The Industry View

Cross-border frictions are creating compliance problems for globally active derivatives users and are contributing to a fragmentation of liquidity pools. ISDA asked a selection of former policy-makers, academics and market participants to author short essays[1] on the path forward for cross-border harmonisation

Jeffrey Sprecher

Chairman and chief executive, Intercontinental Exchange
Chairman, New York Stock Exchange

Over the course of my career, I have negotiated hundreds of deals, from leasing office space to purchasing large companies like the New York Stock Exchange. In every transaction, I came to an agreement on broad principles first, before working out the details later. This may seem like obvious common sense.

However, in the financial regulatory world, especially post-financial crisis, this process has been working differently. It seems that legislators first pass prescriptive laws that, in turn, are implemented via even more prescriptive rules by regulators. It is only then that regulators have sought to harmonise these prescriptive rules, line by line, with other regulators to make sure that jurisdictions are operating in a roughly equivalent way. Like ISDA, I believe that establishing common regulatory principles up front should be the proper framework for ensuring international cooperation over derivatives regulation.

Principles-based regulation allows regulators to define key objectives—for example, mandating that clearing houses must have proper risk management methods, but not prescribing the exact details of such risk methods. The benefit of this approach is that it gives national regulators and market participants flexibility. This likely comes as a surprise to some, but I believe allowing flexibility in regulation is safer for society.

In the late 1880s, the British government passed prescriptive rules mandating that passenger liners over 10,000 metric tonnes carry 16 lifeboats. Correspondence between the Titanic's owners and the builders indicates that ensuring compliance with this regulation was a key concern in deciding how many lifeboats should be on that ship. And, for decades, a 16-lifeboat rule was sufficient to protect passengers—until the Titanic hit the iceberg with a massive loss of life.

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Instead of a prescriptive mandate to carry 16 lifeboats, principles-based regulation could have required there be enough lifeboats for all passengers. With that guidance, the shipbuilder would have the incentive to carry the right amount, whether that was 16 lifeboats or 40.

As I write this essay, global regulators are mired in disagreement over whether Europe's prescriptive margin regime for derivatives is safer than the US's prescriptive margin regime for derivatives. US and European Union regulators have spent lots of time over the past two years working to determine who will change their rules. I believe that a better outcome would have been for regulators to adopt the International Organization of Securities Commissions-Committee on Payments and Market Infrastructures *Principles for Financial Market Infrastructures*, and to require clearing-house operators, with robust regulatory oversight, to manage the details to find the best way to comply. We should all hope that our current prescriptive rules are found to be flexible enough to respond to future events.

1 The opinions expressed by the authors are their own and not necessarily those of the organisations they represent

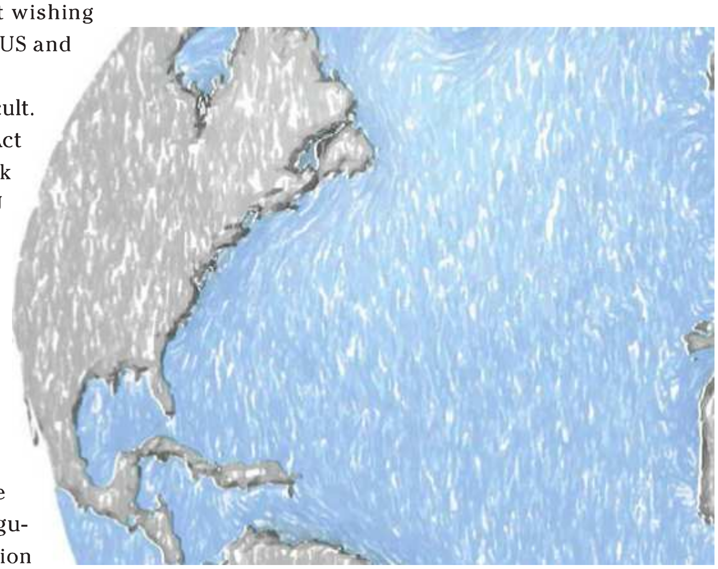
Michael Spencer

Group chief executive officer, ICAP

Six years on from the Group of 20 (G-20) Pittsburgh communique, only the US and China have introduced final rules on derivatives trading, and international regulators have not managed to recognise each other's oversight regimes. So, the collective challenge now is how—and indeed whether—it is possible for us to achieve the objectives of the G-20 and implement harmonised derivatives regulation.

Given the significance of the crisis, the US and European Union (EU) should have been able to address the most esoteric investments—credit default swaps and collateralised debt obligations—and faults in valuation (Warren Buffett's 'mark-to-myth') in a prioritised and coordinated way.

In practice, this did not happen. The US led the way with the Dodd-Frank Act. The objectives were excellent—transparency in price formation and valuation, transparency for regulators, regulation and access for participants. While the implementation of legislation as complex as Dodd-Frank in the time taken was heroic, it was a lone trail-blazer. In the process, it was criticised by several foreign governments and central banks for imposing itself on their markets, participants and currencies. Dodd-Frank resulted in many international banks creating standalone capitalised subsidiaries outside the US and, combined with foreign banks not wishing to be drawn into the scope, this caused a split in liquidity between US and non-US banks in interest rate products.



Perhaps it should be no surprise that coordination has been so difficult. The US legislative starting point was the Commodities and Exchange Act and the Securities Exchange Act of 1934, on to which the Dodd-Frank Act provisions on over-the-counter derivatives were bolted. The EU started with the Markets in Financial Instruments Directive (MIFID) and multiple different systems at the member-state level, currently being expanded by MIFID II.

By the time MIFID II is in force, the Dodd-Frank derivatives rules will have been in operation for three years, liquidity will remain split, and the surviving swap execution facilities (SEFs) will remain confusingly (if necessarily) diverse. In the interim, the EU asked US authorities to recognise its multilateral trading facilities (MTFs), which the US was willing to do—provided they complied with all the SEF rules. While ICAP has established a dually registered and regulated SEF/MTF, no other MTF has applied for that relief, and any notion of mutual recognition of regulated platforms between the US and EU seems frustratingly far off. Similarly, central-bank rules in various Asian countries have made compliance with aspects of Dodd-Frank practically impossible for international participants.

Genuine harmonisation will only occur when there is a reason for regulators and governments to encourage it. The test will be a political/economic one: the Federal Reserve is eyeing signs of economic recovery with a view to raising US dollar interest rates; the EU has proposed a capital markets union as the first genuine attempt to stimulate economic activity since the crisis; and the UK is trying to rehabilitate London's reputation via the Fair and Effective Markets Review. As economies recover, companies invest and banks lend, and as risk has to be measured and mitigated, the rationale for removing inefficiencies and fragmentation will grow greater: harmony is difficult in a recession.

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Policy-makers should emphasise mutual recognition of trading venues. Market participants should be able to choose to trade on a regulated platform in an appropriately regulated location. Transparency of valuation is vital and should be evidence/transaction-based where possible. But pre- and post-trade transparency is only helpful if it does not damage liquidity.

Markets are driven by risk and participation, and there has to be a balance of both to operate effectively. The financial industry should be alongside policy-makers, providing advance warning and contributing to the debate with clarity of social purpose, if we are to achieve genuine and meaningful harmonisation in the future.

Andrew Godwin

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In February this year, ISDA made a submission to the International Organization of Securities Commissions (IOSCO) in response to its consultation on cross-border regulation. IOSCO's report examines the tools that are utilised to regulate cross-border securities market activities. These tools include national treatment, recognition and passporting arrangements.

ISDA suggested that recognition would offer the greatest flexibility and adaptability across different markets, including the over-the-counter (OTC) derivatives markets. It then reiterated various principles for inter-jurisdictional recognition of derivatives regulation, in line with the principles-based substituted compliance methodology that ISDA proposed in August 2013[1].

ISDA correctly noted that, in order to operate effectively as a tool for cross-border regulation, recognition would depend on regulatory harmonisation. This is because recognition, which may occur either on a unilateral or a multilateral basis, relies on a process of assessment under which the host regulator assesses the home regime to determine equivalence in terms of its laws and regulations.

Very few people would argue with the importance that should be attached to regulatory harmonisation. The critical question is how regulatory harmonisation should be achieved. A related question is how, once a satisfactory level of harmonisation has been achieved, should regulators then go about assessing equivalence for the purpose of recognition.

One possible way of dealing with both of these questions would be to adopt a system of accreditation, which would operate at the international level along similar lines to accreditation systems that operate at the domestic level. An example of the latter is the National Association of Insurance Commissioners accreditation programme in the US, which was established to develop and maintain standards to promote effective insurance company financial-solvency regulation.

At the international level, accreditation would indicate that a market had established an appropriate system of regulation in areas such as derivatives regulation, and had reliable procedures in place to permit recognition on a cross-border basis.

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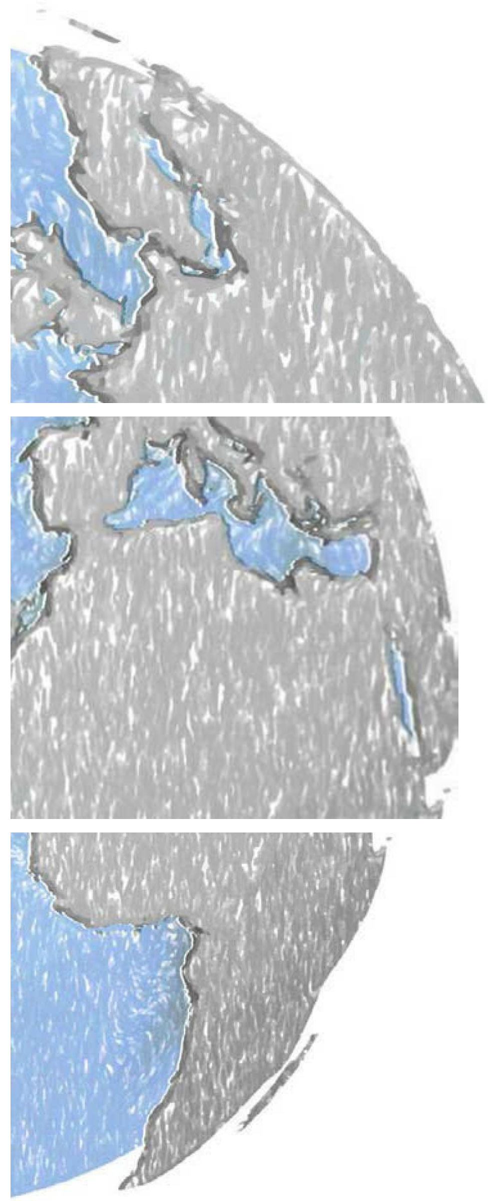
One of the benefits of such accreditation is that it would provide individual markets with an incentive to move towards harmonisation, and would also represent a proactive step that a market could take to encourage other market jurisdictions to grant it recognition. Further, if such a system were supported by a team of experts that could undertake a gap analysis and assist markets to achieve accreditation, then this would overcome many of the practical resourcing and logistical constraints that have hitherto thwarted many efforts to promote greater financial harmonisation and integration.



Footnote 1: http://isda.link/commonexamples

Kenneth Raisler

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The Commodity Futures Trading Commission (CFTC) has made considerable and unprecedented progress in bringing life to the commitments made in 2009 by the G-20 with respect to OTC derivatives reform. However, by being the first mover and the first jurisdiction to finalise and implement many of these reforms, the CFTC faced a challenging paradox. It had to choose either to 1) silo itself and the US by enforcing the OTC reforms only on a domestic basis—in which case, there was a real risk that regulated activity would simply move to other jurisdictions where reform efforts remained in progress but not finalised. Or it could 2) adopt an aggressive position with respect to the definition of US person and the applicability of its rules to non-US persons associated, affiliated or transacting with US persons. This would discourage regulatory arbitrage but would lead to accusations of extraterritorial overreaching.

As global markets mature and national regulators implement G-20 reforms, options 1 and 2 should migrate to a third option of global harmonisation and recognition of substituted compliance. While the CFTC generally has proceeded under option 2, a practical broad-based framework of cross-jurisdictional cooperation in the OTC reform space remains to be adopted. At the same time, and as expected, the existing framework of CFTC guidance on the extraterritorial application of the Dodd-Frank swaps provisions has created friction with regulators around the world, and exposed a series of potential compliance pitfalls for otherwise well-intentioned market participants.

For example, good-faith compliance efforts have, at times, been characterised as evasive, evidenced in part by the noise surrounding efforts by some US-based market participants to remove legacy guarantees from their non-US affiliates. Even more concerning, the previously integrated global derivatives market has been trending into a series of fragmented liquidity pools along geographic lines as a result of divergent regulations across jurisdictions, as highlighted by ISDA research. These current developments motivate a renewed emphasis on practical harmonisation and cooperation with the CFTC's global regulatory partners in order to avoid further implementation friction.

As a whole, market participants have not objected to reform. But they continue to encounter practical impediments associated with trying to comply with two (or more) sets of inconsistent rules governing the same conduct. In this context, global regulators have long recognised that perfect harmonisation is rarely possible (or desirable) for industries that transact in a global market. Instead, regulatory cooperation and mutual recognition schemes are consistently layered in to fill the natural gaps across and between jurisdictions.

The CFTC did issue an initial set of substituted-compliance determinations that attempted to permit market participants to comply with the regulations applicable in other jurisdictions in lieu of compliance with certain of the CFTC's rules. However, these initial determinations need to be expanded to address significant concerns in a number of the most important, and burdensome, areas of regulation, such as reporting, execution and clearing.

The CFTC has long maintained successful futures regulatory programmes that have utilised a broad-based and practical substituted-compliance framework. For example, the CFTC's recent rules on the registration of foreign boards of trade (FBOTs)—formalising a historical CFTC practice—permit US persons to directly access non-US exchanges, provided the exchange registers with the CFTC as a FBOT, and that both the exchange and its clearing house are subject to regulation that is as comprehensive as and comparable (although not identical) to analogous CFTC regulations.

In the same way, the CFTC's Part 30 regime for foreign futures, adopted in 1987, defers to comparable (again, not identical) regulatory regimes in non-US jurisdictions to: (i) allow US market participants to trade via non-US brokers; and (ii) permit non-US market participants to access US markets without the brokers being required to be regulated in the US.

We encourage the CFTC to accelerate the approach it has taken in the futures markets and apply it to OTC derivatives reform—after all, much of the Dodd-Frank Act imports rules and principles originating in the futures markets. Specifically, we suggest the CFTC (as the first mover) and its global derivatives regulatory partners (now making great strides with their own domestic reform efforts) facilitate an OTC derivatives regulatory environment guided by the principle that market participants should not be forced to restrict their activities based solely on the lack of regulatory cooperation between jurisdictions.

In conjunction with these efforts, global regulators should collectively provide for a meaningful transition period, during which a market participant should be permitted to comply primarily with the laws of the country in which it has its principal place of business (provided that country and its regulators are pursuing OTC reforms that are generally consistent with the G-20 commitments).

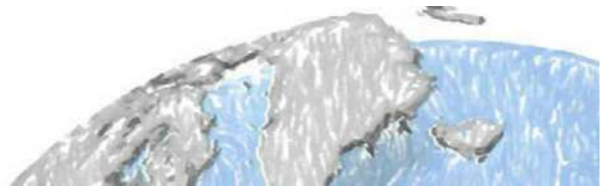
At the same time, when a market participant engages in trading activity in another jurisdiction, substituted compliance should be granted to allow for time-limited recognition in the areas of swaps reporting, clearing-house eligibility and trading-platform accessibility (including swap execution facilities). Importantly, this transition period should be agreed without regard to specific rules, conditions or limitations that would otherwise render the phase-in impractical and unworkable.

During this transition period, regulators should continue to actively work to finalise long-term substituted compliance and recognition regimes in order to achieve the reforms envisioned by the G-20 commitments. Long-term application of first-mover strategies is not healthy for the CFTC or for global markets.

Nicolas Véron

Senior fellow at Bruegel and a visiting fellow at the Peterson Institute for International Economics

At their summits in Pittsburgh in 2009 and Cannes in 2011, G-20 leaders jointly committed to ambitious reforms of OTC derivatives markets. But delivery has been unequal and generally poor. Most jurisdictions were unable to meet the G-20 deadlines. More insidiously, jurisdictions have acted inconsistently, leading to market fragmentation across geographical lines and failure to achieve the G-20's objectives at the global level. Worse still, this is only the beginning. Most derivatives activity is now concentrated in the EU and the US. But it is only a matter of time before market development in Asia leads to a more multipolar landscape, in which coordination challenges will be further exacerbated.



Many of the problems stem from the absence of adequate institutions that would set global standards and incentivise their effective adoption and enforcement by individual jurisdictions. In their absence, national or regional authorities produced uncoordinated rules of their own—sometimes even in a single country (for example, the divergence between the Securities and Exchange Commission and the Commodity Futures Trading Commission in the US).

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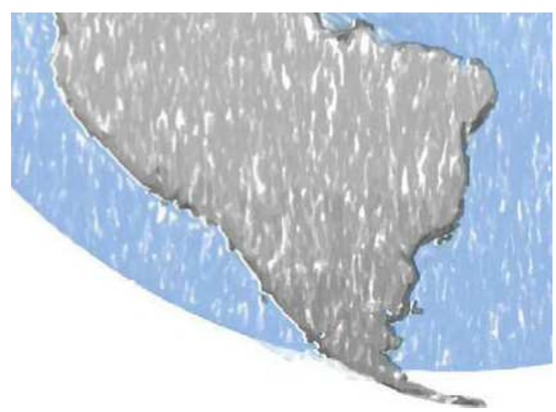
There has been an almost comical proliferation of global bodies. The Financial Stability Board (FSB), the Committee on Payments and Market Infrastructures (formerly the Committee on Payment and Settlement Systems) and the International Organization of Securities Commissions have been complemented by an OTC Derivatives Supervisors Group since 2005, an OTC Derivatives Regulators Forum since 2009, an OTC Derivatives Regulators Group since 2011 and an OTC Derivatives Coordination Group since 2012, with largely overlapping composition and mandates.

By competing for turf, these organisations and their members neutralise each other and ensure collective dysfunction. Not by coincidence, the only parts of the derivatives reform agenda for which global standards have been effectively delivered are the new capital and margin requirements for non-cleared trades—those for which the Basel Committee on Banking Supervision, a comparatively strong organisation with an established track record, was able to take the lead. Considerable resources are being wasted as a consequence. Worse, the G-20 financial stability objectives, including data aggregation and analysis to identify concentrations of risk, are not being met.



The G-20 leaders should wake up to this sorry situation, knock recalcitrant heads, and assign authority. They need to bring together both central banks and market authorities in the key jurisdictions (China and Hong Kong, the EU, Japan, Singapore and the US) into a mechanism that is able to issue proper common standards for OTC derivatives policy, and to monitor their implementation at the global level.

The most effective way may be to form a dedicated team within the FSB, which may develop over time into a permanent specialised organisation. It should be led by a respected and authoritative individual, preferably from Asia to ensure neutrality between the EU and US. If no decisive action is taken, then it is ultimately those same political leaders, not the anonymous regulatory technocrats, who will be responsible for the ongoing failure of an important set of reforms.

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Cyrus Amir-Mokri

Partner, Skadden, Arps, Slate, Meagher & Flom

Former assistant secretary for financial institutions at the US Treasury and senior counsel to the chairman of the Commodity Futures Trading Commission

The OTC derivatives market has played a central role in the narrative on the causes and spread of the global financial crisis. Unsurprisingly, the reform effort that followed the crisis focused heavily on this market. Discussion on refashioning this sector began as early as the initial G-20 meeting in Washington, DC in 2008. By the 2009 summit in Pittsburgh, it had become a prominent element of the G-20 leaders' commitments.

At the Washington, DC summit, the G-20 leaders recognised that international cooperation would be essential to reforming the global derivatives markets. Acknowledging that regulation is "first and foremost the responsibility of national regulators", the G-20 leaders nonetheless noted that financial markets are global in scope. Therefore, "intensified international cooperation among regulators and strengthening of international standards, where necessary, and their consistent implementation, is necessary to protect against adverse cross-border, regional and global developments affecting international financial stability", the leaders stated.

Notwithstanding this warning, one of the most difficult issues regarding derivatives regulation has been cross-border harmonisation. What happened and what is the way forward?

What happened

A post-crisis, globally coordinated reform effort on derivatives faced an institutional shortcoming: in contrast to the regulation of capital and liquidity, which was guided by the Basel Committee on Banking Supervision, there was no established, comparably mature forum to convene and lead the international regulatory effort on derivatives. The effort to carry out the G-20 commitments was accomplished, in the first instance, through national regulation. The FSB was certainly involved, but principally in a monitoring capacity. It was only later, once the national efforts had reached a significant point of crystallisation, that the FSB began to convene the regulators to work through cross-border issues.

As a result, domestic progress on derivatives reform outpaced any efforts to achieve consensus on more specific contours of regulation by convening an international forum of regulators. In that context, the domestic authorities faced two significant challenges. First, the regulators making faster progress had to be sure that other G-20 members would uphold their commitments in a timely fashion. Second, if there were discrepancies between jurisdictions, or if one jurisdiction felt another could fall short on upholding its commitments, there was an incentive for a regulator to protect its domestic financial system by pushing extraterritorial assertions of jurisdiction to the far reaches of its ambit.

The way forward

Six years after the Pittsburgh summit, we face a different set of circumstances. Although a number of countries have still not met their G-20 commitments, many important jurisdictions, particularly the EU, are substantially complete in their work. Because there is convergence between jurisdictions on the nature and quality of regulation, disputes over cross-border regulation should be more susceptible to resolution. As FSB chairman Mark Carney stated in his November 14, 2014 report to the G-20: "To build trust across jurisdictions and to be effective, the system must be founded on consistent implementation of agreed common international standards." In light of the progress made by various jurisdictions in upholding the G-20 commitments on derivatives regulation, there is ample reason for regulators to trust each other's commitment to strong reform.

Convergence also allows us to think of the regulation of derivatives markets as a global, cooperative endeavour between regulators, as opposed to a competitive, nation-based model. In this model of regulation and supervision, international regulators leverage each other's relative expertise and experience, with the acknowledgement that the resources of any individual regulator are insufficient to police worldwide activity. To make the model of cooperative regulation work, three elements are important.

First, supervision should be cooperative. In global markets, participants inevitably have a presence in multiple jurisdictions. Given limited resources, no regulatory agency can singlehandedly supervise the global activities of any particular registered entity. Reliance on the work of other regulators is essential.

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One template for cooperation and division of responsibility appears in Title VIII of the Dodd-Frank Act. It provides protocols for formal cooperation between primary market regulators and the Federal Reserve in supervising designated financial market utilities. Similar paradigms could be used in the cross-border context, where one regulator could take the supervisory lead in its relevant jurisdiction and another participates through consultation and information sharing, with expanded participation as warranted by circumstances and the accountability of each regulator. This approach to cooperative supervision has a precedent in supervisory colleges.

Second, regulators should focus on outcomes. Even when all jurisdictions have satisfied their G-20 commitments, we should expect to find differences in the particulars of derivatives legislation and regulation from one jurisdiction to another. But, even if rules on the surface may sometimes be different, their outcomes will still establish the same market discipline or prudential result. For example, as Commodity Futures Trading Commission chairman Timothy Massad explained recently in his remarks before the European Parliament, both one- and two-day margining for futures contracts could garner similar results in terms of safety and soundness, depending on how exactly the calculation is made. The outcomes principle is applicable in many other contexts.

The focus on outcomes, moreover, should not be confused with reverting to a principles-based regulatory structure. The reality is that any regulatory scheme is a mix of principles and prescriptions. Prescriptions can sometimes be very granular. But even granular prescriptions are designed with a sense of overall outcome. If regulators focus on outcomes, harmonising granular prescriptions can follow.

Third, mutual deference should be expanded. Deference between regulators should follow from improved trust based on the convergence of rules and expanded cooperation. In a letter to the G-20 leaders in November 2014, the FSB chairman noted that this point had been made at the G-20 summit in St Petersburg in 2013. "With respect to OTC derivatives regulation, G-20 leaders agreed in St Petersburg that regulators should be able to defer to each other in the cross-border application of derivatives regulations when justified by the quality of their respective regulatory and enforcement regimes, based on similar outcomes, in a non-discriminatory way, paying due respect to home country regulation regimes," the chairman wrote.

In their declaration after the 2009 meeting in London, the G-20 leaders noted it was important to ensure their domestic regulatory systems are strong. But they also agreed to "establish the much greater consistency and systematic cooperation between countries, and the framework of internationally agreed high standards, that a global financial system requires".

In 2015, with the essential legislation and rules of key jurisdictions converging on those high standards, the case for mutual deference is becoming stronger.

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