

ISDA comment paper on European Parliament draft Own-Initiative Report ‘on relationships between the EU and third countries concerning financial services regulation and supervision’ (Hayes report)

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Introduction

ISDA welcomes the opportunity to comment on the European Parliament’s draft Report ‘*on relationships between the EU and third countries concerning financial services regulation and supervision*’ dated 4 April 2018, under the rapporteurship of Brian Hayes MEP.

ISDA is well-placed to comment on cross-border regulation of derivatives business in particular, representing as it does over 900 member institutions from 68 countries, in what has been the most ‘global’ of financial markets. This business has, however, been affected by regulatory fragmentation¹. The efforts of EU, US and other regulators to facilitate cross-border trading through equivalence, substituted compliance, exemptive relief and other methods have only been partially successful.

ISDA’s view on cross-border harmonization of derivatives regulatory regimes

ISDA believes that regulators should deploy a risk-based approach to the evaluation and recognition of the comparability of regulatory regimes in third-country jurisdictions. In September 2017 ISDA published a whitepaper on cross-border harmonization of derivatives regulatory regimes.² This paper proposed that, in assessing a third-country regime for equivalency, regulators should focus only on whether the third-country has sufficient regulations in place to address or mitigate systemic risk. In doing so, the paper analyzed the rules of a third-country jurisdiction against specific risk-based principles.³

ISDA believes that this risk-based approach is a sound foundation for equivalence determinations affecting cross-border derivatives markets as it focuses on the core policy objectives of the post-financial crisis reforms to derivative markets. Crucially, since the approach is outcomes focused, it allows jurisdictions to implement global commitments in the way most appropriate to their markets, without unduly fragmenting cross-border trade.

¹ Please see our research in 2013-2014 on the impact of SEF rules, for example:
<https://www.isda.org/a/cSiDE/cross-border-fragmentation-an-empirical-analysis.pdf>.

² <http://assets.isda.org/media/85260f13-47/8a2bfb70-pdf/>

³ These risk-based principles broadly cover the areas of: capital and margin; risk-management; recordkeeping; regulatory reporting; and clearing. To provide for a more in-depth analysis, the principles are broken down into further sub-principles. For more information please see, <https://www.isda.org/a/DGiDE/isda-cross-border-harmonization-final2.pdf>.

ISDA comments on the draft report and on the application of equivalence to date in the EU

Reflection on equivalence is timely and appropriate

ISDA believes that this report is timely and important. It is appropriate for EU decision-makers to take stock of the regulatory and private sector experience of the application of the equivalence concept as a means to facilitation of cross-border derivatives business.

In particular, ISDA highlights

- The European Commission (EC)'s ability to complete the CMU by 2019 will be supported by Europe's capital markets being liquid and competitive. This means that Europe's capital markets should not only be able to attract debt and equity capital from EU and non-EU sources alike, but that a safe and efficient cross-border market in risk mitigation should support and optimize these sources of finance.
- The ECON draft report comes after all of the major planks of the post-financial crisis regulatory reform effort have come into effect (the most recent major achievement in this regard being MIFID 2/MIFIR, in force since 3 January 2018).
- As the draft report notes, of the 40 new pieces of EU financial legislation that were adopted in this reform effort, 15 include third country provisions, giving the EC power to decide whether non-EU jurisdictions can be considered 'equivalent'. However a substantial number of the equivalence decisions that EU market participants need in order to be able to conduct important aspects of cross-border business in derivatives have not yet been adopted.
- The EC has itself been reflecting on these issues, drafting a staff working document of 27 February 2017 on 'EU equivalence decisions in financial services policy: an assessment'.
- Other major jurisdictions are actively re-assessing and upgrading the financial regulatory frameworks put in place following the financial crisis (see the CFTC's Swap Regulation 2.0 report⁴, published 26 April 2018, for example).

ISDA agrees that it is appropriate to carefully consider equivalence provisions in legislation of relevance for regulatory relationships with high-impact third countries, particularly where high volumes of cross-border business are in evidence. The current framework already aligns with such a proportionality- and risk-based approach to some degree.

Relationships between the EU and high-impact third countries – by reference to the size and level of development of their capital markets, interconnectivity, and the characteristics of the bilateral relationship with the regulatory authorities there - should be prioritized and considered carefully (consistent with the draft report's paragraph 19).

ISDA acknowledges that the current equivalence framework was not designed with the UK in mind. It is appropriate to apply a risk-sensitive approach to the relationship between the EU and such third countries, in order to fulfil EU objectives in the financial services area.

⁴ https://www.cftc.gov/sites/default/files/2018-04/oce_chairman_swapregversion2whitepaper_042618.pdf

ISDA also underlines that the current concern to address the future relationship with the UK or other high-impact third countries should not result in a framework which makes all engagement in cross-border derivatives business more challenging.

ISDA endorses the ECON draft report's support for the EC's investment in convergent regulation of derivatives and other financial markets, in international organizations and bilaterally

ISDA welcomes paragraphs 21-23 of the draft report, making the following comments:

- We recognize the efforts that the EU and Member States' authorities have made in developing consensus on regulation of derivatives business (among other financial markets) in international organizations e.g. the Basel Committee and IOSCO. The EU institutions and ESAs have also sought to implement consensus forged in these organizations in EU regulation.
- In derivatives business, ISDA would particularly like to acknowledge the support of the EC and EU Member States for the principle of deference, as evoked in successive Financial Stability Board reports addressing derivatives reform. Deference is at the heart of the equivalence concept as implemented to date.
- We endorse the EU authorities and EU Member States' efforts in these international organizations, as crucial to the delivery of convergent global standards and strong international supervisory cooperation. These elements are key to ensuring, open, integrated and appropriately regulated global capital markets
- We support the report's call for more frequent meetings of the EU-US Financial Markets Regulatory Dialogue (FMRD). We urge for the further investment in and deepening of regulatory dialogues with other jurisdictions. We urge the EC to maintain regular dialogue and consult with market participants ahead of FMRD meetings.
- ISDA recognizes the value of ECON delegation engagement with its US counterparts in parallel to the FMRD. We would also welcome interaction between MEPs and market participants in conjunction with these discussions.
- ISDA would support the EC and/or ESMA obtaining 'ordinary membership' status in IOSCO.

ISDA commentary on the ECON draft report's section on 'equivalence procedures'

We broadly support paragraphs 4-20 of the ECON draft report, subject to the following remarks:

- ISDA agrees that the ***focus of EC equivalence determinations should generally be on the outcomes resulting from non-EU jurisdictions' regulatory frameworks***. As mentioned, ISDA also supports the principle of deference as reflected in FSB reports, and believes that the EU should take a primarily risk-based approach in terms of the standards it expects from other jurisdictions' regulatory frameworks as a precondition to third-country recognition for purpose of equivalence.
- ISDA has the following *concerns about the practical application of equivalence* in the context of derivatives regulation, specifically:

- We are concerned that ***the process of granting and obtaining equivalence is insufficiently scalable***. In short, market participants need a large number of equivalence decisions (covering multiple regulatory requirements and multiple jurisdictions) in order to be able to continue with cross-border derivatives business, but there are large gaps. Where equivalence decisions have been taken, they often cover no more than a handful of the largest jurisdictions. As an example, exemptions from requirements to clear or post margin against intragroup trades involving a group entity outside the EU (vital for EU financial institutions to be able to manage risk centrally and to compete in jurisdictions outside Europe) are dependent on Article 13 equivalence decisions, as set out in the 2012 EMIR Regulation. 6 years after the entry into force of EMIR, only one regulatory agency in one jurisdiction (the CFTC in the US) is covered by such a Decision. No trading venue or trading obligation equivalence is in place for Asian jurisdictions in the context of MIFID2/MIFIR.

The relative shortage of equivalence decisions can be attributed to a number of factors including:

- The resource-intensive nature of the equivalence process, in particular in terms of the demands placed on the limited number of EC staff involved in determining whether a specific jurisdiction/requirement can be deemed equivalent.
 - The pre-conditions linked with the equivalence requirement in many pieces of EU legislation are detailed and lengthy (despite the support for the principle of deference).
 - Tendency - in some cases – to exceed standards agreed at international level or in other jurisdictions (e.g. the EU Benchmarks Regulation).
 - A lack of knowledge and understanding in non-EU jurisdictions (especially once EU market participants look past the largest non-EU jurisdictions such, as the US and Japan) as to their having to seek equivalence from the EC. This last factor is exacerbated by a lack of resources among third country market participants, unfamiliarity and lack of transparency as regards the process of obtaining equivalence (with EU firms active in local markets often having to educate these jurisdictions' authorities as to the process), and the fact that in some cases, third-country authorities may be disinclined to apply for equivalence when their local market participants can simply trade with non-EU competitors that are not subject to constraints.
- Where equivalence decisions have not yet been taken, temporary relief is often provided by extension of transitional periods at level 1 or time-limited derogations in level 2 measures. This relief is welcome and absolutely necessary, but it is not optimal in legal certainty or business planning terms to have to rely on it to conduct cross-border business. Optimization of the equivalence process would lessen the need to rely on such relief.
 - The EC is reflecting on the equivalence process, as seen in its 2017 Staff Working Document on the issue. While ISDA understands that some of the measures under

consideration for optimizing equivalence are linked to the decision of the UK to withdraw from the EU, it would observe that some of the steps under consideration (based on a reading of this staff paper) may – if adopted in a non-risk sensitive and non-proportionate way - make equivalence processes more challenging e.g. an enhanced role for the ESAs and ‘monitoring and enforcement of third countries’ on-going compliance’, particularly in relation to requirements for the ability to conduct on-site inspections and to get effective access to data in third countries.

- The existing equivalence mechanism comes with a number of challenges, including:
 - The potential for it be withdrawn at short notice, creating a lack of certainty (consideration should be given to transitional provisions where an equivalence provision may be withdrawn, in this context, in order to prevent and limit detrimental market and financial stability impacts).
 - The inconsistent approach to equivalence across different pieces of legislation (which has been recognized by the EC).
 - The lack of a clear process for consultation with third countries (as mentioned, EU market participants have often found themselves having to educate regulators in third countries as to specific equivalence provisions in EU regulation affecting derivatives in recent years. In legislation such as EMIR or the Benchmarks Regulation, for example, the ability of EU market participants to remain in specific geographical and/or product markets has depended on the ability of non-EU regulators to first understand the existence and implications of equivalence provisions, and then understand who to talk to and where to go to obtain equivalence decisions).
- On ‘EU equivalence procedures’ as addressed in the draft report, we make the following additional remarks:
 - We recognize that equivalence gives third country institutions limited access to the single market for certain products and services (paragraph 7) but underline that ***equivalence is also crucial to the ability of EU firms to operate effectively in non-EU markets (consider the necessity for firms to be able to use a recognized non-EU CCP under EMIR (to comply with the EU clearing obligation) and CRR (in order to avoid a prohibitive increase in capital charges)***, for example. In many non-EU jurisdictions, it would be vital for EU firms to be able to use such a CCP in order to hold our liquidity to local counterparties, and recognition would depend on equivalence).
 - We caution that ***if equivalence is to be addressed via Delegated Acts (suggested under paragraph 11) this could make the equivalence process slower, more complex and politicized.***

- While we support the role of the ESAs in the existing equivalence apparatus, and would welcome (with some caveats relating to scalability, already mentioned) their enhanced involvement in monitoring and implementation of equivalence decisions, we believe that ***a review by the ESAs, every three years of equivalence decisions, would introduce further uncertainty.*** We believe that a better approach would be for the ESAs to be responsible (and adequately resourced) for monitoring the regulatory, supervisory and market developments in equivalent jurisdictions and for there to be regulatory dialogue with third country authorities to foster continued supervisory convergence. Where necessary, the Commission could launch reviews of equivalence status.

We would like to conclude by underlining our support for the deliberations of the European Parliament on this issue. The European Parliament adds considerable value to the EU regulatory process. We welcome this draft report in this context.

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