MEMO# 27358

July 5, 2013

ICI and ICI Global File Further Comment Letter with CFTC on Proposed Cross-Border Guidance

[27358]

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TO: SEC RULES MEMBERS No. 66-13
ICI GLOBAL MEMBERS
DERIVATIVES MARKETS ADVISORY COMMITTEE No. 54-13
INTERNATIONAL MEMBERS No. 29-13
INVESTMENT ADVISER MEMBERS No. 47-13
CLOSED-END INVESTMENT COMPANY MEMBERS No. 60-13 RE: ICI AND ICI GLOBAL FILE FURTHER COMMENT LETTER WITH CFTC ON PROPOSED CROSS-BORDER GUIDANCE

ICI and ICI Global have filed a further comment letter with the Commodity Future Trading Commission ("CFTC" or "Commission") expressing concern regarding the manner in which the Commission is developing its guidance on the cross-border application of the swaps provisions ("cross-border guidance") under Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act. In particular, the letter expresses concern with the definition of "U.S. person" applicable to funds and other collective investment vehicles that ICI and ICI Global understand the Commission is considering as part of its final cross-border guidance. We filed the letter because we understand that the Commission does not intend to extend its exemptive order granting market participants temporary conditional relief from certain provisions of the Commodity Exchange Act, [1] and that the Commission may adopt final cross-border guidance prior to the July 12 expiration date of the Temporary Cross-Border Order that is even broader, in certain respects, than the cross-border guidance the Commission previously has proposed. [2] The letter is attached, and is summarized below.

U.S. Person Definition

The letter urges the CFTC to not adopt cross-border guidance in a hasty manner, but take the time necessary to develop thoughtful and workable guidance that reflects industry input, and that is coordinated with other domestic and international regulators. In the letter, ICI and ICI Global express concern that the definition of U.S. person the CFTC currently is considering could significantly disadvantage non-U.S. publicly offered, substantively regulated funds ("non-U.S. retail funds") [3] that have only a nominal nexus to the United States. These funds may engage in derivatives transactions globally, and may utilize the services of an asset manager located in the United States to manage the funds' assets.

The letter explains that the draft final cross-border guidance being reviewed by the Commission would capture non-U.S. retail funds within the definition of U.S. person in two ways:

1. Funds that have a majority of U.S. investors except for publicly-traded funds that are not offered to U.S. investors; and
2. Funds that have a principal place of business in the United States (which would look to where the sponsor/promoter and investment management activities are being conducted).

It appears that these tests would be applied to non-U.S. funds very broadly. The letter explains that, if a non-U.S. fund is found to be a U.S. person, there would be no substituted compliance permitted for reporting, clearing, or trading requirements.

The letter asserts that modifications to these tests are necessary to avoid applying Title VII to those non-U.S. funds that have only a limited nexus to the United States. The letter explains that the majority U.S. person test is not workable for non-U.S. retail funds. Many non-U.S. retail funds, while publicly offered, are not publicly-traded in the secondary market and therefore would not be excluded by the proposed majority U.S. person test on this basis. The letter further explains that, because shares of many publicly-offered funds are held through omnibus accounts, ownership verification is difficult for "publicly-offered" funds (and for "publicly-traded" funds). These funds cannot verify (for purposes of determining majority ownership) whether fund shareholders are U.S. persons despite not offering their shares to U.S. persons. In addition, certain jurisdictions may prohibit disclosure by intermediaries of beneficial owner information.

The letter further explains that the "principal place of business" test is not appropriate for funds because they generally are externally managed and have no employees or offices of their own. Instead, the fund contracts for services with a variety of providers, which may be located in multiple jurisdictions. The letter urges the CFTC not to base the "principal place of business" test on the location of fund's service providers (such as sponsors/promoters and investment managers). It explains that looking to the location of the activities, employees, or offices of the "sponsor" or "adviser" of a non-U.S. retail fund is not appropriate because the risk of a transaction remains with the non-U.S. fund and would not migrate to the United States with the use of the services of a U.S. adviser or U.S. sponsor.

The letter states that the CFTC's draft definition of U.S. person would impose significant regulatory obligations on non-U.S. retail funds that have only a tangential nexus to the United States. These non-U.S. retail funds would have to comply with the swaps provisions of the CEA, which may overlap or conflict with the regulations of their home country. This result is inconsistent with the Dodd-Frank Act mandate that Title VII will not apply to activities outside the United States unless those activities, in part, have a direct and significant connection with activities in, or effect on, commerce of the United States, and also is unnecessary to achieve the CFTC's regulatory objectives. The letter details the harm that such an overbroad definition could cause.

To address these concerns, the letter recommends that the Commission include in the final cross-border guidance an alternative definition for funds that specifies that a pool, fund or other collective investment vehicle will not be deemed a U.S. person if it is publicly-offered only to non-U.S. persons. Thus, non-U.S. retail funds would not be defined as U.S. persons, even if they have an asset manager or sponsor/promoter located in the United States. The letter acknowledges that certain non-U.S. retail funds may be eligible for sale to the retail public, even if a particular fund may elect to limit its offering to institutional investors. It states, however, that these non-U.S. retail funds also should not be deemed U.S. persons. The letter asserts that this alternative definition would include, as U.S. persons, those non-U.S. funds that have a direct and significant connection with the United States or U.S. investors, while excluding those non-U.S. funds that do not raise risks to U.S. investors or the U.S. markets. The letter notes that non-U.S. retail funds are substantively regulated under the laws of the jurisdiction in which they are organized or authorized for sale, and do not target the U.S. markets or U.S. investors.   The letter reiterates that it is important that the definition focus on to whom the fund is offered, and not require that it also be publicly traded, as many non-U.S. retail funds are publicly offered but not publicly traded.

Substituted Compliance and Grandfathering

The letter requests that, if the CFTC does not fully accept our suggested alternative definition of U.S. person for funds, the CFTC not define as a U.S. person any non-U.S. retail fund the transactions of which are subject to a comparable derivatives regulatory regime (i.e., permit substituted compliance by these funds). The letter also recommends that non-U.S. retail funds be provided a one-year compliance period to seek to ensure that comparable derivatives regimes in applicable jurisdictions have time to develop.

The letter also requests that, if the CFTC does not fully accept our suggested alternative definition of U.S. person for non-U.S. retail funds, it permit existing non-U.S. retail funds that are managed by asset managers in the United States and that are publicly offered only to non-U.S. persons, to be grandfathered under the final cross-border guidance. In particular, the letter notes that certain of these non-U.S. retail funds can, consistent with U.S. law, publicly offer their shares to non-U.S. investors, but make a limited private offering to U.S. persons. It explains that those non-U.S. retail funds that made limited private offerings to U.S. persons did so in good faith under pre-existing offering restrictions, and may be unable to terminate existing investors that were permitted investors at the time of the sale.

Sarah A. Bessin
Senior Counsel

Attachment

endnotes

[1] See Final Exemptive Order regarding Compliance with Certain Swap Regulations, 78 FR 858 (Jan. 7, 2013), available at http://www.gpo.gov/fdsys/pkg/FR-2013-01-07/pdf/2012-31736.pdf (“Temporary Cross-Border Order”).

[2] ICI’s comment letters on the Commission’s prior proposed cross-border guidance are discussed in ICI Memoranda Nos. 26978 (Feb. 6, 2013) and 26408 (Aug. 23, 2012),

available at http://www.ici.org/iciglobal/pubs/memos/memo26978 and http://www.ici.org/iciglobal/pubs/memos/memo26408.

[3] For purposes of the letter, the term “non-U.S. retail fund” refers to any fund that is organized or formed outside the United States, is authorized for public sale in the country in which it is organized or formed, and is regulated as a public investment company under the laws of that country. The letter notes that, generally, non-U.S. retail funds are regulated to make them eligible for sale to the retail public, even if a particular fund may elect to limit its offering to institutional investors. Such funds, like U.S. registered investment companies, typically are subject to substantive regulation in areas such as disclosure, form of organization, custody, minimum capital, valuation, investment restrictions (e.g., leverage, types of investments or “eligible assets,” concentration limits and/or diversification standards).