Work In Progress: Reconciling US And EU Derivatives Rules

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Law360, New York (February 25, 2015, 3:47 PM ET) -- As the Commodity Futures Trading Commission completes the derivatives regulations mandated by the Dodd-Frank Act,[1] the European Union continues to develop its own derivatives rules. Both sets of regulations seek to fulfill the G-20 derivatives reform agenda, which includes regulating dealers, clearing and trading (including trade reporting), mitigating systemic risk, and protecting against market abuse.[2]

As with other areas of financial reform, a major effort for global derivatives regulators has been to coordinate on both timing and substance of the regulations. The G-20, through the Financial Stability Board, have specifically tasked the Over-the-Counter Derivatives Regulatory Group (ODRG) with reporting to them on "conflicts, inconsistencies, gaps, and duplicative requirements."[3]

After its last meeting in November 2014, the FSB published both its eighth progress report on implementation of OTC derivatives market reforms and the ODRG's most recent report. These reports make clear that the FSB, in part through the ODRG, will continue to focus on derivatives regulation harmonization. More specifically, U.S. and EU regulators are expected to continue their work in this area. CFTC Chairman Timothy Massad's recent trip to Asia, for example, had cross-border harmonization as one of its principal themes.

As the reports also indicate, however, despite the efforts to coordinate, and even where there is common ground among regulators with respect to OTC derivatives reform, differences in approach, content and pace of reform persist. These differences continue to leave market participants with many questions regarding cross-border regulation. Many of these entities are concerned about how best to reconcile the sometimes disparate equivalence and substituted compliance approaches in the U.S. and EU since the consequences can sometimes be as stark, for example, as not knowing where to clear trades because of an absence of harmony between the rules.

Moreover, as U.S. and EU enforcement efforts focused on market conduct in the listed and OTC derivatives markets have increased, they further highlight the need for clarity on when and how cross-border regulations will apply so that businesses can set up appropriate compliance arrangements.

The following are some of the principal areas of focus for cross-border harmonization.

Noncleared margin requirements will continue to feature in this discussion, and the recent U.S. proposed 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.

Determinations about mandatory clearing is another area where, notwithstanding the similar focus, U.S.

and EU regulations are in tension. EU regulation is following in the footsteps of the U.S. "mandatory clearing" requirement for interest rate swaps and credit default swaps. However, where the U.S. recognizes an exception from mandatory swap clearing for commercial end users that are not financial entities and that 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) from mandatory clearing. This tension is further exacerbated by the U.S. and EU having potentially different interpretations of the term "hedging." (Indeed, the new position limits requirements in the Markets in Financial Instruments Directive and the Markets in Financial Instruments Regulation (MiFID 2 [4]) 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.)

ODRG members evidenced some appreciation for this tension when, in the ODRG November 2014 report to the FSB, ODRG members agreed to review expeditiously derivatives subject to a clearing determination in another jurisdiction and to "inform each other early" of derivatives on foreign underliers or derivatives with active trading markets in particular jurisdictions.

Law and regulation surrounding swap execution facilities (SEFs), or organized trading platforms (OTPs), as they are referred to by international authorities, present another area in need of harmonization. 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, highlights examples of possible inconsistencies with U.S. derivatives regulation in this area.

For example, MiFID 2 recognizes categories for derivatives execution venues that can be used to transact "trading-eligible" derivatives[5] (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. interaffiliate exceptions, significant differences exist. For example, under MiFID 2, an affiliate would have to apply before it can rely on the "trading obligation" exception.

There is another, perhaps more fundamental concern, noted in the FSB's recent progress report, that the differing pace and approach to mandatory trading among different jurisdictions could cause traders to reduce or even eliminate their cross-border transactions, resulting in a fragmentation of liquidity.

There is also 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 (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, the U.S. Treasury more than two years ago 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 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 recognition of foreign clearinghouses and determining the authorities of each regulator with respect to such entities. As the FSB noted in its recent report, although the ability of clearinghouses to operate in multiple jurisdictions can help facilitate smooth market functioning and the G-20 objectives of central clearing and trade reporting, "[m]arket participants' use of global infrastructures located in other jurisdictions, however, has increased the need for greater cooperation and coordination among various authorities with mutual interest in a particular financial market infrastructure."

In November 2014, 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 notion that, if the clearinghouse is based in a foreign jurisdiction, then the CFTC will defer completely to foreign regulation and regulators for supervising those entities. 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 Massad's suggestion. If the EU maintains its traditional approach, the difference in U.S. and EU approaches 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.

A final 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).[6] 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. As the EU Benchmark Regulation is proposed at this time, this is yet 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.

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[1] Dodd Frank Wall Street Reform and Consumer Protection Act (Pub. L. 111-203).

[2] http://www.treasury.gov/resource-center/international/g7-g20/Documents/pittsburgh_summit_leaders_statement_250909.pdf.

[3] The OTC Derivatives Regulatory Group includes the principals of regulatory authorities with responsibility for regulation of over-the-counter derivatives markets across the globe. http://www.cftc.gov/ucm/groups/public/@internationalaffairs/documents/file/oia_odrgreportg20_1114.pdf. See also http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/odrgreport.pdf.

[4] 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.

[5] 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 is called the "trading obligation."

[6] http://ec.europa.eu/finance/securities/benchmarks/index_en.htm.