MANAGED FUNDS ASSOCIATION
The Voice of the Global Alternative Investment Industry
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MFA DISCUSSION PAPER ON EQUIVALENCE ISSUES UNDER ARTICLE 13(3) OF THE EUROPEAN MARKET INFRASTRUCTURE REGULATION

June 3, 2014

Managed Funds Association ("**MFA**")[1] strongly supports the European Commission's "**Commission**") efforts to improve the functioning of, and reduce systemic risk in, the European financial markets by promulgating derivatives reforms under the European Market Infrastructure Regulation ("**EMIR**"), including central clearing, transaction reporting, and measures intended to enhance customer protections. Since policymakers and regulators in the U.S. and in other jurisdictions are in the process of adopting and implementing equivalent derivatives reforms, we also appreciate the coordination by the Commission and the European Securities and Markets Authority ("**ESMA**") with their U.S., Asian, and other counterparts. In particular, MFA appreciates the agreement between the Commission and the U.S. Commodity Futures Trading Commission ("**CFTC**") on a "common path forward" on regulation of cross-border swaps[2] and the OTC Derivatives Regulators similar understanding on cross-border implementation.[3] We think both of these agreements reflect positive collaboration.

With such coordination in mind, this paper discusses a key issue that remains outstanding with respect to Article 13 of EMIR and the Commission's adoption of an implementing act on equivalence in respect of the U.S. As more fully described below, certain alternative investment funds ("**AIFs**") are legally incorporated outside the U.S. (*e.g.*, a Cayman fund) but are managed by a U.S.-based manager or are majority-owned by U.S. persons, and thus, they are considered "U.S. persons" subject to the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("**Dodd-Frank**")[4] and the CFTC rules. However, when trading with a counterparty established in the European Union ("**EU**") that is subject to

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[1] 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.

[2] *See* Commission Memo "The European Commission and the CFTC reach a Common Path Forward on Derivatives", July 11, 2013, available at: http://europa.eu/rapid/press-release_MEMO-13-682_en.htm?locale=en; and CFTC press release, "The European Commission and the CFTC reach a Common Path Forward on Derivatives", July 11, 2013, available at: http://www.cftc.gov/PressRoom/PressReleases/pr6640-13.

[3] *See* OTC Derivatives Regulators Group "Report on Agreed Understandings to Resolving Cross-Border Conflicts, Inconsistencies, Gapes and Duplicative Requirements" (August 30, 2013), available at: http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/odrgreport.pdf.

[4] Pub. L. 111-203, 124 Stat. 1376 (July 21, 2010), available at: http://www.gpo.gov/fdsys/pkg/PLAW-111publ203/html/PLAW-111publ203.htm.

EMIR, if the Commission does not regard the AIF as being "established" in the U.S. for purposes of Article 13, then both the AIF and its EU counterparty would need to comply with both Dodd-Frank and EMIR.

The vast majority of MFA members' derivatives trading activities take place in the EU and U.S. markets. Moreover, MFA understands that the implementing act on U.S. equivalence is presently the subject of consideration by the Commission. Therefore, in this paper, we discuss this issue further and emphasize that it is important for the Commission to address this issue promptly in order to facilitate the continued vitality of the global derivatives market and ensure that market participants are not subject to duplicative or conflicting regulations in the EU and U.S.[5]

Summary of Article 13 of EMIR

Article 13 of EMIR provides that the Commission, assisted by ESMA, shall monitor and prepare reports for the European Parliament and to the Council on the international application of principles laid down in Articles 4, 9, 10 and 11 of EMIR[6] (in particular with regard to potential duplicative or conflicting requirements placed on market participants) and recommend possible action. Article 13 also permits the Commission to adopt implementing acts declaring that the legal, supervisory and enforcement arrangements of a third country:

(a) Are equivalent to the requirements laid down in EMIR under Articles 4, 9, 10 and 11;

(b) Ensure protection of professional secrecy that is equivalent to that set out in EMIR; and

(c) Are being effectively applied and enforced in an equitable and non-distortive manner so as to ensure effective supervision and enforcement in that third country.

Article 13 continues by providing that the Commission's adoption of an implementing act on equivalence shall imply that counterparties entering into a transaction subject to EMIR shall be deemed to have fulfilled the obligations contained in Articles 4, 9, 10 and 11 "where at least one of the counterparties is established in that third country" [emphasis added] (the underlined wording, the "**Establishment Condition**").

Equivalence of EMIR and U.S. Regime

Article 13 of EMIR is designed to ensure that a mechanism exists such that a financial counterparty ("**FC**"), non-financial counterparty ("**NFC**") or third country entity that is directly subject to EMIR (an "**EMIR Entity**") is not required to comply with Articles 4, 9, 10 and 11 of EMIR as well as the equivalent rules of another jurisdiction.

[5] MFA also notes that the same issue exists under Article 33 (Mechanism to avoid duplicative or conflicting rules) of the Markets in Financial Instruments Regulation and Directive in respect of the trading obligation and clearing obligation under Articles 28 (Obligation to trade on regulated markets, MTFs or OTFs) and 29 (Clearing obligation for derivatives traded on regulated markets and timing of acceptance for clearing) thereunder. Accordingly, this matter has application in the EU beyond the EMIR issues discussed herein.

[6] These Articles of EMIR relate to the clearing obligation, the reporting obligation, non-financial counterparties and risk mitigation techniques for over-the-counter ("**OTC**") derivative contracts not cleared by a central counterparty ("**CCP**"), respectively.

In the case of the U.S., on September 1, 2013, ESMA issued its technical advice to the Commission on the equivalence under EMIR of the U.S. third country regulatory regime.[7] Based on its review, ESMA advised the Commission to grant equivalence with respect to the U.S. requirements relating to central clearing, reporting, CCPs, trade repositories, NFCs, and risk mitigation techniques for uncleared trades where certain enumerated conditions are met.

In addition, in the 2013 common path forward,[8] both the Commission and the CFTC agreed that the "co-ordination and co-operation between the [Commission] and the CFTC have ensured that the rules in place pursue the same objectives and generate the same outcomes" and that EMIR and the CFTC "final rules are essentially identical, even though the regulatory calendars are not always synchronized". In response to this agreement and in recognition of EMIR's equivalence to CFTC rules, the CFTC thereafter issued four no-action letters addressing particular aspects of this agreement.[9]

Given the broad recognition of the equivalence of EMIR and the U.S. derivatives regime, it would be inconsistent with Article 13 for the Commission not to adopt an implementing act with respect to the U.S. In the absence of such an act on equivalence, where an EMIR Entity trades with an AIF subject to Dodd-Frank, those parties would be subject to duplicative and conflicting rules. Specifically, the EMIR Entity would need to adhere to the applicable requirements under EMIR, and accordingly, its AIF counterparty would similarly need to comply with certain EMIR requirements, while at the same time, its AIF counterparty would need to adhere to Dodd-Frank, which would require the EMIR Entity also to comply with certain Dodd-Frank requirements.

In such case, the principle behind Article 13 seems clear and, in the broadest possible terms, might be summarized as an acknowledgement that where market participants are complying with rules of Dodd-Frank (assuming the Commission declares Dodd-Frank rules to be equivalent to those in EMIR), then those market participants are deemed to be in compliance with EMIR. MFA fully supports this principle, which underpins Article 13, and we wish to ensure that the Establishment Condition, especially as it applies to AIFs, does not inadvertently frustrate the purpose of Article 13.

Establishment and Equivalence Issues for AIFs

MFA's concern with respect to the operation of Article 13 is that, if the Commission determines to interpret the term "established" very narrowly and limit its meaning to where an entity is legally incorporated, the Establishment Condition might cause compliance difficulties or impossibilities for MFA members and the European market participants with which they trade.

Primary Fact Pattern

The primary fact pattern that causes concern for MFA and its members involves a trade entered into between:

[7] Available at: http://www.esma.europa.eu/page/Post-trading-documents.

[8] *See supra* note 2.

[9] Available at: http://www.cftc.gov/PressRoom/PressReleases/pr6642-13.

(1) An EU bank that is an FC under EMIR and that may or may not be a "swap dealer" or "security-based swap dealer" within the meaning of Dodd-Frank (together "**SD**"); and

(2) A non-U.S. AIF that is a third country entity under EMIR (*e.g.*, a Cayman AIF managed by a U.S.-based manager that is not an AIFM authorised or registered pursuant to AIFMD), but is subject to regulation under Dodd-Frank (a "**U.S. Offshore AIF**")[10].

Such a U.S. Offshore AIF, which is not legally incorporated in the U.S., will still be subject to regulation under Dodd-Frank because it has a U.S.-based manager and/or because of its percentage ownership by U.S. persons, and thus, the CFTC considers such U.S. Offshore AIF to be a "U.S. Person" for purposes of its final cross-border interpretive guidance.[11] Therefore, in this scenario, when the U.S. Offshore AIF transacts with the EU bank subject to EMIR, the U.S. Offshore AIF must comply with U.S. rules under Dodd-Frank and the EU bank must comply with EMIR.

See Appendix A below for a further discussion of Dodd-Frank rules and their application to AIFs.

Issues Raised by Fact Pattern

The first issue that this fact pattern raises under Article 13 is that, unless the Commission adopts an act on equivalence in respect of the U.S., then it may be necessary for the parties to comply with both Dodd-Frank and EMIR.

The second potential issue results from application of the Establishment Condition to typical AIF structures. Where the Commission adopts the implementing act in respect of the U.S. regime, in order for the U.S Offshore AIF and the EU bank to avail themselves of that equivalence determination and comply only with the equivalent rules of Dodd-Frank, it is necessary for one of these parties to the relevant transaction to be "established" in the U.S. It is clear that the EU bank is not "established" in the U.S. within the meaning of Article 13. However, it remains unclear where the U.S. Offshore AIF is "established" for purposes of EMIR.

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[10] MFA members are also investment managers to AIFs that fall into the following EMIR categories:

(1) AIFs that are FCs under EMIR (*e.g.*, a Cayman AIF managed by an EU-based manager that is an alternative investment fund manager ("**AIFM**") authorised or registered pursuant to the Alternative Investment Fund Managers Directive ("**AIFMD**")), and are subject to CFTC rules because of the AIFs' percentage ownership by U.S. persons ("**Offshore FC AIF**"); and

(2) AIFs that are NFCs under EMIR (*e.g.*, an Irish AIF managed by a U.S.-based manager that is not an AIFM authorised or registered pursuant to the AIFMD), and are subject to CFTC rules because its manager's principal place of business is in the U.S. and/or because of the AIFs' percentage ownership by U.S. persons ("**Onshore NFC AIF**").

The same issues that arise under Article 13 and the Establishment Condition related to U.S. Offshore AIFs are also an issue with respect to AIFs that fall into categories (1) and (2) above. However, as the foregoing fact pattern applies less commonly to these AIFs, we only make occasional reference to these AIFs in this discussion paper.

[11] *See* CFTC final "Interpretive Guidance and Policy Statement Regarding Compliance with Certain Swap Regulations", 78 Fed. Reg. 45292 (July 26, 2013), available at: http://www.gpo.gov/fdsys/pkg/FR-2013-07-26/pdf/2013-17958.pdf ("**CFTC Final Guidance**").

If the Commission determines the AIF's place of establishment for purposes of Article 13 to be where it is legally incorporated, then for purposes of EMIR, the U.S. Offshore AIF would be established in such jurisdiction (*e.g.*, the Cayman Islands). However, unlike U.S. rules, the regulations of such jurisdiction might not be subject to an act of equivalence under EMIR. Therefore, under this fact pattern, even though the U.S. Offshore AIF would be regulated under Dodd-Frank as a "U.S. person", neither the U.S. Offshore AIF nor its EU bank counterparty would be deemed to be in compliance with EMIR by complying with the applicable Dodd-Frank rules.

Indeed, a further complexity arises where the EU bank is also an SD, which is invariably the case in the experience of MFA's members.[12] In this instance, the EU bank is directly subject both to EMIR and to Dodd-Frank. However, it would remain unable to rely upon Article 13 to avoid the application of duplicative or conflicting rules, if the Commission does not consider the U.S. Offshore AIF to be "established" in the U.S. for purposes of the Establishment Condition.

Pursuant to the CFTC Final Guidance, the U.S. Offshore AIF is considered a "U.S. Person", which means that it must comply with the provisions of Dodd-Frank applicable to all market participants subject to the CFTC's jurisdiction. It also means that all SDs, including EU Banks that are also SDs, are required to comply with the full suite of Dodd-Frank regulations that apply when dealing with any other "U.S. Person". Therefore, it is logical that the Commission consider the U.S. Offshore AIF to be "established" in the U.S. for purposes of the Establishment Condition. As a result, if the Commission adopts an implementing act of equivalence with respect to U.S. rules, then it should be available to both the EU bank and the U.S. Offshore AIF such that compliance with the Dodd-Frank rules is deemed to be compliance with EMIR.

MFA emphasizes that this fact pattern is reflective of a significant volume of business in the EU derivatives market. Therefore, this issue should not be underestimated and could have serious consequences on the business of EU banks and U.S. Offshore AIFs as they may cease transacting with each other in order to avoid duplicative or conflicting rules, which would be contrary to the interests of global trading as well as ease of access to markets.[13] As a result, this issue is as significant an issue for EU banks (whether or not they are SDs) as it is for U.S. Offshore AIFs. We expect this issue to become of increasing significance to such EU banks, especially if the act of equivalence in respect of the U.S. does not allow the banks to apply Article 13 when transacting with U.S. Offshore AIFs.

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[12] We note in passing that the reason such EU banks are SDs is by virtue of the volume of business entered into by such banks with "U.S. Persons" (including U.S. Offshore AIFs) within the meaning of the CFTC Final Guidance.

[13] MFA notes that, under this fact pattern, the AIF in question could be an FC or NFC (*e.g.*, an AIF falling within (i) or (ii) above), rather than a third country entity. However, because the AIF would still be a "U.S. Person" under CFTC rules and subject to regulation under Dodd-Frank, the same regulatory conflicts and duplicative requirements would arise if that AIF transacted with an EU bank. Although we understand that the volume of business affected by this fact pattern would less than the fact pattern discussed above, it is nonetheless significant and could impact EU banks as well as discourage our members from conducting business through EU vehicles. The latter would limit investment opportunities for EU-based investors because a number of important EU investors prefer to invest in EU vehicles.

Practical Market Effects of the Issue

To illustrate the difficulties that would result from Article 13 not being available in the context of the fact pattern discussed above, MFA thought that it would be helpful to identify some examples of difficulties faced by U.S. Offshore AIFs and their EU bank counterparties under Articles 4, 9 and 11 or EMIR. We focus upon these Articles to the exclusion of Article 10 because Articles 4, 9 and 11 are of most relevance to MFA's members.

(a) Article 4 (*Clearing obligation*)

Where the U.S. Offshore AIF and EU bank wish to enter into an OTC derivative contract that is subject to the clearing obligation under both EMIR and Dodd-Frank, it is not clear that it will be possible to clear the trade unless the U.S. Offshore AIF satisfies the Establishment Condition. The difficulty is that the EU bank would not be able to clear the trade by relying on the Dodd-Frank rules because, as discussed above, under Article 13 the U.S. Offshore AIF would not be "established" in the U.S. for purposes of the Establishment Condition. Therefore, since the U.S. Offshore AIF would be required to clear the trade subject to the Dodd-Frank rules and the EU bank will be required to clear the trade only under the EMIR requirements, then only if the requirements of the two regimes are not in conflict would clearing the trade be possible.

It may be the case that Article 4(3) of EMIR permits the EU bank to clear through the same U.S. CCP that the U.S. Offshore AIF must clear through for purposes of complying with Dodd-Frank. However, EMIR permits clearing through such CCP only if the U.S. CCP in question is a third country recognised CCP within the meaning of EMIR. Therefore, the EU bank might only be permitted to enter into this transaction by virtue of Article 4(3) rather than Article 13. It is not clear that this outcome is the intention of Article 13, which makes express reference to Article 4, and therefore, contemplates the Commission granting equivalence in respect of Article 4 thereby enabling the EU bank to rely upon Article 13. This point is of relevance generally, rather than for purposes of the Establishment Condition, but we mention it for the sake of completeness.

(b) Article 9 (*Reporting obligation*)

Without an act on equivalence in respect of the U.S., and in the absence of the Commission regarding the U.S. Offshore AIF as satisfying the Establishment Condition, as is presently the case, there will be duplicative reporting under Dodd-Frank and EMIR. Such duplication will result because it will never be possible for market participants to report solely in accordance with the requirements of Dodd-Frank by virtue of Article 13 of EMIR. Imposing duplicative reporting requirements has already been proven to be inefficient and costly.[14]

[14] We note that the problems that arise from duplicative reporting obligations affect Offshore FC AIFs, Onshore NFC AIFs as well as EU banks. All such entities are subject to reporting under EMIR. In addition, EU banks that are SDs are also subject to reporting under Dodd-Frank, regardless of whether they are transacting with Offshore FC AIFs, Onshore NFC AIFs or U.S. Offshore AIFs.

(c) Article 11 (*Risk-mitigation techniques for OTC derivative contracts not cleared by a CCP*)

There are various existing risk mitigation techniques already in force and causing duplicative obligations under EMIR and Dodd-Frank.

For example, certain U.S. Offshore AIFs and their EU bank counterparties are required to engage in portfolio reconciliation under both regimes, which involves the delivery of separate portfolio reports containing different information in order to satisfy the requirements of Dodd-Frank and EMIR. Under EMIR, the counterparties must reconcile "key trade terms",[15] whereas under CFTC rules it is necessary for the counterparties to reconcile "material terms".[16] Market participants commonly regard the CFTC requirement as being more extensive than the EMIR requirement.

In addition, Dodd-Frank and EMIR could subject counterparties that must comply with both regimes to portfolio reconciliation requirements of different frequencies. For example, EMIR requires daily, weekly, or quarterly portfolio reconciliation (depending on the number OTC derivatives trades outstanding between the counterparties) where FCs or NFCs above the clearing threshold ("**NFC+s**") are transacting among themselves or with counterparties that would be FCs or NFC+s if established in the EU.[17] EMIR also requires quarterly or annual portfolio reconciliation where one of the parties is an NFC below the clearing threshold ("**NFC-**") or a counterparty that would be an NFC- if established in the EU.[18] With respect to Dodd-Frank, the CFTC rules provide the same thresholds and portfolio reconciliation frequency for trades between two SDs as EMIR provides for trades among FCs and NFC+s.[19] Similarly, the CFTC rules provide the same thresholds and portfolio reconciliation frequency for trades between an SD and a non-SD (*e.g.*, a U.S. Offshore AIF) as EMIR providers for trades between FCs/NFC+s and NFC-s.[20]

Using the earlier fact pattern, a U.S. Offshore AIF might be a non-SD for purposes of CFTC rules, and might be a counterparty that would be an FC/NFC+ if established in the EU for purposes of EMIR. As a result, if an EU bank and such U.S. Offshore AIF have 100 trades outstanding, EMIR would require weekly portfolio reconciliation,

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[15] *See* Article 13(2) of Commission Delegated Regulation (EU) No 149/2013 of 19 December 2012 supplementing Regulation (EU) No 648/2012 of the European Parliament and of the Council with regard to regulatory technical standards on indirect clearing arrangements, the clearing obligation, the public register, access to a trading venue, non-financial counterparties, and risk mitigation techniques for OTC derivatives contracts not cleared by a CCP ("**Commission Portfolio Reconciliation Regulation**").

[16] *See* CFTC final rules on "Confirmation, Portfolio Reconciliation, Portfolio Compression, and Swap Trading Relationship Documentation Requirements for Swap Dealers and Major Swap Participants", 77 Fed. Reg. 55904, 55962-3 (September 11, 2012), available at: http://www.gpo.gov/fdsys/pkg/FR-2012-09-11/pdf/2012-21414.pdf ("**CFTC Portfolio Reconciliation Rule**"), §23.502(a)(4) and §23.502(b)(4).

[17] *See* Article 13(3) Commission Portfolio Reconciliation Regulation, which allows the frequency of required portfolio reconciliation to vary based on the types of counterparties and number of OTC derivatives trades outstanding between the counterparties.

[18] *See id.*

[19] *See* CFTC Portfolio Reconciliation Rule at 55962-3, §23.502(a)(3).

[20] *See id.* at 55963, §23.502(b)(3).

whereas CFTC rules would require annual portfolio reconciliation. Again, the need to comply with these duplicative requirements results in an increased compliance cost for the affected market participants and is, of course, contrary to the clear intention of Article 13.

In addition to the potential duplicative portfolio reconciliation requirements, MFA considers that market participants in the EU and U.S. will encounter the greatest challenge once the rules relating to margining of uncleared OTC derivatives come into force in the EU and U.S. When this occurs, unless parties are able to apply the Dodd-Frank or EMIR rules to the exclusion of the other, given the different manner in which collateral is taken and held in the EU and U.S. because of local law, we believe that it will not be possible to comply with both regimes at the same time.

Recommended Solution

MFA respectfully urges the Commission to clarify the meaning of "established" for purposes of Article 13 in either the implementing act on equivalence itself or in its "EMIR: Frequently Asked Questions" (most recently updated on 18 December 2013). In particular, we strongly recommend that the Commission clarify that, for purposes of the Establishment Condition, "established" in a third country does not only mean where an entity is legally incorporated, but also includes any third country where that entity is regulated as a person "established" in that third country. For example, in the case of U.S. rules, if an AIF is deemed to be a "U.S. Person" and thus subject to Dodd-Frank and the rules thereunder, then the Commission should consider the AIF to be "established" in the U.S. for purposes of Article 13. We believe such an approach is consistent with, and in furtherance of, the intent of Article 13, which is to avoid duplicative regulation where the relevant market participants are subject to equivalent regulation in another jurisdiction.

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Please do not hesitate to contact Stuart J. Kaswell, Roger Hollingsworth, or Carlotta D. King at (202) 730-2600 with any questions on this matter.

APPENDIX A

APPLICATION OF U.S. DODD-FRANK RULES TO AIFS

Cross-Border Regulatory Mandate under Dodd-Frank

Under Dodd-Frank, Congress established two new classifications that encompass derivatives contracts traded in the U.S. market: swaps and security-based swaps: As a general matter, Dodd-Frank granted regulatory jurisdiction to the CFTC over "swaps", which are typically derivatives contracts based on a broad-based index, and thus, swaps represent the vast majority of trades in the U.S. derivatives market. In contrast, Congress granted the Securities and Exchange Commission ("**SEC**") regulatory authority over "security-based swaps", which are swaps based on a single issuer or issuers of securities in a narrow-based security index.

In Dodd-Frank, Congress also gave the CFTC and SEC mandates as to what the extraterritorial scope of their swap and security-based swap regulations should be. Specifically, under Section 722(d) of Dodd-Frank, Congress amended the U.S. Commodity Exchange Act ("**CEA**")[21] to provide, in relevant part, that Dodd-Frank rules regulating swaps shall not apply to activities outside the U.S., unless those activities "have a direct and significant connection with activities in, or effect on, commerce of the United States". Similarly, under Section 772(b) of Dodd-Frank, Congress amended the U.S. Securities Exchange Act of 1934 ("**Exchange Act**")[22] to provide that Dodd-Frank rules regulating security-based swaps shall not apply to "any person insofar as such person transacts a business in security-based swaps without the jurisdiction of the United States, unless such person transacts such business in contravention of such rules and regulations as the [SEC] may prescribe".

In response to this mandate, the CFTC issued the CFTC Final Guidance, which addresses the extraterritorial application of the CFTC's swap rules. The SEC has issued (but not finalized) proposed rules to address the cross-border application of its security-based swap rules,[23] which are expected to generate similar regulatory outcomes to the CFTC rules. However, as mentioned above, the CFTC has regulatory jurisdiction over the vast majority of the U.S. derivatives market, and therefore, their rules are more relevant for purposes of our discussion of equivalence issues related to Article 13 of EMIR.

CFTC "U.S. Person" Definition

In the CFTC Final Guidance, the CFTC determined to interpret the extraterritorial scope of its swaps regulations by reference to whether a person or entity falls within the CFTC's definition of "U.S. person" or is entering into swaps with a market participant that is a "U.S. Person". The CFTC's definition of "U.S. Person" in the CFTC Final Guidance is as follows:

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[21] The CEA is the U.S. legislation that provides for federal regulation of all swaps, futures, commodities and other products under the jurisdiction of the CFTC.

[22] The Exchange Act is the U.S. legislation that provides federal regulation of the secondary U.S. securities market, which includes the trading of security-based swaps.

[23] *See* SEC "Proposed Rules; Proposed Interpretations on "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", 78 Fed. Reg. 30968 (May 23, 2013), available at: http://www.gpo.gov/fdsys/pkg/FR-2013-05-23/pdf/2013-10835.pdf.

(i) any natural person who is a resident of the United States;

(ii) any estate of a decedent who was a resident of the United States at the time of death;

(iii) any corporation, partnership, limited liability company, business or other trust, association, joint-stock company, fund or any form of enterprise similar to any of the foregoing (other than an entity described in prongs (iv) or (v), below) (a "legal entity"), in each case that is organized or incorporated under the laws of a state or other jurisdiction in the United States or having its principal place of business in the United States;

(iv) any pension plan for the employees, officers or principals of a legal entity described in prong (iii), unless the pension plan is primarily for foreign employees of such entity;

(v) any trust governed by the laws of a state or other jurisdiction in the United States, if a court within the United States is able to exercise primary supervision over the administration of the trust;

(vi) any commodity pool, pooled account, investment fund, or other collective investment vehicle that is not described in prong (iii) and that is majority-owned by one or more persons described in prong (i), (ii), (iii), (iv), or (v), except any commodity pool, pooled account, investment fund, or other collective investment vehicle that is publicly offered only to non-U.S. persons and not offered to U.S. persons;

(vii) any legal entity (other than a limited liability company, limited liability partnership or similar entity where all of the owners of the entity have limited liability) that is directly or indirectly majority-owned by one or more persons described in prong (i), (ii), (iii), (iv), or (v) and in which such person(s) bears unlimited responsibility for the obligations and liabilities of the legal entity; and

(viii) any individual account or joint account (discretionary or not) where the beneficial owner (or one of the beneficial owners in the case of a joint account) is a person described in prong (i), (ii), (iii), (iv), (v), (vi), or (vii).

Application of "U.S. Person" Definition to AIFs

Prongs (iii), (vi) and (vii) of the CFTC's final "U.S. Person" definition are the prongs that capture U.S. Offshore AIFs, and therefore, are important for purposes of understanding MFA's concerns about the Establishment Condition and its application to AIFs.

Prong (iii) – Legal Establishment and Principal Place of Business Tests

As set forth above, prong (iii) applies to, among others, AIFs that are "organized or incorporated under the laws of a state or other jurisdiction in the United States or having its principal place of business in the United States". This prong clearly applies to an AIF that is legally incorporated in the U.S. However, the "principal place of business" ("**PPoB**") test also captures many AIFs that are legally incorporated outside of the U.S.

The CFTC Final Guidance does not specify what constitutes the PPoB of an AIF, or provide a bright line test. Rather, the CFTC recognized the difficulties for AIFs in determining their PPoBs and chose to provide extensive guidance on how an AIF should determine its PPoB

using various facts and circumstances.[24] As a general matter, in the CFTC Final Guidance, the CFTC interprets an AIF's PPoB as its "nerve center" or the location where "high level officers direct, control, and coordinate" the AIF's activities.[25] The CFTC made clear that where the AIF has a registered office, holds board meetings, maintains books and records, or the location of its directors or officers are generally not relevant for purposes of determining PPoB.[26] In contrast, the location of the senior personnel who direct, control and coordinate the investment strategy, trading strategy, formation or promotion of the AIF (*e.g.*, the AIF investment manager or promoters) are relevant in the CFTC's view.[27]

In the case of a U.S. Offshore AIF, it has a U.S.-based manager that has primary responsibility for its investment strategy. Although the U.S. Offshore AIF is legally incorporated outside of the U.S. and has directors and a registered office in such non-U.S. location, the CFTC stated that those considerations are irrelevant for purposes of determining the U.S. Offshore AIF's "U.S. Person" status. Therefore, given the facts and circumstances that the CFTC enumerated as indicative of an AIF's PPoB, the fact that its U.S.-based manager controls the U.S. Offshore AIF's strategy and trading activities is dispositive and results in the U.S. Offshore AIF being a "U.S. Person" under this prong of the CFTC's definition.[28]

Prong (vi) – AIF Majority Ownership Test

The CFTC's intent behind prong (vi) was to capture "collective investment vehicles [that] are created for the purpose of pooling assets from investors and channelling these assets to trade or invest in line with the objectives of the investors".[29] As a result, prong (vi) focuses on whether the AIF is majority-owned by "U.S. Persons" as a proxy for establishing that the AIFs activities have "a direct and significant connection" with the U.S.

As is the case for the PPoB test in prong (iii), application of the "majority ownership" test in prong (vi) to AIFs presents a number of complexities. The CFTC similarly recognized the complexities of determining the "U.S. Person" status of an AIF based on its majority-ownership status, and in the Final Guidance provided general guidance and examples as to how AIFs should apply the "majority ownership" test.[30]

Specifically, for purposes of prong (vi) of the "U.S. Person" definition, an AIF is majority-owned by U.S. persons if U.S. persons have beneficial ownership of more than 50% of the equity or voting interests of the AIF.[31] In determining its majority ownership, the CFTC would first expect an AIF to determine the percentage of its direct beneficial owners that are

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[24] *See* CFTC Final Guidance at 45309-11.

[25] *See id*.

[26] *See id*.

[27] *See id*.

[28] We note that the analysis would be the same for Onshore NFC AIFs, and thus, Onshore NFC AIFs would also fall under this prong of the "U.S. Person" definition because it has a U.S.-based manager.

[29] *See* CFTC Final Guidance at 45314.

[30] *See id*. at 45313-4.

[31] *See id*. at 45313.

U.S. persons.[32] Second, in the event that a legal entity is invested in the AIF that is controlled by or under common control with the AIF (*i.e.*, an entity related to or affiliated with the AIF), the AIF must "look-through" the affiliate to the affiliate's beneficial ownership and count those beneficial owners toward the AIFs ultimate majority ownership.[33] Therefore, an AIF's majority ownership depends on the "U.S. Person" status of not only its direct investors but also its indirect investors, if such indirect investors are the ultimate beneficial owners of the AIF due to investment in the AIF by one or more of its affiliates.[34]

With respect to U.S. Offshore AIFs, the CFTC could consider such AIFs to fall within the "U.S. Person" definition depending on the direct and indirect "U.S. Person" ownership of the relevant U.S. Offshore AIF. We also note that, as discussed above, regardless of the U.S. Offshore AIFs majority "U.S. Person" ownership, the CFTC would consider it to be a "U.S. Person" because it has a U.S.-based manager. However, each prong of the "U.S. Person" definition involves independent analysis by the U.S. Offshore AIF based on the CFTC Final Guidance as to whether such prong applies to it. Therefore, a U.S. Offshore AIF that determines that its PPoB is not in the U.S., and thus, prong (iii) does not apply, might still be captured under prong (vi) of the definition due to its majority U.S. ownership.[35]

Prong (vii) – Legal Entity Majority Ownership and Unlimited Liability Test

Prong (vii) of the "U.S. Person" definition is similar to prong (vi) in that both incorporate a "majority ownership" test. The key differences are that prong (vii):

(1) Applies to all legal entities (not solely AIFs or other pools or collective investment vehicles);

(2) Has a "direct and indirect" majority ownership test where there is no express limitation on the "look-through" to the AIFs indirect owners (*i.e.*, the look-through appears to be unlimited); and

(3) Applies where one or more of the AIF's owners bears unlimited responsibility for the obligations and liabilities of the legal entity (but expressly excludes limited liability partnerships, limited liability companies, or similar entities).

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[32] *See id*.

[33] *See id*.

[34] For the sake of completeness, if a legal entity is invested in the AIF that is not related to or affiliated with the AIF, then the AIF does not need to "look-through" the unaffiliated investor, but can instead reasonably rely on representations from the unaffiliated investor as to its "U.S. Person" status. However, the CFTC prohibits the AIF from relying on such a representation if the AIF has reason to believe that such unrelated investor was formed or is operated principally for the purpose of avoiding the "look-through" (*i.e.*, attempting to evade the "U.S. Person" look-through).

[35] We note that the analysis would be the same for Onshore NFC AIFs, and thus, Onshore NFC AIFs would also fall under this prong of the "U.S. Person" depending of the analysis of their majority ownership.

In addition, for Offshore FC AIFs, since they are neither legally incorporated in the U.S. nor have a U.S.-based manager, it might be presumed that such AIF would not be considered a "U.S. Person" subject to Dodd-Frank rules. However, given the CFTC's interpretation of what activities have a direct and significant effect in the U.S., Offshore FC AIFs with majority ownership by U.S. persons fall within the CFTC "U.S. Person" definition, and thus, are regulated under Dodd-Frank rules to the same extent as an AIF established in the U.S. with a U.S.-based manager.

The CFTC's primary intent behind this prong was to discourage market participants from creating indirect ownership structures to evade Dodd-Frank rules by instead looking to whether U.S. owners are ultimately liable for the entity's obligations and liabilities.[36] The CFTC also clarified that prong (vii) does not cover legal entities organized or domiciled outside of the U.S. whose swap obligation are guaranteed by a "U.S. Person".

As with prong (vi) of the "U.S. Person" definition, prong (vii) could similarly apply to U.S. Offshore AIFs depending on the independent analysis as to majority ownership and unlimited liability of the U.S. Offshore AIF's owners. As most AIFs limit the liability of its investors, we would expect the group of U.S. Offshore AIFs that might fall into prong (vii) to be significantly smaller than prongs (iii) and (vi).

Impact of Combining Prongs (iii), (vi) and (vii)

We note that, when considering prongs (iii), (vi) and (vii) collectively, there are a multitude of AIF structures that are considered U.S. persons for purposes of Dodd-Frank, regardless of whether the AIF is legally incorporated in or outside of the U.S. Therefore, the foregoing analysis of the "U.S. Person" definition is illustrative of the vast number of AIFs that might be subject to duplicative and conflicting EMIR and Dodd-Frank requirements when trading with EU banks, if the Commission does not clarify that, for AIFs, "established" in a third country includes a circumstance where an entity is considered to be "established" in the third country by virtue of being regulated as a person established in that third country.[37]

U.S. Regulatory Obligations Applicable to "U.S. Person" AIFs

An AIF that is classified as a "U.S. Person" for purposes of Dodd-Frank is subject to the full scope of U.S. regulation. For example, under CFTC rules, the AIF would be subject to all applicable "transaction-level" requirements, which the CFTC has defined to include the following requirements:

(1) Clearing and swap processing,

(2) Margin and segregation requirements for uncleared swaps,

(3) Trade execution,

(4) Swap trading relationship documentation,

(5) Portfolio reconciliation and compression,

(6) Real-time public reporting,

(7) Trade confirmation, and

(8) Daily trading records.

[36] *See* CFTC Final Guidance at 45312.

[37] We note that the analysis would be the same for Offshore FC AIFs and Onshore NFC AIFs. Therefore, both categories of AIFs would also fall under prong (vii) of the "U.S. Person" depending of the analysis of their majority ownership and the unlimited liability of their owners.

Under the earlier fact pattern where a U.S. Offshore AIF is trading with an EU bank, once it is determined that the U.S. Offshore AIF is a "U.S. person", the transaction-level requirements apply to all of its transactions with the EU bank.

Substituted Compliance

The CFTC has a substituted compliance regime (*i.e.*, comparable to a Commission equivalence determination) that permits a market participant to request a comparability determination from the CFTC, such that the market participant's compliance with another jurisdiction's requirements will be deemed compliance with Dodd-Frank rules.[38] Generally, the CFTC will make comparability determinations on a requirement-by-requirement basis, rather than based on the foreign regime as a whole.[39] In making such a determination, the CFTC will consider all relevant factors, including but not limited to: (1) the comprehensiveness of those requirements; (2) the scope and objectives of the relevant regulatory requirements; (3) the comprehensiveness of the foreign regulator's supervisory compliance program; and (4) the home jurisdiction's authority to support and enforce its oversight of the registrant.[40]

However, substituted compliance is not available where either party to the trade is a "U.S. Person".[41] As a result, since the U.S. Offshore AIF would be a "U.S. Person", no option is available under the CFTC's substituted compliance regime for compliance by the EU bank and the AIF to constitute compliance with Dodd-Frank.[42]

Essentially Identical Regimes

In addition to the substituted compliance regime, under the CFTC Final Guidance, the CFTC provides that a market participant will be deemed in compliance with the relevant Dodd-Frank requirements where it complies with requirements in its home jurisdiction that are "essentially identical" to the Dodd-Frank requirements.[43] The CFTC will evaluate whether another jurisdiction's requirements are "essentially identical" to the corollary Dodd-Frank requirements on a provision-by-provision basis.[44]

In the case of EMIR, on July 11, 2013, CFTC staff issued a no-action letter related to risk mitigation that found that the CFTC and the EU have essentially identical in areas such as trade confirmation, portfolio reconciliation, portfolio compression, valuation, and dispute

[38] *See* CFTC Final Guidance at 45340-64.

[39] *See id*. at 45342-43.

[40] *See id*. at 45343.

[41] *See id*. at 45351

[42] We note that, where a swap is executed anonymously between any non-U.S. person (*e.g.*, an EU bank) and a "U.S. Person" on a registered designated contracts market or swap execution facility and cleared, CFTC rules will generally consider the non-U.S. person to have satisfied each of the transaction-level requirements that apply to such a swap transaction as a consequence of being so executed, and neither the non-U.S. person nor its "U.S. Person" counterparty will need to take any further steps to comply.

[43] *See* CFTC Final Guidance at 45353.

[44] *See id*.

resolution.[45] However, under this no-action letter, compliance with EMIR will suffice for compliance with the relevant CFTC rules, only if one of the parties to the trade is an SD.[46] Therefore, only if the EU bank trading with the U.S. Offshore AIF is an SD would the parties be able to rely on the CFTC staff no-action relief such that compliance with the EMIR requirements in the foregoing areas would satisfy compliance with CFTC rules.

In addition, even if the CFTC staff no-action relief applies, a number of transaction-level requirements remain (*e.g.*, clearing as well as margin and segregation for uncleared swaps) for which the CFTC has not made any determination that such EMIR requirements are "essentially identical". Therefore, the U.S. Offshore AIF and its EU bank counterparty would have to comply with both the EMIR and CFTC rules in those areas. As discussed under "Practical Market Effects of the Issue" above, those regulatory requirements are where the risk of significant regulatory duplication and conflict exist.

[45] CFTC Division Swap Dealer and Intermediary Oversight, CFTC No-Action Letter No. 13-45, "No-Action Relief for Registered Swap Dealers and Major Swap Participants from Certain Requirements under Subpart I of Part 23 of Commission Regulations in Connection with Uncleared Swaps Subject to Risk Mitigation Techniques under EMIR", (July 11, 2013), available at: http://www.cftc.gov/ucm/groups/public/@lrlettergeneral/documents/letter/13-45.pdf.

[46] *See id*. at 3-4.