ESMA
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Via Electronic Submission: www.esma.europa.eu

16 September 2013

AIMA/MFA Response - Draft Regulatory Technical Standards on contracts having a direct, substantial and foreseeable effect within the Union and non-evasion of provisions of EMIR

Dear Sirs,

The Alternative Investment Management Association[1] (**AIMA**) and Managed Funds Association[2] (**MFA**, and together with AIMA, **we**) welcome the opportunity to provide comments to the European Securities and Markets Authority (**ESMA**) on its Consultation Paper regarding "Draft Regulatory Technical Standards on contracts having a direct, substantial and foreseeable effect within the Union and non-evasion provisions of EMIR"[3] (**CP**).

We strongly support a rational and proportionate approach to the application of EMIR rules to third country entities and to avoiding unnecessary application of duplicative or conflicting rules to derivatives transactions. In particular, we encourage ESMA to adopt an approach that maximises certainty for all relevant stakeholders and that captures only those derivatives contracts with a substantial connection to the European Union. We provide our direct comments to the CP below.

However, to understand to which derivatives contracts the Draft Regulatory Technical Standards (**Draft RTS**) apply, we also ask ESMA to provide further guidance on the application of Article 13 of EMIR. As we highlighted in our previous letter to ESMA of 12 March 2013,[4] we would appreciate it if, within its EMIR Questions and Answers (**ESMA Q&As**), ESMA could clarify its interpretation of the term 'established' under Article 13.

Article 13 specifies that, when the European Commission (**Commission**) has adopted an implementing act with respect to the equivalence of a third country's legislative regime, counterparties entering into a derivative contract subject to EMIR will be deemed to satisfy the requirements of Articles 4, 9, 10 and 11 of EMIR provided that at least one of the counterparties is 'established' in the relevant third country. The meaning of the word 'established' in this context, however, is not clear. We propose that, in interpreting the term 'established', ESMA take into account: (i) that the purpose of Article 13 is to avoid placing duplicative or conflicting requirements upon market participants where those counterparties are subject to an equivalent third country's legal, supervisory and enforcement arrangements; and (ii) the way in which other jurisdictions, in particular the US Commodity Futures Trading Commission (**CFTC**) and US Securities and Exchange Commission (**SEC**), define the scope of their respective rules.

[1] AIMA is the trade body for the hedge fund industry globally; our membership represents all constituencies within the sector – including hedge fund managers, fund of hedge funds managers, prime brokers, fund administrators, accountants and lawyers. Our membership comprises over 1,300 corporate bodies in over 50 countries.

[2] Managed Funds Association represents the global alternative investment industry and its investors by advocating for sound industry practices and public policies that foster efficient, transparent and fair capital markets. MFA, based in Washington, DC, is an advocacy, education and communications organization established to enable hedge fund and managed futures firms in the alternative investment industry to participate in public policy discourse, share best practices and learn from peers, and communicate the industry's contributions to the global economy. MFA members help pension plans, university endowments, charitable organizations, qualified individuals and other institutional investors to diversify their investments, manage risk and generate attractive returns. MFA has cultivated a global membership and actively engages with regulators and policy makers in Asia, Europe, North and South America, and many other regions where MFA members are market participants.

[3] ESMA/2013/892. Available at: http://www.esma.europa.eu/system/files/2013-892_draft_rts_of_emir.pdf

[4] AIMA-MFA Joint Letter proposing updated ESMA EMIR Q&As (12 March 2013). Available at: http://www.aima.org/en/document-summary/index.cfm/docid/A16C2F1B-EA24-4086-A0E23CA6AF5ED1F8

We highlight the situation of an alternative investment fund that is not 'established' (*i.e.*, incorporated) in the US, but that, due to its investor base or the location of its investment manager, will be designated as a 'U.S. person' on 10 October 2013 for purposes of the CFTC swap regulations,[5] and may, in the future, similarly be designated as a 'U.S. person' under the SEC security-based swap regulations,[6] (together, **US Rules**). Such an entity (**US-AIF**), therefore, will be subject to US Rules. For certain regulatory obligations, the CFTC and SEC may deem the US-AIF's compliance with EMIR to satisfy compliance with the applicable US Rules.[7] However, it is also evident that, for certain regulatory obligations (*e.g.*, mandatory reporting), substituted compliance would not be available to the US-AIF under CFTC Guidance, and may not be available under SEC final cross-border rules. In the absence of such substituted compliance or a CFTC deemed equivalence determination, the US-AIF may be unable to enter into certain transactions without becoming subject to conflicting obligations under the relevant US Rules and EMIR provisions, such that the US-AIF would be unable to comply with both sets of rules applicable to its trading activity.

We strongly believe that such an outcome is not desirable or necessary.

Article 13 of EMIR references only where an entity is 'established', but does not give consideration to where the entity is in fact subject to an equivalent third country's rules. We contend strongly that to deny an entity, as described above, the ability to rely upon an equivalence determination, and to subject it to potentially duplicative and/or conflicting rules, would run counter to the intention behind Article 13. We, therefore, urge ESMA to confirm that it will deem a counterparty to be 'established' in a third country for the purposes of Article 13 if that counterparty is subject to the rules of that third country's regime. Accordingly, should the Commission adopt an implementing act of equivalence in respect of the US Rules,[8] we recommend that ESMA enable entities that are subject to the US Rules, but are not incorporated in the US, to rely on the equivalence determination.

Our key points with respect to the questions asked in the CP are as follows:

- We believe that ESMA should use the existence of a guarantee beyond objectively-defined thresholds as the basis to measure the direct, substantial and foreseeable effect of a contract within the EU;

- We agree that it is not necessary for ESMA separately to evaluate the direct, substantial and foreseeable effect of contracts of third country subsidiaries, if those contracts are subject to sufficient guarantees provided by their EU-established parent entities;

- We support ESMA's proposal to use a criteria based, non-prescriptive test to determine evasion; and

- We suggest that ESMA propose a clear and simple test for evasion based on the 'primary purpose' of a contract, taking account of the way it was concluded.

We thank ESMA for the opportunity to provide comments on the CP and would welcome the opportunity to discuss our views in greater detail. Please do not hesitate to contact Jiří Król or Oliver Robinson of AIMA on +44 (0) 20 7822 8380 or Stuart J. Kaswell or Carlotta King of MFA on (202) 730-2600 with any questions you might have.

Yours truly,

/s/

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/s/

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[5] Interpretative Guidance and Policy Statement Regarding Compliance with Certain Swap Regulations - available at: http://www.cftc.gov/ucm/groups/public/@lrfederalregister/documents/file/2013-17958a.pdf

[6] Cross-border Security-Based Swap Activities; Re-proposal of Regulation SBSR and Certain Rules and Forms Relating to the Registration of Security-Based Swap Dealers and Major Security-Based Swap Participants - available at: http://www.sec.gov/rules/proposed/2013/34-69490.pdf

[7] *See e.g.*, CFTC Guidance at 45353, discussing that, although substituted compliance is not available for transactions with U.S. persons, because EMIR is essentially identical to the US Rules, the CFTC staff has issued no-action letters indicating that compliance with EMIR risk mitigation rules will satisfy compliance with the equivalent CFTC rules.

[8] We note ESMA's technical advice on US third country equivalence under EMIR – available here: http://www.esma.europa.eu/system/files/2013-1157_technical_advice_on_third_country_regulatory_equivalence_under_emir_us.pdf - and await the Commission's implementing act. The technical advice, unfortunately, does not provide clarity on the issue of establishment under Article 13.

Annex 1

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?

We agree that it is reasonable to consider derivative contracts between third country counterparties that enjoy a full or partial guarantee from an EU financial counterparty as having a direct and foreseeable effect in the EU.

We do not believe, however, that the notion of the guarantee being 'legally enforceable' (as currently provided by Article 2(2) of the Draft RTS) is necessary or useful. Under current market practice, it is customary for the beneficiary of a guarantee to rely upon a representation that the guarantee is legally enforceable.[9] To require participants to undertake diligence to verify whether such guarantee is legally enforceable, could impose significant diligence requirements upon them. It could also increase ESMA's supervisory burden by requiring ESMA to conclude whether such a guarantee is *de jure* legally enforceable. If ESMA decides to retain the language regarding 'legally enforceable' guarantees, we feel that the Draft RTS and/or ESMA guidance should make clear that this wording does not confer an obligation for participants to undertake additional due diligence beyond their normal practice of obtaining formal representations from the guarantor.

We also ask ESMA not to define the term 'guarantee' in a manner that exceeds the conventional meaning of the term. For example, we do not believe that ESMA intends credit derivatives or insurance contracts - which might have a similar economic effect to a guarantee - to be 'guarantees' for this purpose. Rather, we believe that ESMA should interpret the term 'guarantee' to mean a 'guarantee' properly categorised as such as a matter of the relevant governing law.

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 agree that, once ESMA determines that an OTC derivatives contract has a direct and foreseeable effect in the EU, as above, the requirement for it also to have a substantial effect within the EU would be met if obligations under the contract are the subject of a guarantee that meets the cumulative thresholds described in the CP.

The key issue for the practical implementation of these thresholds, however, is the method of calculation. On the one hand, ESMA could provide that the calculations must involve a rolling average over a particular time scale. On the other hand, ESMA could allow participants to make the relevant determinations at the point when they first enter into the contracts. The latter approach would provide more certainty, although, unlike the former approach, it would not address future movements in notional amount or exposure. On balance though, we consider that certainty is the most important factor for market participants, and thus, we support ESMA allowing participants to determine the direct and foreseeable effect of a contract at the time the parties enter into the trade.

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?

We agree that OTC derivative contracts entered into between two EU branches of third country entities have a direct substantial and foreseeable effect within the Union. We believe such an interpretation will, importantly, encourage and facilitate competition among all relevant entities operating within the EU.

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 with ESMA's view that it should not use the currency or underlying assets of OTC derivative contracts to specify the direct, substantial and foreseeable effect of the contract within the EU. Using these criteria would

[9] Representations are not generally sought when the counterparty is a bank

result in an overly broad application of EMIR, and could introduce unnecessary complexity into the determination of which contracts will be subject to Articles 4, 9, 10 and 11 of EMIR.

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 with ESMA's view. An EU entity would only be legally bound to cover the OTC contracts entered into by its third country subsidiary if the EU entity was guarantor of contracts entered into by the third country subsidiary. Therefore, in our view, it is not necessary to extend the concept of direct, substantial and foreseeable effect specifically to the contracts of such third country subsidiaries where such a guarantee exists.

Our members believe, accordingly, that ESMA would maximise legal certainty by dealing with EU entity/third country subsidiary relationships using the same mechanism as any other relationships that involve an EU entity guaranteeing to a third country entity beyond specific quantitative thresholds. In this regard, please see our responses to Q.1 and Q.2 above.

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?

We believe that it may be possible for an EU parent to provide implicit assistance to its third country subsidiary that may take the form of something other than a guarantee. However, we do not consider that such assistance would expose the EU parent to the risks of its subsidiary's positions to an extent sufficient to have direct, substantial and foreseeable effect in the EU (as contemplated by the guarantee thresholds, described above).

We, therefore, believe that, in absence of a guarantee, it would be an overly broad interpretation of the notion of a 'direct, substantial and foreseeable effect' for ESMA to consider implicit backing of a third country subsidiary by an EU parent.

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 agree with ESMA's intention to follow a criteria-based approach to ensure the flexibility, and address the spirit, of the EMIR anti-evasion regime, rather than creating a prescriptive list of *prima-facie* abusive circumstances.

We are, nonetheless, concerned that Article 3(3) of the Draft RTS (which seeks to describe 'artificial arrangements' put in place to avoid EMIR) does, in fact, take the form of a potentially prescriptive list. We, of course, support ESMA providing robust and accurate guidance. However, we believe that the appropriate place for detailed practical examples would be Level 3 guidance, such as the ESMA Q&As.

Q.10 Do you agree that artificial arrangements that would have for primary purpose to avoid or abuse of any provision of EMIR should be considered as cases where evasion of provision of EMIR should be prevented?

Our members strongly believe that it is desirable for ESMA to propose to the Commission a simple and clear test that seeks to prevent arrangements that have evasion of EMIR as their primary purpose. We, therefore, appreciate and support the intention behind ESMA's test for evasion, as currently formulated within Article 3(2) and (3) of the Draft RTS. However, we believe that the test, as currently worded, would introduce a level of complexity and uncertainty to the detriment of the anti-evasion provisions.

In particular, the Draft RTS currently refer to different terms - including 'evade', 'avoidance'[10] and 'circumvent'.[11] These terms do not have an understood and well-established legal meaning, and are used interchangeably in Article 3 of the Draft RTS. We believe it is important for ESMA to use a single term for the anti-evasion provisions to reduce the complexity of the test and prevent uncertainty as to the relevant legal standard. Therefore, we recommend that ESMA harmonise the wording of Article 3 with the Level II mandates contained within Articles 4(4) and 11(14)(e) of EMIR Level 1, which use solely the term 'evasion'.

[10] *See* Article 3(2)(a).
[11] *See* Article 3(3).

In addition, the Draft RTS introduce potentially duplicative and conflicting tests for evasion. The test under Article 3(2) refers to the 'primary purpose' of the contract, as well as the way in which it was 'concluded'. Specifically, under Article 3(2), ESMA will deem an OTC derivative contract to be evasive of EMIR, if it was concluded with the primary purpose of evading EMIR, or it was concluded through an arrangement the features of which indicate *prima facie* that the contract had the primary purpose of evading EMIR. In contrast, the test under Article 3(3) refers to the 'essential purpose' of the contract and whether it is an 'artificial arrangement', and provides that an OTC contract will be evasive if it is part of an 'artificial arrangement or series of arrangements' with the 'essential purpose' of the avoidance of EMIR.

We strongly urge ESMA to redraft Article 3(3) to harmonise the language with Article 3(2) and provide a single, simplified test based on the 'primary purpose' of the contract and the manner in which it was 'concluded'.

In addition, it is very important for ESMA to preserve counterparties' legitimate ability to structure their contracts (*e.g.*, using choice of law clauses), for commercial or operational reasons, to render the contract subject to the laws of a jurisdiction deemed as equivalent under a relevant Commission implementing act.

In our view, a core goal for G20-related reforms should be to create a globally coherent regulatory framework for businesses that operate in multiple jurisdictions. Therefore, if each G20 country designs its rules according to a common set of regulatory principles, it should result in equivalent regulatory regimes that allow market participants to select their trading counterparties and the governing regulations based on operational and commercial considerations Deemed equivalence under Article 13 of EMIR provides for recognition of third country rules that are substantially identical to EMIR in their scope and intended outcomes. Therefore, we believe it is reasonable to accept that market participants will want to transact legitimately under the regime with which they have the greatest familiarity and expertise and for which they have necessary operational and legal infrastructure in place to comply.

For these reasons, we believe that a rebuttable presumption of non-evasion would be invaluable for market participants in situations where they and their respective counterparties, have agreed to a choice of law clause in their contracts that would render such contracts subject to the rules of a jurisdiction deemed by Commission implementing act to be equivalent to EMIR.