ISDA Safe, Efficient Markets

Kevin Fine
Director, Derivatives
Ontario Securities Commission
20 Queen St West
22nd Floor
Toronto ON, Canada

13 July 2018

By Email: kfine@osc.gov.on.ca

Dear Kevin,

Further Industry Feedback Following the 23 May FSB Round Table in Hong Kong

The International Swaps and Derivatives Association, Inc. ("**ISDA**")[1] and its members thank the Financial Stability Board ("**FSB**") OTC Derivatives Working Group's Workstream on Trade Reporting Legal Barriers ("**Workstream**") and its official sector representatives for organising the round table on trade reporting legal barriers ("**Round Table**") in Hong Kong on 23 May 2018. ISDA and its members support the Workstream's efforts in forging a common, consistent and comprehensive understanding of where legal barriers have in fact been removed, and the extent to which concerns remain.

As a follow-up to the Round Table, members appreciate this opportunity to provide further comments and feedback on the key issues which emerged over the course of the day's discussions. ISDA has collated and consolidated this feedback along thematic lines below, and it is hoped that these additional comments will provide further clarity and be of benefit to the Workstream as it conducts its post-Round Table deliberations. ISDA and its members would also be very happy to continue the productive dialogue with the Workstream, so as to achieve an optimal balance between realising the regulatory imperative of removing barriers to unmasking, and taking account

[1] Since 1985, ISDA has worked to make the global derivatives markets safer and more efficient. Today, ISDA has more than 900 member institutions from 68 countries. These members comprise a broad range of derivatives market participants, including corporations, investment managers, government and supranational entities, insurance companies, energy and commodities firms, and international and regional banks. In addition to market participants, members also include key components of the derivatives market infrastructure, such as exchanges, intermediaries, clearing houses and repositories, as well as law firms, accounting firms and other service providers. Information about ISDA and its activities is available on the Association's website: www.isda.org. Follow us on Twitter @ISDA.

of the legal and regulatory barriers and practical realities which exist in today's domestic and cross-border OTC derivative markets.

While this submission focuses its attention on barriers to reporting the identity of institutions, members also separately note that potentially even more complex issues exist around the identification of individuals.

Client Consent Requirements – A Remaining Practical Barrier to Full Reporting

Members remain of the firm view that any requirement to obtain client consent prior to unmasking does not constitute the complete removal of a barrier to reporting, because obtaining sufficient client consent is itself a substantial barrier. Members note that client consent may already be an existing mechanism by which reporting firms can overcome the barrier, however members also understand first-hand that this consent may not be forthcoming or easily obtained for a number of reasons, including:

- the various permutations and nuances of certain cross-border reporting obligations (such as "nexus" reporting requirements);
- the needs for clients to provide more than one consent (e.g. in relationships where client trades may be booked in different jurisdictions, the laws of each of which may have different consent requirements such as local language requirements);
- the client's relative unfamiliarity or inexperience with derivative transaction reporting;
- the client's refusal to provide consent to have their identity revealed (as may be the case with some sovereign and/or government-type entities);
- a lack of client resources to review and understand the reporting entity's reporting obligations as well as the consent agreement and any related documentation;
- an ability to easily shift trading relationships to other entities not subject to such reporting obligations;
- cessation of the trading relationship, making outreach more difficult; and
- the fact that certain clients may only exist for a certain period of time (such as time-limited securitisation purpose vehicles ("**SPVs**")), and are therefore unable to provide consent in relation to legacy masked trades (as discussed later in this submission).

In relation to obtaining "sufficient" consent as described above, the interpretation of this term may differ according to the jurisdiction in question. In particular, we distinguish between jurisdictions which clearly and definitively require "express" (or "written" or "two-way") consent, and other jurisdictions which may clearly and definitively only require "deemed" (or "implied" or "one-way") consent. Indeed a third category of jurisdiction exists, where the legal position is ambiguous or not clear as to whether express consent is required. In these circumstances, members have advised that they must generally take a conservative, risk-based approach as to whether to accept the risk that deemed consent may not be sufficient. This conservatism is justified from a documentary evidence perspective, and particularly where severe legal liabilities for breach are involved. In this context, it should also be noted that at least some proportion of clients which refuse to provide consent are central banks and sovereign-type entities, where unmasking of their identity may also have other, wider ramifications for the reporting entity.

In addition, there is at least one jurisdiction where even express consent may not cure the barrier completely, and reporting may not be permitted without additional approvals (or at all). In certain jurisdictions, there are prescribed criminal and/or regulatory sanctions for disclosure without consent, with higher risk of enforcement where the reporting entity, or its affiliate, is domiciled in such jurisdiction. In such cases, the barrier to reporting remains high where counterparties may be unwilling to provide consent.

We also take this opportunity to highlight the operational burden and challenges of obtaining client consent and the resulting negative impact to the broader client relationship. The process of trying to obtain client consent is time-consuming, repetitive, resource-heavy, documentation-intensive and in some cases futile. While members will strive to use standard ISDA documentation to obtain consent wherever possible, the client may not be willing to adhere to an ISDA protocol, and language contained in an ISDA Master Agreement may not be broad enough to capture all relevant scenarios (i.e., it may be specific to the counterparty, branch, client and/or product type, rather than covering the counterparty group in all trading permutations). This creates significant complexity, exacerbating the fact that a lack of counterparty consent may impact the derivatives trading relationship.

Many clients trade multiple products under a trading relationship umbrella, with risk management and hedging strategy critically dependent on the ability to trade derivatives. For that reason, a prohibition on further derivative trading with the client due to non-receipt of consent may also lead to a reduction or cessation of trading in other instruments such as bonds, loans, cash market products, currencies, equities and/or commodities, due to the inability to manage the underlying risk through derivatives.[2]

For these reasons, we would encourage the Workstream to characterise any client consent requirement as a remaining barrier to complete reporting. Further, we encourage the Workstream to give thought to how to approach the issue of clients which do not consent to their identity being unmasked, noting that the approach taken to date does not seem to have yielded the desired results in terms of transparency for at least a portion of the market. We make suggestions on how to achieve an optimal, barrier-free regime later in this submission.

State and Bank Secrecy Laws – Liability Concerns

As discussed at the Round Table, members still have significant concerns about reporting full information on transactions with clients in jurisdictions where the extent of legal liability is either (potentially intentionally) unclear or severe. In such jurisdictions, the exact scope, interpretation and application of such state and bank secrecy laws may not be determinable, creating a real risk that unmasking client identity may be considered a criminal offence that subjects individuals to

---

[2] See also: ISDA whiteboard animation: How do derivatives benefit the global economy? https://www.isda.org/2017/05/10/how-do-derivatives-benefit-the-global-economy/

fines and/or imprisonment. Where a firm books a trade in such a location or enters into a trade with a counterparty from such a jurisdiction, this can make the trade and related employees subject to those laws. One member has noted that it has clients in at least 11 such jurisdictions.

State secrecy laws may be an issue in particular, if the definition, scope or application of "state secrecy" is unclear or arbitrary. Taking China as an example, based on legal advice received by members, "state secret" is broadly defined as any secret information which the relevant state secret administration authority determines as a state secret, and may include the sensitive financial information of Chinese government agencies or state-owned enterprises. The determination of what constitutes a state secret may also depend on the view of the relevant regulators, of which there may be more than one. Unauthorised disclosure of state secrets is subject to criminal liability under PRC criminal law.

For these reasons, members often cannot rule out the possibility that some trade information with entities in such jurisdictions may be regarded as a state secret either now or in the future, and therefore cannot trade with impacted counterparties, or report such transaction data to trade repositories or authorities offshore.

Bank secrecy requirements also pose as a barrier in certain jurisdictions (e.g. Singapore), where banks operating in such jurisdictions are mandated to obtain written consent before being able to report transactions, even where counterparties' own jurisdictions do not have any barriers to reporting.

More generally, at the policy level, market participants should not be put in the difficult position of being forced to choose whether to breach regulatory reporting requirements, or state or bank secrecy laws. Rather, we would urge the FSB to prioritise the discussion on the industry's approach towards such laws, particularly where such laws are found in FSB member jurisdictions. Until such laws are removed or are the subject of written remediation, we would strongly encourage that masking relief is provided under the reporting regimes of various jurisdictions to address this situation.

Lastly, while we have focused the above analysis on bank or state secrecy laws with personal and/or criminal liability for non-compliance, it is important to remember that all data confidentiality and/or secrecy laws that constitute a barrier to reporting full information are important, regardless of whether they result in civil damages, regulatory sanction or criminal penalties.

FSB Non-Member Jurisdictions

Members noted that the majority of the discussions over the course of the day of the Round Table centred on achieving consensus on the status of FSB member jurisdictions' efforts to remove barriers to full reporting. Since there are many FSB non-member jurisdictions which are not subject to the current FSB deadlines to remove legal barriers to reporting, it may be useful for the FSB to engage with standard setting bodies such as the International Organization of Securities Commissions ("**IOSCO**"), industry associations and other stakeholders to determine if further study into such FSB non-member jurisdictions should be carried out, especially those for which issues tend to recur across the industry.

Reporting entities may have obtained varying and/or conflicting external legal and other advice as to the existence, nature and application of barriers to full reporting under the regimes of various FSB non-member jurisdictions. Therefore, consensus and clarity on the current status of such barriers, as well as any related efforts to remove such barriers, would assist both regulators and industry to move towards a more consistent and transparent reporting regime overall. We also submit that by removing barriers to full reporting within their own regimes, FSB member jurisdictions can set a useful example for FSB non-member jurisdictions to follow.

Until such time however, we believe it is necessary that appropriate masking relief is available to reporting entities for their reporting obligations in various jurisdictions. Although the proportion of trades facing counterparties in these jurisdictions may be relatively small overall, access to liquidity for institutions in such jurisdictions is a key concern, with the result that liquidity would be harmed if such relief were not provided.

"Nexus" Reporting Requirements and Associated Complications

Members draw the Workstream's attention to certain requirements predominantly found in jurisdictions in the Asia-Pacific region, where the use of an onshore trader and/or certain other functions to execute a trade in such a jurisdiction renders the trade reportable in that jurisdiction, despite its booking elsewhere – commonly referred to as "nexus" reporting. Such requirements can present a variety of complications when reporting trades, including:

- increasing the number of counterparties, trades and reports which need to be submitted and validated;
- requiring firms to explain to clients why their information is required to be reported to a jurisdiction in which they may have no presence themselves;
- requiring firms to obtain expanded client consent for reporting to offshore jurisdictions (which may not be forthcoming for the reasons discussed earlier); and
- increasing the complexity of agreeing a standardised approach, due to firm-specific, evolving booking models.

With reference to obtaining client consent for nexus reporting, members have advised that they often agree to restrict the language of the consent to only cover regulatory reporting to specified jurisdictions that are relevant to the specific counterparty, as opposed to a consent which would apply more broadly, as clients are typically unwilling to agree to this broader consent. This may be due to client sensitivities and desires to provide consent only where perceived to be needed, as well as the fact that consent requirements can differ by jurisdiction (e.g. local language requirements). Reporting entities may also not want to burden counterparties with complex consent requirements that may not have any application yet in the current trading relationship. As and when new jurisdictions come into scope, reporting entities will be required to reach back out to impacted counterparties to obtain broader consent. Where members are not able to obtain broad or restricted consent, client access to markets is hindered because members apply trading restrictions with the client.

We would encourage the Workstream to closely consider whether the lifting of barriers to reporting in a particular jurisdiction also contemplates and allows for reporting under potentially unforeseen scenarios and to potentially unforeseen jurisdictions, as may occur due to nexus reporting. We would also submit that nexus reporting requirements serve to demonstrate the importance of ensuring that barriers to reporting are removed fully and completely.

The Policy and Technical Challenges of Legacy and Outstanding Trades

Expired, Matured and Terminated Trades (Legacy Trades)

On an overall cost-benefit basis, members do not believe that any requirement to unmask expired, matured and terminated trades (collectively, "**legacy trades**") would result in a net regulatory benefit. From a systemic risk monitoring perspective, members would not expect the unmasking of legacy trades to be meaningful in obtaining an accurate picture of current risk in the markets.

From an operational perspective, such trade records may no longer be kept by a trade repository. Therefore, the information would need to be sourced from market participants directly, undoubtedly complicating the process of aggregating data to obtain a historical snapshot of the market. To the extent the records are still maintained by the trade repository, unmasking any such trades would still represent a tremendous operational challenge, as this large population of positions across a multiplicity of jurisdictions would need to be exited manually first, then backloaded again in order to actually unmask them. The scale of the challenge and resources required becomes clear when considering the number of reporting entities, counterparties and service providers in existence across multiple trade repositories and jurisdictions.

Outstanding Positions and Transactions

Similarly, identifying and re-reporting all outstanding masked trades would be a massive operational challenge, given the number of entities involved across the entire post-trade reporting chain and the volume of data to be analysed. Reporting entities, middleware providers, service providers, trade repositories and other market participants would need to identify the population of historical transactions to be unmasked, conduct due diligence to ensure that no barriers to unmasking remain for each trade or trading pattern, exit every position, re-report each position unmasked, validate each submission to ensure it is acknowledged and accepted by the trade repository, potentially update any other trade details at the same time as required by new regulatory requirements, manage and remediate any errors, and follow up on any queries. Any entity that delegates its reporting to another entity is likely to face an even more complicated scenario.

It is also important to note that unmasking of outstanding positions may not yield data of optimal accuracy. Many jurisdictions do not currently require entities to be identified through the use of an LEI, and instead allow a waterfall of identifiers to be used. Therefore, unmasking of positions may only result in non-global identifiers being made transparent, such as national business registry numbers. This would again make the task of meaningfully aggregating such entity data complex, and may not yield high-quality data.

Use of the Legal Entity Identifier

Members noted that discussions at the Round Table centred on the feasibility and potential benefit of combining an unmasking requirement for outstanding positions with a requirement for entities to report an LEI for their counterparty as well as themselves. However, members noted that at this stage LEI use remains mixed, especially in the emerging markets, where there is usually no regulatory requirement for local market participants to obtain or report an LEI for themselves, let alone their counterparty. An LEI requirement could distort competition and create an uneven playing field vis-à-vis firms who must require their client to obtain an LEI and firms who do not have such a requirement. This could be particularly detrimental with respect to competition for government entity-type clients, who may be less incentivised to obtain one.

As more regulators move to require the LEI, it is expected that usage of this identifier will improve. Indeed, ISDA has observed a substantial increase in the number of LEIs issued over the last two years, due to the advent of LEI requirements in other regions. However, at this point in time, members believe that overlaying the LEI as part of a historical unmasking exercise could have the unintended effect of significantly increasing the operational workload of members, by forcing them to further stretch their existing LEI outreach programs while simultaneously trying to still identify, on a trade-by-trade basis, the impacted population of outstanding transactions to unmask. This could lead to significantly increased operational risk, not least due to the potential for human or manual errors. Rather, if unmasking of outstanding positions is required, members would support a prudent approach that provides for some degree of flexibility in terms of the type of counterparty identifier that can be used if the client is unable or unwilling to obtain an LEI.

Non-Active Clients

Members also note the challenges of obtaining client consent where the client no longer exists, or the firm no longer has a trading relationship with the client. Gaining consent from a time-limited SPV, for example, is likely to be difficult or impossible where the SPV's structure has been dismantled or dissolved. Additionally, corporate structures may change, and historical counterparties may have merged, been taken over or otherwise consolidated, again creating a potentially insurmountable barrier to obtaining consent. In these situations, even if the client can be identified, it is likely to be unable, unmotivated or unwilling to provide consent to a firm with which the trading relationship has been severed. Lastly, requiring unmasking of trades with such non-active clients may not yield large benefits, as members believe that the percentage of trades with clients which no longer exist or with whom the financial institution no longer has a trading relationship may only account for a small percentage of masked trades overall.

The Optimal Scenario

Taking into account the discussions during the Round Table, as well as the issues set forth above, members believe an optimal jurisdictional framework, approach and requirements regarding barriers to reporting and unmasking can be defined and described. This optimal scenario would reduce or eliminate uncertainty and duplication, encourage jurisdictions to remove barriers while acknowledging current practical realities, provide protection where needed to market participants, and ultimately achieve a higher transparency, accuracy and quality of reported transaction data. Although the optimal scenario may not be achievable in all jurisdictions or circumstances, members nevertheless believe that it is useful to set out the following steps, which would be required to achieve the above objectives:

- Provision of masking relief in cases where (i) there continue to be legal or regulatory barriers to reporting, or (ii) client consent for reporting is required, and the reporting entity has not been able to obtain such consent despite reasonable efforts;
- Removal of, or exemption from, all blocking statutes, bank secrecy, data privacy, state secrecy or similar laws, as well as any contractual obligations to keep data confidential, which impede or prohibit regulatory reporting in any jurisdiction or trading circumstance[3];
- Removal of, or exemption from, any and all requirements to obtain client consent for regulatory reporting under both domestic and foreign requirements;
- A public statement and confirmation from each regulator confirming that no barriers to reporting exist, as provisions are in place such that entities complying with their regulatory reporting obligations (including sharing of counterparty information) are immune from breaching any of the barriers stated above; and
- Regulatory reporting rules which require that once all barriers are removed, unmasking is to be on a forward-looking basis only (that is, to new trades, entered into with existing or new clients, from a certain date).

* * *

Once again, we take this opportunity to thank the Workstream for their productive efforts to date in facilitating a discussion on barriers to reporting, and reiterate that the industry supports the FSB's efforts to achieve the objective of ensuring that all barriers are removed, across all jurisdictions, counterparties and trading scenarios. We hope this these comments and feedback assist the Workstream in its efforts in preparing its report for the G20 Leaders' summit later this year, and would be happy to continue discussions on this important topic. Please contact Rishi Kapoor, Director, Public Policy, Asia-Pacific, at rkapoor@isda.org should you wish to discuss these matters further.

---

[3] The Workstream may wish to consider Article 9(4) of the European Markets Infrastructure Regulation (EMIR) in this context.

ISDA

Yours sincerely,

Keith Noyes

Regional Director, Asia-Pacific

ISDA

Rishi Kapoor

Director, Public Policy, Asia-Pacific

ISDA