The Asset Management Industry
SERVING INDIVIDUAL INVESTORS
INVESTMENT COMPANY INSTITUTE

MEMO# 26398

August 14, 2012

Draft ICI and ICI Global Comment Letter on CFTC's Proposed Interpretive Guidance on the Cross-Border Application of Certain Swaps Provisions; Member Comments Requested by August 20

[26398]

August 14, 2012

TO: CLOSED-END INVESTMENT COMPANY COMMITTEE No. 27-12
DERIVATIVES MARKETS ADVISORY COMMITTEE No. 44-12
ICI GLOBAL MEMBERS
INTERNATIONAL COMMITTEE No. 30-12
SEC RULES COMMITTEE No. 51-12 RE: DRAFT ICI AND ICI GLOBAL COMMENT LETTER ON CFTC'S PROPOSED INTERPRETIVE GUIDANCE ON THE CROSS-BORDER APPLICATION OF CERTAIN SWAPS PROVISIONS; MEMBER COMMENTS REQUESTED BY AUGUST 20

Recently, the Commodity Futures Trading Commission ("CFTC") issued proposed interpretive guidance regarding the cross-border application of the swaps provisions of the Commodity Exchange Act ("CEA") that were enacted by Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"). [1] The CFTC has issued the Proposed Guidance in recognition that many swaps businesses are conducted across multiple jurisdictions and in response to numerous comments on the application of Title VII of the Dodd-Frank Act to the cross-border activities of non-U.S. and U.S. market participants.

ICI and ICI Global have prepared a draft comment letter, which is attached and briefly summarized below. If you have comments on the draft letter, please provide them to Jennifer Choi at jennifer.choi@ici.org by Monday, August 20.

In the draft letter, ICI and ICI Global take the view that the CFTC's proposed extraterritorial approach extends the swap provisions of the CEA beyond what was intended under Title VII and could result in the imposition of the swap provisions to entities that have only a nominal nexus to the United States. The letter states that the CFTC's approach could

disadvantage U.S. registered investment companies ("U.S. registered funds") and certain non-U.S. investment companies ("non-U.S. funds") that engage in derivatives transactions around the world.

Definition of U.S. Person

The draft letter expresses concerns with two of the definitions that address commodity pools, pooled accounts, and collective investment vehicles. The proposed definition of "U.S. person" would include any commodity pool, pooled account, or collective investment vehicle (regardless of where it is incorporated) of which a majority ownership is held by a U.S. person(s). The letter argues that this definition is unworkable for a couple of reasons. First, many non-U.S. funds are publicly traded in the secondary market, and the manager/operator of the fund and the fund would not know the composition of the investor-base in the secondary market. Second, because of the distribution system for non-U.S. funds and the use of omnibus accounts, the manager/operator of the fund and the fund would not know the ultimate beneficial owners of the funds.

The other definition in the Proposed Guidance would consider any commodity pool, pooled account, or collective investment vehicle the operator of which would be required to register as a commodity pool operator under the CEA to be a "U.S. person." As currently drafted, this prong of the "U.S. person" definition could include a non-U.S. fund that does not itself trigger its operator's registration as a commodity pool operator. The letter argues that, if the CFTC takes this approach, these non-U.S. funds could be considered "U.S. persons" solely because they are operated by a registered CPO (which had to register as a CPO as a result of its commodity interest trading activities apart from the non-U.S. funds). The letter takes the view that the CFTC did not intend such a broad and unnecessary extension of its jurisdiction. The letter urges the CFTC to clarify that a U.S. person would not include a non-U.S. fund solely because it is operated by a registered CPO.

Consequences of Defining Non-U.S. Funds with a Nominal Nexus to the United States as a "U.S. Person"

The draft letter takes the view that the proposed definition of U.S. person would impose significant regulatory obligations on certain non-U.S. funds with only a tangential nexus to the United States. These non-U.S. funds would have to comply with certain swap provisions of the CEA, which may duplicate or conflict with the regulations of their home country. In addition, the letter notes that the broad reach of these proposed definitions has implications not only for the non-U.S. funds that would be captured by them, but for the non-U.S. counterparties that may engage in derivatives transactions with them and become subject to Title VII of the Dodd-Frank Act and CFTC regulations as a result. Specifically, non-U.S. entities that engage in transactions with non-U.S. funds that are deemed U.S. persons may have to calculate whether they cross the threshold for being a "swap dealer" or a "major swap participant" and comply with the significant requirements applicable to such entities. At the very least, a non-U.S. entity engaging in derivatives transactions outside the United States with a non-U.S. fund that is deemed a U.S. person would be required to comply with certain requirements of the Dodd-Frank Act and CFTC regulations.

Alternative Test of "U.S. Person" for Non-U.S. Funds

In lieu of the two tests, the draft letter recommends that the Commission define a commodity pool, pooled account, or collective investment vehicle that is offered to U.S.

persons to be a U.S. person. The letter argues that focusing on the "offer to U.S. persons" has two key advantages. First, if the "U.S. person" determination is made by how a commodity pool, pooled account, or collective investment vehicle conducts its offerings, the definition will be workable and systems are already in place to comply with the standard. This approach also would provide certainty to counterparties at the outset of a swap transaction regarding what laws would govern. Second, the alternative definition would look to whether the commodity pool, pooled account, or collective investment vehicle is attempting to target the U.S. market or U.S. investors and should appropriately be subject to U.S. laws. By focusing on the directed activities of the fund and its manager/operator and not activities that are beyond the control of the fund or its fund manager/ operator, the letter states that the CFTC could readily determine those funds that have a significant connection to the United States or to the U.S. commerce.

With respect to defining a "U.S. person" as a commodity pool, pooled account, or collective investment vehicle that is offered to U.S. persons, the letter requests that the Commission look to Regulation S under the Securities Act of 1933 ("Securities Act") for assistance. The letter notes that market participants around the world, including funds, have built their compliance systems and processes based on Regulation S, which has been in place for over 20 years. Consistency with the Regulation S approach would prevent disruptions, confusion, and additional costs.

Substituted Compliance

In the Proposed Guidance, the CFTC proposes to permit non-U.S. SDs or non-U.S. MSPs to comply with "substituted compliance" whereby a non-U.S. entity is allowed to comply with its home regulations without additional requirements under the CEA if the CFTC finds that such requirements are comparable to requirements under the CEA and CFTC regulations. The draft letter expresses concern that the process for "substituted compliance" may be too burdensome, which could discourage non-U.S. SDs or non-U.S. MSPs from engaging in transactions with U.S. persons, such as U.S. registered funds and certain non-U.S. funds. U.S. entities could be at a competitive disadvantage if non-U.S. entities determine that the burden and costs for obtaining permission for substituted compliance or having to comply with CFTC rules for which there are no foreign counterpart requirements outweigh the benefits of engaging in transactions with U.S. registered funds or non-U.S. funds that are deemed U.S. persons.

Cross-Border Application of Swap Provisions to Transactions Involving Market Participants Other than SDs and MSPs

The CFTC proposes to require the Dodd-Frank Act requirements related to clearing, trade-execution, real-time reporting, Large Trader Reporting, swap data reporting ("SDR") Reporting, and recordkeeping to apply to swaps where one or both of the counterparties to the swap is a U.S. person. The letter questions how non-U.S. counterparties could comply with certain of these requirements, such as clearing and trade execution. The letter also seeks clarification whether the requirement to comply with the enumerated rules would require counterparties to comply with other related rules (e.g., for the clearing requirement, would rules on customer collateral or margin for cleared swaps apply). The letter argues that there likely will be conflicting and duplicative requirements imposed on these counterparties.

In situations where counterparties are under the jurisdiction of multiple regulators, the letter recommends a different approach to the one set forth in the Proposed Guidance. The letter suggests that the CFTC permit counterparties to agree in advance to comply with the requirements of a particular country as long as the jurisdiction regulates derivatives in accordance with the G20 agreement.

Regulatory Coordination and Cooperation

The draft letter emphasizes the importance of global coordination among regulators with respect to cross-border application of derivatives regulations to avoid imposing potentially, at best, duplicative and, at worst, conflicting regulatory requirements on counterparties. The letter recommends real and meaningful coordination among regulators on how these cross-border transactions should be appropriately regulated. Although regulators around the world may be at different points of implementation of derivatives regulation, the letter argues that the extraterritorial approach adopted by the CFTC must consider the fact that other jurisdictions have adopted, and in the future will adopt, regulations and any approach adopted must be workable within this global context.

Unless the regulators coordinate the requirements that would apply to such activities, the letter suggests that there may be reluctance to engage in cross-border derivatives transactions, thereby impeding the ability of funds to hedge their exposures effectively and efficiently. Moreover, there could be negative economic and competitive effects on U.S. persons and the U.S. economy if non-U.S. persons chose not to engage in transactions with U.S persons to avoid triggering compliance with CFTC requirements in addition to their home country regulations. The letter states that this result would be harmful to the U.S. financial markets, including U.S. funds and their investors.

Jennifer S. Choi
Senior Associate Counsel – Securities Regulation

Attachment

endnotes

[1] Cross-Border Application of Certain Swaps Provisions of the Commodity Exchange Act, 77 FR 41214, available at http://www.gpo.gov/fdsys/pkg/FR-2012-07-12/pdf/2012-16496.pdf (July 12, 2012) ("Proposed Guidance"). For a summary of the Proposed Guidance, see ICI Memorandum No. 26291 (July 12, 2012), available at http://www.ici.org/my_ici/memorandum/memo26291.