INVESTMENT COMPANY INSTITUTE

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February 15, 2018

STATEMENT FOR THE RECORD OF THE INVESTMENT COMPANY INSTITUTE ON DISCUSSION DRAFT LEGISLATION:

TO EXCLUDE NON-US REGULATED FUNDS FROM THE DEFINITION OF "UNITED STATES PERSON" AND ENSURE CONSISTENT APPLICATION OF TITLE VII OF THE DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT TO CROSS-BORDER SECURITY-BASED SWAP AND SWAP TRANSACTIONS, AND FOR OTHER PURPOSES

Hearing on "Legislative Proposals Regarding Derivatives"
Subcommittee on Capital Markets, Securities, and Investment
Committee on Financial Services
US House of Representatives
February 14, 2018

Members of the Investment Company Institute[1] include both US mutual funds and similar regulated funds offered to investors in jurisdictions worldwide ("non-US regulated funds"). ICI supports the discussion draft which would exclude non-US regulated funds from the definition of "United States person" and ensure consistent application of title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") to cross-border security-based swap and swap transactions. The discussion draft would ensure that non-US regulated funds, such as UCITS,[2] are not subject to conflicting derivatives rules of two jurisdictions – the fund's home jurisdiction and the United States, solely because they have a US subadviser. As discussed below, these foreign funds have little connection to the United States, and applying US derivatives rules to them only because the funds hire US managers would place American businesses at a significant disadvantage to their non-US counterparts.

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[1] The Investment Company Institute (ICI) is the leading association representing regulated funds globally, including mutual funds, exchange-traded funds (ETFs), closed-end funds, and unit investment trusts (UITs) in the United States, and similar funds offered to investors in jurisdictions worldwide. ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. ICI's members manage total assets of US$21.7 trillion in the United States, serving more than 100 million US shareholders, and US$7.1 trillion in assets in other jurisdictions. ICI carries out its international work through ICI Global, with offices in London, Hong Kong, and Washington, DC.

[2] Non-US regulated funds are offered and sold in countries around the world, and include, for example, "undertakings for collective investment in transferable securities," or UCITS. These funds generally are the non-US equivalent of US mutual funds – publicly offered funds sold to retail investors (as compared to privately offered hedge funds). UCITS are subject to detailed requirements including those related to disclosure and custody, as well as investment restrictions and limitations. They are required to have a European primary manager that remains fully responsible for management of the fund, although the primary manager may appoint a subadviser, including a US subadviser (e.g., to manage the US equities portion of the portfolio).

Background

SEC Rulemakings

The SEC, in a series of rulemakings, has addressed when Title VII of the Dodd-Frank Act would apply to cross-border derivatives activities. The SEC defines a "US person" to include, among others, a "[a] partnership, corporation, trust, investment vehicle, or other legal person organized, incorporated, or established under the laws of the United States or having its principal place of business in the United States . . ."[3] The definition further provides that, "[f]or purposes of this section, ***principal place of business*** means the location from which the officers, partners, or managers of the legal person primarily direct, control, and coordinate the activities of the legal person. With respect to an externally managed investment vehicle, this location is the office from which the manager of the vehicle primarily directs, controls, and coordinates the investment activities of the vehicle. . . ."[4]

The SEC's definition of "US person" fails to exclude non-US regulated funds that are authorized to be publicly offered to non-US persons, but are not publicly offered to US persons. Without an explicit exclusion, non-US regulated funds that have a US subadviser must make a facts and circumstances determination as to whether or not they have "a principal place of business in the United States." These funds could be deemed to be a "US person," even though these funds do not intend to be active in the US markets, the risks of their related transactions reside outside the United States, and investors have no reasonable expectation that US laws would apply to them.[5]

CFTC Guidance and Rulemakings

Title VII of the Dodd-Frank Act added section 2(i) to the Commodity Exchange Act excluding all swap activities outside the United States from its scope, unless those activities have a "direct and significant connection with activities in, or effect on, commerce of the United States." The CFTC issued interpretive guidance in 2013 to implement the new section and clarify the CFTC's cross-border policy applicable to swap transactions. That guidance defined "US person," identifying persons that the CFTC deemed to meet the jurisdictional nexus to the United States under section 2(i), and were therefore subject to the CFTC's regulations. To ensure that non-US regulated funds with a US manager that have only a nominal nexus to the United States are not

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[3] 17 C.F.R. 240.3a71-3.

[4] The SEC explained that "[t]his definition directs market participants to consider where the activities of an externally managed investment vehicle generally are directed, controlled, and coordinated, even if this conduct is performed by one or more legally separate persons." *Application of "Security-Based Swap Dealer" and "Major Security-Based Swap Participant" Definitions to Cross-Border Security-Based Swap Activities*, 79 Fed. Reg. 47277, 47310-11 (Aug. 12, 2014). The SEC suggests this usually will be the location of the primary manager of the investment vehicle. With respect to a UCITS, for example, this generally would be the location of the European manager.

[5] This would be true whether a non-US regulated fund publicly offers its shares to non-US investors, or only is authorized to do so. Generally, non-US retail funds are regulated to make their shares eligible for sale to the retail public, even if a particular fund may elect to limit its offering to institutional investors. Such funds, like US 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). *See, e.g., supra* note 2. Such non-US funds similarly do not raise any US jurisdictional interest, and should not be considered US persons.

subject to the CFTC's regulations, the guidance specifically excluded from the "US person" definition non-US regulated funds that are publicly offered to non-US persons but not offered to US persons, such as UCITS. The definition of US person in recent CFTC rulemakings, however, like SEC rulemakings, does not contain a similar exclusion.[6]

Nominal Nexus to the United States

The Committee's discussion draft would recognize that non-US regulated funds that are authorized to be publicly offered to non-US persons and are not publicly offered to US persons do not have a "direct and significant connection" with the United States or otherwise raise a US jurisdictional interest that would merit imposing US derivatives rules. Although non-US regulated funds may contract with a US manager to manage their assets (e.g., a UCITS that employs a US subadviser to manage the US equities portion of its portfolio), non-US regulated funds have only a nominal nexus to the United States. These funds are marketed and sold publicly to retail investors outside the United States, they do not intend to be active in the US markets, and investors have no reasonable expectation that US laws would apply to them. Furthermore, the financial risks of the transactions of non-US regulated funds remain with the non-US fund and don't migrate to the United States with the use of the services of a US adviser. Each fund is a separate pool of securities with its own assets, liabilities and shareholders, and the non-US regulated fund's US adviser or promoter does not guarantee the fund's transactions.

Promoting a Level Playing Field

Without an explicit exclusion, non-US regulated funds that have a US subadviser could potentially be subject to the conflicting rules of two separate jurisdictions – those of the fund's home jurisdiction as well as SEC or CFTC regulations, a costly and burdensome prospect. To avoid this result, non-US regulated funds may terminate a US asset manager and/or avoid hiring a US asset manager. Non-US dealers may seek to avoid engaging in transactions with non-US regulated funds that could be US persons so that these foreign dealers won't become subject to US requirements. Thus, being deemed a US person could significantly disadvantage US asset managers to non-US regulated funds vis-à-vis their non-US counterparts, resulting in harm to US business and potentially driving asset management business overseas.

A Uniform Standard is Critical

The SEC and CFTC approaches to the regulation of cross-border activities differ. The discussion draft provides an ideal opportunity to achieve consistency in the approach to "US person" by the two agencies. This is important because if non-US regulated funds are subject to inconsistent definitions of "US person," the result will be confusion, operational challenges, and potentially different regulatory treatment of entities transacting in otherwise similar instruments and often from the same trading desk. Global firms face significant costs and burdens if the SEC's and CFTC's regulatory approaches produce different outcomes regarding whether an entity or transaction would be subject to the Dodd-Frank Act. Attempting to analyze derivatives

[6] *See, e.g., Cross-Border Application of the Registration Thresholds and External Business Conduct Standards Applicable to Swap Dealers and Major Swap Participants*, 81 Fed. Reg. 71946 (Oct. 18, 2016); *Uncleared Swaps for Swap Dealers and Major Swap Participants— Cross-Border Application of the Margin Requirements*, 81 Fed. Reg. 34818, 34824 at n.62 (May 31, 2016).

transactions differently for swaps and security-based swaps that are traded typically by the same trading desk or desks of asset managers is unworkable.

Conclusion

For these reasons, we support the discussion draft's exclusion of non-US regulated funds from the definition of "US person," and the bill's requirement that the SEC and CFTC harmonize their definitions.