New world disorder

Transatlantic regulatory conflicts are hampering OTC derivatives' recovery. Cooperation is needed to avoid conflicts arising from the extraterritorial reach of EU and US rules

The recent financial crisis highlighted one of the paradoxes of globalisation: it may actually lead to division, fragmentation and polarisation, with overlapping rules being created by competing authorities.

The global nature of capital markets has not necessarily led to the creation of elegantly inter-connected regimes. Instead, the number of regulatory bodies involved has increased the regulatory complexity of financial services. The rules that affect over-the-counter (OTC) derivatives remain driven by national jurisdictions, and often conflict.

Regulators have recognised this problem and have sought to mitigate it. As a result of the commitments of the Pittsburgh meeting of the main political forum for financial regulatory reform – the G20 – the Financial Stability Board (FSB) was put in charge of coordinating the formulation and implementation of OTC derivatives reform. In addition, in 2009, the European Securities and Markets Authority (Esma) and the US Commodity Futures Trading Commission (CFTC) approved an agreement called the Path Forward – to defer to each other in certain rulemaking areas when it is justified by the quality of their respective regulations and enforcement regime. Further, in April 2010, the FSB set up the OTC derivatives working group comprised of regulators from nine member jurisdictions, officials of several international financial institutions and representatives of the standard-setting bodies – for banks (the Basel Committee), financial markets (Iosco) and settlement systems. Yet another body, the OTC Derivatives Regulator Group was then established in 2012, comprising principals of some 10 major regulatory authorities.

Despite ongoing coordination efforts, harmonisation often competes with other policy issues; different jurisdictions have their own priorities and timetables for rule implementation.

The impasse between regulators on both sides of the Atlantic stems from the assertion of extraterritorial authority and concerns about regulatory arbitrage. Regulators have espoused principles-based recognition, and have instead implemented recognition in a narrow rule-by-rule manner. It is critical for market participants that a robust system of such mutual recognition is implemented as soon as possible, to ensure the continued smooth operation of the global derivatives market.

Extraterritorial reach

The extraterritorial reach of the rules created by European and US jurisdictions is the key source of tension in recent derivatives rule-making.

The application of European Markets Infrastructure Regulation (Emir) extends to all OTC derivative contracts that have a 'direct, substantial and foreseeable effect' (direct effect) in the EU, as well as those which are designed to evade the rules. Under Esma's technical standards (the Cross-Border RTS), an OTC derivative contract of a third-country counterparty (TCE) will have direct effect when the TCE is guaranteed by an EU entity for at least €8 billion ($9.07 billion); equal to at least five percent of the sum of current exposures of the guarantor, or two TCEs enter into the contract through their branches in the EU and such counterparties would qualify as financial counterparties if they were established in the EU.

Without more, a transaction between, say, the London branches of a Cayman bank and a Malaysian bank – swapping Malaysian ringgit for Cayman dollars – is caught by the Cross-Border RTS. If, however, an implementing act has been adopted declaring a third-country regime as equivalent under Emir, then the Cross-Border RTS will not apply.

In the US, the CFTC has provided a series of non-binding CFTC determinations (cross-border guidance) as to when US swap regulations would apply in a cross-border context. Among other things, the cross-border guidance provided new definitions for what constitutes a US person and for other types of entities, such as affiliate conduits and guaranteed affiliates that may also be subject to US jurisdiction. The cross-border guidance took a very broad view of the CFTC's jurisdiction such that many foreign-based entities that may not have expected to be subject to US law are subject to the US swap requirements. For example, foreign branches of US banks were considered part of their home bank, investment vehicles organised outside of the US that are majority-owned by US persons were also deemed to be US persons, and entities guaranteed by US persons are effectively treated as US persons. On top of this, US regulators continue their consideration as to whether non-US subsidiaries of US parents should be subject to certain US rules as well as how to address situations in which non-US persons trade through personnel located in the US.

Comparing rules

Because of such over-reach, regulators must manage the risks of imposing duplicative or conflicting regulations on market participants. Through determining that the regulations of another jurisdiction are comparable and equally comprehensive to local law, regulators could permit relevant market participants to comply with non-local law to satisfy local policy requirements with substantially reduced regulatory burdens.

It is critical for market participants that a robust system of such mutual recognition is implemented as soon as possible

Even that concept of substituted compliance is not a cure-all, however. Rather than choosing whether to comply with requirements under Emir or the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank), regimes have generally been declared equivalent on a rule-by-rule basis.

The regulators who have asserted very substantial overlaps in jurisdiction start with the presumption that parties need to comply with local law, and then provide them with substituted compliance on a limited rule-by-rule or even rule-element by rule-element basis. In addition, in significant cases such as

Other conflicts

There are other significant areas of cross-Atlantic tension in the regulation of derivatives. One such area is the potential for certain OTC derivatives to be subject to both Dodd-Frank's Swap Data Repository and Emir's trade reporting requirements if a foreign branch of the counterparty is used to book the deal. Another area that requires harmonisation relates to the differences in categories for derivatives execution venues under the revised Markets in Financial Instruments Directive (Mifid II) that can be used to transact trading-eligible derivatives – those do not correspond precisely to the US categorisation of designated futures exchanges and swap execution facilities. Finally, further work is required to avoid fragmentation in implementing the margin requirements for uncleared OTC derivatives. All those differences are compounded by pre-existing laws (such as privacy laws, as they impact trade reporting), delays (such as in the Mifid II rule-making process), and institutional differences (such as those between European national regulators in the EU, or between the CFTC and the Securities and Exchange Commission in imposing different views of margin requirements). The analysis of each of those merits its own separate article.

clearing, the regulators have not been able to get to a determination of equivalence due to differences in how to measure and control various risks, and also because of political reasons. That results in a high degree of complexity as market participants need to situate themselves on a rule-by-rule and counterparty-by-counterparty basis within a variety of parallel regulatory regimes, which creates fragmentation and conflict.

Assessing the clearinghouses

The most significant regulatory bottle-neck is clearinghouse equivalence. In the EU, a central counterparty (CCP) established outside the EU may provide clearing services to EU clearing members where it has been recognised by Esma. Such recognition requires an implementing act of the Commission determining that the legal and supervisory regime in the third country in which the CCP is established complies with legally binding requirements that are equivalent to the one laid down in Emir; the CCPs are subject to effective supervision and enforcement in the third country, and the legal framework of that third country provides for an effective equivalent system for the recognition of CCPs authorised under third-country legal regimes.

When making an equivalence determination, the European Commission (EC) relies on Esma's technical advice with respect to a third-country regulatory framework, to determine whether there is equivalence between the requirements of the third country and Emir. Esma's conclusions are drawn per topic, such as effective ongoing supervision and enforcement, requirements related to clearing and reporting that are equivalent to those of Emir. On October 30 2014, the EC adopted four equivalence decisions (implementing acts) for the regulatory regimes of CCPs in Australia, Hong Kong, Japan, and Singapore. As result, eleven CCPs established in those jurisdictions have obtained recognition. Once recognised, such CCP is required only to comply with the rules of its home jurisdiction. EU authorities do not apply any direct oversight over third country CCPs.

However, the EC has notably withheld recognition of US clearinghouses in light of the US refusal to recognise European clearinghouses.

In the US, the CFTC's approach is that a clearinghouse that clears a swap for a US person must register as a Derivatives Clearing Organisation (DCO) or apply for an exemption from DCO requirements. The broad definition of US person, which would generally include both a US clearing member and a US customer of a clearing member, means that foreign CCPs must apply for the DCO exemption. To grant an exemption, the CFTC must ensure that the CCP complies with comparable, comprehensive supervision and regulation in the foreign jurisdiction. There is a complication, though. Only a futures commission merchant (FCM) may intermediate swaps for US persons, and they have to do so as part of an agency model that is subject to certain rules – such as segregation – that effectively requires the CCP to comply with US rules. In that context, it is worth noting that in Europe, the LCH has established a parallel FCM model for interest rate swaps and has registered with the CFTC, effectively creating two clearinghouses in one legal entity.

Even where clearing is not mandatory for the relevant product and entity under the Emir rules, there is another concern for clearing members of CCPs. The EU Capital Requirements Directive and Capital Requirements Regulation require clearing members to capitalise their exposure to derivatives trades transacted through non-qualifying CCPs at a higher rate. The transitional period for the application of those capital requirements was set to expire in June 2014, and has been extended twice. If US clearinghouses are not recognised as qualifying by December 15 2015 (or the transitional period is not extended further), there will be a significant increase in the costs for European banks to continue using US clearinghouses.

Where next

The Ship of Theseus exercise is a thought experiment. It considers whether something which has had its components substituted remains fundamentally the same. For instance, what happens if you change two, or 49, or 51 of the 100 planks constituting the whole ship, or if you change the material of the new planks; does it matter if you swap the elements gradually? And what if you built a second ship of the old planks – does the changed ship remain the Ship of Theseus? If that question can be transposed to regulation, then which set of rules can be substituted while deemed functionally equivalent and not altering the nature of whole system? And who will make that determination?

Some writers suggest that these equivalence decisions can be taken by an overarching governing body such as a global unit appointed by the G20, the FSB, or the Iosco taskforce on cross-border regulation. If the dominant players establish club standards, formulated by a small group of stakeholders, could those rules not then be monitored and enforced through an international organisation? This route appears difficult, however, because it would require new treaties (which then would have to be ratified, throwing up various issues about sovereignty) and may have to rely on soft power mechanisms such as persuasion, socialising and information-based pressure.

An alternative solution would be to agree on a regulatory presumption of equivalence among the G20 countries that comply with standards established by such G20 international bodies, such as the rules on capital and the common principles for financial market infrastructures.

Without recognising other G20 jurisdictions' rules as functionally equivalent, the risk remains that major financial institutions or their foreign branches or affiliates may not be able to transact in a particular jurisdiction and that over-reaching regulatory rules will lead to a fragmented system of ringfenced liquidity pools, where risk is concentrated, not dispersed. All of that, of course, would go directly against the very concept mitigation of systemic risk, agreed at the Pittsburgh meeting.

By Cadwalader Wickersham & Taft special counsel Assia Damianova in London. The author would like to thank Jeff Robins, partner in New York, and Nihal Patel, associate in New York, for their assistance with this article