

Reconciling Regulatory Requirements in Cross-Border Derivatives Takes Center Stage

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As the Commodity Futures Trading Commission (CFTC) completes the derivatives regulations mandated by the Dodd-Frank Act, the European Union continues to develop its own derivatives rules. Both sets of regulations seek to fulfill the Group of 20 (G-20) derivatives reform agenda, announced at the 2009 Pittsburgh Summit, which includes regulating dealers, clearing and trading (including trade reporting), mitigating systemic risk and protecting against market abuse. Over the past few years, one of the major efforts for global financial regulators in the areas of both safety and soundness of the financial system and market regulation has been to coordinate on timing and substance of the regulations. In the area of derivatives, in fact, the G-20 have tasked the Over-the-Counter (OTC) Derivatives Regulatory Group (the principals of regulatory authorities with responsibility for regulation of over-the-counter derivatives markets across the globe) with reporting to it on "conflicts, inconsistencies, gaps, and duplicative requirements."

Despite these coordination efforts, differences in approaches remain. Multinational entities have many questions concerning issues of cross-border regulation, particularly where the U.S. and EU regulatory approaches, though similar in intent, appear to diverge in content. In particular, these entities are concerned about how best to reconcile the sometimes disparate equivalence and substituted compliance approaches in the U.S. and EU. At the same time, U.S. and EU enforcement efforts focused on market conduct in the listed and OTC derivatives markets have increased, further highlighting the need for clarity on when and how cross-border regulations will apply so that businesses can set up appropriate compliance arrangements. In addition to clarity on the substance of regulations, coordination between enforcement authorities is important, particularly in circumstances where the enforcement efforts are multijurisdictional. With implementation of two EU legislative measures — the Markets in Financial Instruments Directive and the Markets in Financial Instruments Regulation (MiFID 2¹) — expected by January 2017, along with more final U.S. regulations on issues such as noncleared margin, further cross-border derivatives harmonization should materialize in 2015. (See "[MiFID 2: Reforming the Regulation of EU Securities and Derivatives Markets](#).")

The recent U.S. noncleared margin requirements illustrate the challenge of achieving consistent global regulation. In 2014, U.S. banking regulators and the CFTC revised their 2011 proposals for imposing margin on OTC noncleared derivatives to be more reflective of margin requirement standards that were recommended a year earlier by the Basel Committee on Banking Supervision and the International Organization of Securities Commissions (IOSCO). The U.S. proposals would require dealers to post and collect initial margin for noncleared derivatives from financial end-user counterparties with a material swap exposure of \$3 billion even though the Basel/IOSCO standards would only require dealers to post and collect initial margin for noncleared derivatives when financial end-user counterparties have a material swap exposure of \$11 billion. The U.S. proposals also would allow only cash collateral for variation margin for noncleared derivatives while the Basel/IOSCO framework would allow posting of noncash collateral.

Clearing is another area where, notwithstanding the similar focus, there is tension between U.S. and EU regulations. EU regulation is following in the footsteps of the U.S. "mandatory

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clearing" requirement for interest rate swaps and credit default swaps. However, where the U.S. regulations recognize an exception from mandatory swap clearing for commercial end users that are not financial entities and use swaps for hedging, the EU determines its exception from mandatory clearing by using notional thresholds specific to a swap asset class entered into for nonhedging purposes. Thus, the EU approach subjects nonfinancial counterparties whose "speculative positions" exceed the thresholds (NFC+s) to mandatory clearing while exempting subthreshold nonfinancial counterparties (NFC-s). This tension is further exacerbated by the U.S. and EU's potentially different interpretations of the term "hedging."

The EU secondary legislation for implementing MiFID 2, which is scheduled to be developed by the European Securities and Markets Authority (ESMA) and the European Commission in the coming year, may give rise to other inconsistencies with U.S. derivatives regulation. For example, MiFID 2 recognizes categories for derivatives execution venues that can be used to transact "trading-eligible" derivatives² (i.e., regulated markets, multilateral trading facilities, organized trading facilities, systematic internalizers) that do not correspond precisely to the U.S. categorization of designated contract markets (futures exchanges) and swap execution facilities. Even where there are substantial similarities, such as MiFID 2's recognition of exceptions to the trading requirement similar to the U.S. inter-affiliate exceptions, significant differences exist. For example, under MiFID 2 an affiliate would have to apply before it could rely on the "trading obligation" exception. In addition, MiFID 2's new position limits requirements will contain a much broader hedging exemption that includes anticipatory hedging, which the current U.S. proposal has mostly eschewed, and MiFID 2 will not require single spot month limits, which the U.S. regime does.

Added to this is ongoing uncertainty over what falls within the definition of foreign exchange (FX) and commodity derivatives, with the United Kingdom, other EU member states and the U.S. all taking a variety of views. The U.K., where the bulk of EU swaps trading occurs, currently does not classify certain categories of deliverable and nondeliverable foreign currency forwards as derivatives. The U.K.'s views, however, have not been shared by all EU member states. Differences in approach also exist in the treatment of physically settled commodity derivatives. These differences matter because the derivatives definition triggers EU reporting, margin, clearing and (in some cases) licensing obligations. ESMA is attempting to harmonize EU member state approaches. In September 2014, ESMA issued for comment draft guidelines to count physically settled commodities trades as derivatives with limited exceptions for spot trades (though there is a debate over whether spot trades must be settled in two or seven days) and certain energy transactions. ESMA supervisory board minutes indicated that EU trade reporting requirements for FX derivatives will wait for clarification of the relevant definition during MiFID 2 implementation, which may take two years, even though ESMA is separately pressing on with a consultation on phasing in the EU clearing obligation for nondeliverable FX forwards. Meanwhile, more than two years ago, the U.S. Treasury exempted physically settled foreign currency forwards and physically settled foreign currency swaps from mandatory clearing and trading and most other CFTC requirements, and the CFTC has provided various exceptions for physically settled energy and agricultural forwards. However ESMA and the U.K. resolve their differences, it seems

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likely that EU derivative definitions will differ from those used in the U.S.

No issue has perhaps presented a greater challenge to harmonization efforts in recent months than recognizing foreign clearinghouses and determining the authorities of each regulator with respect to such entities. In November, CFTC Chairman Timothy Massad laid out his views that this particular cross-border challenge cannot be solved by "a simple notion of deference," thereby rejecting the idea that, if the clearinghouse is based in a foreign jurisdiction, the CFTC would defer completely to foreign regulation and regulators for supervising those entities. Chairman Massad instead embraced the concept of "dual registration and cooperative oversight" among regulators, which is different from the traditional EU approach of deferring completely to home state supervision when: (1) the home state's supervision is equivalent to EU requirements, and (2) the non-EU home state provides reciprocal access to EU clearinghouses. It remains to be seen how European authorities will respond to Chairman Massad's suggestion. If the EU maintains its traditional approach, the difference between the U.S. and EU also may complicate the separate equivalence decisions needed under MiFID 2 to allow EU derivatives counterparties to transact "trading-eligible" derivatives on non-EU exchanges.

Another example of the continuing need for reconciliation of cross-border regulatory approaches is the EU's proposed regulation of administrators and users of indices used as benchmarks in financial instruments and financial contracts (EU Benchmark Regulation). If implemented as proposed, the EU Benchmark Regulation may prohibit European supervised entities from using benchmarks created by administrators located in third countries, such as the U.S., unless certain equivalence standards are met. The EU Benchmark Regulation is proposed at this time, making it another area that bears watching in the new year.

Thus, much important work lies ahead in 2015 toward continuing to resolve different approaches to cross-border regulatory issues.

¹ The Markets in Financial Instruments Directive (2014/65/EC) and the Markets in Financial Instruments Regulation ((EU) 600/2014) will be supplemented over the next two years by a variety of EU secondary legislation and EU member state laws and regulations.

² A "trading-eligible" derivative will be a derivative that is traded on at least one EU trading venue, subject to EU clearing obligations and deemed to be sufficiently liquid so as to require that it be traded on a regulated execution venue and not OTC. This will be called the "trading obligation."