

Common Principles — Examples

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In our “Methodology for Regulatory Comparisons”, ISDA proposed concepts to guide the comparisons of derivatives regulations that will be carried out by regulators assessing the possibility of substituted compliance. Our methodology relies on regulators, with input from the markets, developing common principles that will apply in various subject matter areas within derivatives regulation. These principles should be cast to support comparability of regulation without requiring identical regulation.

To illustrate our proposed methodology, we offer the following examples of common principles. These examples have been developed and organized in relation to several of the original G-20 derivatives goals. (To be clear, these are merely examples and do not purport to illustrate comprehensive treatment of their subject matter areas.)

Common Principles for Substituted Compliance of a Foreign CCP

The BIS/IOSCO Principles for Financial Market Infrastructure (“PFMI”)¹ provide a comprehensive set of principles, each elaborated upon with key considerations and explanatory notes, that address organization, governance, credit and liquidity risk management, settlement, central securities depositories and exchange-of-value settlement systems, default management, general business and operational risk management, access, efficiency and transparency. The PFMI have been recognized in the Basel interim framework for Capital Requirements for Exposure to CCPs as the basis on which a CCP may qualify as a “Qualifying CCP”, trade exposures to which are entitled to a favorable 2% risk weighting.² Accordingly, the PFMI provide an appropriate framework for determining comparability for purposes of a CCP’s eligibility to satisfy another jurisdiction’s clearing mandate.

To be deemed eligible to clear transactions in satisfaction of a jurisdiction’s clearing mandate, a foreign CCP must be subject to supervision by appropriate government authorities in its home country and assessed by them to be in compliance with the PFMI.

¹ Principles for Financial Market Infrastructures, Bank for International Settlements and International Organization of Securities Commissions (April 2012).

² Capital Requirements for Bank Exposures to Central Counterparties, Bank for International Settlements (July 2012) (available at <http://www.bis.org/publ/bcbs227.pdf>).

Common Principles for Clearing Mandate

A. Exceptions, Generally

A clearing mandate is defined by reference to a class of financial instruments and a class of market participants subject to the mandate and, in some cases, particular transaction characteristics, such as failure of a transaction to qualify as a hedge of commercial risks. The OTC Derivatives Regulators Group (“ODRG”) has observed that regulatory gaps may arise due to jurisdictional differences in the scope of the clearing mandate, and has agreed to take a “stricter rule applies” approach to closing such gaps.³ The ODRG has cited the clearing exemption for US small financial institutions and the temporary clearing exemption for EU pension funds as examples of exemptions that would be rejected under a “stricter rule applies” approach.

While we agree that a “stricter rule” outcome may be appropriate under certain circumstances to prevent regulatory arbitrage, we believe that automatic application of the principle should be avoided in favor of balancing a broader set of considerations, including any sovereign policy objectives served by differences in rules and the degree of proportionality between the increased cost and complexity of complying under a “stricter rule” approach and the harm stemming from the gap between jurisdictions’ rules.⁴ Indiscriminate application of the “stricter rule” approach risks fragmenting markets, as it would encourage exempt entities to transact only with domestic dealers, and escalating complexity, as market participants would need to be familiar with the laws of the jurisdictions of each of their counterparties. Notwithstanding the multifaceted nature of the analysis, there are cases where it is apparent that the “stricter rule” approach should not apply. One such case, which is not controverted by the examples cited by ODRG, is that of clearing exemptions based on fundamentally-shared views that certain broad categories of market participants (e.g., end users) or transactions (e.g., between consolidated affiliates)⁵ do not implicate the policy goals of clearing.

Substituted compliance standards for the clearing mandate should permit application of another jurisdiction’s clearing exceptions where the exceptions are based on fundamentally-shared policy and content judgments. This exception should prevail over any general rule for comparing regulatory regimes favoring a “stricter rule” approach. Differences in articulation of those fundamentally-shared policy and content judgments are expected and should be respected, so long as they remain subordinate to the judgments themselves.

B. End-user/Non-financial Party Exceptions

As a prime example of an issue subject to Principle A above, mandatory clearing regimes may admit exemptions for “end-users” – i.e., entities needing unencumbered market access and

³ Report to the G-20 Meeting of Finance Ministers and Central Bank Governors, OTC Derivatives Regulators Group, p.6 (April 18-19, 2013).

⁴ The EU-CFTC “Path Forward” (available at http://europa.eu/rapid/press-release_MEMO-13-682_en.htm) endorses the “stricter rule” approach. We hope that both EU and CFTC will mitigate that approach, as we suggest above.

⁵ The EU-CFTC “Path Forward” acknowledges that both authorities have “essentially identical” processes for regulating intra-group swap transactions.

judged not to be significant contributors to systemic risk, based on their lack of engagement in financial sector activity and/or their level of derivatives transactions not exceeding specified quantitative thresholds. For example, the EMIR clearing mandate does not apply to a “non-financial counterparty” if its positions in OTC derivatives contracts do not exceed the clearing threshold, whereas the end-user exception under Dodd-Frank generally requires that a party not be a “financial entity” (defined by reference to various bodies of US federal law) and is hedging commercial risk. These two different exemptions have broad thematic consistency, though differently articulated.

Because a foreign jurisdiction’s definition of financial sector activity may be based on local regulatory classification, a host jurisdiction should allow substituted compliance under its end-user exception by recognizing another jurisdiction’s definition of “end user.”

Common Principles for Swap Data Reporting

A. Sufficiency of Information

A regulator must be able to rely on a reporting regime to fulfill mandates that may include (i) assessing systemic risk and financial stability, (ii) conducting market surveillance and enforcement, (iii) supervising market participants and (iv) conducting resolution activities.⁶ Information that is particularly relevant to these goals includes:

- all economic terms that are material to determining valuation;
- execution price;
- time of execution;
- a legal entity identifier issued by a local operating unit of the global LEI system and meeting the standards of that system (subject to the need for flexibility in cases where legal impediments exist to the reporting of identity information);
- underlier and other transaction type identifiers, in a standard capable of accommodating ongoing efforts to aggregate data according to product taxonomies; and
- life cycle events.

A common understanding on what constitutes sufficient information would facilitate the aggregation of data maintained in multiple repositories.

Reportable data elements and data standards must be sufficient to provide the regulator with transparency regarding the nature and magnitude of derivatives exposures, the

⁶ See Implementing OTC Derivatives Market Reform, Financial Stability Board, p. 47 (October 2010)

interconnections among institutions and facts regarding the formation of transactions, and any material change in individual transactions.

B. Timing of Reporting

The regulatory goals stated above should be distinguished from price discovery and post-trade price transparency objectives, which were later incorporated by the Financial Stability Board into the G-20 mandate regarding exchange/electronic platform trading.

Differences among jurisdictions in the timing of reporting (i.e., the permitted interval between execution of a transaction and when it must be reported) should be evaluated in light of systemic risk and market supervisory objectives, rather than policies of facilitating price discovery.

C. Distinction in Public Reporting Procedures

A reporting regime may require publication of aggregate data derived from the reported information available to regulators. A BIS/IOSCO report characterizes the goal of public dissemination as “allow[ing] for a broad assessment of the financial stability of the overall OTC derivatives market and the market’s potential impact from the perspective of different jurisdictions, currencies and counterparties”, while recognizing that jurisdictions may take different approaches as to the level of granularity of published information.⁷

Close similarity of public dissemination mandates should not be a prerequisite for substituted compliance of regulatory reporting regimes.

D. Data Access

In considering whether the prerequisites for substituted compliance exist, a regulator should take into account promptness of access and restrictions on access to data that may be imposed by local law governing the trade repository to which substitute reporting is made. However, recognition criteria should not be overly prescriptive regarding means of access -- both direct access as well as “agented” access through operation of a memorandum of understanding should be potentially admissible.

As a condition to extending substituted compliance, the regulator must have adequate access (either directly or through cooperative processes with the other regulator) to data in the trade repository to which substitute reporting is made in order to meet its regulatory responsibilities.

E. Repository Adequacy

The trade repository to which substitute reporting is permitted should meet standards of systems integrity, security and resiliency consistent with those set forth in the PFMI.

⁷ Report on OTC Derivatives Data Reporting and Aggregation Requirements, 21-22 (available at <http://www.bis.org/publ/cpss100.pdf>).

Common principles for real-time reporting

Substituted compliance assessments of public price reporting regimes should be based on price discovery goals with due deference to home country regulators' determinations regarding block exclusions and other mechanisms for protecting liquidity. Transaction price data is meaningful primarily for standardized products of the type that will be prime candidates for clearing and trading mandates. For other products, even relatively simple ones, reported data (which necessarily must be in a condensed format for assimilation in real time) will often fall short of conveying sufficient specificity regarding economic terms to make price information meaningful or will be of limited public use due to characteristics of transactions and their counterparties that are appropriately opaque to the reporting process. Recognizing that price discovery could be impacted by off-venue trading, a comparability analysis may consider whether the real-time reporting obligation should extend to systematic providers of off-venue liquidity in products fungible with those traded on venues.

A substituted compliance analysis of real-time reporting should focus principally on post-trade transparency for standardized transactions taking place on trading venues and similarly public facilities, as well as systematic off-venue trading of fungible products.

Common principles for mandatory trade execution

Application of a trading mandate should be premised on findings of sufficient and sustained liquidity in adequately standardized products, and subject to appropriate exclusions for market-affecting or counterparty-revealing transactions. These exclusions may well be variable, reflecting differences in the relevant markets. A substituted compliance analysis of another jurisdiction's trading venues should consider the integrity of that other jurisdiction's determinations regarding the scope of its trading mandate (but not require congruence with its own), together with the jurisdiction's regime for regulating trading venues.

A mandatory execution requirement may be satisfied by execution on, or pursuant to rules of, a trading venue recognized by another jurisdiction for purposes of its trading mandate, provided that the jurisdiction (a) has an appropriately scoped trading mandate and (b) enforces venue rules that promote competitive execution and appropriate levels of pre- and post-trade transparency, protect against market manipulation and offer non-discriminatory access to market users. Comparability criteria should allow for a variety of execution methodologies (including limit order books, RFQs, batch auctions and others) so as not to stifle innovation.