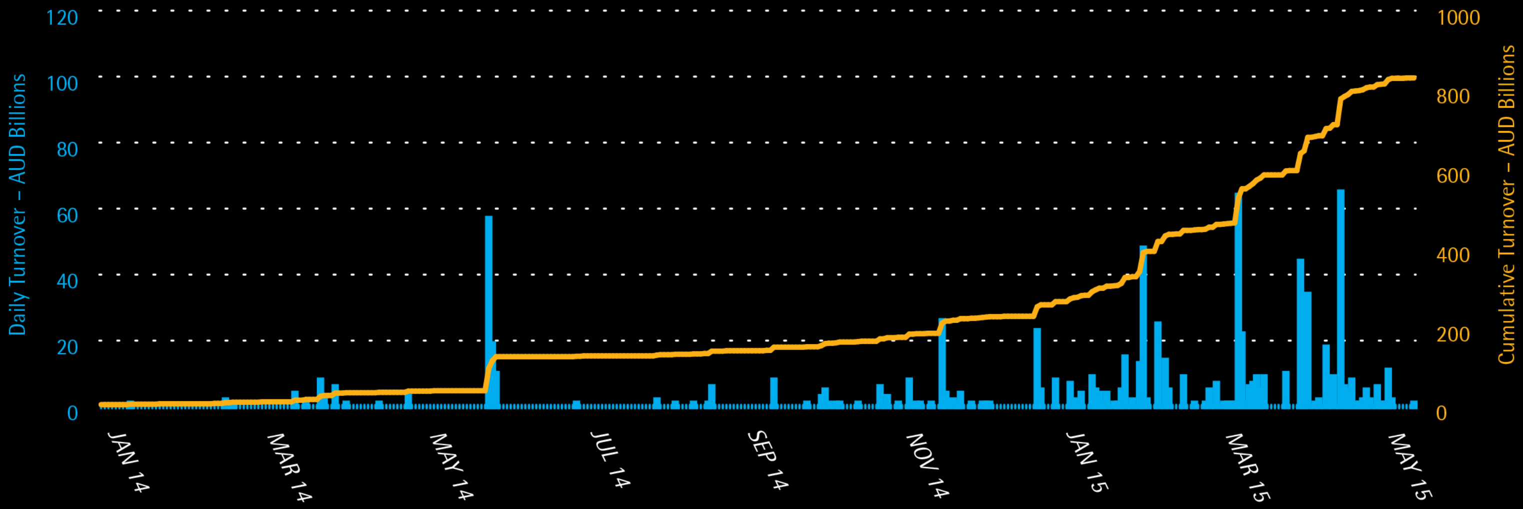
ASX

The Centre for Managing Australian Risk...

ASX

...and Natural Home of $A OTC Liquidity

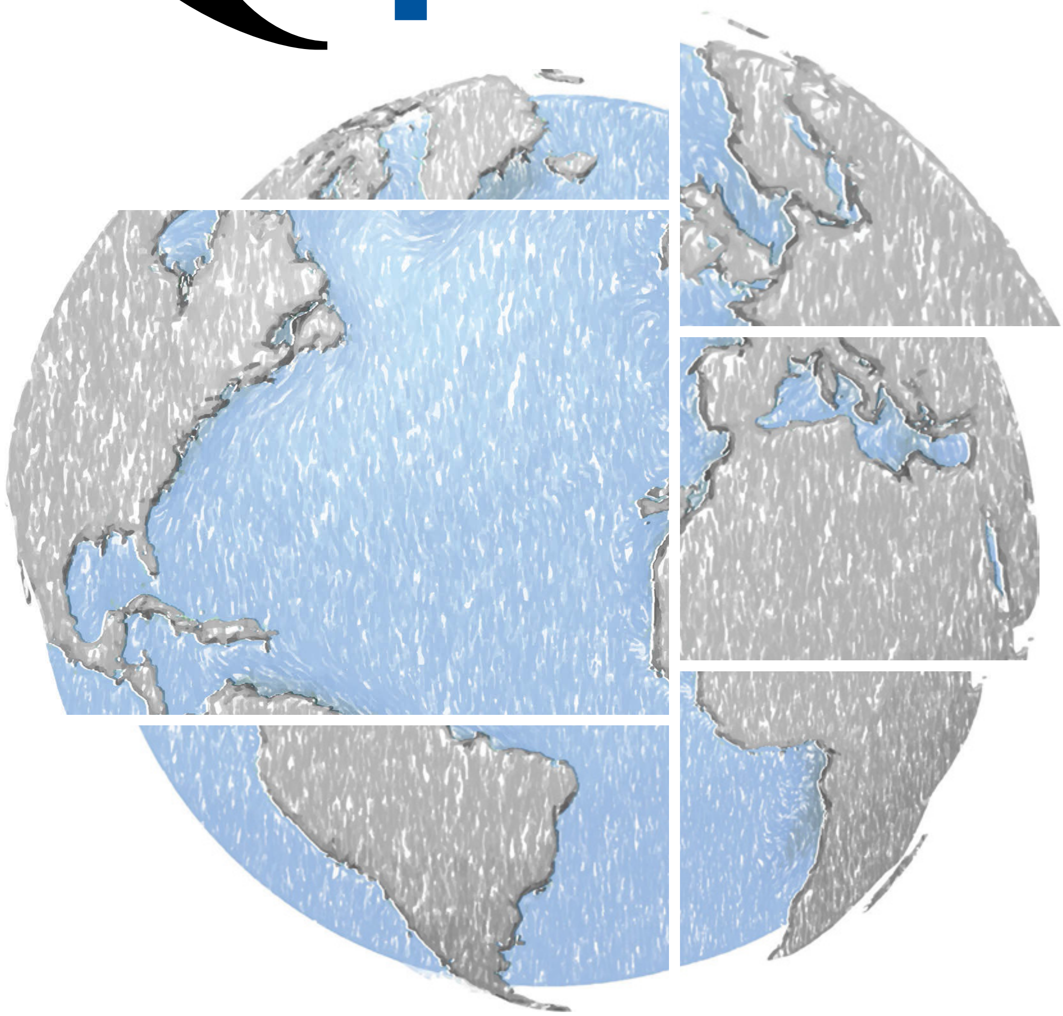


IQ: ISDA Quarterly

IQ

ISDA® Quarterly

Vol 1 Issue 2: July 2015
www.isda.org



SOLVING THE CROSS-BORDER PUZZLE

- The Regulators Speak: US, Europe and Japan
- The Industry View: Spencer, Sprecher and More

ISDA® Safe, Efficient Markets

Vol 1 Issue 2: July 2015 | www.isda.org

Cross-border Conundrum

OCTOBER 2013 MARKED an important turning point in derivatives trading. The month before, more than 28% of the European interdealer market for euro interest rate swaps was traded between European and US dealers. In the space of a month, it fell to under 9%, and it hasn't recovered since.

The trigger is widely considered to be the rollout of the US swap execution facility (SEF) regime, which came into force on October 3, 2013. From that point, non-US platforms that provided access to US entities were required to register with US regulators and meet the SEF rules. Many took the decision that it was easier to simply bar access to US liquidity providers. And non-US firms started to steer clear of trading with US participants to avoid being sucked into US trading and clearing rules before being compelled to meet similar requirements by their own regulators.

An optimist would point to the fact that comparable clearing and trading rules either have been or will soon be implemented elsewhere, reducing the incentives to trade only with domestic counterparties. Pessimists will highlight the slow progress in achieving equivalence determinations – the long-running negotiations between US and European regulators over a possible equivalence decision for US central counterparties are a case in point. Without equivalence determinations between jurisdictions, globally active firms face being subject to duplicative and even contradictory requirements.

In this issue of *IQ: ISDA Quarterly*, we consider the cross-border topic from a number of perspectives. At ISDA's 30th AGM in Montreal in April, leading regulators discussed the problems caused by a lack of regulatory coordination, and suggested possible solutions to promote cross-border harmonisation. Those ranged from a greater role for global regulatory bodies, to automatic equivalence for Group-of-20 regimes. That discussion is featured on pages 16-22.

We also feature a series of essays from leading industry figures, including Jeffrey Sprecher of ICE and Michael Spencer of ICAP, who propose their own solutions to the problem (see pages 24-30). Opinions vary on how best to move forward. But in one regard, everyone agrees: this cannot be resolved unless regulators trust and defer to each other.

It's not all about regulators, though. Industry participants can also play a part in developing common approaches, principles and standards. ISDA has been very active in this space, and recently developed a set of principles aimed at encouraging effective and coordinated trade execution rules. Data is another area where the industry can help to develop product, transaction and reporting standards. ISDA earlier this year published a set of principles to help achieve global harmonisation of reporting standards – recommendations that 10 other trade associations endorsed last month (see page 9).

It's not an easy problem to solve. But it does need to be tackled – and soon. ■

NIck Sawyer
Head of Communications
ISDA

ISDA Safe, Efficient Markets

Published for ISDA | International Swaps and Derivatives Association | www.isda.org
NEW YORK | WASHINGTON | LONDON | BRUSSELS | HONG KONG | SINGAPORE | TOKYO

Nick Sawyer, Head of Communications, nsawyer@isda.org
Steven Kennedy, Global Head of Public Policy, skennedy@isda.org

Published by Naylor Association Solutions, 5950 NW 1st Place, Gainesville, FL 32607, 800-369-6220, www.naylor.com. Publisher Heidi Boe, Sales Manager David Glass, Marketing Manager Edward Ottenga, Editor Christine Cusatis, Design Barry Senyk, Advertising Reps George Baldwin, Janet Frank, Shaun Greyling, Debbie Phillips.

CONTENTS

VOL 1 ISSUE 2: JULY 2015

COVER STORIES

REGULARS

Happy Birthday, Dodd-Frank

THIS MONTH MARKS the fifth anniversary of the signing into law of the Dodd-Frank Wall Street Reform and Consumer Protection Act. This incredibly ambitious, 848-page piece of legislation covered everything from derivatives clearing, reporting and trading, to bank resolution, consumer protection and financial market supervision.

Given its scope and scale, opinions about the law vary widely. There should, however, be a very broad and very clear consensus on one aspect of regulatory reform: the derivatives markets have made substantial progress in achieving the goals set out by policy-makers.

Today, all swaps trades in the US are required to be reported to trade repositories, providing more transparency in derivatives markets than ever before. This means regulators in theory have the ability to scrutinise each transaction, spot areas of concern and take early action. Central clearing is well established, with more than 70% of the global interest rate derivatives market now cleared, according to ISDA analysis. A trade execution regime is also up and running, resulting in more than 50% of daily US interest rate swaps trading volume being conducted on a swap execution facility (SEF). Furthermore, global margin and capital rules are close to finalisation and will soon be implemented.

All this was completed in an amazingly short time frame: Dodd-Frank was passed just 10 months after the Group-of-20 nations agreed on a set of common objectives to overhaul global derivatives markets.

But this first-mover status has also created problems. The speed with which the legislation was drawn up meant little time was given to coordination and cooperation with non-US legislators. Differences in implementation schedules and in the substance of the regulation in different jurisdictions have emerged as a result. Together, this is creating major challenges for derivatives markets, which have always been global in nature. Regulators have been working ever since – with little success – to try and achieve cross-border equivalence.

This needs to be resolved so users can continue to tap into global liquidity pools and avoid the higher costs that would arise from a fragmentation of markets. Reconciling the rules on clearing and trading is a crucial step. Despite adhering to globally agreed principles for financial market infrastructures, US and European regulators have yet to reach agreement on their clearing house regulations. Without a European Union equivalence decision, European participants will be unable to cost-effectively use US central counterparties. A similar outcome will emerge for trading unless more is done to reconcile differences in the trade execution rules.

There are other issues specific to Dodd-Frank. Derivatives reporting requirements have given regulators the ability to drill down to the individual trade level. But the sharing of data globally has been significantly undermined by the swap data repository indemnification requirements of Dodd-Frank. Foreign regulators have been unwilling or unable to provide repositories with indemnification, restricting the sharing of US data with overseas jurisdictions. Given a key objective of data reporting was to enable regulators to build a comprehensive picture of derivatives positions across the globe, this can be marked down as a Dodd-Frank failure.

Dodd-Frank was also tough on end users. While it was broadly thought that commercial end users would be exempt from the requirements, rule-makers have interpreted the legislation in such a way as to pull end users into the net in several areas. For instance, many corporates choose to hedge through centralised treasury units (CTUs) in order to consolidate their hedging activities. This has risk management benefits, as well as reducing transaction costs. However, many CTUs classify as financial entities under the Dodd-Frank Act, subjecting them to clearing requirements.

The Commodity Futures Trading Commission (CFTC) has issued no-action relief to reduce the burden on end users, which is welcome. But legislation that expressly addresses these issues and exempts commercial end users would provide certainty that derivatives participants can rely on.

Other problems relate to transactions between affiliates of a financial group. The CFTC exempted inter-affiliate transactions from mandatory US clearing requirements, subject to certain conditions. But they are not exempt from the margin requirements for non-cleared derivatives under proposals from US prudential regulators published last September. This creates something of a paradox: such transactions will face higher capital and margin requirements as a result of being exempted from clearing.

More generally, market participants would like certainty. It has been nearly three years since the first US swap dealers and swap data repositories were provisionally registered, and almost two years since the first SEFs received temporary registration. Final registration is needed so these entities can move on and put an end to regulatory doubt.

A five-year anniversary is a good opportunity to reflect honestly on successes and failures. An objective review of the challenges will undoubtedly make Dodd-Frank even stronger. ■

Scott O'Malia
Chief Executive Officer
ISDA

ISDA Launches Global UTI Service

ISDA has launched a new service that enables counterparties to obtain a unique trade identifier (UTI) prefix in order to create UTIs for the reporting of derivatives trades.

Called UTIPrefix.org, the free-to-use tool enables derivatives users to apply a standard methodology to generate a 10-character UTI prefix using their 20-character legal entity identifier (LEI) code. A UTI prefix is distinct to the party generating the UTI and, along with a transaction identifier, ensures each reportable transaction is unique.

Significant progress has been made in improving the transparency of derivatives activity in recent years, but major challenges remain, in part because standardised reporting formats have not been adopted quickly or broadly enough. This has created problems for regulators in aggregating data within and across jurisdictions.

"UTIPrefix.org strengthens the value of ISDA's UTI standard, making it the premiere candidate for endorsement by regulators as the global UTI standard for regulatory reporting," said Scott O'Malia, ISDA's chief executive. "ISDA looks forward to continued collaboration with market participants and global regulators to achieve consensus and endorsement of data standards that promote reporting efficiencies and facilitate global data aggregation."

The launch of UTIPrefix.org follows the publication of several ISDA research papers on trade reporting, including *Unique Trade Identifier (UTI): Generation, Communication and Matching,* which highlights that the use of a single UTI value for global reporting is essential for accurate data aggregation and analysis. ISDA's UTI standard addresses the composition of a UTI and establishes a hierarchy and logic for determining which party generates it. The standard also addresses the challenges of UTI communication and assignment for a variety of transaction flows.

In addition, ISDA in February published a set of key principles for standardising, aggregating and sharing data across borders. The principles cover regulatory harmonisation, the global adoption of common standards, the development of new standards and the benchmarking of reporting progress. In particular, it notes that unique identifiers for legal entities, products and transactions should be expanded as necessary and adopted across reporting regimes. ■

> Significant progress has been made in improving the transparency of derivatives activity in recent years, but major challenges remain

Read a full version of the principles paper here: http://isda.link/datapaper. Read the UTI research paper here: http://isda.link/utistudy.

ISDA, Markit Team Up on EMIR Clearing Tool

ISDA and Markit have launched a new online service to help derivatives users prepare for the forthcoming European clearing obligation for interest rate swaps.

The EMIR Clearing Classification Tool is the latest extension of ISDA Amend, an online service jointly developed by ISDA and Markit that enables users to classify their trading entities, as well as amend and share multiple ISDA master agreements. The latest launch enables derivatives users to indicate to their counterparties whether they are subject to clearing obligations set by the European Securities and Markets Association (ESMA) for interest rate derivatives.

Final draft regulatory technical standards on the interest rate swaps clearing obligation were submitted by ESMA to the European Commission (EC) for endorsement on October 1, 2014. The rules establish four categories of derivatives user, and introduce a threshold calculation—based on derivatives notional outstanding—to determine when financial institutions that are not clearing members will have to meet the clearing obligation, and whether they will be subject to frontloading requirements.

The final rules still need to be endorsed by the EC and then reviewed by the European Parliament and Council of the European Union, which, combined with a phase-in period, means the first clearing mandates will now come into force in 2016.

ESMA has launched other clearing obligation consultations, including one on credit derivatives last year and one on interest rate swaps in non-group-of-four currencies in May. The regulator decided not to pursue a clearing obligation for non-deliverable forwards following the release of a consultation paper in October 2014.

ISDA and Markit intend to continue to develop the EMIR Clearing Classification Tool as new regulatory technical standards are introduced.

"ISDA and Markit launched ISDA Amend in August 2012, and it has proved to be a hugely successful technology based tool that automates the information-gathering process and sharing of data to counterparties required by both EMIR and Dodd-Frank regulation," said David Geen, ISDA's general counsel. "The EMIR Clearing Classification Tool broadens the existing offering on ISDA Amend, and was developed by ISDA and Markit following market demand for an automated solution to meet the classification requirements under Europe's clearing obligation." ■

More information on ISDA Amend can be found at http://www2.isda.org/emir/.

ISDA AGM Highlights Cross-border Concerns

Cross-border harmonisation was a recurring theme at ISDA's annual general meeting (AGM) in April, with successive speakers warning about the impact on market liquidity from a lack of consistency in national regulations.

More than 850 industry participants, regulators and policy-makers gathered in Montreal for the 30th ISDA AGM to discuss key issues affecting derivatives markets, including forthcoming rules on the margining of non-cleared derivatives, bank capital requirements, and clearing and trading regulations. A major focus, however, was the need for cross-border harmonisation in financial regulation in order to avoid the fragmentation of liquidity pools.

In his opening remarks, ISDA chief executive Scott O'Malia told delegates that cross-border harmonisation was a key priority for ISDA and its members. "Market participants are now increasingly subject to duplicative and inconsistent requirements because regulators didn't fully consider how their rules would align with other jurisdictions," he said.

This lack of consistency has led to a fragmentation of global liquidity pools, according to ISDA research. An average 94.3% of regional European interdealer volume in euro interest rate swaps was traded between European dealers between July and October 2014, versus 73.4% in the third quarter of 2013, before US trading rules came into force.

"In order to resolve this, there has to be an effective process in place for recognising and deferring to comparable regulatory regimes, with substituted-compliance determinations based on broad, intended outcomes. There also needs to be a concerted effort to make the rules and standards more globally consistent," O'Malia added.

This theme was picked up by a panel of regulators from the US, Europe and Japan, who discussed possible solutions to promote greater cooperation and facilitate equivalence between jurisdictions. Proposals included a greater role for international regulatory bodies, such as the Financial Stability Board, and a 'passport' system of equivalence (see pages 16-22).

Despite proposals such as these, further action is needed to make the rules more consistent and reduce the risk of market fragmentation, said Eric Litvack, ISDA chairman, in his remarks on the second day of the conference.

"Let's be clear: it's not an easy problem to resolve. But more needs to be done. Regulators have to find a way to cooperate, coordinate and defer to other regimes, rather than getting bogged down in considering each other's regulations on a rule-by-rule basis," he said.

In a keynote speech, Commodity Futures Trading Commission (CFTC) chairman Timothy Massad also stressed the importance of harmonisation, and said global regulators are currently working to iron out some of the differences between national margin rules for non-cleared derivatives.

> "We are also working with regulators in Europe and Japan that are formulating rules on margin. I am hopeful that our respective final rules will be similar on most issues"
>
> *—Timothy Massad, Commodity Futures Trading Commission*

European authorities launched their proposal for non-cleared derivatives margining in April 2014, and followed up with a new consultation last month. Japanese authorities published their proposals in July 2014, with US prudential regulators and the CFTC following in September. However, those proposals contained a number of regional discrepancies, including differences on the scope of inclusion and initial margin thresholds.

"We are currently working with the bank regulators to finalise these proposed rules by the summer, and to achieve as much consistency between our respective rules as possible," Massad said. "In addition to harmonising with the US bank regulators, we are also working with regulators in Europe and Japan that are formulating rules on margin. I am hopeful that our respective final rules will be similar on most issues," he said.

Massad also identified a number of potential reforms to US swap execution facility rules, including possible changes to the trade mandate determinations process and the practice of post-trade name give-up.

Industry Associations Endorse ISDA Principles

A group of 11 industry associations published a letter in June supporting a set of principles developed by ISDA aimed at improving consistency in regulatory reporting standards for derivatives.

Major progress has been made in meeting a Group-of-20 requirement for all derivatives to be reported to trade repositories to increase regulatory transparency, but a lack of standardisation and consistency in reporting requirements within and across jurisdictions has led to concerns about the quality of the data being reported. Poor data quality reduces the value of the information for regulators and limits their ability to fulfil supervisory responsibilities. Differences in reporting requirements also increase the cost and complexity for firms that have reporting obligations in multiple jurisdictions.

In their letter, the associations stated that adherence to the ISDA data reporting principles would result in greater consistency in the content and format of the data being reported, further improving regulatory transparency. Market participants would also benefit from greater specificity and harmonisation in their reporting across multiple regimes.

The ISDA principles call for derivatives reporting requirements to be harmonised within and across borders, further development and adoption of global data standards and the removal of impediments that prevent policy-makers from appropriately accessing and sharing data across borders.

The associations also stated that similar principles would benefit global trade reporting requirements beyond derivatives, and lessons learned from derivatives reporting should be applied more broadly.

The associations that signed the letter are: the Australian Financial Markets Association (AFMA), the Alternative Investment Management Association (AIMA), the British Bankers' Association (BBA), the German Investment Funds Association (BVI), the European Fund and Asset Management Association (EFAMA), the Futures Industry Association (FIA Global), the Global Foreign Exchange Division (GFXD) of the Global Financial Markets Association (GFMA), ISDA, the Managed Funds Association (MFA), the Securities Industry and Financial Markets Association (SIFMA) and its Asset Management Group (SIFMA AMG), and The Investment Association. ■

Read the joint association letter here: http://isda.link/jointdataletter.

Read a full version of the principles paper here: http://isda.link/datapaper.

ISDA Elects 12 Board Members

Two new directors have been elected to ISDA's board, while 10 others have been re-elected, ISDA announced at its annual general meeting in Montreal in April.

The two new directors elected were Yasunobu Arima, general manager of the global markets planning division at the Bank of Tokyo-Mitsubishi UFJ (BTMU), and Sam Skerry, global head of structured products and commercial support at BP.

Arima is responsible for global regulatory affairs relating to derivatives and markets business, a position he has held since 2012. He joined BTMU in 1987, and has held a variety of roles in Tokyo and London covering retail banking, derivatives, structuring, equity proprietary trading and equity research.

Based in London, Skerry leads a global cross-commodity derivatives marketing team and the central marketing, strategy and trading analytics functions. She previously served as BP's chief operating officer for gas, where she led the company's natural gas marketing, origination and transportation operations for North America. Other previous BP roles include senior vice-president for strategy and commercial development. ■

The full list of ISDA board members is available here: http://www2.isda.org/about-isda/board-of-directors/.

Netting Tool Enhanced to Cover ISDA Clearing Opinions

An online netting analysis tool for ISDA members will be extended to cover ISDA clearing opinions, ISDA has announced.

The tool—called *netalytics*—provides analysis on ISDA netting opinions across 63 jurisdictions in an easy-to-read, standard format. The enhancement to cover ISDA clearing opinions will occur in the coming months.

ISDA began work on obtaining clearing opinions in 2013. Priority jurisdictions were identified by members, and ISDA has since commissioned a number of clearing member and client reliance opinions, looking at close-out netting and other issues from the perspective of the clearing member and client, respectively. These clearing opinions are available only to ISDA members.

The *netalytics* service is a joint venture between ISDA and aosphere, an affiliate of Allen & Overy. It provides a standard colour-coded report with answers to 14 key netting questions for each jurisdiction covered by an ISDA netting opinion. Features include a compare function, version control and source hyperlinks. Reports are quickly updated to reflect new or updated opinions published by ISDA. ■

More information on *netalytics* is available at www.netalytics.oreg.

ISDA files petition on SEF rules with CFTC

ISDA last month filed a petition with the Commodity Futures Trading Commission (CFTC) calling for changes to the US swap execution facility (SEF) rules. The move is intended to help address challenges that have emerged in SEF trading and facilitate cross-border harmonisation of trade execution regulations.

The US SEF rules were implemented in October 2013, and the first mandatory trade determinations for certain interest rate and credit derivatives products were introduced in February 2014. Since then, SEF trading has become a central facet of US trading activity: more than 50% of average daily interest rate derivatives notional volume is now SEF-traded, according to ISDA analysis (see pages 42-46). But it's also come with teething problems. In particular, the very explicit, granular nature of the US requirements has hampered cross-border trading and led to a split in US and European liquidity pools (see pages 12-15).

These teething problems have prompted senior CFTC officials to acknowledge that certain aspects of the SEF provisions may need to be modified to ensure derivatives markets remain efficient, and to encourage more trading on these venues. ISDA's petition, filed with the CFTC on June 15, outlines specific solutions that should help achieve these objectives.

The targeted amendments are meant to provide fixes to certain issues that have posed challenges to SEF users. For instance, ISDA suggests revised language that would, in limited circumstances, allow greater flexibility in execution mechanisms. While the Dodd-Frank Act allows derivatives to be traded by "any means of interstate commerce", the CFTC's SEF rules restrict execution of mandated products to order-book or request-for-quote-to-three mechanisms. These execution methods may not be appropriate for certain, less liquid instruments, discouraging trading on SEFs. This also differs from the more flexible approach taken by European regulators in their trade execution proposals, which could result in further cross-border fragmentation.

Instead, ISDA proposes language that would enable a SEF to submit a request to the CFTC to approve additional execution methods for particular instruments. ISDA believes this would lead to a wider universe of instruments trading on SEFs, as well as increasing the prospect of cross-border harmonisation.

A further change focuses on the process for making mandatory trading determinations – known as 'made available to trade' (MAT). SEFs will continue to make initial determinations themselves, based on a revised list of more objective considerations including frequency and size of transactions and average trading volumes. But the proposed language gives the authority to the CFTC, following a 30-day public consultation period, to make the final MAT determination. Importantly, ISDA also proposes a mechanism that would allow a SEF or SEF user to petition the CFTC for the removal of a MAT determination in the event trading characteristics of a particular instrument change.

The treatment of block trades under current SEF rules has also been problematic. The rules currently require block trades to be executed away from SEFs, which is not required by law. This creates problems for futures commission merchants (FCMs), which are required to perform pre-execution credit checks for orders on or subject to the rules of a SEF. However, the FCM may not have any involvement in a block trade executed away from the SEF platform, making it difficult to comply. In response, the ISDA proposal suggests a change to the rules to allow block trades to be executed on SEFs.

Read ISDA's petition here: http://isda.link/cftcpetition. ■

Single-Name CDS to Move to Semiannual Roll

ISDA has published a recommendation for an amendment to the single-name credit default swap (CDS) roll frequency.

The recommendation is in response to market feedback, and is aimed at improving liquidity and facilitating greater levels of clearing in the single-name CDS market. Under the new recommended standard schedule, single-name CDS transactions would roll to a new 'on-the-run' contract on a semiannual, rather than quarterly, basis. The move will further align single-name CDS contracts with CDS index trades.

Under the current convention, market participants roll to a new on-the-run contract each quarter, on March 20, June 20, September 20 and December 20. ISDA has recommended that the frequency of this roll is reduced to March and September. All other features of the current standard single-name CDS contract – for instance, settlement payments – will remain unchanged.

As well as improving liquidity on the new semiannual roll dates, the recommendation is intended to improve the affordability of single-name CDS trades by reducing capital costs, improve netting fungibility, and increase the clearing of single-name CDS transactions, with more buy-side participation.

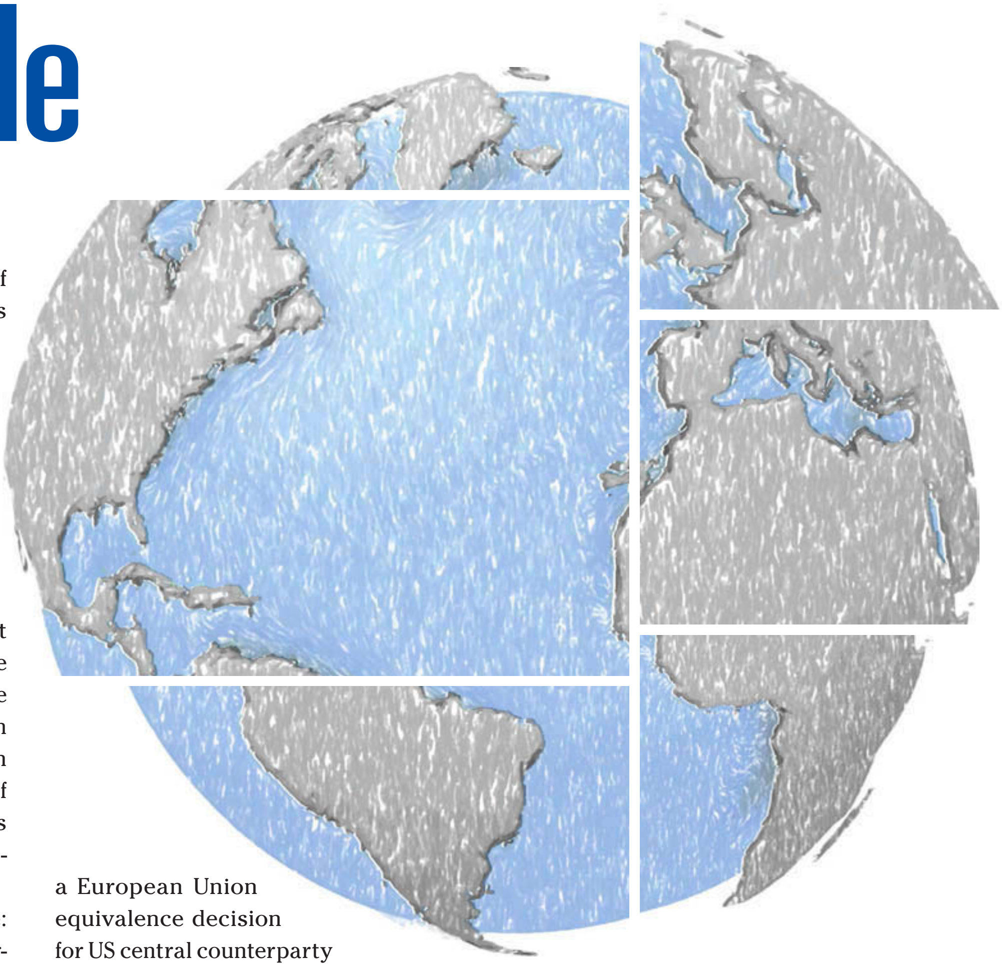
The implementation schedule for the new calendar is still under consideration, with a potential go-live date of December 20, 2015. The initial implementation schedule would skip the December 20 roll, and the single-name CDS contracts that rolled on September 20, 2015 would be considered on-the-run until March 2016.

In addition, ISDA is working with market participants to consider whether any changes should be proposed for legacy transactions to align with the new recommendation.

The reduction in roll frequency is effective for all regions and sectors. However, there is no requirement to adopt the proposed roll frequency, and market participants can continue to use the current calendar if they prefer.

Further details can be found on ISDA's website: http://www2.isda.org/asset-classes/credit-derivatives/. ■

Solving the Cross-border Puzzle



WITH THE WRITING of derivatives regulations more or less complete in the largest jurisdictions, attention has firmly focused on implementation and on how the various domestic rules will interact with each other. The signs aren't good. Differences in the implementation schedule and divergences in how national policy-makers have interpreted the high-level blueprint for derivatives reform set by the Group-of-20 (G-20) nations in 2009 have created a significant compliance burden for globally active derivatives users. In some cases, the extraterritorial reach of certain domestic requirements means derivatives users are subject to multiple, potentially inconsistent rules.

On the face of it, the answer is simple: for one regulator to defer to another, foreign regulator when derivatives transactions are cross-border in nature, so long as the rules in the overseas jurisdiction are equivalent. Nearly everyone agrees on how to do this: equivalence or substituted compliance determinations should be based on broad outcomes, rather than detailed, rule-by-rule comparisons.

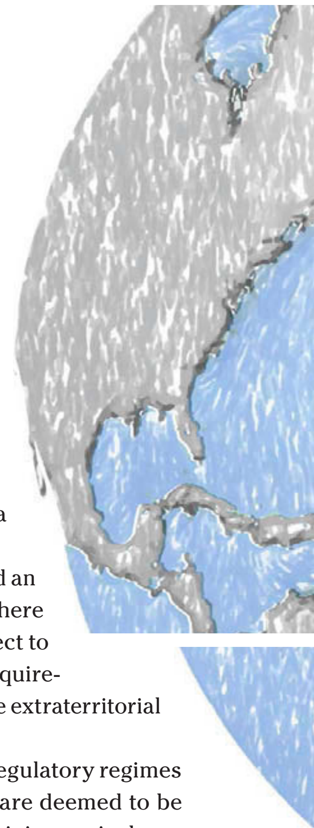
Turning that into a reality, however, has been far, far more difficult. When push comes to shove, regulators have found themselves dragged into comparing often technical, highly granular requirements. The lack of progress on achieving a European Union equivalence decision for US central counterparty rules is a case in point. After a lot of back and forth between European and US regulators, the issue has finally come down to differences in margin methodologies. The result? Glacial progress on enabling cross-border central clearing, a key part of the G-20 commitments.

Regulators and market participants have suggested a variety of ways of addressing these issues, from automatic equivalence for G-20 members, to a global 'passporting' system. In this issue of *IQ: ISDA Quarterly,* we set out possible solutions from both regulators (see pages 16-22) and industry participants (see pages 24-30).

The one certain thing about all of this is that a solution does need to be found—and fast. Analysis by ISDA shows that markets are already fragmenting along geographic lines as derivatives users shun trading with foreign counterparties to avoid being subject to multiple rules. Unless this issue is resolved, the global derivatives market will continue to splinter into regional pools. The result will be less choice, less liquidity and higher costs for derivatives users. ■

Border Skirmish

The extraterritorial reach of some domestic regulations has left derivatives users between a rock and a hard place—having to meet their domestic rules as well as duplicative and potentially contradictory foreign requirements. The result is a fragmentation of global liquidity pools



WHEN THE LEADERS of the Group-of-20 (G-20) nations convened in Pittsburgh in September 2009 at what would be a defining summit in the evolution of post-crisis derivatives reforms, they were not blind to the challenges of regulating cross-border markets. In their closing statement, the leaders committed to raising standards "in a way that ensures a level playing field and avoids fragmentation of markets, protectionism, and regulatory arbitrage".

After nearly six years of rule-making, the reality has strayed some distance from the aspiration. Regulators have made significant progress in implementing the G-20 commitments in their own markets, but have made little headway in aligning their rules with other jurisdictions. Differences in the timing of implementation, as well as in the substance of the requirements, have posed compliance challenges for derivatives users that have historically been able to tap into a global liquidity pool.

In some cases, domestic rules have also had an extraterritorial reach, creating a situation where overseas counterparties are potentially subject to two or more possibly contradictory sets of requirements—those of their own jurisdiction and the extraterritorial rules of foreign regulators.

In theory, regulators can defer to foreign regulatory regimes in certain instances, so long as those rules are deemed to be equivalent. In practice, the process for determining equivalence or allowing for substituted compliance has been hampered by an inability to reconcile differences between national rule sets.

The result is that markets have become fragmented, with derivatives users increasingly choosing to trade with counterparties in their own jurisdiction wherever possible. It's a situation that has caused anxiety among industry participants.

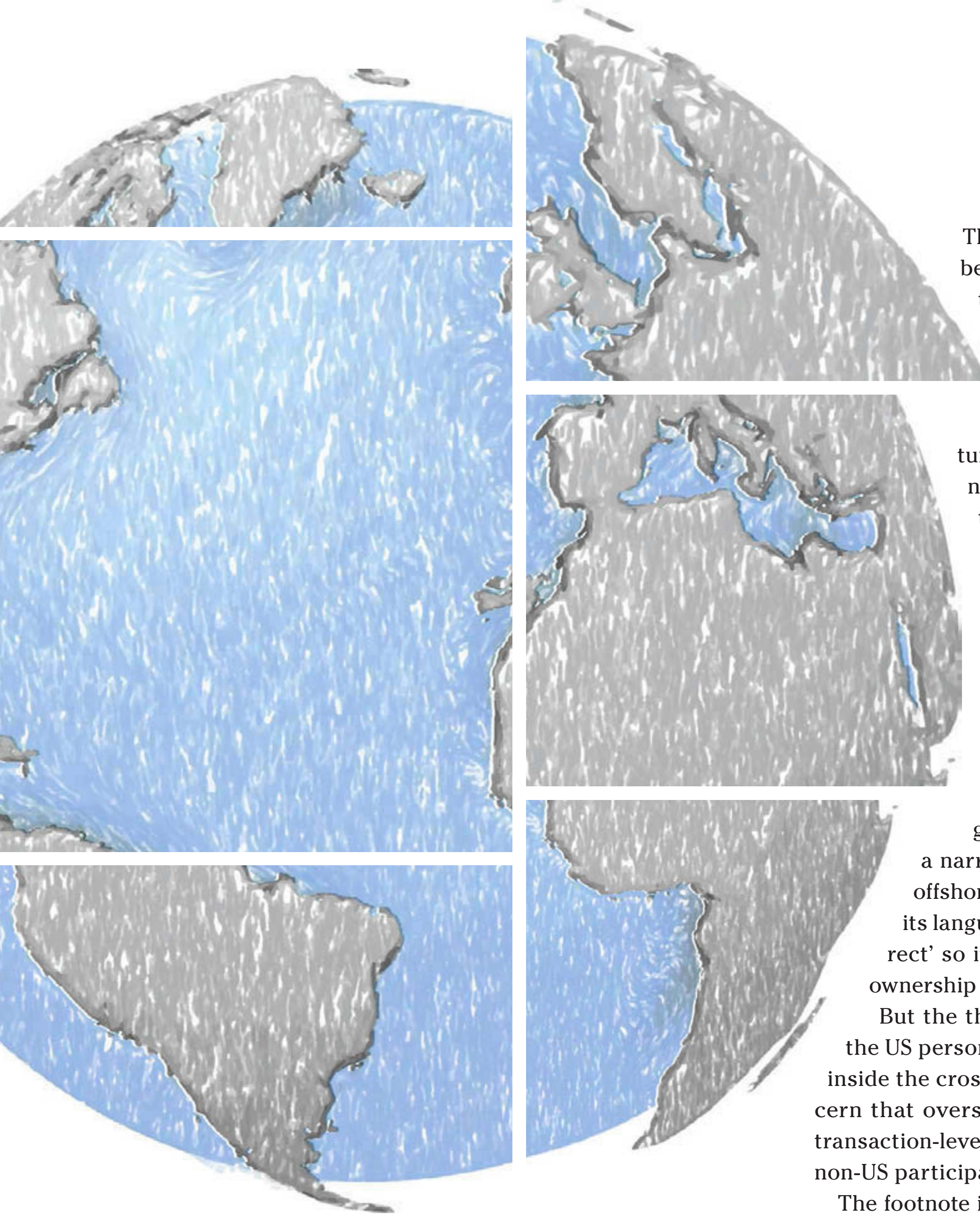
"Derivatives markets have always been global, but differences in how and when domestic rules have been applied, and a lack of progress with substituted compliance and equivalence, has meant derivatives users are choosing to trade with local counterparties. That deprives end users of choice, and ultimately will mean higher costs as there will be less liquidity in these fragmented local pools," says Scott O'Malia, chief executive of ISDA.

Regulators are also increasingly expressing concern about the impact of cross-border disparities. "The emergence of a global market for financial services over the past few decades has been a positive development that led to rising living standards, but what we have seen since 2009 is the failure of global cooperation in a number of key areas, which is leading to the balkanisation of that global market into regional and national markets," says J. Christopher Giancarlo, a commissioner at the US Commodity Futures Trading Commission (CFTC).

While fears that misaligned regulation could lead to fragmented liquidity have been voiced since 2009, there are signs

AT A GLANCE

- Some domestic derivatives rules exert jurisdiction over transactions conducted in foreign countries, exposing derivatives users to duplicative rule sets.
- As an example, CFTC staff advisory 13-69 states that a non-US swap dealer has to apply Dodd-Frank transaction-level rules when trading with a non-US counterparty if the trade is arranged, negotiated or executed by US personnel.
- No-action relief currently exists for this requirement, but it is due to expire in September.
- Rather than be subject to duplicative rules, some participants are choosing to shun foreign counterparties, leading to a fragmentation of liquidity.
- 94.3% of regional European interdealer volume in euro interest rate swaps was traded between European dealers between July and October 2014, versus 73.4% in the third quarter of 2013.



it is now happening. Following the introduction of the US swap execution facility (SEF) regime in October 2013, non-US derivatives users are choosing to avoid trading certain products with US dealers where possible to avoid being caught by US requirements (see box, *SEF Rules and Fragmentation).*

Between July and October last year, 94.3% of regional European interdealer volume in euro interest rate swaps was traded between European dealers, up from 73.4% in the third quarter of 2013, just before the SEF rules came into force, according to ISDA analysis[1].

"One of the hallmarks of the derivatives industry in recent years has been its efficiency as a global market, but with the lack of cross-border harmonisation, we are regressing 20 years to a time when dealing took place on a regional or national basis. Being non-compliant is not an option, so wherever there is conflict or lack of clarity in rules, participants will look to trade elsewhere if they can," says TJ Lim, global head of markets at UniCredit and a board member at ISDA.

The lack of harmonisation is a particular concern because of the extraterritorial reach of some of the requirements. This issue came to the fore in 2012 with attempts by the CFTC to formulate a definition of US person for the purposes of the Dodd-Frank Act. Early attempts raised the prospect that the definition could capture overseas firms with only the loosest connection to the US—for instance, offshore funds that are indirectly majority owned by one or more US person.

Not only would those firms have to comply with Dodd-Frank requirements, but non-US dealers would also have to count trades with those entities when determining whether they had breached an $8 billion de minimis threshold of swaps with US persons for the purposes of US swap-dealer registration.

Ultimately, the CFTC's final cross-border guidance, published in July 2013, incorporated a narrower definition of US person. In the case of offshore funds, for example, the agency pared back its language and dropped the terms 'direct' and 'indirect' so it captured only those entities with majority ownership by US persons.

But the threat of extraterritoriality did not end with the US person definition. An arcane footnote buried deep inside the cross-border guidance caused even greater concern that overseas firms could be caught by Dodd-Frank transaction-level requirements, even when trading with other non-US participants.

The footnote in question, 513, states that a US branch of a non-US swap dealer or major swap participant would be subject to transaction-level requirements, without the availability of substituted compliance. While recognising a US branch of a non-US swap dealer is a non-US person, the CFTC states that it has a strong supervisory interest in regulating dealing activities that occur within the US.

> "It's very concerning that no agreement has been reached on CCP recognition"
> *–Eric Litvack, ISDA chairman*

The CFTC followed that up with staff advisory 13-69 in November 2013, which noted that a non-US swap dealer would have to comply with Dodd-Frank transaction-level requirements when trading with a non-US person if the trade is arranged, negotiated or executed by personnel or agents of the non-US swap dealer located in the US. In other words, a European

1 http://isda.link/marketfragendyear2014

bank might trade a US dollar swap with a corporation in Asia, but could be caught by Dodd-Frank simply by sourcing a price from a trader in its US branch.

"The industry was somewhat blindsided by 13-69," says Joshua Cohn, co-head of the global derivatives and structured products practice at law firm Mayer Brown. "The CFTC only took a territorial approach in a few small parts of its cross-border guidance, and one of those was in Footnote 513, which effectively treats the US branch of a non-US swap dealer as a US person for the purposes of transaction-level rules. Then, in 13-69, the CFTC staff further imposed transaction-level rules on trades between a non-US swap dealer and other non-US parties if the trades are regularly arranged, negotiated or executed in the US."

Many months have passed since the publication of 13-69, but it continues to be seen by industry participants as one of the most egregious examples of extra-territoriality in the hundreds of pages of Dodd-Frank rule-making issued by the CFTC since 2010.

At the heart of the debate is the question of whether the physical presence of personnel on US soil constitutes a legitimate basis on which the CFTC can assert its authority over a trade. In a response to the CFTC in March 2014, ISDA warned that "personnel-based tests have profoundly undesirable practical consequences". For example, banks might respond to the CFTC ruling by excluding their US personnel from the trade, or relocating them elsewhere to avoid the rules, hindering the effective structuring and risk management of the trade.

> "What we have seen since 2009 is the failure of global cooperation in a number of key areas, which is leading to the balkanisation of that global market into regional and national markets"
>
> *–J. Christopher Giancarlo, CFTC*

SEF RULES AND FRAGMENTATION

ISDA analysis shows there has been a clear split in liquidity pools for euro interest rate swaps (IRS) since the third quarter of 2013. In that three-month period, 73.4% of regional European interdealer volume in euro IRS was traded between European dealers, with the remaining share almost all traded between European and US dealers.

In the space of a month, that changed dramatically. In October 2013, 90.7% of euro IRS was traded exclusively between European dealers. That has continued throughout 2014, reaching a peak of 95.7% in August of that year.

The timing of this change coincided exactly with the introduction of US swap execution facility (SEF) rules, implemented on October 2, 2013. From that point, any electronic venue that provided access to any US person had to register as a SEF—and many non-US platforms decided not to register, meaning US persons couldn't access the liquidity on these venues. The first SEF trade mandates were introduced in February 2014. As a result, non-US participants started to avoid trading mandated products with US firms where possible, so as not to have to trade on a CFTC-registered SEF and clear through a central counterparty.

That has had several implications. The vast majority of euro IRS liquidity is centred off-SEF, between European dealers, in Europe. This means US customers may not be able to access the deepest liquidity pool for euro IRS.

Reacting to industry concerns about 13-69, the CFTC has issued four successive no-action relief letters since November 2013 to exempt market participants from compliance. The latest relief, issued in November 2014, will expire on September 30, 2015. As that date begins to edge closer, the issue is rising to the top of the industry's agenda once again.

"For non-US dealers, this raises big questions over how they organise themselves to deal with clients in US time zones without being swept into Dodd-Frank. It could mean moving whole teams to non-US locations, which is a big operation, so dealers are naturally getting more and more nervous about the guidance as we creep towards the end of another no-action relief period," says Jeffrey Robins, partner in the financial services group at law firm Cadwalader, Wickersham & Taft.

While the successive issuance of no-action relief suggests the CFTC is sympathetic to the challenges this poses, it doesn't necessarily mean it will fundamentally alter its position. In a speech in November 2014, CFTC chairman Timothy Massad asserted that physical presence or conduct in the US has "long been a traditional basis for jurisdiction", adding that "protecting our economy against the importation of risk from abroad" is a legitimate regulatory goal.

Some CFTC commissioners are more critical of 13-69, however. In a speech in September 2014, commissioner Giancarlo criticised both the cross-border guidance and 13-69 itself, declaring that while the agency may have been trying to insulate the US from systemic risk, the one-size-fits all approach does almost nothing to reduce counterparty risk.

"I have called for the withdrawal of 13-69 and for the CFTC to go back and issue a cross-border regulation through proper notice, comment and cost-benefit analysis rather than the interpretive guidance we have right now. The fundamental problem with 13-69 is that it adds a territorial dimension to a basic personhood analysis in the earlier guidance. There is a lack of intellectual clarity in having these two different standards," Giancarlo tells *IQ: ISDA Quarterly*.

Alternative approaches are beginning to be discussed. Speaking at the ISDA annual general meeting in Montreal in April, CFTC commissioner Mark Wetjen outlined two plausible approaches to trades conducted by non-US entities that are arranged, negotiated or executed by US persons (see pages 16-22).

First, the CFTC could assert jurisdiction over the trade, but would allow substituted compliance so that the counterparties could comply with rules in their home jurisdiction, as long as those rules are deemed to be equivalent with those in the US. In the second scenario, the CFTC would regulate only the specific activities taking place on US soil, while the rest of the activities associated with the trade would fall under the jurisdiction of the home regulator. That might mean the trade would be subject only to US external business conduct rules rather than full transaction-level requirements, for example.

This second scenario appears closer to the position of the US Securities and Exchange Commission (SEC), which proposed its own rules on the treatment of non-US persons' dealing activity in the US on April 29. The SEC proposals would not impose clearing or execution requirements on a swap between non-US persons solely because it is arranged, negotiated or executed using US-based personnel, but they would apply regulatory reporting and public dissemination requirements.

While this type of approach has been welcomed by some industry participants, it is not yet clear which path—if any—the CFTC will follow.

"Our position has generally been that regulators should focus on practices that involve the importation of risk back to the US. A trade that is booked overseas but may rely on some ancillary or back-office personnel in the US is not a trade over which the CFTC should have jurisdiction," says Christopher Young, head of US public policy at ISDA.

Deferring to equivalent overseas regimes would help resolve many of the problems, but the process for determining equivalence and substituted compliance has proven to be painfully slow so far. European and US regulators, for instance, have yet to reach agreement on their clearing house rules. A meeting in May between the CFTC chairman and European Union (EU) commissioner Jonathan Hill failed to end the deadlock over a possible EU equivalence decision for US central counterparties (CCPs). The long-running negotiations are understood to have stalled over technical differences between the margining methodology demanded in the US and Europe.

"It's very concerning that no agreement has been reached on CCP recognition, because if a third-country CCP is not recognised as a qualifying CCP under the European Market Infrastructure Regulation, trades cleared through it would attract a staggering capital surcharge under the fourth Capital Requirements Directive—the risk-weighting of exposure to the default fund would go from 2% to 100% if the CCP is not recognised. Given these are some of the largest clearing houses in the world, the additional charge on bank capital would be very significant indeed," says Eric Litvack, head of regulatory strategy at Société Générale Global Banking and Investor Solutions and chairman of ISDA.

> "Regulators need to be able to coordinate, cooperate and ultimately defer to each other's regulatory regime based on broad outcomes. A detailed comparison of individual requirements will make it extremely difficult to achieve substituted compliance"
>
> *–Scott O'Malia, ISDA*

A joint statement issued by Massad and Hill on May 7 expressed the hope of finalising their approach by the third quarter of this year, but many believe the deadlock over technical issues highlights the inherent challenge of taking a granular rule-by-rule approach to substituted compliance determinations.

"Regulators need to be able to coordinate, cooperate and ultimately defer to each other's regulatory regime based on broad outcomes. A detailed comparison of individual requirements will make it extremely difficult to achieve substituted compliance. With Europe set to finalise its trade execution rules through the revised Markets in Financial Instruments Directive shortly, it's imperative these issues are resolved now to avoid a repeat of the CCP equivalence issue," says ISDA's O'Malia.

This is a situation politicians and standard-setters had been keen to avoid. Following the G-20 summit in St Petersburg in September 2013, leaders agreed that regulators should be able to defer to other regulatory regimes if justified by the quality of the overseas regime and if they achieve "similar" outcomes.

Recognising the merits of an outcomes-based approach could prove to be critical in resolving many of the cross-border issues that continue to vex derivatives participants. It would mean that trading could continue to take place on a global basis, with regulators recognising each other's regimes if the broad outcomes are the same, rather than splitting hairs over the granular differences between the rules.

"We have consistently argued for a holistic approach to mutual recognition that is based on outcomes, rather than a line-by-line comparability analysis. The challenge is that the G-20 commitments are very broad and can be interpreted in many different ways, and some regulators don't appear to be ready to take the outcomes-based approach," says ISDA's Young. ■

The Regulatory Response

Regulators have been working to improve coordination with their counterparts in other countries, but inconsistencies in the rules between jurisdictions have led to liquidity fragmentation. A group of regulators[1] discussed possible responses to the lack of cross-border harmonisation at ISDA's 30th AGM in Montreal

THE PARTICIPANTS

- **Moderator: Scott O'Malia**, chief executive officer, ISDA
- **Masamichi Kono,** vice-minister for international affairs, Financial Services Agency, Japan
- **Michael Piwowar,** commissioner, US Securities and Exchange Commission (SEC)
- **Kay Swinburne,** member of the European Parliament, European Conservatives and Reformists Group coordinator on the Economic and Monetary Affairs committee
- **Mark Wetjen,** commissioner, US Commodity Futures Trading Commission (CFTC)

Scott O'Malia (SOM): In your view, what is the ideal framework for achieving recognition of another jurisdiction's derivatives rules? Is an outcomes-based approach the common goal? What does an outcomes-based approach look like?

Masamichi Kono (MK): We have come a long way in designing a system that will make these markets safer, and we have been making steady progress on implementation. We are behind in terms of the original schedule committed by the Group of 20 (G-20) nations, but this is partly due to the fact that we took an interest in listening to our stakeholders and making the necessary revisions and working on cross-border consistency. All the good intentions are there. There is a G-20 commitment, and the St Petersburg summit declaration in 2013 included an agreement that jurisdictions should be able to defer to each other when it is justified by the quality of their respective regulatory enforcement regimes, based on similar outcomes in a non-discriminatory way, paying due respect to home-country regulation regimes.

We have to distinguish between the short term and the medium to longer term. In the short term, I don't think we have any choice: we just have to do it. I'm afraid this process has been taking too much time. In the medium to longer term, you talk about what this outcomes-based approach should look like. If we are allowed to go back to the drawing board, then I think we should work on some kind of a passport in the future. This may not be exactly the same as the European passport as it is applied within the parameters of the European Union (EU). But if you don't have that, then we will still be arguing over the differences across jurisdictions, and those differences are simply not going to go away. So either we end up with very different regimes that are overlapping and inconsistent, or we have a global passport, maybe combined with a periodic assessment of where jurisdictions are in terms of fulfilling the requirements of the passport. This is what I can imagine as the way forward, but I'd like to emphasise the distinction between the near term and the longer term.

> "Either we end up with very different regimes that are overlapping and inconsistent, or we have a global passport, maybe combined with a periodic assessment of where jurisdictions are in terms of fulfilling the requirements of the passport"
> *— Masamichi Kono, Financial Services Agency, Japan*

Michael Piwowar (MP): With respect to achieving recognition between

1 This is an edited version of a panel discussion that took place on April 22, 2015 at ISDA's annual general meeting in Montreal. The views expressed by the panellists are their own and do not necessarily reflect the views of the organisation they work for

From left to right: Mark Wetjen, CFTC; Kay Swinburne, European Parliament; Michael Piwowar, SEC; Masamichi Kono, FSA, Japan; Scott O'Malia, ISDA

jurisdictions, Kono-san said we need to pay due respect to home-country regimes. That's the starting point: respect for foreign regulators or regulators in other jurisdictions. At the SEC, we've had a long history of mutual recognition in a number of different regulatory spheres. Scott asked whether an outcomes-based approach is a common goal. Well, the alternative would be a rules-based approach and we're never going to get to the point where we have harmonisation in the rule book, so there's no possible way that's ever going to happen. Given that, an outcomes-based approach is the only possible path forward. There are the thorny issues involved with that. That's where conversations with foreign regulators come in: respect for one another, relying on the fact we're working with them in other areas, building that respect and building that trust so we can move forward on these particular issues.

Kay Swinburne (KS): We are feeling the frustration that a global outcomes-based approach doesn't seem to be coming anytime soon, even though there is huge political will on both sides of the Atlantic and around the world. The G-20 mandate is where all this started for derivatives and, actually, if we hadn't had a G-20 mandate, I don't think we would be talking about any form of global standards right now. So I would advocate the only way forward is to have an entity such as the Financial Stability Board (FSB) provide more granular detail, and for its working groups to establish global standards for us all to then implement in our different jurisdictions.

I suspect the problems we're having at the moment, where we've got the two largest regions still arguing over something that should be technically very trivial, are actually embarrassing everybody in terms of global harmonisation of derivatives rules. So I would advocate that the FSB should have a much more detailed role going forward. If you have a mandate from the G-20, then the FSB working groups – with all of the regulators involved at that level – should start talking before legislation is put through everybody's statute books.

Mark Wetjen (MW): There are some differences in the approaches taken by Europe and the US over recognition, equivalency or substituted compliance. The key difference is that the Europeans tend to take an equivalency approach where they don't necessarily assert jurisdiction over entities or activities outside of the continent. We have taken a different approach at the CFTC, where we have made assertions of jurisdiction, even in cases where the entity or activity might be offshore, and that has resulted in registration requirements in some cases. But we've also tried to embody a substituted-compliance framework as well.

> "I would advocate the only way forward is to have an entity such as the Financial Stability Board provide more granular detail"
> *— Kay Swinburne, European Parliament*

To state the obvious, we don't, as policy-makers, set out to fragment the markets. No one is trying to do that. But there is an element of a first-mover impact, which has occurred because of the CFTC moving first in a lot of these cases. But, again, we've tried to be very reasonable and flexible by allowing substituted compliance when feasible. We did that with all of the major jurisdictions, where we have swap dealers outside of the US registered with us. We've allowed for substituted compliance for those dealers to follow home laws and regulations, with a couple of exceptions. If we have a particular stake – for example, in a reporting requirement – then we would still require reporting specifically to the CTFC under our rule. But, by and large, we've allowed for substituted compliance. As for the merits of either approach, it really shouldn't matter too much, so long as we're doing a good job at the CTFC on the substituted-compliance front. And I think we have a decent record.

That's been the approach so far, but I think there are ways we can take an approach that's more similar to the way the Europeans have done it. Scott, when you were at the agency, we talked about how to deal with providing exemptive status for clearing houses. The same framework is provided under our statute with respect to trading venues. We did some work on that last year for the multilateral trading facilities (MTFs) based in London. That relief didn't have a lot of practical impact, mostly for other reasons, but that's essentially a substituted-compliance approach: there was no requirement for registration for those platforms. You'll probably continue to see some kind of a hybrid approach from the CFTC. There'll be certain instances where the agency will need to assert jurisdiction but will continue to rely on substituted compliance. In other instances, there will be more of an equivalency type of approach.

MP: I wanted to respond to something Kay brought up. I agree with her that putting these decisions in Europe in the hands of the politicians perhaps may not be the best thing in the world. But I disagree with her that the FSB is the place to do that. The FSB doesn't suffer from a lack of confidence. It knows nothing about the insurance industry, but it's moving forward with regulation in that sector. It knows nothing about the asset management industry, and it looks like it's moving forward with regulation in that space. The FSB is dominated by prudential regulators and, in fact, mostly by central banks, which have objectives other than having a well-functioning over-the-counter derivatives market. If you want to have an international coordinating body work on this, then it should perhaps be something like the International Organization of Securities Commissions (IOSCO), which is dominated by markets regulators who actually understand markets and realise that prices can sometimes go down and that's not necessarily a bad thing.

Scott O'Malia, ISDA

Kay also mentioned the G-20 mandate. One of the things people have been talking about is mutual recognition as a starting point. The default is nobody's going to recognise anybody unless they meet certain objectives at some point, and we can debate what those things are. Why don't we flip it? Why don't we start with the default position that all G-20 members should automatically recognise each other? That's the starting point, unless we come up with some reason why one of the G-20 members is not meeting certain objectives. Once you get the G-20, then you can maybe add in Singapore and a couple of other jurisdictions, and you get to 99.9% of the market. So I'd like to throw that out there as a potential path forward.

MK: I've been an FSB member for the past six years, and also at one point I was chairing the IOSCO board, so I should say something. But it's not really to defend the FSB or IOSCO. It is true that market regulators are, on the whole, under-represented on the FSB. But, in some cases, more data or more analytical capacity lies with the central bank or some other institution, and not with the market regulator necessarily. At IOSCO, we've been trying hard to come to grips with the situation and take forward some work that would help resolve these issues. There's even a group called the OTC Derivatives Regulators Group, which is a group of market regulators that have authority over those transactions and market participants. But these groups have not been as effective as some people would have wanted. I can understand why, but it is difficult to expect a breakthrough. So with all those constraints and with each international body having its own problems, there will be no magic body that will be able to resolve this overnight.

> "To state the obvious, we don't, as policy-makers, set out to fragment the markets. No one is trying to do that"
> — *Mark Wetjen, CFTC*

Mike mentioned an automatic recognition of G-20 members. Even if you don't go that far, you can still have a passport that would be valid for a number of jurisdictions, where you can be reasonably sure measures have been taken to make those markets safer, and the national authority has the competence and the willingness to cooperate. So that is really an excellent idea and we hope we can pursue it in some form.

SOM: We'll come back to this question of whether there is a body best placed to resolve these issues, but let me dig down to the next level. In the US, the no-action relief for the 13-69 staff advisory on the applicability of transaction-level requirements to activity in the US – the so-called arrange, negotiate and execute advisory – is set to expire in September. What can we expect from the CFTC?

MW: What I'm about to say is what I hope could happen, as opposed to what I expect will happen. For activities being conducted by a sales person working at a desk in New York, there's no doubt in my mind that it's appropriate for the CTFC to assert jurisdiction over those activities. These are people going to work on US soil and involved in US commerce. There's a long history in our country of asserting jurisdiction over activity taking place on US soil. So that's the easy part.

Where we go from there becomes trickier and will depend on some important policy considerations. There are two ways we could go with this that could be sensible, and I haven't made up my mind which one's better, to be honest. One approach would be to say, 'Okay, if it's attached to a legal entity outside the US, then the involvement of the sales force in New York is enough that we have jurisdiction not only over the people in New York, but over the transaction that the entity offshore is involved in'. But we would have to be willing to find substituted compliance in that circumstance. So that's one approach. Since we have jurisdiction over the activities and it's related to the activities of this non-US legal entity, we have jurisdiction over its activities but we find substituted compliance.

An alternate would be to put aside the second part of the analysis and just stop at the activities themselves taking place on US soil. So, in other words, if there is activity on US soil that triggers certain compliance obligations under US rules, then those rules should apply, but it should only be with respect to those activities and nothing else. In which case, you leave the other activities of the non-US entity involved in the transaction to the jurisdiction where the entity is located.

Masamichi Kono, Financial Services Agency, Japan

Either one of those approaches could work. Part of this will depend on how the dialogue goes with other jurisdictions, and we would want to understand what their preference would be. But I don't think it's the right approach for us to say, as the staff advisory originally said, that in every instance involving a US sales desk, we assert CTFC transaction rules to the entities involved.

KS: In Europe, we're used to having 28 member states and 28 national competent authorities that are all trusted by each other to actually do an equivalent job. Whenever I hear substituted compliance, I'm not sure we're at the stage where we would trust one another. Until we get to that stage, I'm not sure what this means. We're still going back to rule by rule, line by line. I am more inclined to agree with Mike's suggestion, where it would be accepted unless you can prove otherwise.

We've got different timing issues, but the control mechanisms by the national competent authorities are very, very similar, so the outcome is going to be the same. These are regulated entities and we have to accept that whether or not the regulator is in the UK, whether it's in Singapore, in Japan or in the US, they have oversight. They are already well regulated and we should accept that whoever is on the ground overseeing it, it is being overseen.

The 28 member states in the EU have had to accept and trust each other, and we have to start getting to that position. I'm just not sure how we go from where we are now, which has been almost a stand-off between the two biggest regions not accepting each other. I'm not sure what message it sends to the rest of the world if the two biggest regions can't actually accept that they have equivalence in terms of their regulatory standards.

MW: If we were to take an outcomes-based approach and something other than a rule-by-rule approach, then the equivalency decision probably would have been made by now. But we all have home statutes that we have to abide by. One of the things we have to be mindful of under our statute is the competitive impact of any policy decisions we make. As I understand it, there's some requirement in Europe to consider any distortive effects on the market from your policy decisions. So both the US and Europe have statutory obligations to take these sorts of considerations into

> "I'm not sure what message it sends to the rest of the world if the two biggest regions can't actually accept that they have equivalence in terms of their regulatory standards"
> — *Kay Swinburne, European Parliament*

account. I think that's why we are where we are – whether that's with the equivalency decision for US central counterparties (CCPs) and perhaps other issues as well. Everyone likes this idea of an outcomes-based approach, and it's a sensible way to do it. But the problem is we have these other obligations as well, and people are sensitive to those related but separate obligations.

So looking at differences in margin, which is at the heart of the equivalency decision – the one-day gross versus two-day net requirements. Someone who doesn't really go into the details of what the numbers look like under the two different approaches might say, 'That looks similar enough. The decision's easy enough to make – let's just go on with our lives'. But the decision hasn't been made because people are worried about the sensitivity of the market to those two different approaches. There is a lot of concern about what that impact could be, and it's very difficult to make a decision as a result.

MK: I'd like to express my hope that the regulators of the two largest markets can come to an agreement and build mutual trust and confidence. For third-country regulators, this is really becoming a headache. We really appreciate that the European Commission (EC) was able to recognise Japan and some other jurisdictions as equivalent in the context of CCP rules. I think there was flexibility by the EC in adopting an outcomes-based approach and also, in some cases, a proportionality test, which enables authorities to be more flexible.

On the other hand, it is not a question of proportionality between the EU and the US, but more a need to build mutual trust and confidence that is really needed. The longer this issue over one day versus two days continues, it seems to be brewing more contentious issues and giving rise to further differences than we would like to have. So we have a strong hope that this will get resolved very, very soon.

Michael Piwowar, SEC

> "Why don't we start with the default position that all G-20 members should automatically recognise each other?"
>
> — *Michael Piwowar, SEC*

KS: We're talking about the fact there is a competition element to this, as well as the systemic risk issues. Actually there shouldn't be. The G-20 came together because it wanted to mitigate systemic risk. So this should all be about whether the system on both sides of the Atlantic actually mitigates the risk it set out to do. Do we have adequate supervision and do we have the relevant client protection rules that would mean the system would work on both sides? And if the answer to that question is a simple 'yes', then that's it. It shouldn't go anywhere else.

It's not acceptable that more than five years on from that G-20 meeting in Pittsburgh, we still can't get the recognition of CCPs. CCPs are operating globally. There are clearing members that are members of these clearing houses across the world. It's not acceptable to market participants, it's not acceptable to investors and it's certainly not acceptable to the politicians that we're still arguing and wrangling about whether or not equivalence is going to be granted between the EU and the US. We have equivalence between the EU and four other jurisdictions around the world. They've already been made. So we have to actually break through this.

There's a risk assessment currently being done. The data from two large entities has been given to both sides to actually run the models between the one day/two day, gross versus net. This should not be about gross versus net and one versus two. It should be about risk. That data set should show us where the risk lies. And we should accept that, whichever side actually has the greater risk, and then we just move on. Because ultimately it's about risk.

Both sides have got to find a solution soon. My timetable on this is, if this is not done before June, then we have failed and we should go back to the drawing board. In Europe, we have a review clause built into the European Market Infrastructure Regulation, and that review starts this year. So we can fix things in our legislation if we've got them wrong. What is the mechanism if the politicians got it wrong in the US or elsewhere? How do you fix it? I can understand the agencies have to deal with what they've been given. But the problem is that if the politicians got it wrong when they did Dodd-Frank – in one piece of legislation, in a hurry – how do you fix it?

MP: After disagreeing with Kay earlier, I couldn't agree more. Having been working on the Senate Committee on Banking, Housing and Urban Affairs during Dodd-Frank and hearing Senator Dodd and Congressman Frank saying, 'Of course we didn't get everything right in Dodd-Frank and of course there's going to be a technical corrections bill to Dodd-Frank', five years afterwards we still do not have a technical corrections bill. We know that Title VII in particular

– the over-the-counter derivatives title in Dodd-Frank – was highly politicised at the very end. There are a number of provisions in there that were thrown in at the last minute. One of them, directly relevant to the discussion we're having today about international harmonisation and working together with regulators, is the indemnification provision in Dodd-Frank.

There are these odd provisions in Title VII – two on the CTFC side and one on the SEC side – that require foreign regulators to indemnify the CTFC or the SEC in case there's any problem with the data they get on the CFTC side from either the swap data repositories (SDRs) or the derivatives clearing organisations, and on the SEC side from the security-based SDRs. That's a huge sticking point. When I talk with international regulators about this, it's the elephant in the room. If we could repeal that, then it would allow for more reasoned conversations with the foreign regulators.

The reason I mention there's two on the CFTC side and one on the SEC side is because this was a provision that was thrown in literally at the last minute of Dodd-Frank. It got no vetting. It was not in the House bill, it was not in the Lincoln Amendment, which was a bipartisan amendment, and it wasn't in any of the Banking Committee bills, either on the Democratic side or the Republican side. It was thrown in at the last minute. They put them in on the CFTC side and they meant to copy and paste both and put them on the SEC side. But whoever the staffer was forgot to copy and paste the second one, so it only made it over on our side for SDRs and not for clearing agencies. If there's anything that shows there's a mistake in Dodd-Frank, this one should be front and centre.

We should repeal this immediately. This should not be highly political. Unfortunately, the climate in Washington, DC is such that anything that even the regulators want to repeal is somehow seen as the big banks winning in this space. I think we need to fight against that rhetoric and that may help us to do better.


Mark Wetjen, CFTC

SOM: The panellists have talked about how there are differences between the US and Europe, but there's a big difference between the SEC and CFTC. Can we address that?

MW: You asked before about the staff advisory on the use of US personnel. There's been a considerable amount of coordination on that issue between the two agencies. I'm not sure the timing of action by either agency will be perfectly in sync but, regardless of who moves first and deals with this issue, it will be the result of conversations that have been taking place for some time[1]. We put that staff advisory out for comment at the end of 2013, so we have a pretty good comment file. I know the SEC saw some benefit in that – they got to review that even before they proposed something. So I would expect there will be considerable coordination on that issue.

> "I'd like to express my hope that the regulators of the two largest markets can come to an agreement and build mutual trust and confidence. For third-country regulators, this is really becoming a headache"
> *— Masamichi Kono, Financial Services Agency, Japan*

MP: I totally agree. You may have noticed that the SEC is a little bit slower than the CFTC. I'd use the analogy of Aesop's fable about the tortoise and the hare. We hope that slow and steady wins the race in terms of getting to a robust set of rules.

In terms of transactions involving US personnel, it is something we've been struggling with for a while at the SEC. We went forward last year with our cross-border release. We actually carved that out and said, 'Look, we need to make sure we get this right in terms of how we scope this out'. In the meantime, the staff has been trying to figure out what the proper scope is and how we define it. People keep asking, 'Well, what happens if there are two non-US entities and one of them calls somebody in New York to get market colour, does that all of a sudden come under our jurisdiction?'. It's that sort of stuff, and we're working through those issues. I can say our staff has been working very closely with the CTFC on this. The fact the CFTC's issue is live as well and has received public comment has meant our staff has been looking very closely at the comments too. So you can rest assured that we're not just looking with blinders and saying, 'We're only going to look at the public comment file in our space'.

SOM: Coming back to the issue of whether there's a global body that can deal with these cross-border issues. Do

1 Shortly after this panel discussion, the SEC proposed cross-border security based swap rules regarding activity in the US on April 29 (www.sec.gov/rules/proposed/2015/34-74834.pdf)

you think it would be a viable option for regulatory authorities to rely on a third party like IOSCO for adherence on the equivalency standards for cross-border supervision in swaps?

MK: IOSCO has its strengths and its weaknesses. IOSCO is certainly capable of gathering the relevant market regulators around the table and has an opportunity to develop global standards. If it crosses over with the jurisdictions of central banks, then we have bodies such as the Committee on Payment and Settlement Systems, now called the Committee on Payments and Market Infrastructures, which works with IOSCO (CPSS-IOSCO/CPMI-IOSCO). So we can certainly develop standards there. When I co-chaired the CPSS-IOSCO group, we did issue a set of financial market infrastructure principles, which I hope are still being implemented across countries. So that is possible.

The weakness is that IOSCO does not have any regulatory authority at all. All those standards have to be implemented by the individual members in their own jurisdictions. Sometimes implementation is done in different ways and the timetable can differ from country to country, and there can be some friction around that.

One issue IOSCO handled rather well was financial benchmarks, where IOSCO principles were developed and there is now a robust mechanism for assessing implementation. This has fed into the FSB process to work further on alternatives for some of the financial benchmarks. At this stage, more attention should be paid to whether those standards developed at IOSCO are implemented across countries in a consistent and timely manner. That has not necessarily been the case. In some cases, the IOSCO principles had to be put aside to give way to national considerations. IOSCO does not have any power to force countries to adopt its principles.

Kay Swinburne, European Parliament

KS: It's much easier if there are global standards already that we can refer to, so we can end up with a much more coordinated set of rules across different jurisdictions. In European legislation over the past couple of years, we've started to build in compliance with IOSCO standards as one of the mechanisms by which we can hopefully avoid some of the third-country issues that we've had with the CCPs.

> "A lot of the debate is over the US and Europe, and it may end up being the case that a lot of trading moves to Asia"
>
> — *Michael Piwowar, SEC*

SOM: What is your prognosis on finding common agreement over the US swaps execution facility (SEF) rules and Europe's revised Markets in Financial Instruments Directive (MIFID II)?

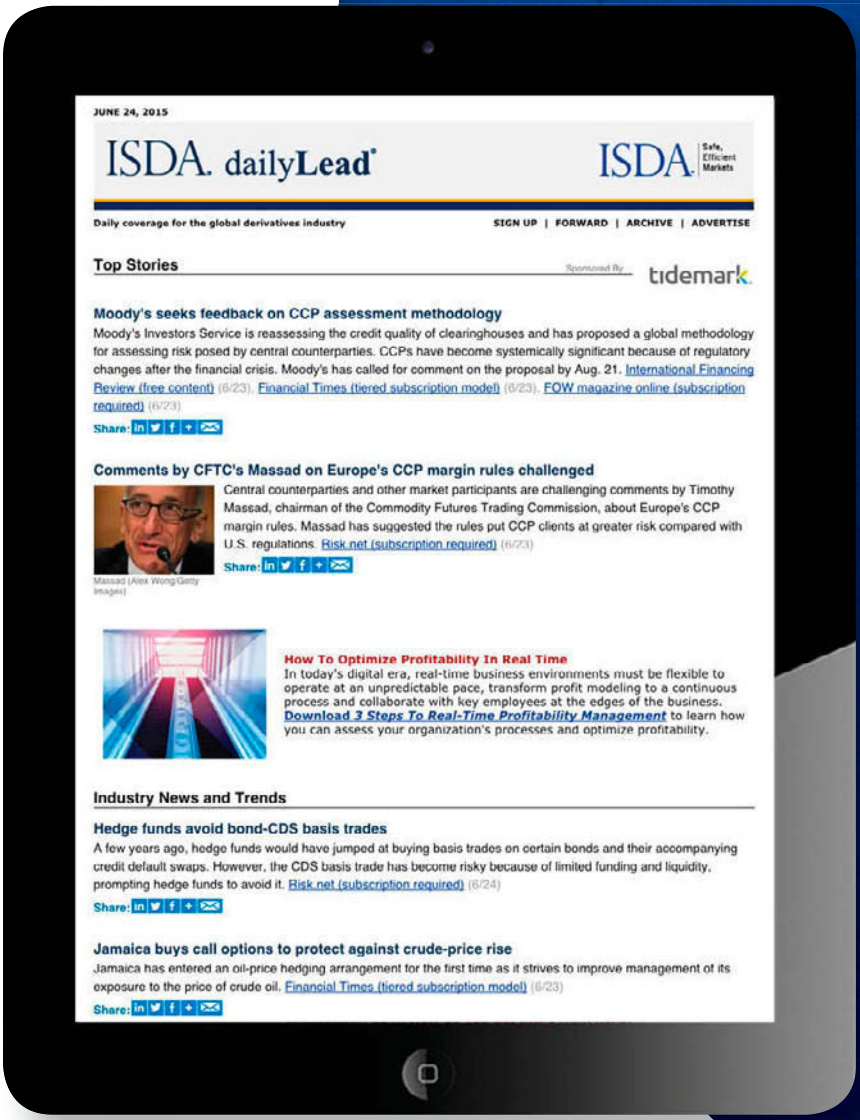
MW: I think we would all agree that it's hard to know at this moment. It will be much easier to look into a crystal ball after the CCP equivalency matter is resolved. MIFID sets out different categories and platforms – you've got the MTFs, the regulated markets and the organised trading facilities (OTFs). There's not a perfect comparison. But if you look at our SEFs, in some respects they look a lot like the MTFs. In other respects, they look a bit like the OTFs. So, at first blush, you look at that and say, 'Well, it shouldn't be that hard to find comparability there'. As I understand it, there are a couple of key requirements for the MTFs and OTFs – this notion of impartiality or impartial access. That's a key regulatory objective in our SEF framework.

The other key thing is the promotion of trading on SEFs and the promotion of pre-trade price transparency. Again, just reviewing it in a fairly cursory way, it would seem that it shouldn't be terribly difficult to find comparability. There's a separate issue about the products mandated for trading, but as long as that lines up, it shouldn't be terribly problematic.

SOM: What happens when we turn east and look at Asian markets – less liquidity, far fewer trading and clearing mandates. Then how do we look at it?

MW: It's a tough question, but here's how I would answer it. I think through an equivalency approach or a substituted compliance approach as the CFTC has taken – through either approach – there's some flexibility built in, and so there's a way to take into account differences in the liquidity characteristics of certain markets and certain instruments. I don't think that should stand in the way of comparability determinations.

MP: A lot of the debate is over the US and Europe, and it may end up being the case that a lot of trading moves to Asia. I was in Singapore in December, and it's standing ready to be the next London. It's clear to me it wants to set up a regulatory structure that works but is also flexible enough to take advantage of whether the US or Europe makes a mistake. So looking across this room, there may be a number of you who are moving to Singapore sometime soon.



JUNE 24, 2015

ISDA. dailyLead® ISDA. Safe, Efficient Markets

Daily coverage for the global derivatives industry

SIGN UP | FORWARD | ARCHIVE | ADVERTISE

Top Stories

Sponsored By tidemark.

Moody's seeks feedback on CCP assessment methodology

Moody's Investors Service is reassessing the credit quality of clearinghouses and has proposed a global methodology for assessing risk posed by central counterparties. CCPs have become systemically significant because of regulatory changes after the financial crisis. Moody's has called for comment on the proposal by Aug. 21. International Financing Review (free content) (6/23), Financial Times (tiered subscription model) (6/23), FOW magazine online (subscription required) (6/23)

Share:

Comments by CFTC's Massad on Europe's CCP margin rules challenged

Central counterparties and other market participants are challenging comments by Timothy Massad, chairman of the Commodity Futures Trading Commission, about Europe's CCP margin rules. Massad has suggested the rules put CCP clients at greater risk compared with U.S. regulations. Risk.net (subscription required) (6/23)

Share:

Massad (Alex Wong/Getty Images)

How To Optimize Profitability In Real Time

In today's digital era, real-time business environments must be flexible to operate at an unpredictable pace, transform profit modeling to a continuous process and collaborate with key employees at the edges of the business. Download 3 Steps To Real-Time Profitability Management to learn how you can assess your organization's processes and optimize profitability.

Industry News and Trends

Hedge funds avoid bond-CDS basis trades

A few years ago, hedge funds would have jumped at buying basis trades on certain bonds and their accompanying credit default swaps. However, the CDS basis trade has become risky because of limited funding and liquidity, prompting hedge funds to avoid it. Risk.net (subscription required) (6/24)

Share:

Jamaica buys call options to protect against crude-price rise

Jamaica has entered an oil-price hedging arrangement for the first time as it strives to improve management of its exposure to the price of crude oil. Financial Times (tiered subscription model) (6/23)

Share:

The Industry View

Cross-border frictions are creating compliance problems for globally active derivatives users and are contributing to a fragmentation of liquidity pools. ISDA asked a selection of former policy-makers, academics and market participants to author short essays[1] on the path forward for cross-border harmonisation

Jeffrey Sprecher

Chairman and chief executive, Intercontinental Exchange
Chairman, New York Stock Exchange

Over the course of my career, I have negotiated hundreds of deals, from leasing office space to purchasing large companies like the New York Stock Exchange. In every transaction, I came to an agreement on broad principles first, before working out the details later. This may seem like obvious common sense.

However, in the financial regulatory world, especially post-financial crisis, this process has been working differently. It seems that legislators first pass prescriptive laws that, in turn, are implemented via even more prescriptive rules by regulators. It is only then that regulators have sought to harmonise these prescriptive rules, line by line, with other regulators to make sure that jurisdictions are operating in a roughly equivalent way. Like ISDA, I believe that establishing common regulatory principles up front should be the proper framework for ensuring international cooperation over derivatives regulation.

Principles-based regulation allows regulators to define key objectives—for example, mandating that clearing houses must have proper risk management methods, but not prescribing the exact details of such risk methods. The benefit of this approach is that it gives national regulators and market participants flexibility. This likely comes as a surprise to some, but I believe allowing flexibility in regulation is safer for society.

In the late 1880s, the British government passed prescriptive rules mandating that passenger liners over 10,000 metric tonnes carry 16 lifeboats. Correspondence between the Titanic's owners and the builders indicates that ensuring compliance with this regulation was a key concern in deciding how many lifeboats should be on that ship. And, for decades, a 16-lifeboat rule was sufficient to protect passengers—until the Titanic hit the iceberg with a massive loss of life.

> "Principles-based regulation allows regulators to define key objectives—for example, mandating that clearing houses must have proper risk management methods, but not prescribing the exact details of such risk methods"

Instead of a prescriptive mandate to carry 16 lifeboats, principles-based regulation could have required there be enough lifeboats for all passengers. With that guidance, the shipbuilder would have the incentive to carry the right amount, whether that was 16 lifeboats or 40.

As I write this essay, global regulators are mired in disagreement over whether Europe's prescriptive margin regime for derivatives is safer than the US's prescriptive margin regime for derivatives. US and European Union regulators have spent lots of time over the past two years working to determine who will change their rules. I believe that a better outcome would have been for regulators to adopt the International Organization of Securities Commissions-Committee on Payments and Market Infrastructures *Principles for Financial Market Infrastructures*, and to require clearing-house operators, with robust regulatory oversight, to manage the details to find the best way to comply. We should all hope that our current prescriptive rules are found to be flexible enough to respond to future events.

1 The opinions expressed by the authors are their own and not necessarily those of the organisations they represent

Michael Spencer

Group chief executive officer, ICAP

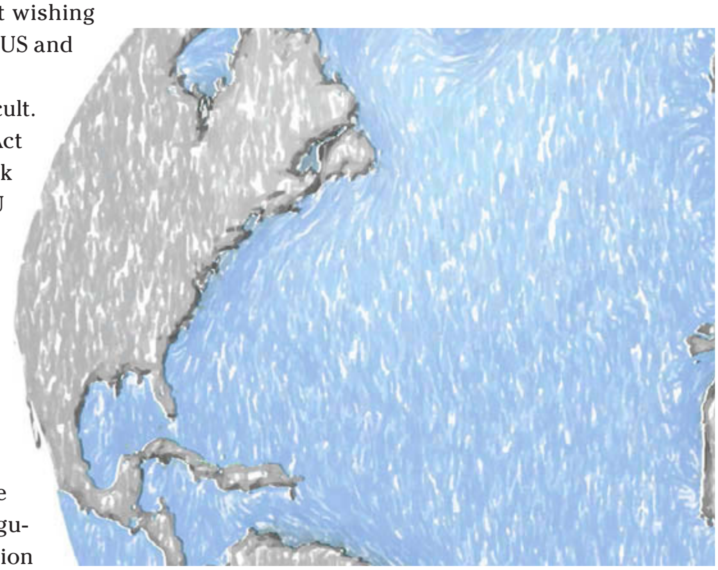
Six years on from the Group of 20 (G-20) Pittsburgh communique, only the US and China have introduced final rules on derivatives trading, and international regulators have not managed to recognise each other's oversight regimes. So, the collective challenge now is how—and indeed whether—it is possible for us to achieve the objectives of the G-20 and implement harmonised derivatives regulation.

Given the significance of the crisis, the US and European Union (EU) should have been able to address the most esoteric investments—credit default swaps and collateralised debt obligations—and faults in valuation (Warren Buffett's 'mark-to-myth') in a prioritised and coordinated way.

In practice, this did not happen. The US led the way with the Dodd-Frank Act. The objectives were excellent—transparency in price formation and valuation, transparency for regulators, regulation and access for participants. While the implementation of legislation as complex as Dodd-Frank in the time taken was heroic, it was a lone trail-blazer. In the process, it was criticised by several foreign governments and central banks for imposing itself on their markets, participants and currencies. Dodd-Frank resulted in many international banks creating standalone capitalised subsidiaries outside the US and, combined with foreign banks not wishing to be drawn into the scope, this caused a split in liquidity between US and non-US banks in interest rate products.

Perhaps it should be no surprise that coordination has been so difficult. The US legislative starting point was the Commodities and Exchange Act and the Securities Exchange Act of 1934, on to which the Dodd-Frank Act provisions on over-the-counter derivatives were bolted. The EU started with the Markets in Financial Instruments Directive (MIFID) and multiple different systems at the member-state level, currently being expanded by MIFID II.

By the time MIFID II is in force, the Dodd-Frank derivatives rules will have been in operation for three years, liquidity will remain split, and the surviving swap execution facilities (SEFs) will remain confusingly (if necessarily) diverse. In the interim, the EU asked US authorities to recognise its multilateral trading facilities (MTFs), which the US was willing to do—provided they complied with all the SEF rules. While ICAP has established a dually registered and regulated SEF/MTF, no other MTF has applied for that relief, and any notion of mutual recognition of regulated platforms between the US and EU seems frustratingly far off. Similarly, central-bank rules in various Asian countries have made compliance with aspects of Dodd-Frank practically impossible for international participants.



Genuine harmonisation will only occur when there is a reason for regulators and governments to encourage it. The test will be a political/economic one: the Federal Reserve is eyeing signs of economic recovery with a view to raising US dollar interest rates; the EU has proposed a capital markets union as the first genuine attempt to stimulate economic activity since the crisis; and the UK is trying to rehabilitate London's reputation via the Fair and Effective Markets Review. As economies recover, companies invest and banks lend, and as risk has to be measured and mitigated, the rationale for removing inefficiencies and fragmentation will grow greater: harmony is difficult in a recession.

Policy-makers should emphasise mutual recognition of trading venues. Market participants should be able to choose to trade on a regulated platform in an appropriately regulated location. Transparency of valuation is vital and should be evidence/transaction-based where possible. But pre- and post-trade transparency is only helpful if it does not damage liquidity.

Markets are driven by risk and participation, and there has to be a balance of both to operate effectively. The financial industry should be alongside policy-makers, providing advance warning and contributing to the debate with clarity of social purpose, if we are to achieve genuine and meaningful harmonisation in the future.

> "Market participants should be able to choose to trade on a regulated platform in an appropriately regulated location"

> "Genuine harmonisation will only occur when there is a reason for regulators and governments to encourage it. The test will be a political/economic one"

Andrew Godwin

Director of studies, banking and finance law, Melbourne Law School, The University of Melbourne

In February this year, ISDA made a submission to the International Organization of Securities Commissions (IOSCO) in response to its consultation on cross-border regulation. IOSCO's report examines the tools that are utilised to regulate cross-border securities market activities. These tools include national treatment, recognition and passporting arrangements.

ISDA suggested that recognition would offer the greatest flexibility and adaptability across different markets, including the over-the-counter (OTC) derivatives markets. It then reiterated various principles for inter-jurisdictional recognition of derivatives regulation, in line with the principles-based substituted compliance methodology that ISDA proposed in August 2013[1].

ISDA correctly noted that, in order to operate effectively as a tool for cross-border regulation, recognition would depend on regulatory harmonisation. This is because recognition, which may occur either on a unilateral or a multilateral basis, relies on a process of assessment under which the host regulator assesses the home regime to determine equivalence in terms of its laws and regulations.

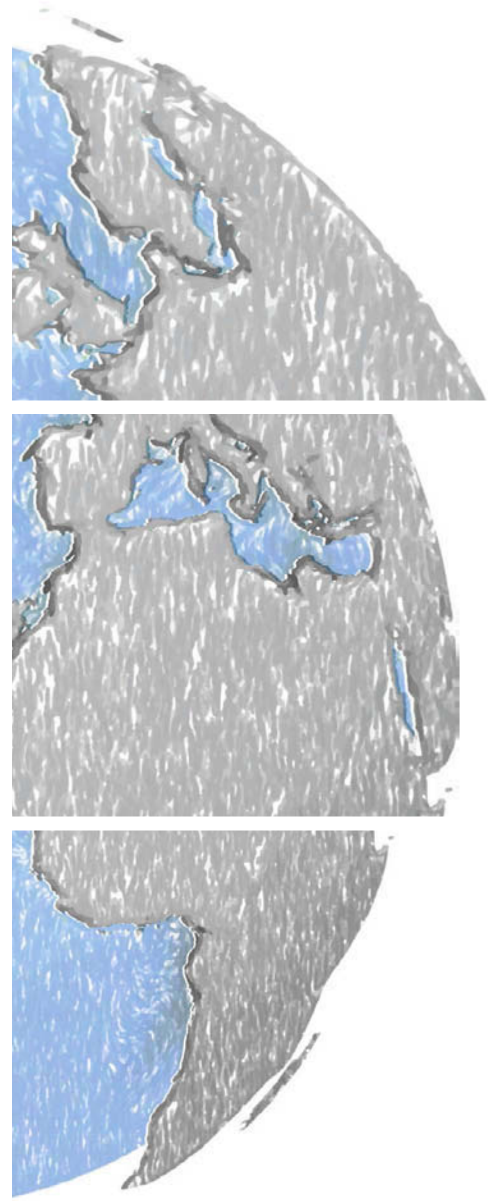
Very few people would argue with the importance that should be attached to regulatory harmonisation. The critical question is how regulatory harmonisation should be achieved. A related question is how, once a satisfactory level of harmonisation has been achieved, should regulators then go about assessing equivalence for the purpose of recognition.

One possible way of dealing with both of these questions would be to adopt a system of accreditation, which would operate at the international level along similar lines to accreditation systems that operate at the domestic level. An example of the latter is the National Association of Insurance Commissioners accreditation programme in the US, which was established to develop and maintain standards to promote effective insurance company financial-solvency regulation.

At the international level, accreditation would indicate that a market had established an appropriate system of regulation in areas such as derivatives regulation, and had reliable procedures in place to permit recognition on a cross-border basis.

> "At the international level, accreditation would indicate that a market had established an appropriate system of regulation in areas such as derivatives regulation, and had reliable procedures in place to permit recognition on a cross-border basis"

One of the benefits of such accreditation is that it would provide individual markets with an incentive to move towards harmonisation, and would also represent a proactive step that a market could take to encourage other market jurisdictions to grant it recognition. Further, if such a system were supported by a team of experts that could undertake a gap analysis and assist markets to achieve accreditation, then this would overcome many of the practical resourcing and logistical constraints that have hitherto thwarted many efforts to promote greater financial harmonisation and integration.



Footnote 1: http://isda.link/commonexamples

Kenneth Raisler

Head of the commodities, futures and derivatives group, Sullivan & Cromwell
Former assistant US attorney for the District of Columbia and general counsel of the Commodity Futures Trading Commission

The Commodity Futures Trading Commission (CFTC) has made considerable and unprecedented progress in bringing life to the commitments made in 2009 by the G-20 with respect to OTC derivatives reform. However, by being the first mover and the first jurisdiction to finalise and implement many of these reforms, the CFTC faced a challenging paradox. It had to choose either to 1) silo itself and the US by enforcing the OTC reforms only on a domestic basis—in which case, there was a real risk that regulated activity would simply move to other jurisdictions where reform efforts remained in progress but not finalised. Or it could 2) adopt an aggressive position with respect to the definition of US person and the applicability of its rules to non-US persons associated, affiliated or transacting with US persons. This would discourage regulatory arbitrage but would lead to accusations of extraterritorial overreaching.

As global markets mature and national regulators implement G-20 reforms, options 1 and 2 should migrate to a third option of global harmonisation and recognition of substituted compliance. While the CFTC generally has proceeded under option 2, a practical broad-based framework of cross-jurisdictional cooperation in the OTC reform space remains to be adopted. At the same time, and as expected, the existing framework of CFTC guidance on the extraterritorial application of the Dodd-Frank swaps provisions has created friction with regulators around the world, and exposed a series of potential compliance pitfalls for otherwise well-intentioned market participants.

For example, good-faith compliance efforts have, at times, been characterised as evasive, evidenced in part by the noise surrounding efforts by some US-based market participants to remove legacy guarantees from their non-US affiliates. Even more concerning, the previously integrated global derivatives market has been trending into a series of fragmented liquidity pools along geographic lines as a result of divergent regulations across jurisdictions, as highlighted by ISDA research. These current developments motivate a renewed emphasis on practical harmonisation and cooperation with the CFTC's global regulatory partners in order to avoid further implementation friction.

As a whole, market participants have not objected to reform. But they continue to encounter practical impediments associated with trying to comply with two (or more) sets of inconsistent rules governing the same conduct. In this context, global regulators have long recognised that perfect harmonisation is rarely possible (or desirable) for industries that transact in a global market. Instead, regulatory cooperation and mutual recognition schemes are consistently layered in to fill the natural gaps across and between jurisdictions.

The CFTC did issue an initial set of substituted-compliance determinations that attempted to permit market participants to comply with the regulations applicable in other jurisdictions in lieu of compliance with certain of the CFTC's rules. However, these initial determinations need to be expanded to address significant concerns in a number of the most important, and burdensome, areas of regulation, such as reporting, execution and clearing.

The CFTC has long maintained successful futures regulatory programmes that have utilised a broad-based and practical substituted-compliance framework. For example, the CFTC's recent rules on the registration of foreign boards of trade (FBOTs)—formalising a historical CFTC practice—permit US persons to directly access non-US exchanges, provided the exchange registers with the CFTC as a FBOT, and that both the exchange and its clearing house are subject to regulation that is as comprehensive as and comparable (although not identical) to analogous CFTC regulations.

In the same way, the CFTC's Part 30 regime for foreign futures, adopted in 1987, defers to comparable (again, not identical) regulatory regimes in non-US jurisdictions to: (i) allow US market participants to trade via non-US brokers; and (ii) permit non-US market participants to access US markets without the brokers being required to be regulated in the US.

We encourage the CFTC to accelerate the approach it has taken in the futures markets and apply it to OTC derivatives reform—after all, much of the Dodd-Frank Act imports rules and principles originating in the futures markets. Specifically, we suggest the CFTC (as the first mover) and its global derivatives regulatory partners (now making great strides with their own domestic reform efforts) facilitate an OTC derivatives regulatory environment guided by the principle that market participants should not be forced to restrict their activities based solely on the lack of regulatory cooperation between jurisdictions.

In conjunction with these efforts, global regulators should collectively provide for a meaningful transition period, during which a market participant should be permitted to comply primarily with the laws of the country in which it has its principal place of business (provided that country and its regulators are pursuing OTC reforms that are generally consistent with the G-20 commitments).

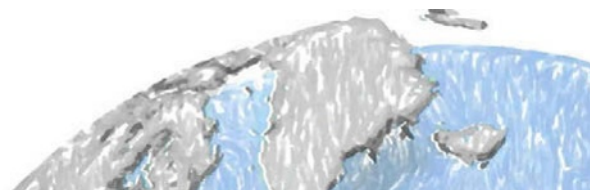
At the same time, when a market participant engages in trading activity in another jurisdiction, substituted compliance should be granted to allow for time-limited recognition in the areas of swaps reporting, clearing-house eligibility and trading-platform accessibility (including swap execution facilities). Importantly, this transition period should be agreed without regard to specific rules, conditions or limitations that would otherwise render the phase-in impractical and unworkable.

During this transition period, regulators should continue to actively work to finalise long-term substituted compliance and recognition regimes in order to achieve the reforms envisioned by the G-20 commitments. Long-term application of first-mover strategies is not healthy for the CFTC or for global markets.

Nicolas Véron

Senior fellow at Bruegel and a visiting fellow at the Peterson Institute for International Economics

At their summits in Pittsburgh in 2009 and Cannes in 2011, G-20 leaders jointly committed to ambitious reforms of OTC derivatives markets. But delivery has been unequal and generally poor. Most jurisdictions were unable to meet the G-20 deadlines. More insidiously, jurisdictions have acted inconsistently, leading to market fragmentation across geographical lines and failure to achieve the G-20's objectives at the global level. Worse still, this is only the beginning. Most derivatives activity is now concentrated in the EU and the US. But it is only a matter of time before market development in Asia leads to a more multipolar landscape, in which coordination challenges will be further exacerbated.

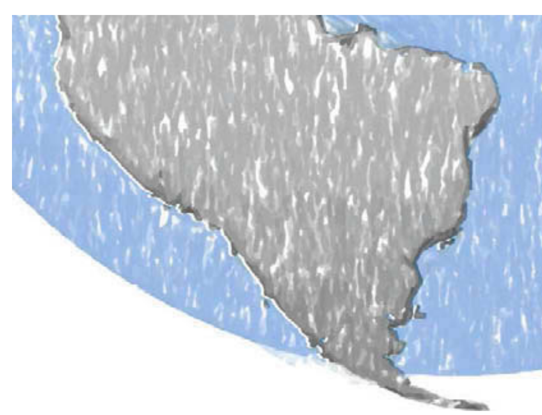


Many of the problems stem from the absence of adequate institutions that would set global standards and incentivise their effective adoption and enforcement by individual jurisdictions. In their absence, national or regional authorities produced uncoordinated rules of their own—sometimes even in a single country (for example, the divergence between the Securities and Exchange Commission and the Commodity Futures Trading Commission in the US).

> "Many of the problems stem from the absence of adequate institutions that would set global standards and incentivise their effective adoption and enforcement"

There has been an almost comical proliferation of global bodies. The Financial Stability Board (FSB), the Committee on Payments and Market Infrastructures (formerly the Committee on Payment and Settlement Systems) and the International Organization of Securities Commissions have been complemented by an OTC Derivatives Supervisors Group since 2005, an OTC Derivatives Regulators Forum since 2009, an OTC Derivatives Regulators Group since 2011 and an OTC Derivatives Coordination Group since 2012, with largely overlapping composition and mandates.

By competing for turf, these organisations and their members neutralise each other and ensure collective dysfunction. Not by coincidence, the only parts of the derivatives reform agenda for which global standards have been effectively delivered are the new capital and margin requirements for non-cleared trades—those for which the Basel Committee on Banking Supervision, a comparatively strong organisation with an established track record, was able to take the lead. Considerable resources are being wasted as a consequence. Worse, the G-20 financial stability objectives, including data aggregation and analysis to identify concentrations of risk, are not being met.



The G-20 leaders should wake up to this sorry situation, knock recalcitrant heads, and assign authority. They need to bring together both central banks and market authorities in the key jurisdictions (China and Hong Kong, the EU, Japan, Singapore and the US) into a mechanism that is able to issue proper common standards for OTC derivatives policy, and to monitor their implementation at the global level.

The most effective way may be to form a dedicated team within the FSB, which may develop over time into a permanent specialised organisation. It should be led by a respected and authoritative individual, preferably from Asia to ensure neutrality between the EU and US. If no decisive action is taken, then it is ultimately those same political leaders, not the anonymous regulatory technocrats, who will be responsible for the ongoing failure of an important set of reforms.

> "The G-20 leaders should wake up to this sorry situation, knock recalcitrant heads, and assign authority"

Cyrus Amir-Mokri

Partner, Skadden, Arps, Slate, Meagher & Flom

Former assistant secretary for financial institutions at the US Treasury and senior counsel to the chairman of the Commodity Futures Trading Commission

The OTC derivatives market has played a central role in the narrative on the causes and spread of the global financial crisis. Unsurprisingly, the reform effort that followed the crisis focused heavily on this market. Discussion on refashioning this sector began as early as the initial G-20 meeting in Washington, DC in 2008. By the 2009 summit in Pittsburgh, it had become a prominent element of the G-20 leaders' commitments.

At the Washington, DC summit, the G-20 leaders recognised that international cooperation would be essential to reforming the global derivatives markets. Acknowledging that regulation is "first and foremost the responsibility of national regulators", the G-20 leaders nonetheless noted that financial markets are global in scope. Therefore, "intensified international cooperation among regulators and strengthening of international standards, where necessary, and their consistent implementation, is necessary to protect against adverse cross-border, regional and global developments affecting international financial stability", the leaders stated.

Notwithstanding this warning, one of the most difficult issues regarding derivatives regulation has been cross-border harmonisation. What happened and what is the way forward?

What happened

A post-crisis, globally coordinated reform effort on derivatives faced an institutional shortcoming: in contrast to the regulation of capital and liquidity, which was guided by the Basel Committee on Banking Supervision, there was no established, comparably mature forum to convene and lead the international regulatory effort on derivatives. The effort to carry out the G-20 commitments was accomplished, in the first instance, through national regulation. The FSB was certainly involved, but principally in a monitoring capacity. It was only later, once the national efforts had reached a significant point of crystallisation, that the FSB began to convene the regulators to work through cross-border issues.

As a result, domestic progress on derivatives reform outpaced any efforts to achieve consensus on more specific contours of regulation by convening an international forum of regulators. In that context, the domestic authorities faced two significant challenges. First, the regulators making faster progress had to be sure that other G-20 members would uphold their commitments in a timely fashion. Second, if there were discrepancies between jurisdictions, or if one jurisdiction felt another could fall short on upholding its commitments, there was an incentive for a regulator to protect its domestic financial system by pushing extraterritorial assertions of jurisdiction to the far reaches of its ambit.

The way forward

Six years after the Pittsburgh summit, we face a different set of circumstances. Although a number of countries have still not met their G-20 commitments, many important jurisdictions, particularly the EU, are substantially complete in their work. Because there is convergence between jurisdictions on the nature and quality of regulation, disputes over cross-border regulation should be more susceptible to resolution. As FSB chairman Mark Carney stated in his November 14, 2014 report to the G-20: "To build trust across jurisdictions and to be effective, the system must be founded on consistent implementation of agreed common international standards." In light of the progress made by various jurisdictions in upholding the G-20 commitments on derivatives regulation, there is ample reason for regulators to trust each other's commitment to strong reform.

Convergence also allows us to think of the regulation of derivatives markets as a global, cooperative endeavour between regulators, as opposed to a competitive, nation-based model. In this model of regulation and supervision, international regulators leverage each other's relative expertise and experience, with the acknowledgement that the resources of any individual regulator are insufficient to police worldwide activity. To make the model of cooperative regulation work, three elements are important.

First, supervision should be cooperative. In global markets, participants inevitably have a presence in multiple jurisdictions. Given limited resources, no regulatory agency can singlehandedly supervise the global activities of any particular registered entity. Reliance on the work of other regulators is essential.

> "Given limited resources, no regulatory agency can singlehandedly supervise the global activities of any particular registered entity"

One template for cooperation and division of responsibility appears in Title VIII of the Dodd-Frank Act. It provides protocols for formal cooperation between primary market regulators and the Federal Reserve in supervising designated financial market utilities. Similar paradigms could be used in the cross-border context, where one regulator could take the supervisory lead in its relevant jurisdiction and another participates through consultation and information sharing, with expanded participation as warranted by circumstances and the accountability of each regulator. This approach to cooperative supervision has a precedent in supervisory colleges.

Second, regulators should focus on outcomes. Even when all jurisdictions have satisfied their G-20 commitments, we should expect to find differences in the particulars of derivatives legislation and regulation from one jurisdiction to another. But, even if rules on the surface may sometimes be different, their outcomes will still establish the same market discipline or prudential result. For example, as Commodity Futures Trading Commission chairman Timothy Massad explained recently in his remarks before the European Parliament, both one- and two-day margining for futures contracts could garner similar results in terms of safety and soundness, depending on how exactly the calculation is made. The outcomes principle is applicable in many other contexts.

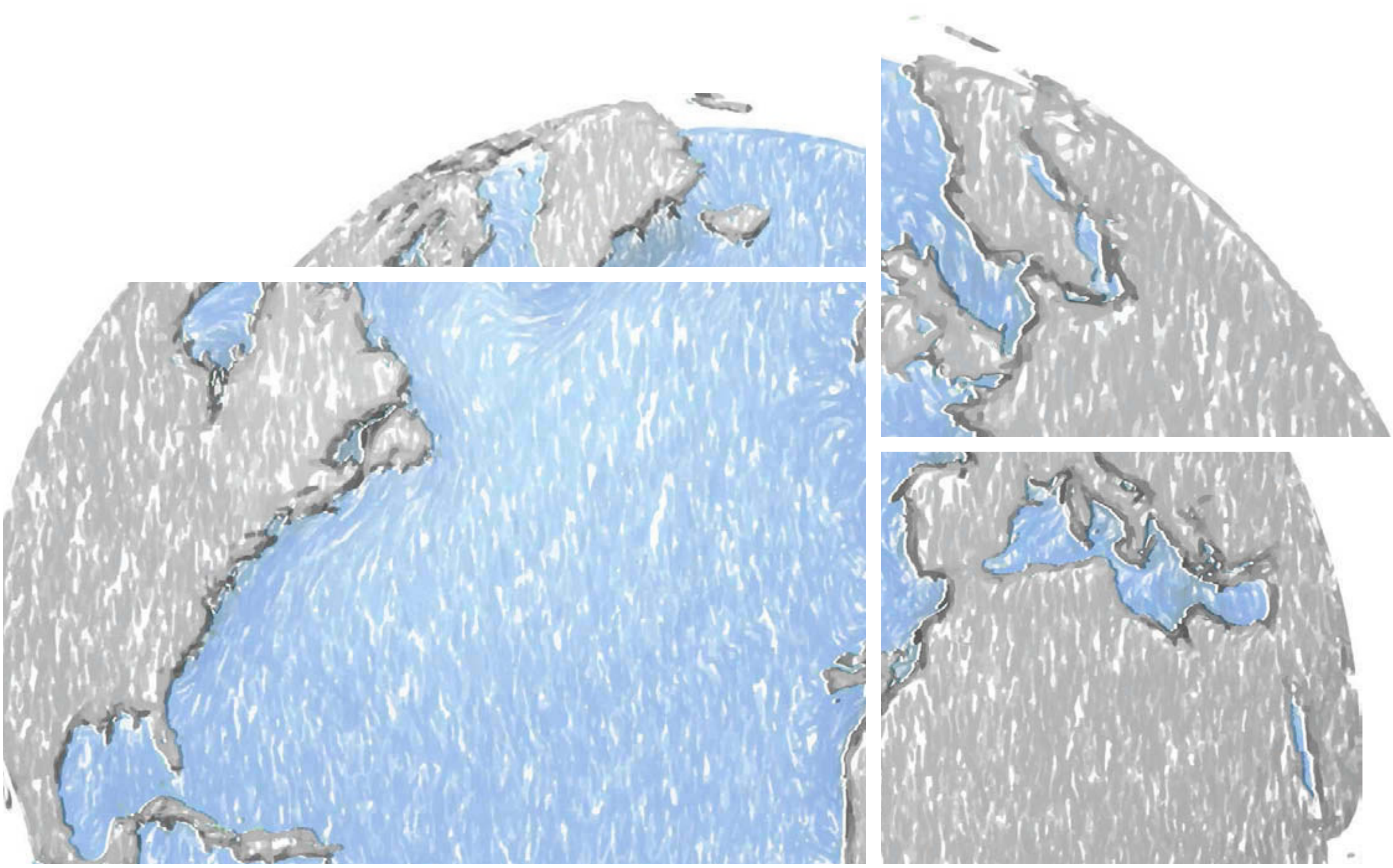
The focus on outcomes, moreover, should not be confused with reverting to a principles-based regulatory structure. The reality is that any regulatory scheme is a mix of principles and prescriptions. Prescriptions can sometimes be very granular. But even granular prescriptions are designed with a sense of overall outcome. If regulators focus on outcomes, harmonising granular prescriptions can follow.

Third, mutual deference should be expanded. Deference between regulators should follow from improved trust based on the convergence of rules and expanded cooperation. In a letter to the G-20 leaders in November 2014, the FSB chairman noted that this point had been made at the G-20 summit in St Petersburg in 2013. "With respect to OTC derivatives regulation, G-20 leaders agreed in St Petersburg that regulators should be able to defer to each other in the cross-border application of derivatives regulations when justified by the quality of their respective regulatory and enforcement regimes, based on similar outcomes, in a non-discriminatory way, paying due respect to home country regulation regimes," the chairman wrote.

In their declaration after the 2009 meeting in London, the G-20 leaders noted it was important to ensure their domestic regulatory systems are strong. But they also agreed to "establish the much greater consistency and systematic cooperation between countries, and the framework of internationally agreed high standards, that a global financial system requires".

In 2015, with the essential legislation and rules of key jurisdictions converging on those high standards, the case for mutual deference is becoming stronger. ■

> "Because there is convergence between jurisdictions on the nature and quality of regulation, disputes over cross-border regulation should be more susceptible to resolution"



The Drive for Compression

Compression activity has increased significantly over the past year, helping to drive interest rate derivatives notional outstanding levels lower. What's behind this change?

THE NOTIONAL OUTSTANDING size of a bank's derivatives book never used to matter that much. Operational issues aside, the notional stock of legacy trades was less important than the net risk posed by those transactions. Not anymore. Under the Basel Committee on Banking Supervision's leverage ratio, gross notional exposure, rather than risk, is the basis for determining capital requirements. Getting those notional exposures down has suddenly become important: without doing so, banks may end up quickly hitting leverage-ratio constraints.

This has acted as a major incentive for banks to squash their legacy derivatives trades. Combined with changes in compression technology, it has resulted in a significant increase in compression volumes over the course of this year. According to data from Stockholm-based TriOptima, CME Group and LCH.Clearnet, total cleared and non-cleared compression volumes (adjusted for double counting[1]) reached an estimated $448.1 trillion in the first quarter of 2015. That compares with an estimated cumulative total of $384.1 trillion at the end of last year and $219.8 trillion at the end of 2013 (see Figure 1).

Compression activity at clearing houses accounts for a large share of that increase. Average monthly interest rate derivatives compression volumes at CME Group and LCH.Clearnet increased by 34.6% between the fourth quarter of 2014 and first three months of this year, from $15.85 trillion to $21.33 trillion (see Figure 2). Total cleared interest rate derivatives compression volumes reached $63.9 trillion in the first quarter of 2015, versus $160.1 trillion over the whole of 2014.

As well as compressing existing trades, firms have looked to proactively reduce the number of line items in their portfolios by executing packages of transactions on US swap execution facilities (SEFs) specifically meant to match and offset outstanding cleared trades. ISDA estimates that compression-related activity comprised 6%-7% of total SEF volumes in the first quarter of 2015.

These initiatives appear to be contributing to a reduction in notional outstanding volumes. According to the Bank for International Settlements (BIS), interest rate derivatives notional outstanding fell to $505.45 trillion at the end of 2014, compared with $563.29 trillion six months earlier.

AT A GLANCE

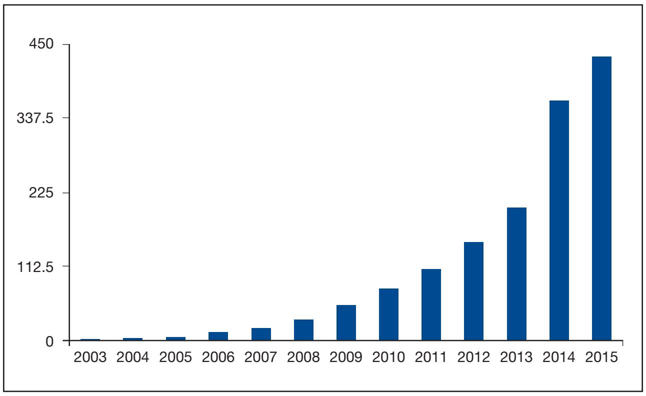
- The leverage ratio will hit banks with big derivatives books hard, as the measure is based on gross notional exposure rather than net risk.
- Compression activity has risen significantly as a result, helped by developments in compression services.
- Cumulative cleared and non-cleared compression volumes reached $448.1 trillion at the end of the first quarter of 2015.
- Average monthly cleared interest rate derivatives compression volumes increased 34.6% between the fourth quarter of 2014 and first quarter of 2015.
- Multilateral compression services are most popular, where two or more parties submit trades for matching and offsetting.
- So-called solo cleared compression, where firms compress trades in their own cleared portfolios only, have also proved popular with clearing clients.

Compression

Compression services have existed since 2003 as a way of enhancing operational efficiencies, but the emergence of the leverage ratio has elevated the importance of controlling and reducing gross notional exposures. As it stands, the leverage ratio will be particularly

1 Bilateral trades are counted twice when cleared. Notional figures have been adjusted to reflect a single count of cleared/compressed transactions

Table 1: Cumulative cleared and non-cleared compression volume (US$ trillions)



Source: CME Group, LCH.Clearnet, TriOptima
Note: Figures have been adjusted for double counting

problematic for banks with client clearing businesses, as both legs of a cleared client trade must be included in the exposure calculation, and no recognition is given to segregated client initial margin. As a result, there has been a keen focus on improving and extending compression technology for cleared trades in particular.

A significant change to cleared compression services occurred last year, with the unlinking of trades at LCH.Clearnet. Previously, trade records continued to link the original counterparties after clearing, meaning both parties had to agree for a trade to be compressed – a requirement that had acted to curtail compression volumes. By unlinking these records, it became possible for each counterparty to compress the trades it had cleared through the central counterparty (CCP) without the involvement of the original counterparties.

This in turn enabled the launch of a so-called blended-rate compression service at LCH.Clearnet in September last year – an equivalent service at CME Group launched a few months earlier. The two services allow participants to compress trades with different interest rates but with the same cashflow dates, widening the universe of trades eligible for compression. In fact, LCH.Clearnet estimates the blended-rate service enables firms to compress seven times more than they were previously able to.

It works by taking a portfolio of trades – for instance, a group of receiver and payer swaps positions with different fixed rates and notional – and replacing them with a single risk replacement trade with a weighted average replacement rate.

The rollout of these services at CME and LCH.Clearnet initially led to a surge in blended-rate compression volumes in both house and client accounts. Together, blended-rate services comprised 37% of total interest rate derivatives compression volume in November 2014, representing $5.02 trillion in volume.

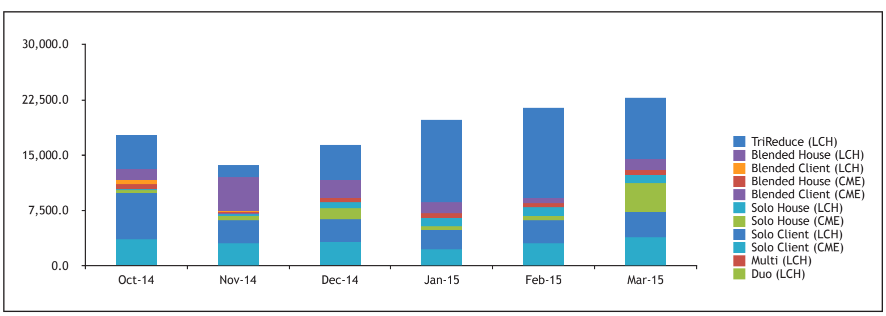
Unlinking has also paved the way for an expansion of the multilateral compression runs at LCH.Clearnet (see Figure 3). The CCP currently offers its own multilateral compression service, which allows two or more users to reduce their outstanding number of trades and potentially enter into a smaller number of risk replacement trades. It also offers third-party multilateral compression through Stockholm-based TriOptima's triReduce service.

The triReduce unlinked compression service works on a risk-free basis, offsetting those trades where coupon rates are different but maturity dates are the same, without affecting the risk of the portfolio. It can also handle transactions with different maturity dates, where the trades are assigned to predefined time buckets and counterparties set a certain risk tolerance.

The TriOptima multilateral compression service is also scheduled to launch on CME Group from the second half of this year, initially for clearing members clearing US dollar interest rate swaps in their house accounts.

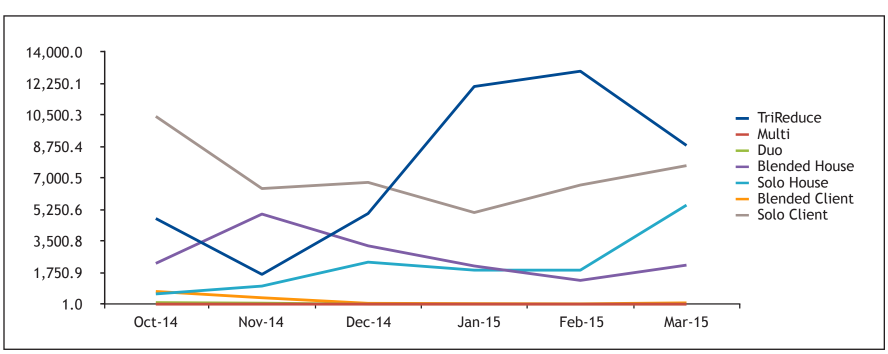
Even ahead of that launch, multilateral services comprise the largest share of cleared interest rate derivatives compression activity, at a monthly average of 50.1% in the first quarter of 2015, according to ISDA estimates. That compares with a monthly average of 21.9% in the prior quarter. The first-quarter peak was reached in February, when $12.13 trillion was compressed.

Figure 2: Monthly cleared IRD compression volumes by type/CCP (US$ billions)



Source: CME Group, LCH.Clearnet, TriOptima
Note: Figures have been adjusted for double counting

Figure 3: Monthly cleared IRD compression volumes by type (US$ billions).



Source: CME Group, LCH.Clearnet, TriOptima
Note: Figures have been adjusted for double counting

Solo services – where counterparties tear up their own offsetting cleared trades, without the involvement of the counterparty – makes up the second largest portion of interest rate derivatives compression activity, at a monthly average of 41.5% in the first quarter of 2015. Of that, solo compression by clients at both CME Group and LCH.Clearnet comprise the largest share. Solo compression had accounted for the largest share in the previous quarter, at a monthly average of 54% of activity – again, driven by client activity at CME and LCH.Clearnet.

SEF

A desire to reduce outstanding positions has also influenced trading activity on SEFs. Several venues now offer netting and compression services, which allow participants to enter into new trades that offset existing cleared transactions.

This was previously only achievable through a manual process, which was time-consuming and prone to operational risk. Since late 2013, however, participants have been able to automate this through SEFs such as Bloomberg, Tradeweb and trueEX.

These services enable firms to price and execute a package of hundreds of trades that match and offset existing cleared trades. These are then sent to clearing houses, which net those trades with the outstanding transactions. The result is fewer line items, lower clearing fees and potential margin and capital efficiencies.

In a further step, participants can execute new trades to retain the risk position of the original transactions but with a fewer number of line items – known as compaction.

The pace of compression-related activity has grown in recent months, reaching an estimated $987 billion in the first quarter of 2015 – approximately 6-7% of total SEF trading volume over the period, according to ISDA estimates. That compares with approximately $1.17 trillion over the whole of 2014.

Compression and notional volume

A growing portion of the interest rate derivatives market is cleared. According to analysis of trading activity compiled by ISDA SwapsInfo, 72.5% of interest rate derivatives average daily notional volume was cleared in the first quarter of this year. More than 70% of the global interest rate derivatives market is now cleared overall.

Clearing acts to increase total notional volumes, as a single bilateral trade is counted twice when it is cleared: one transaction between counterparty A and the CCP; and one between counterparty B and the clearing house. Conversely, compression results in a reduction in gross notional outstanding volumes.

The BIS reports semiannual derivatives outstanding notional figures that are adjusted for compression but not the double counting of cleared derivatives trades. Nonetheless, the BIS has reported a decline in interest rate derivatives notional outstanding over the past two periods – from $584.80 trillion in December 2013 to $563.29 trillion in June 2014, followed by a further fall to $505.45 trillion at the end of 2014. The BIS attributes this decline partly to increased compression.

Compression has also reduced the notional cleared outstanding at CME Group and LCH.Clearnet. Cleared interest rate derivatives notional outstanding after compression totalled approximately $176.45 trillion at the end of March 2015 (on a single-count basis), compared with $203.82 trillion at the end of December. That's despite average monthly interest rate derivatives clearing flows at the two clearing houses of roughly $26.96 trillion in the first quarter. ■

UNDERSTANDING COMPRESSION

- **CCP linked model:** This describes the relationship of two parties to an original transaction, both of which must agree to compress legacy positions. Dealer-to-dealer cleared transactions at LCH.Clearnet were linked until September 2014, when the unlinking process of legacy and new trades began. CME Group transactions were always unlinked.
- **CCP unlinked model**: Unlike the legacy linked model, unlinking allows clearing members to compress trades irrespective of the original counterparty to the trade. Unlinking enhances compression possibilities using multilateral, solo or blended-rate compression types.
- **Multilateral/triReduce compression:** This enables two or more parties to compress portfolios with similar or risk-constrained economic characteristics. Weekly single-currency 'cycles' are conducted at LCH.Clearnet. These are designed to leave the clearing house cashflow neutral.
- **Solo compression:** This enables a single party to unilaterally net eligible offsetting cleared trades with the same economic characteristics, irrespective of the original counterparty to the trade. Participants remain cashflow neutral in this process, which is also known as 'risk-free' compression.
- **Blended-rate compression:** This service extends solo cleared compression by enabling a participant to net trades with different rates but otherwise identical economic terms.
- **Duo compression**: A party works with another counterparty to agree to compress cleared trades conducted between them. This is part of the legacy linked model.
- **SEF compression and netting services:** Firms are able to execute packages of trades specifically intended to match and offset existing cleared trades in an effort to reduce line items in their portfolios.
- **Compaction:** A new trade is executed to replicate the risk of legacy trades that have been compressed. The counterparty will have the same or similar risk exposure, but fewer line items.

10 QUESTIONS WITH…

Eraj Shirvani

Eraj Shirvani, head of fixed income for EMEA and global head of emerging markets for investment banking at Credit Suisse, and an ISDA board member, talks about the challenges in transitioning to the new regulatory environment, the shift towards derivatives standardisation, and his first ever job – at a forerunner of Credit Suisse

1 IQ: What have you spent most of your time on at work over the past month?

Eraj Shirvani (ES): I recently took on a new role as global head of emerging markets, so a lot of what I've been doing recently has focused on that. I've spent a lot of time travelling and meeting with clients and thinking about how to further build out our emerging markets business. My travel schedule has been fairly intense – I've been to Turkey, South Korea, Russia and China, among other places, over the past month – but it's been fascinating.

I've also spent a lot of time on the regulatory side, and particularly on the ISDA Resolution Stay Protocol. Eighteen banks signed the protocol last year, which essentially means those firms have opted into certain special resolution regimes that limit the exercise of termination rights in the event a bank counterparty enters into resolution. Regulators have been clear they want to extend the use of contractual stays further, so we've been working to understand exactly what the regulators want to achieve during the next phase and how we get to that point. The buy side has been involved in the process since the start, so we've been able to get their perspective on this too.

2 IQ: What are the three biggest challenges facing the derivatives market at the moment?

ES: The transition to the new regulatory framework is a big challenge. We're moving from a predominantly bilaterally traded, non-cleared market to an electronic-venue-traded, cleared market. That requires a big investment in infrastructure, but it also comes at the same time a variety of new funding and capital charges come into play. The end result may well be better, but getting to that stage is very, very challenging. The dynamics of the derivatives market are changing, and banks are having to look closely at the economics of some businesses.

Another challenge is the lack of cross-border regulatory harmonisation. The Group of 20 agreed a broad set of objectives in 2009, but individual policy-makers have gone about applying those objectives in their jurisdictions in different ways. That's encouraged some end users to stop trading with counterparties in other jurisdictions to avoid being subject to overlapping rules. A derivatives liquidity pool that has always been global is therefore starting to fragment, and that's a concern. Ultimately, it will mean higher costs for end users of these markets.

The third challenge relates to an increasing tendency by regulators to try and regulate the entire market through the banks. Regulators are trying to influence the behaviour of non-bank participants by layering requirements onto the banks, in the hope these charges will be passed on. This kind of indirect regulation – for instance, requiring banks to hold higher capital when they trade with clients that don't want to clear, or prohibiting banks from trading with counterparties that don't agree to contractual stays – creates a huge burden for the banking sector. An alternative would be to pass legislation that applies to everyone the regulators want to target.

3 IQ: Will the derivatives markets look different in five years' time? How?

ES: The market will be much more standardised, more automated and much less bespoke. A large proportion of the derivatives market will be traded on electronic venues and cleared. The flipside is that clients may not be able to hedge their risk as perfectly as they did before. If a client had a very specific exposure on a certain date, it could previously put on a customised hedge that exactly matched that exposure. The dial will have shifted along the spectrum: derivatives trades will be much more transparent, but they'll be less effective as hedges. So it's a trade off.

4 IQ: How long have you served on the ISDA board?

ES: I've been on the ISDA board since 2004, and was chairman from April 2008 until April 2011. That obviously coincided with the peak of the financial crisis, which was incredibly challenging. But the work ISDA did during that time to help build safer, more efficient markets – through improved standardisation in the credit derivatives markets, to name just one – is something I'm extremely proud of.

5 IQ: What is ISDA's biggest achievement since you've been involved with the association?

ES: It's actually difficult to highlight one single achievement. Ever since it was established 30 years ago, ISDA has been a key driver of just about every advancement we've had in the derivatives industry – from the first standard documentation, to collateral agreements to netting opinions.

More recently, ISDA has been at the forefront of efforts to increase standardisation in the credit derivatives market through what we call the big and small bang protocols, which introduced an auction settlement system into credit derivatives documentation to help encourage central clearing. It's led efforts to develop data standards to help firms meet their regulatory reporting requirements, it's helped facilitate the move to clearing through its protocols and other initiatives, and it's brought the industry together to develop a standard initial margin model for non-cleared derivatives. The ISDA Resolution Stay Protocol is another example. Regulators wanted to tackle the risk that cross-border derivatives transactions might not be covered by national resolution regimes, and asked ISDA to come up with a contractual solution – and to do it quickly.

We all tend to forget how many obstacles and challenges our market has faced. And ISDA has really been the driving force in addressing each of these challenges and coming up with solutions for them.

6 IQ: What do you see as the biggest benefits of being an ISDA member?

ES: It allows each member to become fully immersed in the issues and have a voice in the debate and in shaping the future of the market. It really is the centre of the intellectual debate on derivatives. ISDA brings every constituent together and allows them to articulate their perspectives, their concerns, their objectives, and it somehow makes sense of all those completely varied perspectives and comes up with a coherent solution for the market. You want to be a member because of that. You want to have access to that dialogue and have your voice heard.

7 IQ: What was your first job and why did you leave?

ES: I joined First Boston Corporation in July 1988, and I've been at the same firm for the 27 years since. I'm proud of that.

8 IQ: If you didn't work in the financial markets, what do you think you would be doing?

ES: That's a tough one. I really enjoy doing what I'm doing, and 27 years on, I'm still learning new things. I always planned on returning to my alma mater and teaching in a small town in New Hampshire. Who knows? Perhaps I will still do that one day.

9 IQ: Who is the smartest person that you know?

ES: The smartest person I know is my wife, Celeste, who happens to also be my best friend.

10 IQ: Tell us something interesting about yourself?

ES: I've roughly spent a third of my life in each of Iran, the US and England. Going through a revolution is life-defining, and has really shaped my thinking and my attitude towards life. And despite spending so many years in both England and America, I am probably one of the few people who understands neither baseball nor cricket – even though I attend a tremendous number of games and matches with my kids! ■

The End-User View

End-user respondents to recent ISDA surveys say they are concerned about aspects of the new regulatory framework, and particularly the potential for liquidity to fragment, but derivatives remain crucial to their risk management strategies

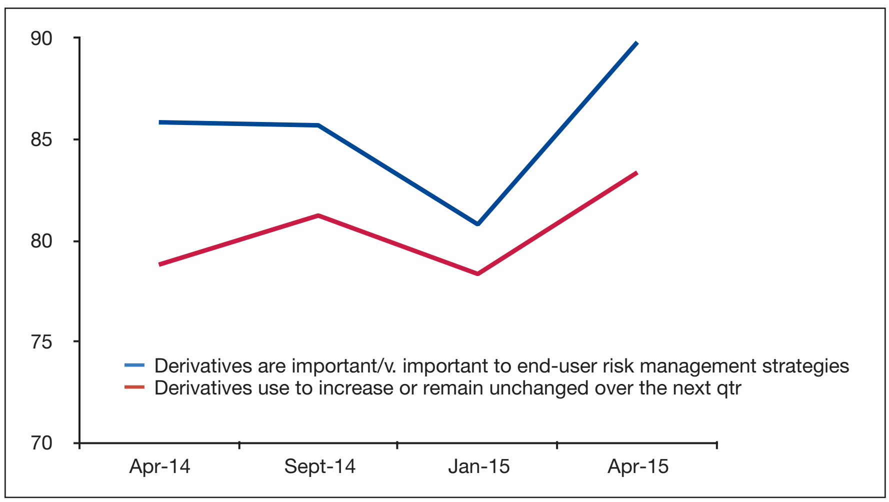
DERIVATIVES REMAIN A vital part of end-user risk management strategies, and the vast majority of firms expect to keep their use of derivatives at current levels or increase their use further. That's despite some concerns about the new regulatory framework – in particular, the impact on price and liquidity arising from a lack of coordination between global policymakers on how the rules are implemented across jurisdictions.

The fourth ISDA end-user survey was published in April 2015, and reveals many of the same themes and trends that emerged in three earlier surveys in January 2015 and September and April

AT A GLANCE

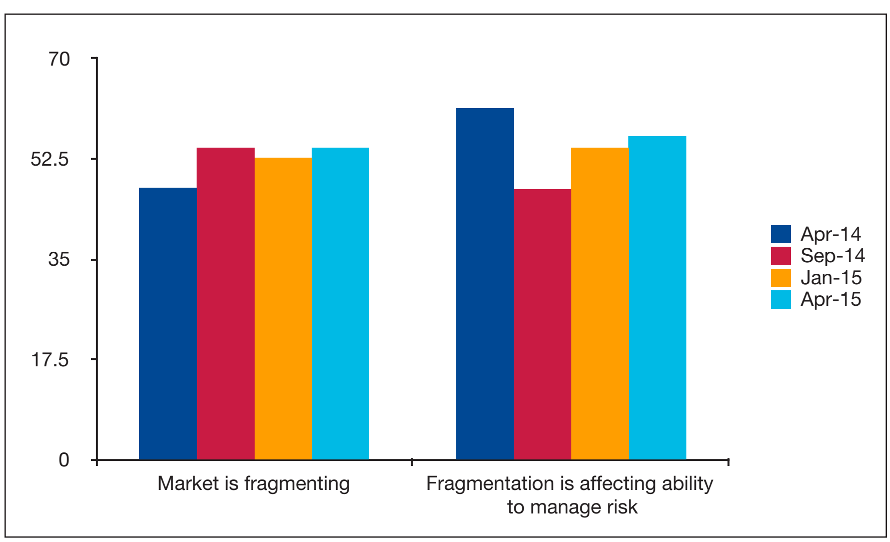
- 90% of end-user respondents see derivatives as important or very important to their risk management strategies – an increase since January.
- 54% think markets are fragmenting, and more than half of those say it is having a negative impact on their ability to manage risk.
- More than a third of respondents think liquidity has fallen over the past year, with fewer dealers prepared to offer prices.

Figure 1: End user survey – derivatives usage (%)



Source: ISDA

Figure 2: End user survey - fragmentation (%)



Source: ISDA

2014[1]. Most striking was the importance of derivatives to end-user risk management strategies: 90% of respondents felt derivatives were either very important or important to risk management, up nine percentage points from the previous survey in January 2015 and the highest level since the survey began (see Figure 1).

Derivatives are used for a variety of risk management purposes. But the most popular uses were managing currency, interest rate and commodity exposures (67%), hedging exposures in international markets (42%) and reducing financing costs (38%).

However, end users expressed some concern about the impact of new regulations – and particularly the lack of cross-border harmonisation in derivatives rules. Fifty-four per cent of respondents to the latest survey now believe the market is fragmenting, with liquidity pools split along geographic lines – the highest proportion since the survey began (see Figure 2). That is borne out by ISDA research, which found that an average 94.3% of regional European interdealer volume in euro interest rate swaps was traded between European dealers between July and October 2014. In comparison, the exclusive European dealer pool for euro interest rate swaps averaged 73.4% in the third quarter of 2013.

The change coincides with the introduction of US swap execution facility (SEF) rules in October 2013, which required electronic trading venues that provide access to US persons to register with the US Commodity Futures Trading Commission and comply with SEF rules. In response, many non-US platforms decided not to register as SEFs, which meant US persons couldn't access the liquidity on these venues.

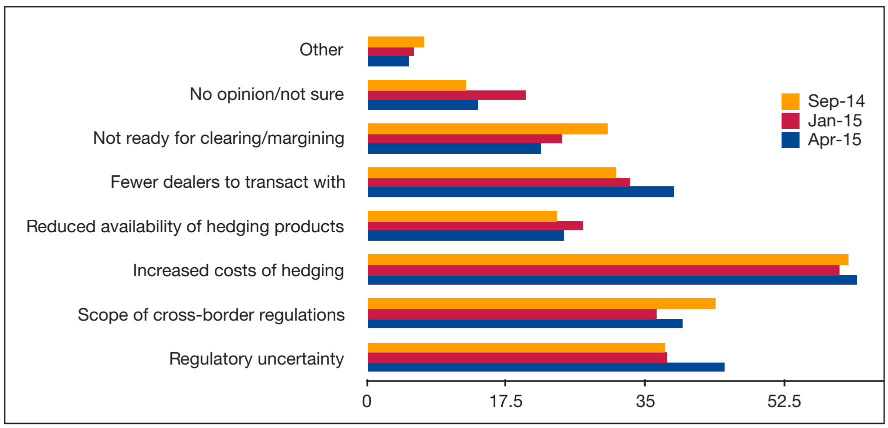
These types of issues are affecting the ability of end users to manage risk. Fifty-seven per cent of those who thought the market was fragmenting said it had had a negative or strong negative impact on their risk management, up slightly from 55% in January 2015 and 47% in September 2014.

In fact, the scope of cross-border derivatives regulation was identified as one of the three biggest concerns for end users (40%). The others were increased costs of hedging (62%) and regulatory uncertainty (45%) (see Figure 3). The same three issues have consistently been flagged as the top concerns for end users since the question was introduced to the survey in September 2014. Other issues are growing in importance, however. In particular, the prospect of having fewer dealers to trade with has become increasingly significant, with 38% of respondents highlighting this issue in April 2015, versus 33% in January 2015 and 31% in September 2014.

This concern appears to be becoming a reality. More than one-third of respondents to the April 2015 survey thought liquidity had deteriorated over the past year (see Figure 4), with a similar proportion highlighting a decline in the number of dealers willing to offer prices. Nearly two thirds of those who thought liquidity had declined said it had negatively affected their ability to manage risk. This appears to have had a knock-on impact on cost: more than half of all respondents thought the cost of hedging had increased over the prior 12 months.

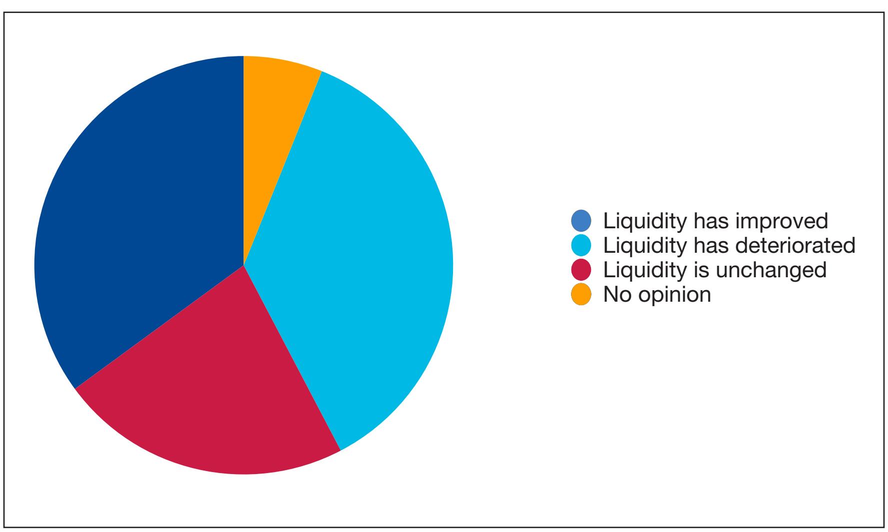
Despite these concerns, there is little indication that end users are reining in their use of derivatives. Eighty-three per cent of respondents said their use of derivatives would increase or remain the same over the forthcoming quarter. That's slightly higher than the proportion in the previous three surveys: 78% in January 2015, 81% in September and 79% in April 2014 (see Figure 1).

Figure 3: What are your biggest concerns regarding your ability to use derivatives to manage risk? (%)



Source: ISDA

Figure 4: Have you noticed any change in derivatives market liquidity over the past year? (%)



Source: ISDA (April 2015)

1 Visit www2.isda.org/functional-areas/research/end-user-surveys for the survey archive

Making Sense of the FRTB

The Fundamental Review of the Trading Book is an ambitious Basel Committee initiative to revamp trading book capital rules. But what does it mean? And what are the implications and challenges?

THE END OF THIS year is scheduled to bring to a close a three-year-plus project to review the Basel Committee on Banking Supervision's existing trading book capital rules and finalise an alternative. It's a project that, when implemented, will result in a brand new standardised approach for calculating market risk, the replacing of value at risk with an expected shortfall measure, and the introduction of desk-level model approvals, among other things (see box, *FRTB in Brief*).

AT A GLANCE

- The FRTB framework is due to be finalised at the end of 2015, followed by a period of calibration.
- The rules will overhaul current market risk capital rules, with the aim of creating more consistency and less variation between banks.
- Preliminary analysis had suggested certain markets and products important for the wider economy would be most affected under the current proposals.
- The Basel Committee agreed in June to run an additional impact study in the coming months in order to finalise the framework.

Keeping to that schedule means regulators and industry participants have a busy few months in store. Certain elements of the proposed overhaul have not been fully assessed, leading to concerns that some products and markets could be hit by punitive and disproportionate capital increases. What is more, early analysis suggested the products likely to be most affected would be those that are most important for the wider economy – bonds, securitisation, small- to medium-sized enterprise credit and small cap equities – prompting concerns that national regulators would apply their own fixes to the Basel framework, leading to divergences in implementation.

In response, the Basel Committee agreed last month to run new analysis that will further assess specific components of the framework, with the aim of giving regulators the information they need to make any final adjustments deemed to be necessary. That's a welcome development, industry participants say. They point to several key outstanding issues that, if addressed over the coming months, will help ensure the final framework is more robust.

Timing will be tight, though – especially as the Basel Committee intends to also include an evaluation of securitisation and credit valuation adjustment in its new impact study on the trading book capital rules.

The proposed revision to the trading book rules first saw light of day in May 2012 with publication of an initial consultation paper. The aim was to replace the current crop of measures under Basel 2.5 with a more coherent and consistent framework, an initiative widely supported by industry participants. While Basel 2.5 had been developed as a quick, stop-gap measure to lift trading capital requirements in response to the financial crisis, the Fundamental Review of the Trading Book (FRTB) was meant to be a more considered attempt to address shortcomings in market risk capital rules, reduce the variability in capital levels between banks, and narrow the gap between the numbers generated by standardised and internal models.

"The FRTB contains a number of improvements over the current approach. The development of a more

> The Basel Committee agreed last month to run new analysis that will further assess specific components of the framework

risk-sensitive standardised approach is particularly welcome, as it is meant to create a credible fall-back should a bank lose its approval to use internal models. But several areas still need further assessment or modification," said Mark Gheerbrant, head of risk and capital at ISDA, speaking on a panel at the 30th ISDA annual general meeting in Montreal in April.

The first consultation was followed by a second, more detailed paper in October 2013, and a third consultation in December last year. Alongside the consultations, the Trading Book Group of the Basel Committee ran a series of quantitative impact studies (QISs) – a hypothetical portfolio exercise in the first half of 2014, followed by two studies based on actual bank portfolios in late 2014 and early 2015.

But despite the flurry of activity over the past year or so, industry participants had argued further analysis is needed to hone the framework and ensure the rules are coherent and robust. That's largely because it's not entirely clear what impact the new rules will have on individual business lines. The two firm-wide studies conducted so far were hampered by operational and specification issues that affected the quality of data that banks reported, participants say. In particular, a lack of clarity over what needed to be reported led to a wide variation in the data submitted by banks in certain areas.

The results of the second and third QISs have not been published by the Basel Committee. However, industry participants expressed concern that the framework in its current form could result in a significant increase to capital levels, on top of the increases that resulted from Basel 2.5. In addition, the proposals would likely lead to sizeable variance in capital requirements under the standard rules – called the sensitivity based approach (SBA) – and internal-model outputs.

Reducing this gap was a fundamental goal of the FRTB, enabling regulators to withdraw permission for failing internal models without having to worry about the impact of sudden, destabilising capital increases resulting from a switch to the standardised approach. However, industry participants were concerned this wouldn't play out in reality, meaning a move from internal models to the SBA would result in multiple times the amount of capital.

Any variance between internal-model and SBA outputs would also present problems for the calibration of a capital floor. The Basel Committee has proposed the rollout of a floor on internal model capital numbers, most likely based on a percentage of the SBA metric. A significantly higher capital requirement under the SBA could reduce the benefit of – and therefore the incentive for developing – internal models.

Although the precise impact on overall capital levels is not clear, industry participants believe the framework as it stands would likely have a disproportionate impact on certain business lines. Some the most affected products would be those with the greatest significance for the wider economy, such as bond markets, SME credit, securitisations, small-cap equities, and commodity and foreign exchange hedges.

For instance, high-yield debt has a 120-day liquidity horizon under the FRTB versus the current 10 days, which would result in a material increase in capital. This could potentially affect the ability of SMEs to access the high-yield bond market. A downgrade would increase capital charges further: by an estimated 40% for high-yield debt and 73% for sovereigns.

Higher trading book capital requirements in these markets will increase underwriting and funding costs, and reduce liquidity in the secondary market, industry participants say. Faced with lower liquidity, investors will be less willing to participate in the worst-affected markets, while those that do may well require a higher liquidity premium, further contributing to financing costs.

This potentially contrasts with other policy initiatives, participants point out. Policy-makers are increasingly focused on initiatives to generate and sustain global economic growth. For instance, efforts are under way in the European Union to establish a capital markets union, while a number of Asian countries are attempting to further develop local bond markets, in an attempt to diversify

Industry participants had argued further analysis is needed to hone the framework and ensure the rules are coherent and robust

FRTB IN BRIEF

- New rules determining the scope of instruments eligible for inclusion in the trading book, and more stringent requirements governing internal risk transfers between the banking and trading book.
- A revised standardised approach for market risk based on price sensitivities, which is intended to be more risk sensitive compared to the existing standard approach, and therefore reduce the gap between internal models and standard rules.
- The substitution of value at risk and stressed value at risk with an expected shortfall risk measure to capitalise for loss events in the tail of the P&L distribution.
- The introduction of liquidity horizons in the expected shortfall calculation to reflect the period of time required to sell or hedge a given position during a period of stress.
- Replacement of the incremental risk charge with an incremental default risk model, which is designed to capture default risk in the market risk framework.
- Back-testing requirements of internal models at trading desk level. Failure to meet the validation criteria would force a desk to revert to using the standardised approach.
- Enhanced public disclosures on market risk capital charges, including regulatory capital charges calculated using both standardised and internal models approaches.

funding sources for companies that have predominantly relied on bank credit.

There is also a risk that national regulators would attempt to apply their own fixes to counter these effects, resulting in divergent implementation – undermining the objective of the Basel Committee to create a consistent and coherent capital framework.

The new QIS will help develop a more detailed picture of some of these potential effects, market participants say. A new study will also enable the industry to properly test revisions to the framework that are currently under consideration, while resolving known outstanding policy issues and concerns (see box, *Key ISDA Issues)*. This will inform the policy process and avoid any unintended consequences and disruption in the financial markets. ■

KEY ISDA ISSUES

Liquidity horizons

The FRTB introduces liquidity horizons (LHs) under the internal model approach, which aim to capture the amount of time required to liquidate a specific instrument in the market. But the LH buckets for many instruments are overly conservative and lack granularity, giving rise to cliff effects.

For a large-cap, high-yield corporate name, for example, the LH for credit spread and volatility is 120 days and 250 days, respectively, while the LH for equity price and equity volatility is 10 days and 20 days. The credit market is not as deep as the equity market, but the differences are overstated and are not borne out by experience, even in stressed markets. This could result in increased underwriting and lending costs (or an unwillingness by banks to underwrite new issues), and reduced liquidity in secondary markets.

ISDA believes the liquidity horizons should be re-evaluated to better reflect market experience, and recommends targeted studies to ensure that the capital impact is well understood before implementation.

Non-modellable risk factors

The Basel Committee wants to provide incentives for banks to source high-quality data for use within internal models. As a result, it has proposed standards that will determine whether a risk factor can be used within an internal model calculation, or whether it has to be assigned to a non-modellable risk factor bucket and therefore be subject to a capital add-on (no diversification benefit).

The introduction of eligibility criteria to enhance data quality is positive, but the proposed requirements are currently unworkable in practice. If interpreted strictly, references to "continuously" available, "real prices" and a sufficient set of representative "transactions" could be too restrictive for practical use, resulting in serious implementation challenges. ISDA believes end-of-day marks should be allowed, as these are already subject to well-established processes and controls.

Revised standard rules

The FRTB revises the standard rules for market risk capital requirements. The intention is to provide regulators with a credible fall-back approach for each trading desk in the event that internal models are deemed inadequate. The new standard approach (the sensitivity based approach, or SBA) is significantly more risk sensitive than the current standard framework, which is welcome, but some areas still require refinement. Key issues include:

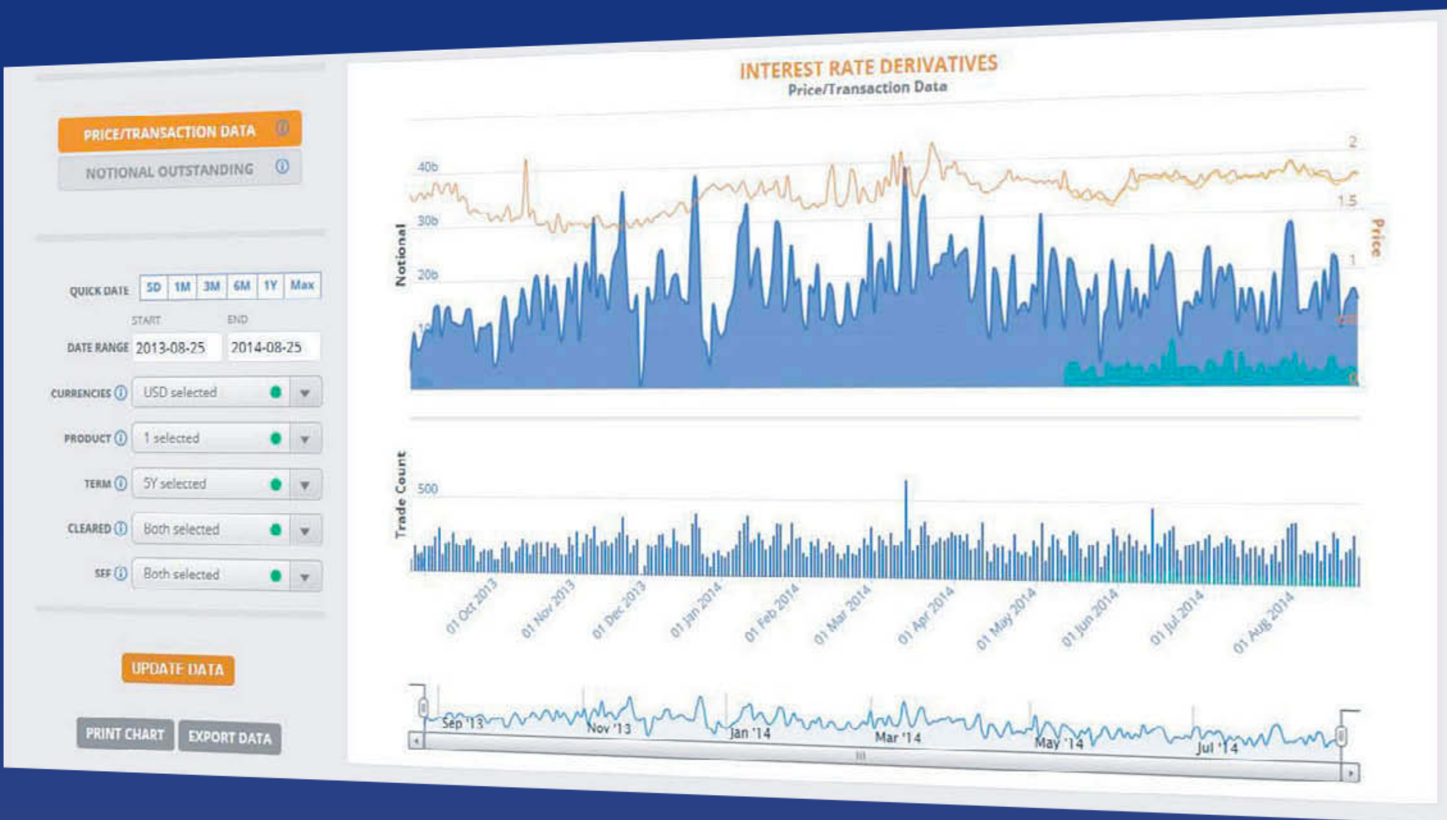
- **Asymmetric correlations:** Under the SBA, two correlation values (asymmetric correlations) are specified for each pair of risk positions in order to capture the lack of stability in correlation parameters: a higher value for the risk pairs with the same sign (eg, two long or short positions); and a lower value for the risk pairs with different signs (eg, a short and long position). However, this approach comes with challenges. Exposures within a portfolio can change frequently, even over the course of a single day, potentially requiring the correlation parameters to be continually revised. This could lead to high capital charges for even well-hedged basis positions, and increased volatility and uncertainty over portfolio capital requirements. A simpler, alternative approach would be to use a coherent, consistent correlation matrix.
- **Securitisations:** Capital requirements for all securitisation exposures must be calculated using the standardised approach (internal models are not allowed), which entails adding together a credit spread risk charge and a default risk charge. However, there is a high degree of overlap between the two measures, resulting in double counting. Combined with extremely high risk weights for securitisation products (ranging from 800 basis points to 5,000bp) and a lack of granularity in risk buckets, this is likely to lead to unjustifiably high capital requirements. The end result is likely to be lower liquidity and a higher liquidity premium demanded by investors, putting upwards pressure on financing costs for borrowers. ISDA believes an alternative approach should be developed based on recalibrated credit spread stresses and the elimination of double counting.

Trading book/banking book boundary

The FRTB imposes strict limits on internal risk transfers between the banking and trading books. While recognising the regulatory purpose of eliminating capital arbitrage, ISDA believes the current proposals for internal risk transfers are overly restrictive. Under current proposals, banking book positions can only be transferred into the trading book if the risk is neutralised through separate, matched external hedges. Banks should retain the ability to transfer banking book risk to the trading book in a way that allows the risks to be managed on a portfolio basis, subject to trading book regulatory capital requirements, trading book limits and governance standards that meet supervisory approval.

ISDA SwapsInfo

ISDA SwapsInfo brings greater transparency to OTC derivatives markets. It transforms publicly available data on OTC derivatives trading volumes and exposures into information that is easy to chart, analyze and download.



ISDA SwapsInfo covers the interest rate derivatives and credit default swaps markets.

Interest Rate Derivatives

Price/Transaction Data
Daily IRD prices and trading volumes, measured by notionals and trade count.

Notional Outstanding
Notional outstanding, and trade count, for a range of IRD products.

Credit Default Swaps

Price/Transaction Data
Daily CDS prices and trading volumes, measured by notionals and trade count.

Market Risk Activity
CDS trading volume for single name and indices that results in a change in market risk position.

Notional Outstanding
Gross and net notional outstanding, and trade count, for single names and indices.

SwapsInfo.org

ISDA Safe, Efficient Markets

ISDA SwapsInfo Update: SEFs Hold Steady

Average daily interest rate derivatives volume increased over the first three months of this year, while volumes in the credit default swap index market shrank slightly. But a common theme in both markets is the continued importance of clearing and electronic trading, according to the latest ISDA analysis of swap repository data

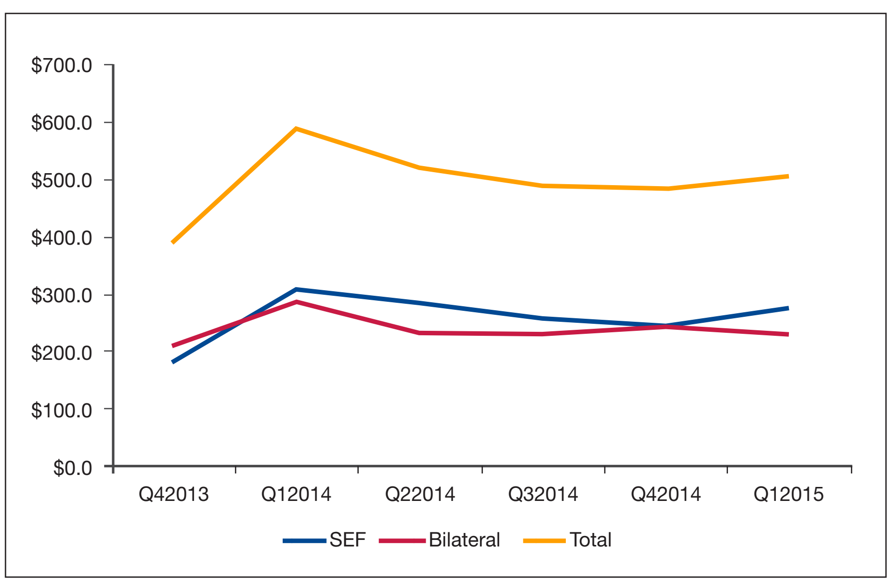
AT A GLANCE

- 54.5% of IRD and 70.7% of CDS index average daily notional volume was SEF-traded in the first quarter of 2015.
- 72.5% of IRD and 80.6% of CDS index average daily notional volume was cleared in the first three months of the year.
- Total IRD average daily notional increased by 4.2% to $504.7 billion in the first quarter after three successive quarters of decline. That's 14.2% lower than the $588 billion peak in the first quarter of 2014.
- Total CDS index average daily notional volume fell by 12.5% over the first quarter to reach $29.9 billion. Average daily notional volume had hit a high of $34.2 billion in the prior quarter.

MORE THAN HALF of interest rate derivatives (IRD) and over 70% of credit default swap (CDS) index average daily notional volume was traded on swap execution facilities (SEFs) in the first quarter of 2015, according to an ISDA analysis of trade information reported to US swap data repositories and compiled by ISDA SwapsInfo.org.[1]

The proportion of trading conducted on electronic platforms grew in the first three months of the year, reaching 54.5% of total IRD average daily notional volume versus 50.1% in the previous quarter and 52.4% over the whole of 2014.

Chart 1. IRD average daily notional volume: total and SEF/bilateral (US$ billions)



Source: ISDA SwapsInfo

1 ISDA Swapsinfo.org aggregates information reported to the Depository Trust & Clearing Corporation and Bloomberg swap data repositories

The proportion of trading conducted on electronic platforms grew in the first three months of the year, reaching 54.5% of total IRD average daily notional volume

A similar trend occurred in the market for CDS indices, with SEF trading accounting for 70.7% of total average daily notional volume compared to 62.5% for the whole of last year. However, the first-quarter figures represent a small decline from the fourth quarter of 2014, when 72.5% of CDS index average daily notional volume was SEF-traded.

The changes follow the introduction of the SEF rules on October 2013, and the first US SEF trading mandates for certain interest rate and credit derivatives index products in February 2014. Following the rollout of the new regime, SEF-traded IRD average daily notional has increased by 52.6% from $180.4 billion in the fourth quarter of 2013 to $275.3 billion in the first quarter of 2015, while SEF-traded CDS index average daily notional volumes have more than tripled from $6.7 billion to $21.2 billion.

A large proportion of the interest rate and credit derivatives market is also now cleared. Cleared trades comprised 72.5% of total IRD average daily notional volume in the first quarter of 2015, compared with 76.5% over the whole of 2014 and 71.7% in 2013. Just over 80% of CDS index average daily notional was cleared in the first three months of this year, versus 74.7% in 2014 and 37.7% in 2013.

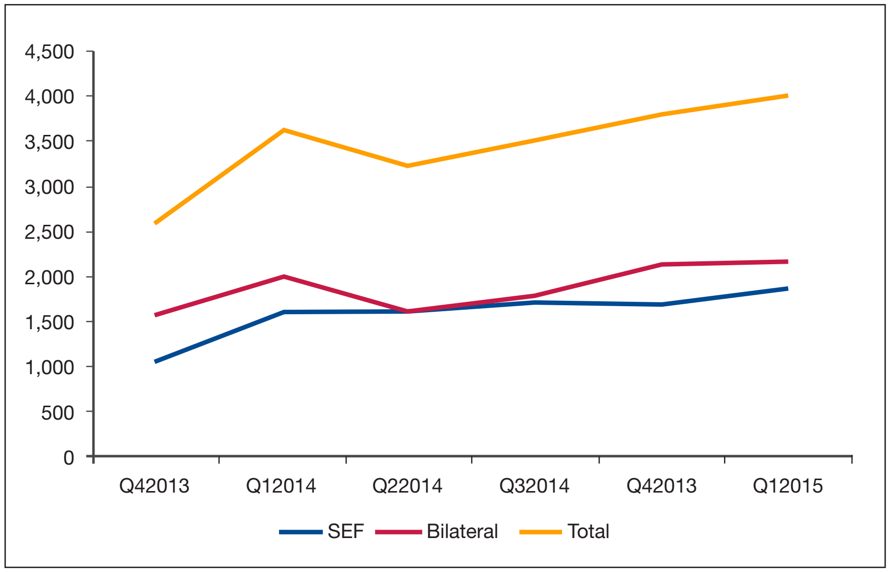
Interest rate derivatives

Having reached a year-low of $484.5 billion in the fourth quarter of 2014, total average IRD daily notional volume picked up in the first quarter of 2015, increasing 4.2% to $504.7 billion (Chart 1, yellow line). But that's still some way short of the year peak of $588 billion in the first quarter of 2014.

The average daily number of total trades counts also increased over the quarter, rising from 3,800 in the fourth quarter of last year to 4,024—the third successive quarterly increase and the highest level since the start of the data series in the first quarter of 2013 (Chart 2, yellow line). Unlike average daily notional, the rising trend in trade counts is apparent over a 12-month period too. Over the year, average total daily trade counts increased 11.1% from 3,622 in the first quarter of 2014.

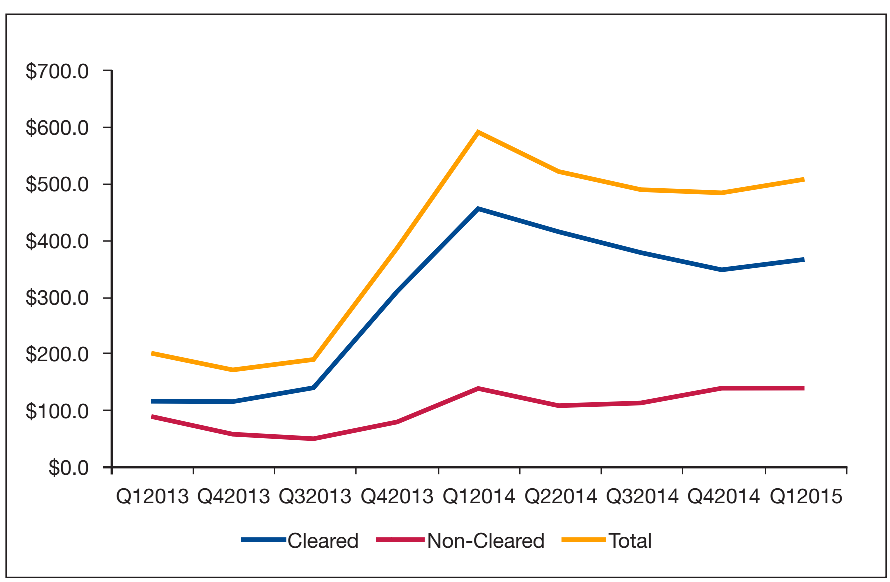
Similarly, SEF-traded IRD average daily notional volume increased from $242.5 billion in the fourth quarter of 2014—a year low—to $275.3 billion in the first three months of this year, an increase of

Chart 2. IRD average daily trade count: total and SEF/bilateral



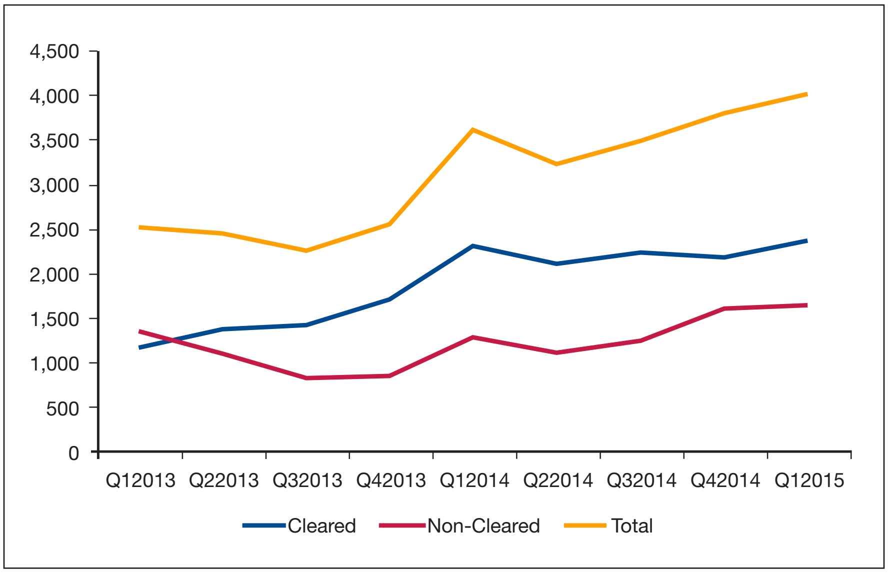
Source: ISDA SwapsInfo

Chart 3. IRD average daily cleared/non-cleared notional volume (US$ billions)



Source: ISDA SwapsInfo

Chart 4. IRD average daily cleared/non-cleared trade count



Source: ISDA SwapsInfo

13.5% (Chart 1, blue line). That upswing was not enough to offset three straight quarters of decline, however. The latest notional figure was 9.7% lower than the high point of $304.8 billion in the first quarter of 2014.

The average number of daily SEF trades rose on both a quarterly and an annual basis, however. On average, SEF users traded 1,867 times a day in the first quarter of 2015, up 11.6% on the quarter and 16% over the year (Chart 2, blue line). Average daily SEF trade counts now comprise 46.4% of the total versus 44% during the last three months of 2014.

In comparison, bilateral average daily notional volume dropped by 19% over the year and by 5.2% between the fourth quarter of 2014 and the first three months of this year (Chart 1, red line). Average daily trade counts, however, climbed on a yearly and quarterly basis, albeit by a small amount (Chart 2, red line).

These dynamics have resulted in significant changes in average trade size over the year. Total IRD average trade size has declined by 22.8% between the first quarter of 2014 and the same period in 2015, from $162.4 million to $125.4 million, suggesting derivatives users are trading more frequently but in smaller size. Over the quarter, average trade size fell 1.6% from $127.5 million in the fourth quarter of 2014.

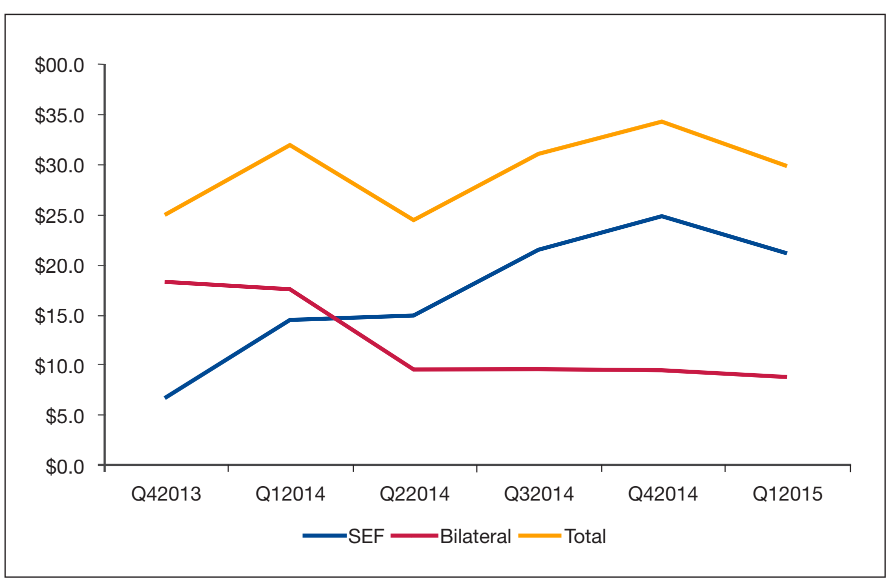
Average SEF trade size fell by a similar percentage amount over the 12-month period: from $189.4 million to $147.5 million, a decline of 22.1%. However, the first-quarter-2015 figure is slightly higher than the previous quarter's $145 million, increasing by 1.7%. Bilateral average trade sizes were smallest, at $106 million in the first quarter of this year, compared with $113.7 million in the previous quarter and $140.7 million in the first quarter of 2014.

Having reached a year-low of $484.5 billion in the fourth quarter of 2014, total average IRD daily notional volume picked up in the first quarter of 2015

Meanwhile, average daily cleared notional volume increased 5.5% between the fourth quarter of 2014 and first three months of 2015, from $346.6 billion to $365.8 billion per day (Chart 3, blue line). But that represents a 19.5% drop from the peak of $454.2 billion in the first quarter of 2014. Cleared notional comprised 77.2% of total average IRD daily notional volume in that three-month period versus the current 72.5%.

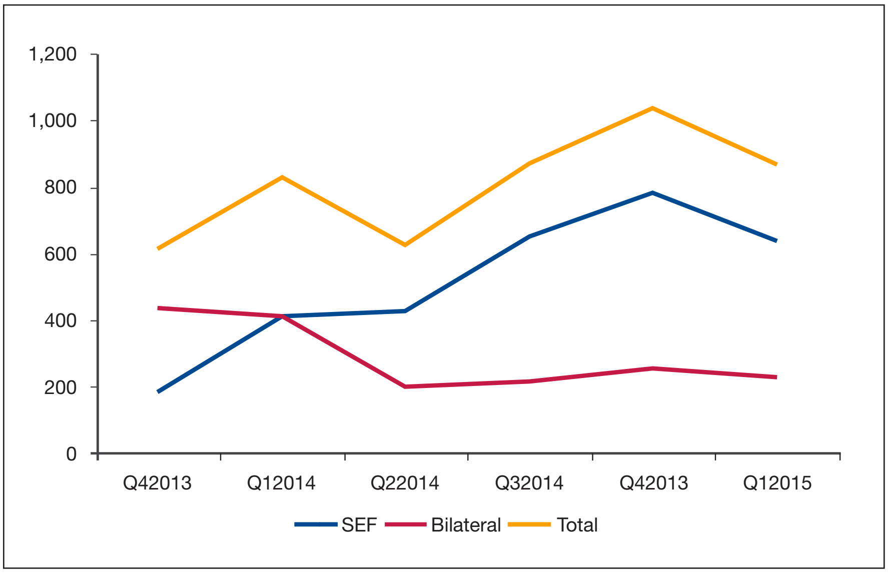
In comparison, non-cleared average daily notional volumes increased both over the quarter (up 0.8%) and the year (up 3.8%). Average non-cleared daily notional volume reached $138.9 billion in the first quarter of 2015, versus $137.8 billion three months before and $133.8 billion in the first quarter of 2014 (Chart 3, red line).

Chart 5. CDS index average daily notional volume: total and SEF/bilateral (US$ billions)



Source: ISDA SwapsInfo

Chart 6. CDS index average daily trade count: total and SEF/bilateral



Source: ISDA SwapsInfo

As with notional volumes, the average number of daily cleared and non-cleared transactions increased on a quarterly basis, rising 9.2% for cleared (Chart 4, blue line) and 1.4% for non-cleared (Chart 4, red line). However, both also climbed over the year, with the number of cleared trades rising from 2,326 in the first quarter of 2014 to 2,387 a year later (up 2.6%) and non-cleared increasing from 1,296 to 1,637 (up 26.3%) over the same period. Overall, cleared trade counts comprised 59.3% of the total in the first quarter of this year, versus 57.5% in the previous three months and 64.2% in the first quarter of 2014.

Reflecting the decline in trade sizes over the past year, the average cleared transaction size was $153.2 million in the first quarter of 2015, a decline of 21.6% from the $195.3 million average in the first quarter of 2014.

> Total IRD average trade size has declined by 22.8% between the first quarter of 2014 and the same period in 2015

CDS indices

A slightly different picture emerges in the CDS index market. Total average daily notional fell 12.5% from its year high of $34.2 billion in the fourth quarter of 2014 to $29.9 billion in the first quarter of this year (Chart 5, yellow line).

This is mirrored in both SEF and bilateral figures. SEF-traded average notional volume fell from a $24.8 billion peak in the fourth quarter of 2014 to $21.2 billion in the first three months of this year, a 14.7% decline (Chart 5, blue line). Meanwhile, bilateral average daily notional volumes fell by 6.7% over the quarter, from $9.4 billion to $8.8 billion (chart 5, red line).

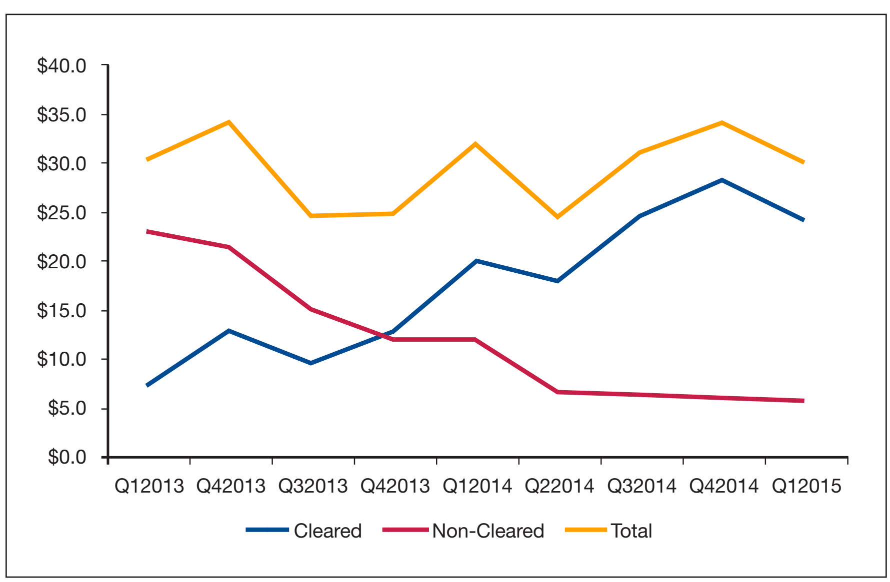
While both the total and bilateral average daily notional volume fell over the year as well, SEF-traded volumes increased sharply over the 12-month period, from $14.4 billion to $21.2 billion, an increase of 46.7%.

This is reflected in trade counts. The average number of SEF daily transactions fell by 18.3% over the quarter, from 782 to 639. But the first-quarter number represents a 53.6% increase over the 416 recorded in the first quarter of 2014 (Chart 6, blue line).

Total average daily trade count also fell over the quarter, from a high of 1,041 to 868 (down 16.6%), and recorded a much more modest 4.3% uplift over the year (Chart 6, yellow line). Bilateral trade counts, however, fell on both a year-on-year and quarterly basis (Chart 6, red line).

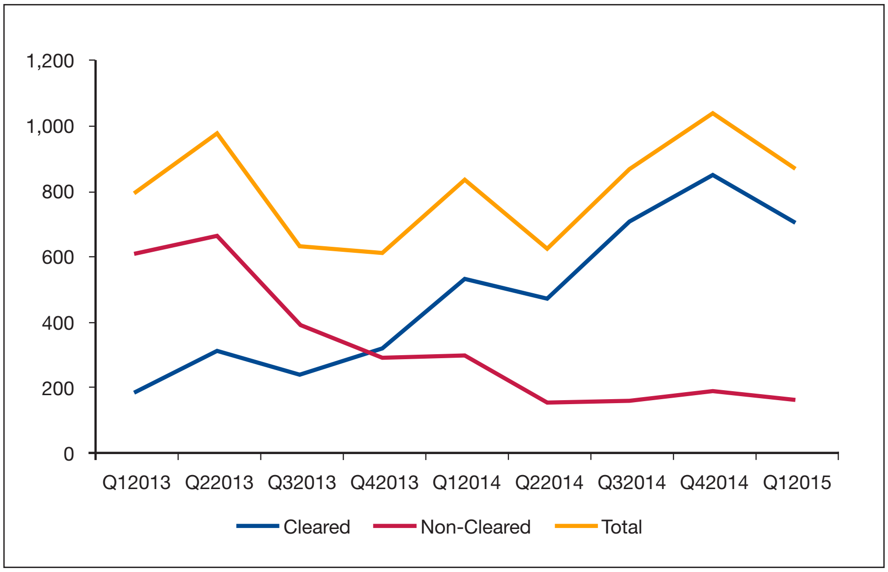
These trends have caused average trade sizes to rise modestly over the quarter. Total average trade size increased 4.9%, from $32.8 million in the fourth quarter of 2014 to $34.5 million, while the average size of a SEF trade climbed 4.5%, from $31.7 million to $33.1 million.

Chart 7. CDS index average daily cleared/non-cleared notional volume (US$ billions)



Source: ISDA SwapsInfo

Chart 8. CDS index average daily cleared/non-cleared trade count



Source: ISDA SwapsInfo

The fourth quarter of 2014 also represented a peak for clearing, with 82.5% of CDS index average daily notional volume and 81.7% of average daily trade counts cleared. The first quarter of this year saw a 14.5% decline in average daily cleared notional, from $28.2 billion to $24.1 billion (Chart 7, blue line), and a 17.1% decline in cleared trade counts, from 851 to 705 (Chart 8, blue line). Cleared transactions represented 80.6% of average daily notional and 81.2% of trade counts in the first three months of this year.

The most recent figures represent an increase on last year's level, however. Average daily cleared notional has increased by 20.3% since the first quarter of 2014 (Chart 7, blue line), and the average number of transactions cleared has risen by 31.6% (Chart 8, blue line). Clearing accounted for 62.8% of average daily notional volume and 64.1% of trade counts in the first quarter of 2014.

Non-cleared average daily notional volume saw a 51.5% decrease between the first quarter of 2014 and the first three months of 2015, from $12 billion to $5.8 billion (Chart 7, red line). The declining trend is also apparent on a quarter-by-quarter basis, with non-cleared average notional falling 3.1% over the three-month period. Likewise, non-cleared average daily trade counts fell by 45.4% over the year and 14.1% over the quarter (Chart 8, red line). ■

An Eye on Asia

Asia-Pacific is seen by many as a region primed for growth in local derivatives markets. Where do the opportunities lie? And what are the challenges of running a derivatives business in the region? *IQ: ISDA Quarterly* asked three leading market participants for their thoughts

THE PARTICIPANTS

John Feeney, head of pricing, fixed income, commodities and currencies, National Australia Bank (NAB)

Nitin Gulabani, global head of FX, rates and credit trading, Standard Chartered Bank

Jin Su, managing director, head of Asia-Pacific and currency trading, Bank of America Merrill Lynch (BAML)

IQ: Are you optimistic about the potential for growth of the Asian derivatives markets in 2015/2016?

John Feeney, NAB: Yes, I believe the derivatives markets globally will adjust to the new regulatory environment and present great opportunities in a range of Asian currencies. The current period of regulatory change has allowed more participants to enter derivatives markets. This, I believe, will benefit Asian markets in particular as the number and diversity of participants increases, creating more liquid and transparent markets.

Clearing of over-the-counter derivatives is a critical component of this expansion, as it removes the credit constraints for firms trading bilaterally. Likewise, reporting of trades will give greater transparency to markets and attract broader participation. Both of these changes should contribute to the growth of Asian derivatives markets.

Nitin Gulabani, Standard Chartered: Yes. After a slow down in the first half of 2014, we have seen double-digit growth and expect this trend to continue. Continued global policy divergences, especially US dollar-led developed markets versus emerging markets, will drive flows as clients hedge their risk in this increasingly volatility and uncertain environment. Longer term, we expect emerging-market asset allocation to grow in line with emerging-market

GDP growth. Globally, less than 5% of fund allocation is currently in emerging markets, providing a huge opportunity for growth.

> "The current period of regulatory change has allowed more participants to enter derivatives markets. This, I believe, will benefit Asian markets in particular as the number and diversity of participants increases"
> — *John Feeney, NAB*

Jin Su, BAML: Growth in 2015 will not be as strong as in previous years. From a macro perspective, investors want to have a clear picture over the US and China. There is also an adjustment period while the market gets used to the rules and liquidity with regards to central counterparties (CCPs). Medium term, we are very bullish as financial markets are a relatively smaller portion of Asia's GDP and should grow with the region.

IQ: Which countries present the biggest potential for growth?

John Feeney, NAB: China is the clear standout for derivatives growth. The underlying economics and growing use of CNH and CNY will inevitably lead to demand for derivatives linked to the currency. As more participants are attracted to Asian derivatives markets due to greater liquidity and transparency, China will be a major focus.

As well as China, the larger economies of north Asia have benefited from increasing exports over the past few years. I expect currencies associated with these countries will also see demand for additional derivatives products to provide longer-tenor hedging for end users.

Nitin Gulabani, Standard Chartered: Opportunities are abundant in Asia. For example, China's growth—although slowing—will still be 5%-plus over the next few years. As the economy continues its growth trajectory, there are unique opportunities to help globalising Chinese companies and multinational corporations in China. In addition, CNH growth will accelerate once the inclusion of the CNH in the special drawing rights basket is approved.

The other two big Asian countries are Indonesia and India, where political mandates were given to reformers as opposed to the status quo politicians, which should spur the next level of growth.

Jin Su, BAML: We expect China to have large growth potential within Asia's fixed income, currencies and commodities derivatives markets. According to BAML research, China currently has the third largest bond market in the world, and the Chinese government has accelerated reform of the financial industry and markets since 2014. According to the government's five-year plan, the financial industry will comprise 5% of total GDP growth by the end of 2015. Interest rate liberalisation reform will also be achieved and the CNY foreign-exchange-rate mechanism will be improved. In addition, the capital account will become more open and financial innovation will be encouraged.

Currently, use of structured loans and interest rate swaps to manage CNY liabilities is becoming more common. On the asset side, asset-linked structured deposits and other yield-enhancement products are being sought by wealth management companies and private banks in the current low interest rate environment. Furthermore, the Dim Sum and Formosa bond markets have been active. Issuers continue to use the US dollar/CNH derivatives market to manage their funding in CNY/CNH and to hedge their balance sheet risk.

As further progress is made in interest rate liberalisation and the opening of the capital account, end users will have a greater incentive to use CNY derivatives for risk management. Compared to China's economy and capital market size, the current derivatives market is still small. We expect China to experience significant growth in its derivatives market.

IQ: How do you expect the Asian derivatives markets evolve over the next five years?

John Feeney, NAB: The Asian markets will likely follow global trends for greater use of CCPs and increased transparency. The current and emerging local CCPs will continue to expand and offer a wider range of currencies and products for clearing. This will undoubtedly encourage greater liquidity as a wider range of participants are able to trade in currencies that were previously difficult to access.

> "Compared to China's economy and capital market size, the current derivatives market is still small. We expect China to experience significant growth in its derivatives market"
> — *Jin Su, BAML*

Nitin Gulabani, Standard Chartered: I see three broad themes affecting derivatives markets over the next five years. First, derivatives regulations such as the Dodd-Frank Act and European Market Infrastructure Regulation, and ultimately local Asian regulations, mean clients will increasingly require clearing services. We think the longer-term impact will be a market-share shift to the larger banks that offer both the infrastructure capability and the pricing matrix that clients want.

Secondly, as RMB grows and internationalises, clients will require a wider product offering to cover their increasing needs. We are already seeing this trend unfolding, and clients are increasingly interested in innovative RMB solutions.

Finally, we will see a continued shift towards electronic platforms as margins compress and transparency rises across Asia. These will become key as market players fight for market share.

Jin Su, BAML: China is expected to become an important growth centre in the Asian derivatives market over the next five years. CNY globalisation, the Asian Infrastructure Investment Bank and the 'one belt, one road' plan will increase the usage of CNY and encourage CNY-related hedging activity. We expect CNY-related FX derivatives to be used increasingly frequently in the coming five years. There is also increasing demand for leverage trades and carry in the current low interest rate environment. China asset-linked derivatives will become popular for investment and yield-enhancement needs. In addition, the State-owned Assets Supervision and Administration Commission of the State Council recently released regulation on derivatives trades for China state-owned enterprises (SOEs). We expect the hedging and investment needs from large SOEs to add substantial demand to the Asia derivatives market.

Meanwhile, north Asia will continue to grow as a destination to sell investment products. A combination of low yields and ageing demographics will force domestic insurance companies and pension funds to invest in yield-enhancement products. This should provide a boost to the derivatives market. The Formosa bond market and the Korean exotics market are good examples of local demand driving derivatives products and structured-note issuance.

> "One of the biggest challenges facing derivatives is navigating the myriad evolving regulatory requirements that are applied at different speeds, depending on your jurisdiction"
>
> *— Nitin Gulabani, Standard Chartered*

IQ: What are biggest challenges facing derivatives users in Asia?

John Feeney, NAB: The greatest challenge (and greatest advantage) for Asian derivatives markets is the inconsistency in regulation across the region. Different jurisdictions are adopting different approaches, at different times, to derivatives market regulation and infrastructure. More coordination would make the compliance impost on participants lower and encourage greater use of the emerging derivatives markets. Infrastructure such as CCPs to support derivatives markets will need to be created and supported across the region. Finally, access to markets and infrastructure will be a challenge to establish, as there will be global competition for resources and investment.

Nitin Gulabani, Standard Chartered: One of the biggest challenges facing derivatives is navigating the myriad evolving regulatory requirements that are applied at different speeds, depending on your jurisdiction. For instance, European Union and UK regulations, which Standard Chartered has to adhere to, may differ considerably from those being followed by our local and regional competitors in Asia. Regulatory requirements come under four broad themes: capital, market structure, margining and recovery/resolution.

Another challenge is that clients, especially in Asia, will have to learn to adjust to the increased cost of business, whether from capital or liquidity. This adjustment will be an evolving process for market suppliers and users.

Jin Su, BAML: Multiple legal and regulatory destinations is a challenge. Multiple small CCPs makes business expensive to execute. It is expensive from a collateral management point of view, as we cannot net across different CCPs. We need to maintain collateral at different CCPs, which will probably mean larger amounts of collateral. This will increase our operational, compliance and funding costs. From a risk point of view, it bifurcates liquidity: swaps are no longer fungible if they are cleared on different CCP platforms. A good example of this is a recent blowout in the CME Group-LCH. Clearnet US dollar swaps basis: 2 basis points over 10 years! The market has become more segmented and liquidity is no longer fungible in the new world. People are now starting to mark different risk curves for this.

To solve this, we need global harmonisation of CCP recovery and resolution rules, as well as similar approaches to margin requirements. Perhaps there is a need for a 'super CCP', but this will be difficult to resolve given each country's interest in protecting and regulating its own market. ■

ISDA MISSION STATEMENT

ISDA fosters safe and efficient derivatives markets to facilitate effective risk management for all users of derivative products. ISDA achieves its mission by representing all market participants globally, promoting high standards of commercial conduct and leading industry action on derivatives issues. This includes being:

The source for robust and trusted documentation

Providing standardised documentation globally to ensure legal certainty and maximum risk reduction through netting and collateralisation

An advocate for effective risk management and clearing

Enhancing counterparty and market risk practices and advancing the effective use of central clearing facilities and trade repositories

The architect of a secure and efficient infrastructure

Promoting infrastructure that supports an orderly and reliable market-place, as well as transparency to regulators

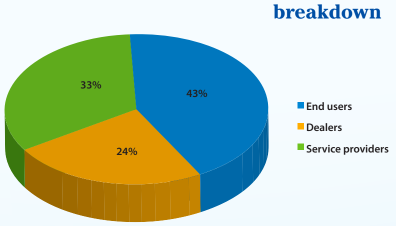
The voice for the global derivatives market-place

Representing the derivatives industry through public policy, ISDA governance, ISDA services, education and communication

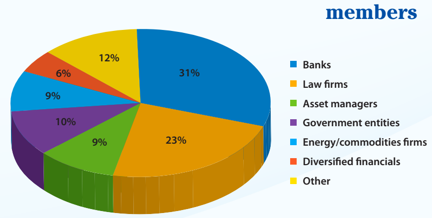
MEMBERSHIP

ISDA has over 800 member institutions from 67 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. Members also include key components of the derivatives market infrastructure, such as exchanges, clearing houses and repositories, as well as law firms, accounting firms and other service providers.

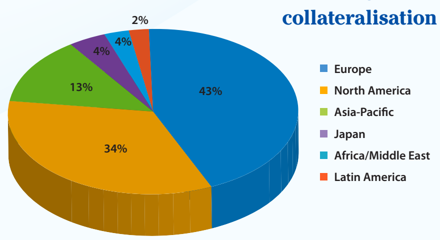
Membership breakdown



Types of members



Geographic collateralisation



Additional information regarding ISDA's member types and benefits, as well as a complete ISDA membership list, is available on the Association's website: http://www2.isda.org/membership/

OFFICE LOCATIONS

NEW YORK
360 Madison Avenue
16th Floor
New York, NY 10017
Phone: 212 901 6000
Fax: 212 901 6001
isda@isda.org

WASHINGTON
1101 Pennsylvania Avenue
Suite 600
Washington, DC 20004
Phone: 202 756 2980
Fax: 202 756 0271
isda@isda.org

LONDON
One Bishops Square
London E1 6AD
United Kingdom
Phone: 44 (0) 20 3088 3550
Fax: 44 (0) 20 3088 3555
isdaeurope@isda.org

BRUSSELS
ISDA c/o NCI Park Leopold
Business Centre
4th Floor
38/40 Square de Meeûs
Brussels 1000
Phone: 32 (0) 2 401 8758
Fax : 32 (0) 2 401 8762
isdaeurope@isda.org

HONG KONG
Suite 1502 Wheelock House
20 Pedder Street
Central, Hong Kong
Phone: 852 2200 5900
Fax: 852 2840 0105
isdaap@isda.org

SINGAPORE
Marina Bay Financial Centre
Tower 1, Level 11
8 Marina Boulevard
Singapore, 018981
Phone: 65 6653 4170
isdaap@isda.org

TOKYO
Otemachi Nomura Building
21st Floor
2-1-1 Otemachi
Chiyoda-ku, Tokyo 100-0004
Phone: 813 5200 3301
Fax: 813 5200 3302
isdajp@isda.org

BOARD OF DIRECTORS

OFFICERS

Eric Litvack, Chairman
Managing Director, Head of Regulatory Strategy
Société Générale Global Banking and Investor Solutions

Richard Prager, Vice Chairman
Managing Director and Global Head of Trading and Liquidity Strategies
BlackRock

Keith Bailey, Secretary
Managing Director, Market Structure
Barclays

Diane Genova, Treasurer
General Counsel, Corporate and Regulatory Law
J.P. Morgan Chase & Co.

DIRECTORS

Yasunobu Arima
General Manager, Global Markets Planning Division
The Bank of Tokyo-Mitsubishi UFJ, Ltd.

Biswarup Chatterjee
Global Head Electronic Trading and New Business Development, Credit Markets
Citigroup Global Markets

Bill De Leon
Managing Director, Global Head of Portfolio Risk Management
PIMCO

Elie El Hayek
Managing Director, Global Head of Rates, Credit and Emerging Markets
HSBC Bank Plc.

Nitin Gulabani
Global Head of FX, Rates and Credit Trading
Standard Chartered Bank

Jonathan Hall
Advisory Director
Goldman, Sachs & Co.

George Handjinicolaou
Deputy Chief Executive Officer
ISDA

Kieran Higgins
Head of Trading, Corporate & Institutional Banking
The Royal Bank of Scotland Plc.

Jonathan Hunter
Global Head of Fixed Income and Currencies
RBC Capital Markets

TJ Lim
Global Head of Markets
UniCredit

Ted MacDonald
Managing Director, D. E. Shaw & Co.
L.P. Chief Risk Officer
D.E. Shaw Group

Christopher Murphy
Global Co-Head of FX, Rates & Credit
UBS Investment Bank

Ciaran O'Flynn
Managing Director, Global Co-Head of Fixed Income Electronic Trading
Morgan Stanley

Scott O'Malia
Chief Executive Officer
ISDA

Emmanuel Ramambason
Head of Global Market xVA Trading
BNP Paribas

Will Roberts
Head of Global Rates, Structured Credit Trading and Counterparty Portfolio Management
Bank of America Merrill Lynch

Koji Sakurai
Senior Vice President, Head of Business Planning Team, Derivative Products Division
Mizuho Bank, Ltd.

Eraj Shirvani
Head of Fixed Income for EMEA and Global Head of Emerging Markets for Investment Banking
Credit Suisse Group AG

Sam Skerry
Global Head of Structured Products & Commercial Support
BP Plc.

Emmanuel Vercoustre
Deputy CEO & CFO
AXA Bank Europe

ISDA EXECUTIVES

OFFICE OF THE CEO

Scott O'Malia
Chief Executive Officer

George Handjinicolaou
Deputy Chief Executive Officer and Head of Europe, Middle East and Africa

Mary Cunningham
Chief Operating Officer

Steven Kennedy
Global Head of Public Policy

David Geen
General Counsel

SENIOR STAFF

Katherine Tew Darras
General Counsel, Americas

Huzefa Deesawala
Chief Financial Officer

Corrinne Greasley
Chief Human Resource Officer

Dillon Miller
Chief Technology Officer

Clive Ansell
Head of Infrastructure Management

Roger Cogan
Head of European Public Policy

Audrey Costabile Blater, PhD
Director of Research

Karel Engelen
Co-head of Data, Reporting and FpML

Tara Kruse
Co-head of Data, Reporting and FpML

Mark Gheerbrant
Head of Risk and Capital

Marisa Irurre Bauer
Head of Conferences

Mary Johannes
Senior Director and Head of ISDA WGMR Initiative

Tomoko Morita
Senior Director and Head of Tokyo Office

Keith Noyes
Regional Director, Asia-Pacific

Nick Sawyer
Head of Communications

Liz Zazzera
Head of Membership

ISDA CONFERENCES

Education has been part of ISDA's mission since the Association's inception. With now over 150 conferences, seminars, training courses and symposia held each year, ISDA's highly qualified instructors continue to educate members and non-members globally on topics including: legal and documentation, clearing, collateral, data and reporting, risk management, regulation and other related issues. Conferences in 2015 have focused on margin rules for non-cleared swaps, the ISDA Resolution Stay Protocol, regulatory developments for the buy side, and the commodity derivatives markets.

An additional bonus in most of these courses is the availability of continuing education credits. ISDA's educational efforts have been accredited by the New York Continuing Legal Education Board, the National Association of State Boards of Accountancy (NASBA) and other regional continuing educational organisations.

In addition to ISDA's regular courses, the Association also offers regional updates during the third and fourth quarters in New York, London, Sydney, Hong Kong or Singapore (these rotate every year) and Tokyo. These one-day conferences are intended to inform both members and non-members, regulators and the press of ISDA's regional work.

The ISDA Annual General Meeting (AGM) is ISDA's premier, members-only event. Every year, the ISDA AGM takes place in different financial centres around the world, rotating among the major economically developed countries. ISDA's 30th AGM took place on April 21-23, 2015 in Montreal, and featured a discussion on cross-border harmonisation by leading regulators and legislators.

The current conference schedule is posted on the ISDA website at www2.isda.org/conference. For additional updates on ISDA's conferences, please follow us on Twitter at @ISDAConferences.

@ISDAConferences

UPCOMING ISDA 2015 CONFERENCES AND EVENTS

- September 17, 2015: Annual North America Conference, New York
- September 22, 2015: Annual Europe Conference, London
- October 22, 2015: Annual Australia Conference, Sydney
- October 26, 2015: Annual Asia-Pacific Conference, Hong Kong
- October 29, 2015: Annual Japan Conference, Tokyo

Additional information regarding the 2015 ISDA Regional Conferences is available on the ISDA website at http://reg.isda.org.

UPCOMING CONFERENCE TOPICS

- The New Regulatory Environment for Commodity Derivatives Markets
- Fundamentals of OTC Derivative Operations and Trade Processing
- Global Reporting Requirements
- ISDA Resolution Stay Protocol
- Liquidity: Trading in the New OTC Market
- Overview of the Capital Regulations
- FpML Training Courses
- Clearing: Legal Basics
- Fundamentals of Derivatives
- Understanding the ISDA Master Agreement
- Understanding Collateral Arrangements
- Understanding Tax Related Provisions of the ISDA Master Agreement Including current updates to 871(m) & FATCA
- Derivatives Products Overview
- Fundamentals of OTC Derivatives Clearing
- Ethical Issues Confronting Lawyers in the Financial Services Industry in 2015
- ISDA Master Agreement and Credit Support Annex: Negotiation Strategies
- Current Issues in the Derivatives Landscape
- Recovery Resolution Directive

ADVERTISERS