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ISDA®

Regulatory Driven Market Fragmentation

It has been 10 years since policy-makers came together through the Group of 20 (G-20) to agree a globally consistent regulatory agenda for derivatives. Since then, substantial progress has been made at the national level to implement rules on clearing, margin, trading, capital in line with the G-20 standards. Derivatives markets are safer, more transparent and more resilient as a result.

But while this progress is unmistakable, these regulatory reform efforts often differ in substance, scope and timing across jurisdictions. This has led to inefficiencies and higher costs for derivatives users, and ultimately results in increased risk.

This paper identifies examples of differences in how global standards have been implemented in individual jurisdictions, and recommends a series of steps that can be taken to address this issue. In particular, ISDA believes that global standard-setting bodies have a role to play in ensuring greater consistency in how rules are implemented, and in achieving a predictable, consistent and timely substituted compliance framework.

INTRODUCTION

Regulatory driven market fragmentation leads to inefficiencies and higher costs for derivatives market participants, and ultimately results in increased risk

"An open and resilient financial system, grounded in agreed international standards, is crucial to support sustainable growth… We will continue to monitor and, if necessary, tackle emerging risks and vulnerabilities in the financial system; and, through continued regulatory and supervisory cooperation, address fragmentation."

G-20 Leaders' Declaration, December 1, 2018

Fragmentation of financial markets, including derivatives, is a key area of focus for global policy-makers and market participants. The issue has priority status on the finance track agenda[1] of the Japanese G-20 presidency in 2019.

Why the concern?

As one senior Japanese policy-maker has said: "Fragmentation can impair financial stability by reducing market liquidity and trapping scarce resources. It can drag efficiency and economic growth. Combatting market fragmentation should be our common goal."[2]

This view is widely shared. The European Central Bank has highlighted that "the risk of global regulatory fragmentation imposes an additional vulnerability" to the euro area banking system[3]. The chief executive of the UK's Financial Conduct Authority recently noted that: "Fragmented markets reduce diversification and transparency, thereby increasing risk."[4] A senior IMF official has commented that fragmentation of banking and capital markets "would prove costly"[5].

Nowhere is the potential adverse impact of regulatory fragmentation on market fragmentation of more concern than in the global derivatives markets. These markets play an important role in enabling corporations, governments, asset managers, financial institutions and other entities around the world to transfer and better manage the currency, interest rate, credit, commodity and equity risks to which they are exposed in the normal course of business.

As the Financial Times has written: "Fragmentation in global derivatives markets would be bad news for anyone who directly or indirectly uses them to hedge their risk…with the net result that companies, pension funds and financial institutions have to pay more to hedge risks. The world, and Europe in particular, already stands on the verge of disruption from the multiple geopolitical and market risks that overhang it. So pursuing a fragmented approach to financial regulation, and in the process pushing up the cost of managing many of those very same risks, seems obtuse to say the least."[6]

[1] *See* G-20 2019 Japan: Summit Details, available at: https://g20.org/en/

[2] Speech by R. Himino, JFSA vice minister for international affairs, to ISDA Annual Japan Conference, October 2018, available at: https://www.fsa.go.jp/common/conference/danwa/20181026.pdf

[3] *See* ECB Banking Supervision: Risk Assessment for 2019, available at: https://www.bankingsupervision.europa.eu/ecb/pub/pdf/ra/ssm.ra2019.en.pdf?0b44507c0c278f20595d8d87c2d9c6bc

[4] *See* The Future of the City, speech by Andrew Bailey, available at: https://www.fca.org.uk/news/speeches/future-city

[5] *See* Post-Brexit market fragmentation in Europe would be 'costly', IMF No. 2 says, by Will Martin (November 14, 2017), available at: https://www.businessinsider.com/imf-deputy-david-lipton-warns-post-brexit-market-fragmentation-2017-11

[6] *See* Why we could all pay the price for obscure derivatives rules, by Patrick Jenkins (October 29, 2018), available at: https://www.ft.com/content/1846b720-d87a-11e8-a854-33d6f82e62f8

To contribute constructively to the Japanese G-20 presidency's dialogue on this issue, ISDA has conducted a comprehensive review of global derivatives regulation to identify where and how regulatory driven market fragmentation has impeded risk management and imposed excessive costs and burdens on market participants without commensurate regulatory benefit. Regulatory driven market fragmentation is defined as disparities in the implementation of global reform initiatives by individual jurisdictions that raise the cost and reduce the availability of derivatives.

This paper also offers suggestions of ways in which policy-makers and market participants could work to reduce regulatory driven fragmentation. This includes recognizing the important role that global markets play in generating sustainable economic growth, and reducing the gap between global standards and national regulations to ensure greater consistency across borders. It is also proposed that, for smaller jurisdictions or those with limited market activity, global standards are implemented when and where appropriate.

ISDA believes policy-makers should implement a risk-based framework for the evaluation and recognition of the comparability of derivatives regulatory regimes, and that international standard-setting bodies should establish a process that would enable national regulators to implement equivalency and substituted compliance determinations in a predictable, consistent, and timely manner. Finally, the paper suggests that international standard-setting bodies should regularly review reform initiatives to ensure they remain relevant and appropriate and are efficiently and effectively achieving policy goals.

Despite the development of global standards, regulatory reform efforts often differ in scope, substance and timing, resulting in fragmentation

SOURCES OF REGULATORY DRIVEN MARKET FRAGMENTATION

Derivatives markets are global. They are global from a demand perspective: thousands of firms on six continents need and use these instruments to manage the common business and financial risks they face. They are global from a supply perspective: firms that deal in derivatives manage their books and related risks on a centralized, global basis.

Recognizing the global nature of the markets, policy-makers over the decade since the financial crisis have worked to establish and implement a consistent regulatory framework for derivatives across jurisdictions. The G-20's derivatives market reform initiative centers on five key areas: central clearing, capital, margin, trade execution and trade reporting[7].

The success of these efforts is clear[8]. Significant progress has been made – and continues to be made – in strengthening the financial markets. However, these and other regulatory reform efforts too often differ in scope, substance and timing across jurisdictions. This regulatory fragmentation results in added cost, complexity and inefficiency, contributes to market fragmentation, and ultimately increases risk for market participants and the financial markets.

Policy-makers today are aware of the need to review and potentially recalibrate their rule sets. For example, Federal Reserve Board of Governors vice chairman Randal Quarles has stated that "we are now at a point – with 10 years of experience in setting up and living with the body of post-crisis regulation – where it is both relevant and timely to examine the post-crisis reforms and identify what is working well and what can be improved"[9].

More specifically on fragmentation, the US Treasury recommended in its report on capital markets that policy-makers focus on "improving cross-border regulatory cooperation….to minimize market fragmentation, redundancies, undue complexity and conflicts of law"[10].

The Japanese Financial Services Agency (JFSA) has voiced similar concerns, noting that there are "four types of harmful regulatory fragmentation which unduly increase the risk of market fragmentation: discrepancies, overlaps, desynchronization, and competition"[11].

[7] *See* G-20 2019 Japan: Summit Details, available at: https://g20.org/en/

[8] More than 85% of US interest rate derivatives trading volume was cleared in 2018. Since 2011, internationally active banks have added €1.9 trillion of Tier 1 capital to their balance sheets. New initial margin (IM) and variation margin (VM) rules for non-cleared trades are reshaping the market. According to an ISDA survey, over €1.5 trillion of IM and VM was exchanged between market participants for their non-cleared derivatives trades as of end 2017. All derivatives trades are required to be reported to trade repositories, increasing transparency. A growing number of jurisdictions are mandating trade execution requirements

[9] Speech by R. Quarles, Federal Reserve Board vice chairman, to the Institute of International Bankers annual Washington conference, March 2018, available at: https://www.federalreserve.gov/newsevents/speech/quarles20180305a.htm

[10] *See* US Department of the Treasury, A Financial System That Creates Economic Opportunities: Capital Markets, available at: https://www.treasury.gov/press-center/press-releases/Documents/2017-044856_CAPITALMRKTS_factsheet_v1%20FINAL-FINAL.pdf

[11] Speech by R. Himino, JFSA vice minister for international affairs, to ISDA Annual Japan Conference, October 2018, available at: https://www.fsa.go.jp/common/conference/danwa/20181026.pdf

> *First, discrepancies. There are many cases of incompatible requirements being imposed by different authorities to the same financial institution…*
>
> *The second category is the overlap. For various policy reasons, jurisdictions incorporate extraterritoriality in their regulations. Such practice results in the application of two different regulatory regimes on the same market or transaction…*
>
> *The third category is desynchronization, or the staggered implementation of internationally agreed standards by different authorities…*
>
> *The fourth category is competition. Jurisdictions use regulations, such as location policy, ring-fencing regimes, or internal [total loss-absorbing capacity (TLAC)] requirements, to secure resources or activities within their own jurisdictions.*[12]

Policy-makers have pointed out that it is not possible, or even desirable, to completely eliminate any and all national differences in regulation. Jurisdictions with different market structures, those that are in different stages of development or those that have different levels of financial activity may choose different regulatory approaches.

ISDA agrees with this view. But it should also be noted that fragmentation may occur when firms are forced to develop and implement different systems and solutions in different jurisdictions because of varying regulatory requirements – even though those requirements are being implemented to meet a global standard.

Data and reporting is an obvious example. If all jurisdictions require market participants to report generally the same information to trade repositories, but each requires different data forms and formats in which such information should be reported as part of its rule set, then firms will incur significant expense in complying with myriad rules. Discrepancies such as those related to data standards will also impact the ability of regulators to monitor risk on a global basis.

Fragmentation may also occur when overly burdensome rules are applied in jurisdictions with small trading volumes that pose little risk. The imposition of such rules increases the cost of doing business and makes access to derivatives risk management more difficult.

[12] Speech by R. Himino, JFSA vice minister for international affairs, to ISDA Annual Japan Conference, October 2018, available at: https://www.fsa.go.jp/common/conference/danwa/20181026.pdf

EXAMPLES OF DERIVATIVES MARKET FRAGMENTATION

There are numerous examples of differences in how global standards have been implemented in individual jurisdictions, affecting clearing, trading, capital, margin and reporting

Significant jurisdictional differences in derivatives-related regulations are evident in virtually every aspect of the markets, from legal issues to capital, margin and clearing to data and reporting. These differences are outlined in the tables in the annex.

Extraterritoriality – or the scope of the application of a jurisdiction's rules – must also be considered. In a global market, a firm based in the US that needs to trade in Asia with an Asian counterparty, or a bank based in Europe that transacts with a Brazilian end user, should know and be able to comply with the relevant regulatory framework.

The problem is, what is the relevant regulatory framework? Is it that of the location where the dealer is based? Is it that of the country where the trade is executed? Or is it both? Where the rules of one jurisdiction have an extraterritorial reach, a trade conducted outside that jurisdiction's borders could fall into scope, as well as being subject to the rules of the other country.

This points to another issue: the process of equivalency and substituted compliance, or determining whether the regulations of one jurisdiction are comparable to those of another and therefore can be used to comply with the other jurisdiction's regulations. Substituted compliance has an obvious and important role to play in providing regulatory certainty and clarity, and in mitigating market fragmentation. While there have been successes in achieving substituted compliance determinations, decisions have in practice been slow to arrive and are too often made on a granular, rule-by-rule basis. This is also discussed in the examples that follow.

ISDA is cognizant of the fact that the issue of regulatory driven market fragmentation may seem to some like an attempt to use jurisdictional differences in regulation to achieve a better regulatory outcome on a global basis (in other words, a form of regulatory arbitrage). We would note, however, that the impetus for this paper is the Japanese G-20 presidency's prioritization of the market fragmentation issue.

ISDA believes global standard-setting bodies have a role to play in ensuring greater consistency in how rules are implemented, and in achieving a predictable, consistent and timely substituted compliance framework

POTENTIAL SOLUTIONS TO REGULATORY DRIVEN MARKET FRAGMENTATION

POTENTIAL SOLUTIONS TO FRAGMENTATION

Policy-makers could work to reduce regulatory-driven fragmentation in the following ways:

- Recognize the important role that global markets play in generating sustainable economic growth while developing regulations that address jurisdictional concerns.
- Reduce the gap between global standards and national regulations to ensure greater consistency in implementation.
- For smaller jurisdictions or those with limited market activity, implement the global standards when and where appropriate. In the meantime, market participants from larger jurisdictions should be allowed to engage in de minimis derivatives activity in these smaller jurisdictions.
- Implement a risk-based framework for the evaluation and recognition of the comparability of derivatives regulatory regimes.
- International standard-setting bodies (FSB, IOSCO, CPMI, BCBS) should establish a process that would enable national regulators to implement equivalency and substituted compliance determinations in a predictable, consistent and timely manner.
- International standard-setting bodies should also regularly review reform initiatives to ensure they remain relevant and appropriate, and are efficiently and effectively achieving policy goals.

Solutions exist to address regulatory driven market fragmentation.

Most importantly, policy-makers and market participants should continue to affirm the value and benefits of global markets in generating sustainable economic growth. The appropriate balance can and should be struck between support for global markets and the need for appropriate regulation in individual jurisdictions.

It is also important that global standard-setting bodies (the Financial Stability Board (FSB), the International Organization of Securities Commissions (IOSCO), the Committee on Payments and Market Infrastructures (CPMI) and the Basel Committee on Banking Supervision (BCBS)) develop rule sets that can be implemented consistently and appropriately across jurisdictions.

For example, there are often gaps between the principles espoused by the G-20 and the standards set by global policy-making bodies and the national regulations implemented by various jurisdictions. ISDA recognizes that, as the JFSA has noted, there must be room for national authorities to adapt global standards when implementing them in their jurisdictions. Too often, however, the space between the regulations and the standards is too large, leading to significant differences in the resulting rule sets.

ISDA does not mean to suggest that the G-20 initiatives need to be more prescriptive. However, we do believe it would be helpful for global standard-setters to ensure there is sufficient consensus among all sets of policy-makers (finance ministries, central banks, prudential supervisors and market regulators) for implementing consistent standards prior to their being published.

ISDA also believes it is important that policy-makers clarify the roles and responsibilities of individual jurisdictions in implementing the reforms. ISDA has been in dialogue with several jurisdictions that have indicated their desire to implement some reforms in response to what they see as regulatory pressure to conform, even though their markets are too small or too closed to support such reforms. Smaller and developing markets have important risk management needs, and barriers to effective derivatives usage can result in fragmentation for them as a result of the increased costs of doing business. Until such time as these reforms are implemented, market participants from larger jurisdictions should be allowed to engage in de minimis derivatives activities in smaller jurisdictions.

Another key solution to regulatory driven market fragmentation is cross-border recognition. ISDA has suggested a risk-based framework for the evaluation and recognition of the comparability of derivatives regulatory regimes of foreign jurisdictions[13]. The framework establishes a set of risk-based principles that may be used as a tool in the assessment of foreign derivatives regulatory regimes.

ISDA believes the proposed framework strikes a proper balance by focusing on risk and its cross-border implications, rather attempting to align each and every regulatory requirement between jurisdictions. This approach will allow for outcomes-based substituted compliance determinations, while reducing the chances of protracted negotiations that could lead to diminished liquidity and market fragmentation.

Global standard-setting bodies should establish a process that would enable national regulators to implement equivalency and substituted compliance determinations in a predictable, consistent and timely manner. Such a uniform process would ensure that equivalency and substituted compliance determinations are reached using an outcomes-based approach, rather than being conducted on a granular, rule-by-rule basis.

Finally, policy-makers should consider establishing regular, periodic reviews of the regulatory reform initiatives to ensure that related standards and regulations remain relevant and appropriate. This would include analyzing and determining whether they continue to support policy goals, or if alternatives have arisen that are more efficient and effective. One example is the clearing mandate. In the US, for example, the percentage of interest rate derivatives that is cleared now exceeds that which is required to be cleared. This calls into question the need for a clearing mandate. ISDA is encouraged by recent actions by the FSB (such as its study on clearing incentives) to review the impact and consequences of reforms.

Global derivatives markets enable firms to efficiently and cost-effectively raise financing and manage their risk. For this to work properly, we need regulatory consistency, trust, cooperation and recognition. Failure to achieve this will ultimately serve no one – not the firms looking to raise the capital and investment needed for economic growth, nor the entities that need to manage their risk.

[13] *See* ISDA, Cross-Border Harmonization Of Derivatives Regulatory Regimes: A risk-based framework for substituted compliance via cross-border principles, September 2017, available at: https://www.isda.org/a/9SKDE/ISDA-Cross-Border-Harmonization-FINAL2.pdf; *see also* ISDA, A Practical Guide to Navigating Derivatives Trading on US/EU Recognized Trading Venues, April 2018, available at: https://www.isda.org/a/COmEE/A-Practical-Guide-to-Navigating-Derivatives-Trading-on-US-EU-Recognized-Trading-Venues.pdf

ANNEX

EXAMPLES OF DERIVATIVES MARKET FRAGMENTATION

Extraterritoriality

Regulation	Source of Fragmentation	Impact
Scope of Application of a Jurisdiction's Rules: Most jurisdictions (eg, US) require (1) transactions executed outside of their borders by entities they define to be within their regulatory purview, or (2) activities conducted inside their borders by third-country firms, to comply with their rules even when they would fall under the oversight of a third-country regulator.	Overlap	Counterparties, particularly derivatives end users, seek to mitigate inconsistencies and uncertainties in the scope of application of a jurisdiction's rules by transacting within, and with firms governed by, their home markets. This essentially leads to regionalized markets and creates inefficiencies in providing and using derivatives risk management products.
Equivalency/Substituted Compliance Determinations: The process by which regulators in one jurisdiction determine the regulations in another jurisdiction to be comparable is often conducted on a granular, rule-by-rule basis.	Competition	Rather than being forced to comply with the rule sets of two jurisdictions, putting market participants in the position of running duplicative and (in many cases) conflicting compliance programs, firms regionalize their activity to ensure their activities are not captured by other jurisdictions, decreasing competition and liquidity.

Capital

Regulation	Source of Fragmentation	Impact
Market Risk Capital Rules (Fundamental Review of the Trading Book, FRTB): Significant uncertainties exist about the timing and extent of implementation of these rules in key jurisdictions.	Desynchronization	ISDA welcomes the recent revisions published by the BCBS that address many of the shortcomings of the market risk standards at an international level. However, inconsistencies in the substance and timing of implementation of the market risk capital rules in key jurisdictions will have significant impact on the relative abilities of firms to offer, price and risk manage derivatives to their counterparties and to support strong, liquid markets.
Net Stable Funding Ratio (NSFR): The global standard developed by the BCBS as part of its review of the net stable funding ratio gives national jurisdictions the ability to impose a gross derivatives liability add-on (GDLA) for derivatives that ranges from 5% to 20%.	Competition	Inconsistent application of the GDLA by individual jurisdictions would have the potential to adversely affect the ability of banks to provide market services that facilitate client financing, investing and hedging.
Credit Valuation Adjustment (CVA): Jurisdictions differ in their implementation of the BCBS CVA risk framework.	Competition	CVA risk can affect the cost of capital of derivatives trades under the Basel standards and therefore in determining the price of those trades. The differing treatment of CVA risk could consequently affect the cost and availability of derivatives for end users in certain jurisdictions.
Leverage Ratio: Jurisdictions differ in whether they require segregated margin posted by clients with their bank counterparties for cleared swaps transactions to be counted in calculating banks' capital requirements under the leverage ratio.	Competition	Cash collateral posted by clients, which reduces credit exposure, would count as on-balance-sheet assets and therefore increase the capital requirement in the leverage ratio for banks in such jurisdictions. This could consequently increase the cost of clearing and limit access to it in these jurisdictions. ISDA is encouraged by the recent Basel consultation on this matter and supports a risk-based SA-CCR that takes into account initial margin (option 3 in the consultation).

Non-Cleared Margin

Regulation	Source of Fragmentation	Impact
Timeframe for Posting Margin: Jurisdictions differ in the time frame they impose for the calculation and settlement of both initial margin (IM) and variation margin, with some requiring it in T+1, and others requiring T+2 or later, depending on the standard settlement cycle of the relevant collateral.	Overlap	Inhibits timely settlement when two counterparties are not located in the same time zone. In particular, counterparties in Asian time zones find it difficult to transact with US counterparties for which T+1 settlement is required.
Collateral Eligibility Requirements: Collateral eligibility requirements vary considerably across jurisdictions.	Competition	Firms may be disincentivized to trade with entities subject to different collateral eligibility requirements because doing so requires both parties to the transaction to follow the strictest requirements applicable, potentially limiting the sources of collateral for the relevant portfolio.
Posting of Initial Margin for Inter-Affiliate transactions: Some jurisdictions (eg, US prudential regulators) require swap dealers that are banks to post and collect IM for their inter-affiliate transactions. The US Commodity Futures Trading Commission (CFTC) provides an exemption, as does the JFSA and many other jurisdictions.	Discrepancies	Banks subject to inter-affiliate IM rules are incurring substantial funding costs for trades that pose no systemic risk.
Standard Initial Margin Model (ISDA SIMM) Backtesting: Some jurisdictions (eg, EU and Japan) may require all counterparties, including non-dealers, to monitor and back-test industry standard models used to calculate IM for their trades.	Discrepancies	End users generally do not have the resources or expertise to perform this type of testing and, as such, may be disadvantaged and forced to use the standard grid, which could potentially lead to higher prices.
Documentation for Phase 5 Counterparties: Some jurisdictions (eg, US) require counterparties to have in place regulatory IM documentation (including collateral support agreements) if they are above the $8 billion notional threshold that's effective September 2020, even if they would not exchange IM under the rules because their IM calculation is less than the allowed IM threshold (up to $50 million).	Discrepancies	Counterparties that are not required to post IM would be subject to time-consuming and expensive documentation negotiations and dormant custodial accounts in jurisdictions with this requirement.

Clearing

Regulation	Source of Fragmentation	Impact
Clearing Location Policy: Some jurisdictions (eg, Japan) require certain trades (eg, yen-denominated swaps in Japan) executed within their borders to be cleared at central counterparties (CCPs) within their borders that are subject to local supervision. Clearing mandates in jurisdictions with closed currency markets also create de facto CCP location policies.	Competition	Clearing location policies adversely impact liquidity, as evidenced by the basis risk that arises from time to time at different CCPs clearing the same product. In addition, clearing location policies force firms to split their netting sets, which can significantly increase capital and margin requirements and related costs. Competition is therefore stifled and global systemic risk is increased.
Client clearing: Some jurisdictions require persons/clients that are not members of CCPs to only clear swaps with CCPs that are registered locally (eg, registered with the CFTC as a derivatives clearing organization).	Competition	This requirement prevents firms from providing liquidity and hedging for certain customers at offshore CCPs. In the US, this is the result even where local CCPs have obtained an order of exemption from the CFTC.
MPOR for IM Requirements: Jurisdictions differ in the minimum margin period of risk (MPOR) they require CCPs to use in setting IM they require for cleared transactions.	Competition/Discrepancies	Differences between jurisdictions in the minimum MPOR required for cleared IM could result in customers having to post different amounts of IM for the same transaction, depending on the jurisdiction of the CCP in which their trade is cleared.

Trade Execution

Regulation	Source of Fragmentation	Impact
Trading Location Policy: Requirements that certain trades must be executed on designated platforms within a particular jurisdiction.	Competition	Location-based trading regulations have fragmented liquidity across platform and cross-border lines, resulting in separate liquidity pools and prices for similar transactions. While the 2018 US-EU trading venue equivalence determination has alleviated some market fragmentation concerns, the lack of trading venue recognition across other jurisdictions continues to fragment global markets.
Trading Personnel Location Policy: US rules require trades between non-US entities that are arranged, negotiated or executed by US personnel (ANE transactions) to be cleared, executed and reported pursuant to US rules[14].	Competition/Overlap	This discourages non-US entities from using US personnel for fear of being captured by US rules and subject to duplicative (potentially conflicting) requirements. Non-US entities that seek to engage in these transactions must build duplicative compliance systems to ensure they are compliant with CFTC rules and local clearing and trading rules, which may not be consistent.

Data and Reporting

Regulation	Source of Fragmentation	Impact
Trade reporting: Jurisdictions differ in whether they require one or both counterparties to a trade to report the transaction to a trade repository.	Discrepancies	Buy-side market participants and end users in a jurisdiction that requires them to report their derivatives transactions are disadvantaged, being burdened with onerous obligations that duplicate the data reported by their counterparty.
Required data fields: Different jurisdictions have different definitions, formats and allowable values for the trade data required to be reported	Discrepancies	Lack of consistency in the type and format of data required across jurisdictions creates inefficiencies that not only inflate the requisite cost and resources, but also impede the ability of regulators to aggregate and reconcile data.

Netting

Regulation	Source of Fragmentation	Impact
Scope of Eligible Counterparties: Jurisdictions differ in the scope of eligible counterparties covered by netting legislation. Some differentiate based on type of bank (state-owned vs. privately owned) and others by type of firm (bank vs. securities vs. insurance).	Competition/Overlap	Differences in the scope of eligible counterparties restricts the benefits of netting (which includes, among other things, a reduction in counterparty credit exposure) to a minimum or limited number of counterparties.
Scope of Eligible Transactions: Jurisdictions differ in the scope of eligible transactions covered by netting legislation. For example, some jurisdictions do not recognize physically settled commodity transactions as eligible transactions, but do recognize financially settled commodity transactions.	Competition/Overlap	Differences in the scope of eligible transactions restricts the benefits of netting, which is an important tool for reducing counterparty credit exposure.

Benchmarks

Regulation	Source of Fragmentation	Impact
Certain jurisdictions (eg, EU) require that only approved benchmarks or indices can be used within their borders in order to ensure their accuracy and integrity. Benchmark administrators and data contributors are subject to new rules and processes. Providers and users of unapproved benchmarks may be fined.	Competition	If benchmark administrators and contributors find the rules too onerous or do not receive approval, the number of available benchmarks will decrease, fragmenting liquidity and reducing investment choices

[14] This requirement is currently subject to CFTC time-limited no-action relief

The examples provided in this paper generally refer to instances where rules are currently in place and have been or will be implemented. However, there are a number of *potential* areas of concern stemming from regulatory driven market fragmentation that may arise.

Brexit is the most obvious and important example. Significant questions over the nature and timing of the UK's exit from the European Union are raising serious concerns for market participants in all jurisdictions about the impact of fragmentation in derivatives trading, clearing, reporting, risk management and related areas. These concerns could significantly affect the ability of dealer firms to provide, and the ability of end users to use, risk-hedging instruments by adversely affecting market liquidity, raising the costs of managing risk through derivatives, and/or reducing the availability of risk-hedging instruments. They could also have adverse consequences on legacy transactions by raising barriers to events (eg, trade compression) that routinely occur over the lifecycle of a transaction.

Other examples of potential regulatory driven market fragmentation include:

- Jurisdictions with smaller markets and/or closed currencies inappropriately mandating clearing within their borders. This would mean each such jurisdiction would have its own central counterparty, leading to heightened risks, decreased efficiency and impediments to accessing global liquidity pools;

- Potential inconsistencies in the rollout of global data standards (unique product identifiers, unique transaction identifiers and critical OTC derivatives data elements), either in terms of their usage or their timing, and in rationalizing these standards with data currently required in trade reporting. Such inconsistencies would result in operational and technological inefficiencies.

- Jurisdictions with small trading volumes implementing mandatory trade execution requirements. This could result in reduced liquidity and unnecessary expenses.

- Potential deviation from the global two-day norm for statutory stays on the exercise of default rights in financial contracts. Any such deviation could have a significant impact on recognition of netting for capital and margin purposes.