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COMMENT LETTER

September 16, 2013

ICI and ICI Global Comment Letter on Proposed Draft Standards for Derivatives Contracts Between Non-EU Entities Potentially Subject to EU Regulations (pdf)

September 16, 2013 Mr. Steven Maijoor Chair European Securities and Markets Authority CS 60747 103 Rue de Grenelle 75345 Paris Cedex 07 France Re: Consultation Paper: Draft Regulatory Technical Standards on contracts having a direct, substantial and foreseeable effect within the Union and non-evasion provisions of EMIR Dear Mr. Maijoor: The Investment Company Institute ("ICI")1 and ICI Global2 appreciate the opportunity to provide comments on the consultation paper issued by the European Securities and Markets Authority ("ESMA") on the Draft Regulatory Technical Standards on contracts having a direct, substantial and foreseeable effect within the European Union and non-evasion provisions of the European Market Infrastructure Regulation ("Draft RTS").3 We generally support the approach taken by ESMA, which would circumscribe appropriately the application of the European Market Infrastructure Regulation ("EMIR") to only those transactions between third-country entities with direct, substantial and foreseeable effects within the European Union. We also have some specific comments on the Draft RTS as proposed, which are discussed below. 1 The Investment Company Institute is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds ("ETFs"), and unit investment trusts ("UITs"). ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. Members of ICI manage total assets of $15.4 trillion and serve over 90 million shareholders. 2 ICI Global is the global association of regulated funds publicly offered to investors in leading jurisdictions worldwide. ICI Global seeks to advance the common interests and promote public understanding of global investment funds, their managers, and investors. Members of ICI Global manage total assets in excess of US $1 trillion. 3 Consultation Paper, Draft Regulatory Technical Standards on contracts having a direct, substantial and foreseeable effect within the Union and non-evasion provisions of EMIR, European Securities and Markets Authority (July 17, 2013), available at http://www.esma.europa.eu/system/files/2013-892_draft_rts_of_emir.pdf ("Consultation Paper"). ICI/ICI Global Letter to Mr. Steven Maijoor September 16, 2013 Page 2 of 7 Background Regulation (EU) No. 648/2012 of the European Parliament and Council on OTC derivatives, central counterparties and trade repositories (EMIR) was adopted on July 4,

2012 and entered into force on August 16, 2012. EMIR introduces provisions to improve transparency, establish common rules for central counterparties ("CCPs") and for trade repositories ("TRs"), and reduce the risks associated with the OTC derivatives market. In this respect, it provides for the obligation to centrally clear certain OTC derivatives contracts or to apply risk mitigation techniques such as the exchange of collateral for uncleared OTC derivatives contracts. These obligations generally apply to OTC derivatives contracts when counterparties are established in the European Union. When one counterparty to an OTC derivatives contract is established in the European Union and the other counterparty is established in a third country (i.e., a cross-border transaction), the clearing obligation or risk mitigation requirements apply subject to mechanisms for the avoidance of duplicative or conflicting rules.4 The primary method to prevent duplicative or conflicting regulations of cross-border transactions is to permit the counterparties to comply with the regulations of the third country if those regulations are found to be equivalent to those under EMIR. ESMA has provided advice to the EU Commission regarding the equivalence of regulations in the United States, Japan, Australia, Hong Kong, Singapore, and Switzerland. We look forward to the EU Commission's equivalence determinations with respect to those jurisdictions. We note that the Consultation Paper does not address the application of EMIR in this context. When both counterparties are established in third countries, under Article 4(4) and Article 11(14)(e) of EMIR, the clearing obligation or the risk mitigation techniques would apply to a contract between such counterparties if it would have a direct, substantial and foreseeable effect within the European Union or the application of EMIR would be necessary or appropriate to prevent the evasion of provisions of EMIR. The Draft RTS provides the conditions under which a contract between two non-EU counterparties would meet this standard of EMIR and is intended to avoid the imposition of duplicative or conflicting rules. U.S. funds that are regulated under the Investment Company Act of 1940 ("ICA") and non- U.S. regulated funds publicly offered to investors (collectively, "Regulated Funds") use OTC derivatives contracts in a variety of ways. OTC derivatives contracts are a particularly useful portfolio management tool in that they offer Regulated Funds considerable flexibility in structuring their investment portfolios. Uses of OTC derivatives contracts include, for example, hedging positions, equitizing cash that a Regulated Fund cannot immediately invest in direct equity holdings, managing a Regulated Fund's cash positions more generally, adjusting the duration of a Regulated Fund's portfolio, or managing a Regulated Fund's portfolio in accordance with the investment objectives stated in a Regulated Fund's prospectus. ICI and ICI Global members conduct derivatives businesses across multiple jurisdictions. To employ OTC derivatives contracts in the best interests of fund shareholders, ICI and ICI Global members have a strong interest in ensuring that the derivatives markets are highly 4 See Article 13 of EMIR. ICI/ICI Global Letter to Mr. Steven Maijoor September 16, 2013 Page 3 of 7 competitive and transparent and are regulated consistently worldwide. Specifically, we have an interest in ensuring that where a fund established outside of the European Union (such as a U.S. fund regulated under the ICA) enters into an OTC derivatives contract with a counterparty that also is established outside of the European Union, the circumstances in which EMIR would apply to its activities are clear, proportionate and duplicative or conflicting regulations are avoided. We respond below to various aspects of the Consultation Paper that are relevant to ICI and ICI Global members. Contracts considered to have a direct, substantial and foreseeable effect within the European Union In the Consultation Paper, ESMA provides two situations in which an OTC derivatives contract between two non-EU counterparties may have a direct, substantial, and foreseeable effect within the European Union ("EMIR Covered Contract"). We share ESMA's views that the criteria for determining when a contract entered into by two third country counterparties would be considered an EMIR Covered Contract should be clear and detailed to provide certainty. We also welcome ESMA's confirmation that EMIR

would not apply to an EMIR Covered Contract if at least one of the parties is established in a country for which equivalence has been declared. (a) Guarantee by an EU guarantor Q.1 Do you agree that a full or partial guarantee issued to the benefit of a third country counterparty by an EU guarantor, whatever is its form, be considered in order to specify the direct, substantial and foreseeable effect of the contract? For Regulated Funds, the first situation would most likely arise where a Regulated Fund (established outside of the EU) enters into an OTC derivatives contract with a non-EU subsidiary of an EU bank that is guaranteed by the bank in respect of such OTC derivatives contract. ESMA limits, however, the scope of this provision to guarantees issued by financial counterparties and for which the amount of the guarantee exceeds two thresholds related to the value of the OTC derivatives contract guaranteed and the value of the guarantee compared to the OTC derivatives activity of the EU financial counterparty providing the guarantee. The two thresholds which ESMA has proposed in this respect are as follows: (i) the guarantee must be in respect of more than EUR 8 billion of notional amount of OTC derivative contracts; and (ii) the guarantee must be in respect of more than 5% of the total OTC derivative contract exposure of the European financial counterparty. Although we recognize ESMA's concern that the guarantee by an EU financial counterparty may have direct, substantial, and foreseeable effects in the European Union, the non-EU counterparty may not be aware of the guarantee or whether the two thresholds have been reached. We request that ICI/ICI Global Letter to Mr. Steven Maijoor September 16, 2013 Page 4 of 7 ESMA permit non-EU counterparties to rely on representations by their counterparties that the transactions are not guaranteed by an EU financial counterparty or that the guarantee is below the two thresholds. Q.2 Do you agree with the 2 cumulative thresholds proposed in the draft RTS? Do you consider that the proposed value of the thresholds is set at an appropriate level in order to specify the direct, substantial and foreseeable effect of the contract? Please provide relevant data to justify your answer. We generally believe the two cumulative thresholds proposed in the Draft RTS are appropriate. We note that the first threshold is consistent with the threshold adopted by the Basel Committee on Banking Supervision and IOSCO for the imposition of initial margin for uncleared derivatives. This threshold will focus on guarantees of sufficient magnitude that may potentially have a direct, substantial, and foreseeable effect in the European Union. (b) EU branches of non-EU entities In addition, ESMA proposes that, where two non-EU entities enter into an OTC derivatives contract and where both entities act through a branch in the EU, the contract should constitute an EMIR Covered Contract. Q.3 Do you agree that OTC derivative contracts entered into between two EU branches of third country entities would have direct effect within the Union? Regulated Funds do not operate through branches. Accordingly, this question is not relevant to Regulated Funds. (c) Other cases considered by ESMA We appreciate ESMA discussing the other circumstances in which it has considered whether or not an OTC derivatives contract between two non-EU entities should constitute an EMIR Covered Contract. We agree with ESMA's analysis that none of the three circumstances described below should give rise to an EMIR Covered Contract. (i) Currency and underlying of the OTC derivative contract: Q.4 Do you agree that criteria related to the currency or underlying of the OTC derivative contracts should not be used to specify the direct effect of the contract within the Union? We agree that it would not be appropriate to provide that an OTC derivatives contract with a currency or underlying connected to the European Union should constitute an EMIR Covered Contract. We agree with ESMA's analysis that using such criteria would entail using an unnecessarily ICI/ICI Global Letter to Mr. Steven Maijoor September 16, 2013 Page 5 of 7 broad definition of the "direct" nature of the effect of the OTC derivatives contract in the European Union. (ii) Subsidiaries: Q.5 Do you agree that contracts of third country subsidiaries of EU entities would not have a direct substantial and foreseeable effect within the EU? We agree that it would not be appropriate to consider OTC

derivatives contracts entered into by non-EU subsidiaries of EU entities to be EMIR Covered Contracts. We do not believe that the mere fact that a counterparty is a subsidiary of an EU entity without more would cause its derivative transactions with other non-EU entities to have direct, substantial and foreseeable effects within the European Union. Q.6 Do you believe that in absence of a guarantee, there is limited implicit backing by the EU parent of a third country subsidiary that can result in a direct, substantial and foreseeable effect in the EU? Yes (iii) Contractual effect: Q.8 Do you agree that the acceleration of the obligation of listed entities resulting from the OTC derivative contract should not be considered to specify the direct, substantial and foreseeable effect of the contract? We agree that a default by a non-EU entity under an OTC derivatives contract with another non-EU entity ("Non-EU Derivatives Contract") that gives rise to a right to accelerate an EU entity's obligations under an OTC derivatives contract ("EU Derivatives Contract") should not convert the Non-EU Derivatives Contract into an EMIR Covered Contract. Given that the EU Derivatives Contract is already subject to EMIR, it would seem disproportionate to require the Non-EU Derivatives Contract to be subject to EMIR. Prevention of Evasion We note that EMIR includes anti-evasion rules designed to subject transactions entered into by counterparties established outside of the EU to the clearing obligation and risk mitigation techniques required by EMIR where this is necessary or appropriate to prevent the evasion of EMIR. ESMA proposes that the key consideration is the primary purpose of the arrangement. If the arrangement is established because of a business or commercial reason or economic justification, ESMA would view it as legitimate. In the absence of such a rationale, ESMA would consider such an arrangement to be artificial and states that it may give rise to "characterization as a case where evasion should be ICI/ICI Global Letter to Mr. Steven Maijoor September 16, 2013 Page 6 of 7 prevented."5 In determining whether the arrangement or series of arrangements is artificial, ESMA would look to certain enumerated factors. Q.9 Do you agree with a criteria based approach in order to determine cases where it is necessary or appropriate to prevent the evasion of any of the provisions of EMIR? We believe that a principles-based approach for determining whether an arrangement is designed to evade the provisions of EMIR would be more appropriate. We agree with ESMA that it should not develop a prescriptive list of transactions or circumstances that would violate the anti- evasion rule. Therefore, the examples provided by ESMA of situations that would give rise to the application of the anti-evasion rule may risk ESMA adopting an approach that it wishes to avoid, i.e., a prescriptive list of transactions or circumstances. Further, we believe that ESMA should explicitly include in Article 3 of the RTS ESMA's acknowledgment in the Consultation Paper that if an arrangement is established "because of a business, commercial reason or economic justification, it [ ] would be legitimate."6 Finally, we do not believe it is appropriate or necessary to expand the anti-evasion rule by adding the concept of an "abuse of application of [EMIR] such as the benefit of an exemption."7 We believe that this confuses the purpose and scope of the anti-evasion rule and respectfully urge ESMA to reconsider the need for such a provision. Given our suggestions above, we set out in Appendix A recommended amendments to Article 3 of the RTS and related recitals for ESMA's consideration. Q.10 Do you agree that artificial arrangements that would have for primary purpose to avoid or abuse of any of provision of EMIR should be considered as cases where evasion of provision of EMIR should be prevented? We are of the view that any such arrangements should be subject to the test that we have proposed in our response to Q.9. We believe that the approach set out in the Draft RTS is unnecessarily detailed and difficult to apply. * * * * * 5 See Consultation Paper, supra note 3, at paragraph 49. 6 Id. 7 Recital 8 of the Draft RTS. The Consultation Paper does not describe in any detail its concept of "abuse of application of any provision" of EMIR. ICI/ICI Global Letter to Mr. Steven Maijoor September 16, 2013 Page 7 of 7 We appreciate the opportunity to respond to the Consultation Paper. If you have any questions

on our comment letter, please feel free to contact the undersigned or Sarah Bessin at +1-202- 326-5835, Jennifer Choi at +1-202-326-5876, or Giles Swan at +44-203-009-3103. Sincerely, /s/ Karrie McMillan /s/ Dan Waters Karrie McMillan Dan Waters General Counsel Managing Director Investment Company Institute ICI Global 202-326-5815 44-203-009-3101 kmcmillan@ici.org dan.waters@ici.org UK1 6584113v.1 APPENDIX A Recitals 7 and 8: (7) OTC derivative contracts may be entered into by specific counterparties with the primary purpose to avoid application of the clearing obligation or of the risk mitigation techniques that would have applied to entities that would have been the natural counterparties to the contract, or to abuse their application. Such contracts should be considered as an evasion as they defeat the object, spirit and purpose of the clearing obligation or risk mitigation techniques prescribed by Regulation (EU) No 648/2012. (8) OTC derivative contracts that are part of an arrangement whose feature is not supported by a business, commercial reason or economic justification rationale and which demonstrate that the primary purpose of the arrangement is to prevent application of Regulation (EU) No 648/2012, or to abuse the application of the Regulation such as the benefit of an exemption, should be considered an evasion of the Regulation (EU) No 648/2012. Article 3: Article 3 Cases where it is necessary or appropriate to prevent the evasion of any provision of Regulation (EU) No 648/2012 1. It is necessary or appropriate to prevent the evasion of any provision of Regulation (EU) No 648/2012 where OTC derivative contracts would have been subject to the clearing obligation or the risk mitigation techniques but have been concluded in a way which is contrived to evade application of the clearing obligation or of the risk mitigation techniques. 2. For the purposes of this Article, an OTC derivative contract is deemed to have been contrived to evade the application of any provision of Regulation (EU) N.648/2012 if the way in which the OTC derivative contract has been concluded is considered, viewed as a whole, and having regard to all the circumstances, to have as its primary purpose, or to have features which would not be in the arrangement by which the contract was concluded if it did not have as its primary purpose: (a) the avoidance of the application of any provision of Regulation (EU) N.648/2012, or (b) the abuse of the application of any provision of Regulation (EU) N.648/2012. 3. Notwithstanding Article 3(2) above, where the OTC derivative contract forms part of an arrangement established because of a business, commercial reason or economic justification it will be in compliance with this Article 3. For the purposes of paragraph 2, it shall be considered that an OTC derivative contract has been contrived to circumvent Regulation (EU) N.648/2012 when it is part of an artificial arrangement or an artificial series of arrangements which has been put into place for UK1 6584113v.1 2 the essential purpose of avoidance of any provision of Regulation (EU) N.648/2012 or to exploit the application of Regulation (EU) N.648/2012. An arrangement may be concluded through any contract, transaction, scheme, action, operation, agreement, grant, understanding, promise, undertaking or event any may comprise more than one step or part. An arrangement, or a series of arrangements is artificial where it lacks commercial substance or relevant economic justification in itself. In determining whether the arrangement or series of arrangements is artificial, it shall be considered, in particular, whether they involve one or more of the following situations: (a) the legal characterization of the individual steps of an arrangement is inconsistent with the legal substance of the arrangement as a whole; (b) the arrangement or series of arrangements is carried out in a manner which would not ordinarily be employed in what is expected to be a reasonable business conduct; (c) the arrangement or series of arrangements includes elements which have the effect of offsetting or cancelling the economic meaning of each other; (d) transactions concluded are circular in nature; (e) the arrangement or series of arrangements results in non-application of Regulation (EU) No 648/2012 but this is not reflected in the business risks undertaken by the entities relating this activity. The purpose of the arrangement is considered essential where any other

purpose of this arrangement or series of arrangements appears at most negligible, in view of all the circumstances of the case. The purpose of an arrangement or series of arrangements, consists in avoiding the Regulation (EU) N.648/2012 where, regardless of any subjective intentions of the entities involved, it defeats the object, spirit and purpose of the Regulation (EU) No 648/2012 provisions that would otherwise apply. 4. In determining whether an arrangement or series of arrangements has led to the evasion of Regulation (EU) No 648/2012 as referred to in paragraph 4, the requirements of Regulation (EU) No 648/2012 applicable to the entities involved, having regard to those arrangements, shall be compared with the requirements that would be applied under the same circumstances in the absence of the arrangements.
