215); Salazar (n 206).

220 Nusret Cetin, 'Legal Reforms in the Aftermath of the Financial Crisis: Opportunities and Challenges for Emerging Market Economies' (Social Science Research Network 2012) SSRN Scholarly Paper ID 2246598; Prasad (n 8).

221 'COM (2010) 484' (n 6).

222 Bank for International Settlements, 'Macroeconomic Impact Assessment of OTC Derivatives Regulatory Reforms' (Bank for International Settlements 2013); European Securities and Markets Authority, 'Annex VIII of the Final Report on Draft Regulatory and Implementing Technical Standards on Regulation (EU) 648/2012 on OTC Derivatives, Central Counterparties and Trade Repositories' (European Securities and Markets Authority 2012) ESMA/2012/600/Annex VIII. See also, 'The Cumulative Impact of Regulation' (n 203); Tieben, Kerste and Akker (n 203); Pottker (n 203).

points) is Euro 13.60 (0.136 bps), while that of non-centrally cleared OTC derivatives contracts is Euros 170.50 (1.705 bps).<sup>223</sup>

The implications are that market participants will withdraw from the emerging economies' OTC derivatives markets, due to shrinking revenue or losses in certain trades, resulting in low liquidity and less vibrant markets.<sup>224</sup> Secondly, industry groups also observe that onerous regulatory costs on emerging markets increase hedging costs for emerging market end-users, where these risk mitigation instruments are integral for trading in volatile commodity markets.<sup>225</sup> This threatens emerging markets' fragile economies and commodity markets.<sup>226</sup> While it must be borne in mind that industry lobby groups are usually consistent in pushing back financial regulations, especially on grounds of increased regulatory costs, it is important to examine whether the additional costs are proportionate to the regulatory welfare for the industry.

EU regulators and policy makers justify the additional regulatory costs as necessary short-term costs that are small in comparison to the long-term benefits of stable and safer global OTC derivatives markets.<sup>227</sup> In addition, they contend that increased hedging costs are a correction of the mis-pricing of various risks.<sup>228</sup> This policy rationale, however, does not apply to emerging markets, to the extent that they do not register a net benefit from EMIR's main regulatory welfare. Some international financial regulators agree. For example, while the Bank for International Settlement (BIS) argues that the regulatory compliance costs are offset by the benefits of market stability, it admits that these benefits may not equally reflect in emerging markets.<sup>229</sup>

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223 Deloitte UK, 'OTC Derivatives - The New Cost of Trading' (Deloitte UK 2014) <<http://www2.deloitte.com/uk/en/pages/financial-services/articles/the-new-cost-of-trading.html>> accessed 7 July 2015.

224 *Ibid.*

225 Institute of International Finance, 'Specific Impacts of Regulatory Change on End-Users' (Institute of International Finance 2012) <<https://www.iif.com/file/5120/download?token=fHcVZxYZ>> accessed 7 July 2015.

226 *Ibid.*

227 'COM (2010) 484' (n 6).

228 *Ibid.*

229 'Macroeconomic Impact Assessment of OTC Derivatives Regulatory Reforms' (n 221).

The issue this argument presents is the trade-off between systemic risk and financial markets development. What is the level of urgency requiring the application of such onerous extraterritorial regulations against nascent, unthreatening EMDE derivatives markets? While market development and containing systemic risk may not necessarily be mutually exclusive concerns, it could be argued that sequencing onerous, pre-emptive financial stability measures before certain market development strategies puts paid to the latter's viability.<sup>230</sup>

Since financial market development strategies always embody a level of risk, the trade-off or delicate balance is usually consciously made by national regulators in respective national macroeconomic policy frameworks.<sup>231</sup> Indeed, financial stability achieved should be a balance between risk and financial markets development.<sup>232</sup> Hence the unilateral nature of EMIR attracts the critique that it fails to balance the regulatory benefits of safer and more stable EU and other third country derivatives markets, with the regulatory costs incurred by the third countries in implementation.

### 3.2.3. DECREASED LIQUIDITY/GLOBAL FLOW OF CAPITAL INTO THIRD COUNTRY EMERGING MARKETS

Increased cross-border capital flows and trade liberalization has opened up emerging economies' derivative markets to EU and US financial institutions, which dominate domestic and cross-border transactions in Asian and other emerging markets.<sup>233</sup> Increased and onerous cross-border regulatory costs on both EU and non-EU entities may result in EU clearing members withdrawing from third country CCPs due to non-compliance, and also from transacting with non-EU counterparties that are non-compliant with EMIR obligations such as trade

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230 World Economic Forum, *The Financial Development Report 2008* (World Economic Forum USA Inc 2008) 7.

231 World Bank, *World Development Report 2014: Risk and Opportunity - Managing Risk for Development* (World Bank Publications 2013) 214; Tatiana Didier and Sergio L. Schmukler, *Emerging Issues in Financial Development: Lessons from Latin America* (World Bank Publications 2013) 520.

232 *The Financial Development Report 2008* (n 229) 7.

233 See generally, Erlend Nier, Tahsin Saadi Sedik and Tomas Mondino, *Gross Private Capital Flows to Emerging Markets: Can the Global Financial Cycle Be Tamed?* (International Monetary Fund 2014) 3.

reporting.<sup>234</sup> This may have an adverse impact on the inflow of finance from EU markets to emerging markets, and therefore a liquidity crunch.<sup>235</sup> Most of the EU entities are therefore considering establishing subsidiaries in these markets.<sup>236</sup> However, subsidiaries would still be less capitalized than the parent companies, thereby resulting in less liquidity in these derivatives markets.<sup>237</sup>

The EC EMIR impact assessment report and subsequent policy papers have not addressed the deterrence that EMIR creates for cross-border trades with emerging markets.<sup>238</sup> Since the strategies of most emerging economies' derivatives market regulators depend on international linkages to boost liquidity in their markets, EMIR poses a significant hurdle, and therefore lacks interest balancing.<sup>239</sup>

#### 4.2.4. MARKET DISRUPTION, FRAGMENTATION, INCREASED SYSTEMIC RISK AND OBSTRUCTION OF DEVELOPMENT OF OTC DERIVATIVES MARKETS IN EMERGING ECONOMIES'

As discussed above, EU regulators and policy makers cite the need to contain regulatory arbitrage and contagion from third countries as justification for EMIR's extraterritoriality. However, EMIR does not consider the characteristics and level of development of OTC derivatives markets in emerging economies.<sup>240</sup> The onerous compliance costs, withdrawal of EU entities from third country derivatives markets, and the subsequent liquidity shocks are expected to have a disruptive effect on the third country emerging economies' OTC derivatives markets, resulting in market instability.<sup>241</sup> Critics of EMIR have also argued that the mandatory clearing by CCPs will increase concentration risks in small economies, in the event that the CCPs experience financial problems.<sup>242</sup> In addition, the complex, conflicting

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234 'GFMA, Impact of EU Extraterritorial Legislation on Asian Markets' (n 203); 'Macroeconomic Impact Assessment of OTC Derivatives Regulatory Reforms' (n 221).

235 *Ibid.*

236 'GFMA, Impact of EU Extraterritorial Legislation on Asian Markets' (n 203) 3.

237 *Ibid.*

238 'COM (2010) 484' (n 6).

239 Cetin (n 219).

240 'COM (2010) 484' (n 6).

241 'FSB, Monitoring the Effects of Agreed Regulatory Reforms on Emerging Market and Developing Economies 2013' (n 203).

242 Murphy (n 116); Alexander and Dhumale (n 110); Gregory (n 104).

legislation that third country emerging markets are subjected to may actually increase systemic risk, since it will be difficult for third country regulators to monitor and capture activity in these markets.<sup>243</sup>

Another systemic risk concern is the endogenous risk.<sup>244</sup> Where all the global OTC derivatives market players and regulators play according to identical rules, there is an even greater contagion risk, and concentration risk.<sup>245</sup> This is especially where a particular regulatory action or remedy (such as EMIR) is ill-advised.<sup>246</sup> EMIR's equivalence provisions therefore takes away the safety net of regulatory competition that emanates from different, contextualized regulatory actions.<sup>247</sup>

More importantly, international regulators such as the FSB have noted that the increased regulatory compliance costs, additional risk mitigation measures, and the attendant liquidity and market disruption effects will hamper the development of derivatives and capital markets in some emerging markets.<sup>248</sup> One effect, for

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243 See generally, Tang, Ng and Chan (n 218); Salazar (n 206); Bickel (n 215). For a review of the effects of the reforms in the South African OTC Derivatives markets, see 'FSB Peer Review of South Africa, February 2013' (n 203).

244 Endogenous risk refers to the risk from shocks generated and amplified within the financial system, by identical reactions of market participants to a market event. See Jon Danielsson and Hyun Song Shin, 'Endogenous Risk' in Peter Field (ed), *Modern Risk Management: A History* (Risk Books 2003) 297; Emiliós Avgouleas, *Governance of Global Financial Markets: The Law, the Economics, the Politics* (Cambridge University Press 2012) 244.

245 Regulatory harmonization limits regulatory competition and may lower regulatory quality in the long-term. See Jonas Vlachos, 'Does Regulatory Harmonization Increase Bilateral Asset Holdings?' <[http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=562061](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=562061)> accessed 9 July 2015. In addition, it may cause "destructive coordination" by cancelling out the core assumptions underlying financial risk management strategies. See Charles K Whitehead, 'Destructive Coordination' (2011) 96 Cornell Law Review 323.

246 See Slavisa Tasic, 'The Illusion of Regulatory Competence' (2009) 21 Critical Review 423. Regulators may make wrong regulatory policies reinforced by the illusion of their regulatory competence and biases, and which are only unravelled by major financial crises such as the 2007 global financial crisis.

247 While regulatory cooperation is necessary, a level of policy differentiation is also necessary. See AO Sykes, 'Regulatory Competition or Regulatory Harmonization? A Silly Question?' (2000) 3 Journal of International Economic Law 257. For example, regulatory competition and harmonization can be seen as complements rather than supplements. See Jeanne-Mey Sun and Jacques Pelkmans, 'Regulatory Competition in the Single Market' (1995) 33 JCMS: Journal of Common Market Studies 67.

248 'FSB Peer Review of South Africa, February 2013' (n 203); 'FSB, Monitoring the Effects of Agreed Regulatory Reforms on Emerging Market and Developing Economies 2013' (n 203).

example, is that EMIR will hamper the development of homogenous derivatives contracts, which may be necessary for emerging economies' commodity markets with market needs that do not fit globally standardized contract volumes and commodity characteristics.<sup>249</sup> In addition, as discussed above, third country CCPs, trade repositories, issuers and counterparties may be locked out of the EU market, which is a significant source of liquidity for emerging markets.<sup>250</sup>

EU policy makers' argument that the long-term market stability benefits of EMIR are greater than the costs to third country markets cannot be taken at face value, since there is no evidence of the EC or other EU regulators conducting extraterritorial impact assessments of EMIR. On the other hand, impact assessments undertaken by regulators and industry so far argue otherwise. It should, however, be noted that most of these studies are preliminary, since there is insufficient data to examine the impact of regulatory implementation over an appropriate period of time. EMIR, nevertheless, does not answer questions as to its cost-benefit utility, in respect of third countries, and fails to make an effort to balance the interests of the EU and third country emerging markets.

In the present international law framework on extraterritorial legislation, it is unlikely that the US and EU would take into account third country concerns, as both jurisdictions are accountable to their respective domestic constituencies only. Hence the need for third country advocacy on their concerns. Some potential strategies are considered below.

#### V. PROPOSALS FOR REFORM IN THE USE OF EXTRATERRITORIAL EU OTC DERIVATIVES MARKET REGULATIONS

The foregoing discussion has laid a basis for the re-examination of the legality of the extraterritorial provisions of EMIR. This situation therefore requires a review and reform in how regional and national OTC derivatives markets regulators assert extraterritorial jurisdiction to reign in systemic risk and financial instability in the global markets. The following are proposed starting points in a conversation among emerging markets, on strategies for reviewing EMIR and other extraterritorial OTC derivatives regulations.

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249 *Ibid.* See also, 'Macroeconomic Impact Assessment of OTC Derivatives Regulatory Reforms' (n 221).

250 *Ibid.*

#### 4.1. AFFIRMING AND MODERNIZING INTERNATIONAL LAW AND PRINCIPLES OF EXTRATERRITORIAL JURISDICTION

Due to the split juridical opinion on its place in international law, and the increasing use of extraterritorial regulations by the EU and US, and potentially other competitive financial centres, the doctrine of proportionality of extraterritorial legislation requires to be formally anchored in international law.<sup>251</sup> Regulators and market participants, especially from third countries, should endeavour to promote the proportionality doctrine as international law by instituting international proceedings on improper assertion of extraterritorial jurisdiction at the ICJ.<sup>252</sup> They can also influence international customary law by way of diplomatic protests, blocking statutes, claw-back statutes, and judicial measures.<sup>253</sup>

In addition, State-to-State groups of EMDEs should lobby for soft law financial standards formulated at international regulatory forums such as the Basel Committee, FSB and IOSCO, to recognize and promote the doctrine of proportionality as an essential element of valid assertion of extraterritorial jurisdiction, especially in regulation of global markets such as OTC derivatives markets.<sup>254</sup> Once the requirement is formalized in international law, extraterritorial legislation grounded on various lawful rationale will be more legitimate, enforceable and acceptable in the global financial markets, including emerging markets.

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251 Dallara (n 2); Ryngaert (n 60); Meessen (n 67); Bourgeois (n 68).

252 'UN Doc A/61/10' (n 44) 529. However, private actors and civil society are more willing than States to engage in international litigation against other States, since this invites a scrutiny of the initiating State's own adherence record to international law. The dependence of EMDEs on aid and grants from the US and EU also discourages litigation against the latter. See Karen J Alter, *The New Terrain of International Law: Courts, Politics, Rights* (Princeton University Press 2014) 7.

253 'UN Doc A/61/10' (n 44) 529. These strategies, however, depend on the relative power of the relevant markets. For example, a small developing country's blocking statute is of no consequence to the EU market as compared to, for example, China's blocking Statute.

254 Dallara (n 2) 56. For an account of EMDE contestations of global economic governance, see generally, Joachim Betz, 'Emerging Powers and Global Financial Governance' (2014) 38 *Strategic Analysis* 293; Gilbert Gagne, 'Emerging Powers in Global Governance: Lessons from the Heiligendamm Process' (2011) 17 *Canadian Foreign Policy Journal* 190; Matthew D Stephen, 'Rising Powers, Global Capitalism and Liberal Global Governance: A Historical Materialist Account of the BRICs Challenge' (2014) 20 *European Journal of International Relations* 912.

#### 4.2. BENCHMARKING OF EXTRATERRITORIAL LEGISLATION BY TRANSNATIONAL FINANCIAL REGULATORS

Unilateral EU and US extraterritorial legislation, especially on banking and derivatives sectors, have overshadowed and undermined transnational regulatory approaches that would have been more sensitive to issues in both emerging and developed derivatives markets.<sup>255</sup> EU and US regulators, policy makers and analysts in support of extraterritoriality have, however, criticized the transnational regulatory approaches as too slow, and whose regulatory outputs are too generalized, weak, and ineffective.<sup>256</sup> While these criticisms are valid, the hegemonic interests of the US and the EU, and their aversion to multilateral financial regulatory forums such as the World Trade Organization (WTO) must be borne in mind.<sup>257</sup> Nevertheless, multilateral negotiation of certain global financial regulatory standards such as Basel III has been successful, and especially to the extent that emerging market concerns have informed the final standards.<sup>258</sup>

The engagement of broad-based and inclusive international regulators such as the FSB, Basel Committee and IOSCO (especially since 2009) may provide a credible peer review forum that can competently engage with legislating countries in considering and mitigating negative impacts of extraterritorial OTC derivative legislation.<sup>259</sup> They can also create and promote the adoption of harmonization frameworks that are sensitive to both developed and emerging markets.<sup>260</sup> However,

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255 Dallara (n 2); Greene and Potiha (n 30); Coffee (n 33).

256 Bickel (n 215) 570; Coffee (n 33). For example, the US and EU regulators have adopted banking regulatory standards that are more stringent than Basel III.

257 See generally, Pierre-Hugues Verdier, 'Political Economy of International Financial Regulation, The' (2013) 88 *Ind. LJ* 1405; Mark Beeson and Stephen Bell, 'The G-20 and International Economic Governance: Hegemony, Collectivism, or Both?' (2009) 15 *Global Governance: A Review of Multilateralism and International Organizations* 67.

258 Eilis Ferran and Kern Alexander, 'Can Soft Law Bodies Be Effective? Soft Systemic Risk Oversight Bodies and the Special Case of the European Systemic Risk Board' (Social Science Research Network 2010) SSRN Scholarly Paper ID 1676140; Financial Stability Board, 'Monitoring the Effects of Agreed Regulatory Reforms on Emerging Market and Developing Economies (EMDEs)' (Financial Stability Board 2014) <[www.financialstabilityboard.org/wp-content/uploads/Monitoring-the-effects-of-reforms-on-EMDEs.pdf](http://www.financialstabilityboard.org/wp-content/uploads/Monitoring-the-effects-of-reforms-on-EMDEs.pdf)> accessed 8 July 2015.

259 So far, the FSB has consistently addressed the intended and unintended consequences of US and EU extraterritorial legislation in its reports to the G20. See 'Monitoring the Effects of Agreed Regulatory Reforms on Emerging Market and Developing Economies (EMDEs)' (n 257).

260 Dallara (n 2) 56.

there is need to keep in mind the pervasive hegemony of US and other G-7 countries in the transnational regulatory networks, which may still tilt the contributions of these transnational regulators in favour of unilateral extraterritorialism.<sup>261</sup>

#### 4.3. REQUIREMENT FOR GLOBAL MARKET REGULATORY IMPACT ASSESSMENTS

A more specific regulatory reform measure for the assertion of extraterritorial jurisdiction by national financial legislations is obliging the enacting States' regulators and policy makers to undertake a global market regulatory impact assessment.<sup>262</sup> Regulatory impact assessments should typically outline the policy and regulatory justifications, the logic and methodology, the various alternatives to, and the impacts of the proposed extraterritorial measures, in respect of all affected jurisdictions.<sup>263</sup> In accordance with the first two proposals, the regulatory impact assessments should measure and make recommendations on a proposed extraterritorial law's compliance with the doctrine of proportionality.<sup>264</sup>

In addition, this regulatory impact assessment should have the input of transnational regulators such as the FSB, which have the benefit of a global perspective of the global OTC derivatives and entire financial markets. It should also have the input of affected third parties, including third country regulators, policy makers and market participants.<sup>265</sup> A properly structured international legislative framework for extraterritorial legislation will streamline such a demanding process into an efficient and less costly regulatory impact assessment exercise. The consequence of non-compliance with the global market regulatory impact assessment should be the judicial and political invalidation of the enactment, or further negotiations and review of a proposed measure.<sup>266</sup>

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261 Verdier (n 256); Beeson and Bell (n 256).

262 See, for example, the suggestion by the financial services industry to US and EU regulators in GFMA and others to US Treasury Secretary and EU Commissioner for Internal Markets and Services, 'Extraterritorial Legislation: The Problems Posed for Markets, Clients and Regulators' (19 April 2012) <[trade.ec.europa.eu/doclib/html/149702.htm](http://trade.ec.europa.eu/doclib/html/149702.htm)> accessed 7 September 2015.

263 For an overview of regulatory impact assessment, see generally, CH Kirkpatrick and David Parker, *Regulatory Impact Assessment: Towards Better Regulation?* (Edward Elgar Publishing 2007).

264 Vranes (n 9). For a general overview of the policy trade-offs involved, see generally, Diana Fuguitt and Shanton J Wilcox, *Cost-Benefit Analysis for Public Sector Decision Makers* (Greenwood Publishing Group 1999).

265 Dallara (n 2) 58.

266 See the previous discussion on State litigation as a strategy, in 'UN Doc A/61/10' (n 44) 529; Alter (n 251) 7.

This reform proposal, of course, encounters cooperation challenges from third countries that may not see the net benefit of extraterritorial measures where, for example, they benefit from regulatory arbitrage. In addition, regulatory impact assessment as a transnational policy itself encounters difficulties of adoption and implementation, especially by the hegemonic powers in international finance, such as the US and other G7 countries, which wield unilateral powers in transnational economic governance.<sup>267</sup>

#### 4.4. REGULATORY EXEMPTIONS

The outcomes and recommendations of a global market regulatory impact assessment exercise, in respect of emerging markets, should be regulatory exemptions for certain jurisdictions, regulators, and market participants.<sup>268</sup> In essence, extraterritorial legislation should integrate the special and differential treatment (SDT) principle that has guided the vesting and implementation of obligations in international trade agreements under the WTO treaties.<sup>269</sup> For example, market participants, regulators and regulatory regimes from under-developed jurisdictions in emerging markets, which do not pose significant systemic risk to the EU financial markets, and which will be adversely affected by EMIR's extraterritorial obligations, should be exempted from those obligations, as long as these conditions persist.<sup>270</sup>

Considering that most emerging market OTC derivatives regulators outside of the G20 have declared willingness to implement the G20's OTC derivatives reform recommendations, these regulatory exemptions should merely give them regulatory space to undertake sustainable and effective regulatory reforms.<sup>271</sup> In addition, the exemptions will mitigate the negative effects that may hinder the development of derivatives markets in these emerging market economies.<sup>272</sup>

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267 For a political economy overview of regulation through impact assessments, see generally, Claudio M Radaelli, 'Diffusion without Convergence: How Political Context Shapes the Adoption of Regulatory Impact Assessment' (2005) 12 *Journal of European Public Policy* 924.

268 Dallara (n 2) 58; Greene and Potiha (n 30) 293.

269 See generally, Bernard M Hoekman, Constantine Michalopoulos and L Alan Winters, *More Favorable and Differential Treatment of Developing Countries: Toward a New Approach in the World Trade Organization*, vol 3107 (World Bank Publications 2003).

270 *Ibid.*

271 'IOSCO Emerging Markets Committee Report FR07/10' (n 101).

272 Cetin (n 219).

#### 4.5. MUTUAL RECOGNITION, SUBSTITUTED COMPLIANCE AND EQUIVALENCE REGIMES

Another proposed reform measure to the implementation of EMIR's extraterritorial provisions, where exemptions may not be efficient, is to introduce mutual recognition, substituted compliance or equivalence regimes in respect of third country emerging market OTC derivative regulatory regimes.<sup>273</sup> These equivalence regimes should be different from EMIR's equivalence regime, and Dodd-Frank's substituted compliance regimes, to the extent that the proposed regimes should consider the effect of the third country regulation, rather than whether it conforms to the legislative letter of EMIR or Dodd-Frank.<sup>274</sup>

If such an equivalence regime is implemented, it will resolve the problems of conflict between EMIR and the third country regulation, uncertainties of third countries implementing many conflicting extraterritorial legislations, regulatory duplication, increased compliance costs, and inefficient implementation of EMIR through economic duress.<sup>275</sup> In addition, it will give third countries the space to formulate OTC derivatives policies and regulations that conform to both a third country's economic blueprints, and EMIR's regulatory objectives, mainly that of containment of contagion from third country markets.<sup>276</sup>

#### VI. CONCLUSION

The main question that this study has considered is the impact of EMIR's extraterritorial provisions on third country emerging economies' OTC derivatives markets. EMIR has applied the CCP clearing, trade reporting and risk mitigation obligations to both EU and non-EU central counterparties, CCPs and trade repositories. In addition, its equivalence regime mandates third country regulators to reform their OTC derivatives regulatory regimes to reflect EMIR's requirements, if the third country's CCPs and trade repositories are to access EU markets.<sup>277</sup>

These extraterritorial provisions are expected to have adverse effects on nascent, emerging economies' OTC derivatives markets, since these markets are underdeveloped, illiquid, and rely extensively on liquidity and market infrastructure from EU and other developed OTC derivatives markets.<sup>278</sup> The study has adopted the three-tier proportionality doctrine proposed by Vranes, to assess whether the regulatory benefits of EMIR's extraterritorial provisions are

suitable, necessary, and balanced, and whether assertion of extraterritorial jurisdiction under EMIR is justified.<sup>279</sup>

The discussion concludes that while the CCP clearing, reporting and risk mitigation measures are effective, they are not suitable or necessary to most emerging economies' OTC derivatives markets. This is because these markets are insignificant in size (less than 0.5% of the global OTC derivatives market), and do not trade much in CDS contracts, which were blamed for accelerating the 2008 financial meltdown.<sup>280</sup> In addition, the emerging economies' OTC derivatives markets remained largely stable during the financial crisis.<sup>281</sup>

<sup>282</sup> EMIR also fails to balance the benefits of reigning in contagion from third country emerging markets, against the immense and unequal costs incurred by third countries in implementing its provisions.<sup>283</sup> These costs include regulatory conflicts causing derailment of third country economic development policies and market uncertainty, increased regulatory compliance costs, reduced liquidity through withdrawal of both EU and non-EU liquidity providers from third country derivatives markets because of high compliance costs and non-compliance.<sup>284</sup>

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273 Greene and Potiha (n 30) 293.

274 'GFMA, Extraterritoriality Issues in US and EU' (n 216); 'GFMA, Impact of EU Extraterritorial Legislation on Asian Markets' (n 203).

275 *Ibid.*

276 Cetin (n 219).

277 Articles 4, 9, 11, 13, 55 and 77 of EMIR (n 3).

278 Dallara (n 2); 'Identifying the Effects of Regulatory Reforms on Emerging Market and Developing Economies: A Review of Potential Unintended Consequences' (n 22); 'Macroeconomic Impact Assessment of OTC Derivatives Regulatory Reforms' (n 221).

279 Vranes (n 9) 95.

280 'IOSCO Emerging Markets Committee Report FR07/10' (n 101); Jackson and Miller (n 13); Robert J Shiller, *The Subprime Solution: How Today's Global Financial Crisis Happened, and What to Do about It* (Princeton University Press 2012).

281 *Ibid.*

282 'Identifying the Effects of Regulatory Reforms on Emerging Market and Developing Economies: A Review of Potential Unintended Consequences' (n 22); Dallara (n 2); 'OTC Derivatives - The New Cost of Trading' (n 222); 'Macroeconomic Impact Assessment of OTC Derivatives Regulatory Reforms' (n 221).

283 See generally, the discussion under section 4 above.

284 *Ibid.*

Other costs include increased regulatory risks and endogenous risks caused by adoption third country adoption of EMIR regulatory frameworks under economic duress, market disruption, fragmentation, and increased systemic risk.<sup>285</sup> These costs ultimately act as barriers to the development of nascent emerging economies' OTC derivatives markets, most of which are still nascent and poorly developed, and have traditionally relied on EU and US markets for liquidity and market infrastructure.<sup>286</sup>

In a global financial regulatory market increasingly characterized by extraterritorial legislation adverse to third country emerging markets, there is a need for at least six measures to curb invalid assertion of extraterritorial jurisdiction.<sup>287</sup> First, third country regulators, international regulatory bodies, and global market participants must work together to elevate the doctrine of proportional assertion of extraterritorial jurisdiction in international law.<sup>288</sup> Secondly, international regulatory forums such as the G20, Basel Committee, FSB, IOSCO, IMF and the World Bank should increasingly work with the EU and US regulators, to ensure that much needed extraterritorial legislation are proportional.<sup>289</sup> This will work towards promoting both financial stability and market development in emerging economies' OTC derivatives markets.

Thirdly, the international regulatory frameworks should also mandate inclusive and participatory global market regulatory impact assessment exercises by states enacting extraterritorial jurisdiction, so that there is evidence of implementation of the proportionality doctrine.<sup>290</sup> These impact assessment reports can then inform the implementation of two other measures - exemption measures and effects-centred mutual recognition regimes - to mitigate the negative effects of extraterritorial legislation on emerging economies' OTC derivatives markets.

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285 *Ibid.*

286 'GFMA, Impact of EU Extraterritorial Legislation on Asian Markets' (n 203); 'FSB Peer Review of South Africa, February 2013' (n 203); 'Identifying the Effects of Regulatory Reforms on Emerging Market and Developing Economies: A Review of Potential Unintended Consequences' (n 22); 'Macroeconomic Impact Assessment of OTC Derivatives Regulatory Reforms' (n 221).

287 See generally, 'UN Doc A/61/10' (n 44).

288 Dallara (n 2)

289 *Ibid.*

290 'GFMA, Extraterritoriality Issues in US and EU' (n 216); 'GFMA, Impact of EU Extraterritorial Legislation on Asian Markets' (n 203); and others (n 261).

Since EMIR and Title VII of Dodd Frank are yet to be fully implemented, assessments of their benefits and costs, especially to third countries, are merely indicative. There is need for a more inclusive policy and market research and dialogue between international and national regulators, and global market participants, to determine the accurate benefits and costs of extraterritorial OTC derivatives regulations such as EMIR. This will provide an informed basis for reviewing and reforming EMIR, to ensure that the regulatory measure contain systemic risk and market instability, while safeguarding the much-needed growth of emerging economies' OTC derivatives market.