

Methodology for Regulatory Comparisons

Inter-jurisdictional recognition of derivatives regulation through a Principles-Based Substituted Compliance Methodology¹

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This paper sets forth ISDA's views regarding a conceptual framework and substantive processes for inter-jurisdictional recognition of derivatives regulation through a principles-based substituted compliance methodology. Our framework prioritizes achievement of the G-20 goals for OTC derivatives.

- *The five G-20 consensus goals reflect the principal shared concerns emerging from the financial crisis; they are the basis of derivatives regulatory reform and the basis of commonality among separate jurisdictions' regulatory regimes.*
- *The five G-20 goals should be met through regional or national efforts of sufficient consistency to avoid fragmenting global markets. The G-20 spoke expressly on this point.*
- *In order to minimize burdens on regulators and markets, and to maintain global markets, regional and national regulators must recognize each other's efforts in order to avoid market fragmentation; each must evaluate the other's regimes to allow for substituted compliance.*
- *Comparisons allowing one jurisdiction to accept satisfaction of another jurisdiction's requirements as satisfaction in whole or substantial part of its own requirements may be approached through a variety of analytical methods (e.g., regime recognition, outcome comparability, etc.) that are chiefly distinguishable by scale or degree of granularity. All methods, however, require a comparative evaluation by one jurisdiction of regulation in another.*
- *All comparisons must start with identification of a set of commonly-held principles ("common principles") that elaborate upon and give substance to the G-20 regulatory*

¹ Various terms are in use to denote the process by which a regulator may recognize compliance with another jurisdiction's regulations as being equivalent to, or substitutable for, compliance with that regulator's own regulations. These include "substituted compliance", "mutual recognition" and "equivalence". We regard these as broadly similar concepts for purposes of this discussion and, for simplicity and convenience, use the single term "substituted compliance".

goals. These common principles would articulate means of achieving the five G-20 goals and provide common implementation standards. All comparisons should evaluate regulatory regimes against these common principles, rather than requiring identity or element-by-element correspondence of rules. International development of these common principles and of substituted compliance methodology is a first and necessary step towards the bilateral jurisdictional review that will determine the extent of satisfactory comparison between any two jurisdictions.

- *Ultimate decisions regarding comparability require not only bilateral dialogue between regulators but also a transparent process in which the views of market participants can be elicited and taken into account.*
- *Regulators should consult and cooperate with each other before implementing their derivatives regulations; unilateral early implementation will appear pre-emptive and discourage needed cooperation.²*

I. Principles-based approach, with G-20 commitments as its source

The declaration issued by the G-20, following the September 2009 Pittsburgh meeting,³ is the recognized source of the primary goals of derivatives regulation that became embodied in the Dodd-Frank Act, EMIR and similar legislation elsewhere. The five primary G-20 goals address principal concerns stemming from the financial crisis, and offer a path for significantly reducing systemic risk, while allowing a robust, liquid OTC market that can continue to meet the needs of national economies and businesses. It is vitally important to observe that the G-20 at its Pittsburgh and Cannes summits set only five goals with respect to derivatives regulation: clearing of standardized derivatives; exchange/electronic trading, where appropriate; reporting to trade repositories; higher capital requirements for uncleared trades; and margin requirements for uncleared trades.⁴ These five goals are the appropriate starting points for elaborating common principles that will support an appropriate international comparative mechanism.

Underlying the simply-stated G-20 goals was the understanding that these goals could be implemented in a complementary manner across multiple jurisdictions. Regulators and the market are now engaged in discussion of how separate jurisdictions can recognize each other's

² We take note of the "Path Forward" announced by the European Commission ("EC") and the US Commodity Futures Trading Commission ("CFTC") (available at http://europa.eu/rapid/press-release_MEMO-13-682_en.htm). We welcome the EC and CFTC recognition of the international nature of the derivatives markets and the need for cross-border regulatory cooperation. The nature and scope of CFTC substituted compliance and EC "equivalence" decisions, and the means of giving effect to such decisions is unclear. We remain concerned that the "Path Forward" blurs the distinction between G-20 and ancillary goals, placing a heavy burden on substituted compliance/equivalence analyses. Issues of timing remain.

³ See Pittsburgh Summit Declaration, articulating four goals, available at <http://www.g20.org/documents/> (the "Leaders' Statement"). Margin requirements for uncleared derivatives were endorsed at the G-20 Cannes meeting in November 2011. See Cannes Summit Final Declaration at ¶ 24, available at <http://www.g20.org/documents/>. ("Cannes Declaration")

⁴ See Leaders' Statement at ¶ 13; Cannes Declaration

implementation efforts and give effect to that understanding of complementary regulation. Among the approaches discussed are “regime recognition” and “outcome comparability.” Regardless of approach, a system (which we will call “substituted compliance”) is required that will enable market participants to meet the requirements of several jurisdictions by compliance with the requirements of another jurisdiction. Moreover, the system must be sufficiently robust to give national regulators comfort that international participation in their home markets, as well as the activities of domestic institutions abroad, do not jeopardize their regulatory missions.

In matters as complex and sweeping as new regulation of a substantial global market, a principles-based approach to cross-border compliance is a necessity. The G-20 commitments were to certain broad regulatory goals, not to global adoption of any one jurisdiction’s legislative and regulatory program. In the same Leader’s Statement in which it set derivatives regulatory goals, the G-20 stated its mission as implementing “global standards in a way that ensures a level playing field and avoids fragmentation of markets, protectionism, and regulatory arbitrage....”⁵ This emphasis on the global perspective should be maintained in standards for substituted compliance. The value of the derivatives market in any jurisdiction is reflective of the fact that the derivatives market is global. Walled-off national derivatives markets will not enhance national economies to the same extent as will access in each nation to the global market. The G-20 goals are intended to diminish systemic risk without diminishing the effectiveness of the global market. This is consistent with widespread recognition of the fact that conflicting regulation places unsustainable burdens on regulators and markets.⁶

It is possible that in meeting the G-20 goals, a jurisdiction may choose to establish ancillary mechanisms and goals. Local law concerns also may emerge. For instance, a jurisdiction may determine that certain market intermediaries should be licensed and regulated. It is vital that the distinction between the five G-20 goals and these ancillary mechanisms be maintained. A jurisdiction’s satisfaction of its ancillary concerns should not become a barrier to an effective cross-border compliance regime attaching to the G-20 goals. Efficient and fair cross-border compliance will require correct prioritization of the G-20 consensus goals over ancillary goals and local law concerns, without unduly slighting ancillary goals or those concerns. We acknowledge this to be a meaningful challenge.

While the G-20 commitments for the reform of derivatives markets are globally shared, supervisory practices vary significantly between jurisdictions. Supervisory practices established in one jurisdiction will be adapted to the facts of that jurisdiction. This lack of commonality should not be assumed to be a defect in supervisory standards; although the techniques may differ, the objectives are broadly identical. Legislative harmonization is alluring, but not without risks; via cooperation based on comparative assessment regulators can ensure that policies increase the overall efficiency and effectiveness of supervision, to the benefit of consumers and supervisors alike. Standards of comparability, however, should not be used as a tool to export regulations from one jurisdiction to another.

⁵ Leaders’ Statement ¶ 12.

⁶ Transatlantic Coalition on Financial Regulation, “IOSCO: Facilitating Mutual Regulation and Substituted Compliance,” 2-3 (2012), available at <http://www2.isda.org/...=IOSCO%20paper%20-%20FINAL>.

Some have criticized a principles-based approach as inadequately detailed to be responsive to specific national interests. We think a principles-based approach allows for the establishment of an appropriate lens through which national differences may be viewed and understood, and, hence, reconciled consistently with the national interest.

II. Substituted Compliance Methodology

A comparative evaluation of another jurisdiction's regulatory scheme is inherently at the heart of any substituted compliance mechanism. ISDA submits that a comparison must start by identifying a set of common principles that elaborate on the G-20 regulatory goals. These principles should be framed at an appropriate level of generality so as not to be tethered to jurisdiction-specific institutional features of legal systems and markets. A comparison should evaluate the subject regime guided by this set of principles. The ultimate substituted compliance inquiry should be whether the subject set of regulations is reasonably designed to achieve the goals articulated in the principles and is likely to be effective.

A key question is the degree of granularity at which the common principles themselves are framed.

Under one view of a regime-based approach, comparability would exist if a jurisdiction has implemented sufficient regulations or mandates to meet each of the elements of the G-20 commitments. The general characterization of sufficiency should be one developed communally and cooperatively as described in Section IV below. In order to mitigate the harshness of potential all-or-nothing outcomes flowing from a regime-based approach, such an approach should preserve the regulator's flexibility to permit substituted compliance conditioned on the application of a limited number of the regulator's own regulations to offset any perceived material gaps in the other regime.

Alternatively, a comparison could examine broad, functional groupings of rules that underlie most jurisdictions' responses to the G-20 goals. This approach would allow for granularity in comparison, but that granularity would remain subservient to satisfaction of G-20 goals. It may be helpful, for example, to classify derivatives rules by the categories of affected market participants or activities, to isolate the goals of each rule category, and to evaluate any rule inconsistencies in light of these goals. Such an approach might lead to the following categories:

- 1) Transactional rules that apply to market participants generally – clearing, reporting, trade execution.
- 2) Market infrastructure – clearing organizations, exchanges and other trading facilities, and trade repositories.
- 3) Derivatives market intermediaries – licensing, capital, internal governance, business conduct.

This type of framework can provide concrete guidance to the determining regulators and therefore may allow for greater objectivity and transparency in the determination process.

In developing either approach, selected reports and standards of international groups, such as the Financial Stability Board and IOSCO, can serve as sources for common principles. Recognizing that some standards may be aspirational and not every recommendation will have been uniformly adopted, these publications nonetheless have value for this purpose because they have been worked out in an international forum, are informed by the regulatory experiences of member jurisdictions, and of necessity are framed in a common language. Examples of such sources are the recommendations contained in the FSB's October 2010 report⁷ and the IOSCO reports on principles of financial markets infrastructure, international standards for derivatives market intermediary regulation,⁸ and on data reporting and aggregate requirements.⁹ Common principles, however, must not reproduce the details of these reports. Common principles should establish broad themes that allow for some degree of nation-by-nation variation.

Common principles for recognition of CCPs, for example, must establish general requirements of adequacy in topics as diverse as risk management, governance and financial resources. Reporting core principles would need to provide generalized, thematic treatment of terms to be reported, transaction and transactor identification, reportable events and more. In each case this must be done in a way that recognizes reasonable national diversity.

III. Dangers of reciprocity/protectionism

Substituted compliance determinations must not become opportunities for trade negotiations, in which tit-for-tat concessions are sought as conditions for finding comparability. Although regulators should strive to give maximum effect to principles of comity, they must recognize that their peers may be constrained by legislative enactments, and there may be circumstances in which a one-way finding of comparability may be entirely appropriate. Market fragmentation is likely to occur if reciprocity considerations are not held in check. Conversely, majority success in achieving reciprocal substituted compliance determinations should, simply as a competitive matter, stimulate greater efforts by those reluctant to adopt substituted compliance methodology.

IV. Process – multilateral development of methodology; bilateral determinations - with transparency

International coordination among regulators in the development of a common methodology for substituted compliance can yield important benefits. A multilateral consultation process on substituted compliance, such as the one undertaken by the OTC Derivatives Regulators Group must be encouraged. Such a process is informed by detailed knowledge of the range of approaches taken by various jurisdictions, and should lead to a workable assessment methodology based on shared values to a greater extent and benefit than one based on one-on-one comparison. Furthermore, consultation while regulatory implementation is still ongoing should foster a harmonized approach to implementation.

ISDA, however, submits that ultimate decisions regarding comparability require bilateral dialogue between regulators and a transparent process in which the views of market participants can be elicited and taken into account. Actual bilateral substituted compliance determinations

⁷ Available at http://www.financialstabilityboard.org/publications/r_101025.pdf

⁸ Available at <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD381.pdf>

⁹ Available at <http://www.bis.org/publ/cpss100.pdf>

using this assessment methodology would be made in response to applications by either regulators or market participants, individually or in groups. In either case, both regulators and market participants should be involved. Regulatory authorities would be viewed by other regulators as the best source of information regarding regulatory frameworks and manner of supervision, and their involvement would be needed in any event in order to agree upon a framework for supervisory and enforcement cooperation. The views of market participants, and their greater knowledge of operational practicalities, must be tapped as well, so that the effectiveness of the global market is well-served.

V. Timing Issues

The G-20 leaders established a time line for achieving the G-20 goals that, for good reason, has not been met.¹⁰ The regulatory re-engineering of a complex international market cannot be achieved overnight. Different jurisdictions are bound to need different periods of time to achieve common goals. Recognizing this, jurisdictions that complete regulatory schemes before other jurisdictions do so should be willing to offer their work as demonstrative of what can be done. They should not, however, move hastily or preemptively to impose their regulatory template on other jurisdictions. The last global financial crisis was exactly that, global. Global cooperation in regulatory structuring and implementation timing should be the hallmarks of the fulfillment of the G-20 process.

In its introduction to its report on “Objectives and Principles of Securities Regulation”, IOSCO states: “an increasingly global marketplace also brings with it the increasing interdependence of regulators. There must be strong links between regulators and a capacity to give effect to those links. Regulators must also have confidence in one another. The development of these linkages and this confidence will be assisted by the development of a common set of guiding principles and shared regulatory objectives.” This message is strikingly apposite to international regulation of derivatives markets.

¹⁰ See, e.g., the five progress reports of the Financial Stability Board, available at <http://www.financialstabilityboard.org>.