ISDA® Safe, Efficient Markets

May 29, 2014

Mr. Ashley Alder
Chair, IOSCO Task Force on Cross-Border Regulation
Chief Executive Officer, Hong Kong Securities and Futures Commission

Mrs. Anne Héritier Lachat
Vice-Chair, IOSCO Task Force on Cross-Border Regulation
Chair, FINMA

Re: IOSCO Task Force on Cross-Border Regulation invitation for industry submissions

Dear Mr. Alder and Mrs. Héritier Lachat,

The International Swaps and Derivatives Association, Inc. (ISDA) [1] appreciates the International Organization of Securities Commissions (IOSCO) Task Force on Cross-Border Regulation's engagement with the industry at meetings in Hong Kong on April 7, London on April 25 and Washington, DC on April 28, 2014. Further to discussions during those meetings, ISDA wishes to comment on a number of specific issues, and highlight how over-the-counter (OTC) derivatives markets have been affected by a lack of effective cross-border regulatory harmonization. OTC derivatives markets have historically been the most global in nature of all financial markets, and the absence of consistency in regulatory reform is having a direct impact on these markets as a result. This also affects other product areas and, more importantly, threatens the efficiency with which 'real economy' end-users can manage and transfer business risk to financial markets.

In this letter, ISDA addresses the subject of how cross-border regulatory harmonization could be achieved, and suggests ways in which IOSCO can reduce undesirable regulatory outcomes that threaten the efficient functioning of markets.

1. Managing cross-border regulatory conflict – IOSCO role

IOSCO is one of a number of international organizations that have the ability to influence cross-border regulatory coordination. The Basel Committee on Banking Supervision (BCBS) has a significant role in many areas, as does the Financial Stability Board (FSB).

[1] Since 1985, ISDA has worked to make the global OTC derivatives markets safer and more efficient. Today, ISDA has over 800 member institutions from 64 countries. These members include a broad range of OTC derivatives market participants including corporations, investment managers, government and supranational entities, insurance companies, energy and commodities firms, and international and regional banks. In addition to market participants, members also include key components of the derivatives market infrastructure including exchanges, clearinghouses and repositories, as well as law firms, accounting firms and other service providers. Information about ISDA and its activities is available on the Association's web site: www.isda.org.

Notwithstanding this, ISDA believes the IOSCO task force can realistically propose improvements in the way its members coordinate activities that have cross-border implications, as well as the future role of IOSCO in the international regulatory community.

Many of the current cross-border challenges exist due to the fact that there is an inherent focus on domestic markets at the IOSCO member level. National securities regulators are generally explicitly required to consider the impact of their conduct (including rule-making, supervision and enforcement) on their domestic market as a priority, rather than consider any effect outside their jurisdiction. Further, securities regulators may face constraints in fully implementing IOSCO standards or recommendations, particularly in the realm of rule-making.

This domestic focus explains some of the challenges IOSCO and its members have faced in implementing the Group of 20 (G-20) commitments in a way that avoids fragmentation of markets, protectionism and regulatory arbitrage between different jurisdictions[2]. Smooth global implementation of the G-20 commitments has been further impeded by insufficient cooperation and coordination among securities regulators.

In section 2, we set out a number of proposed principles that we believe IOSCO and its members could adopt to promote cross-border regulatory coordination. The principles focus on coordination on the development and implementation of IOSCO standards that may have a cross-border impact, not on cross-border supervisory coordination.

2. ISDA principles for inter-jurisdictional recognition of derivatives regulation

ISDA supports adherence to the following principles, as regulators address the causes of and solutions for harmful extraterritorial regulation.

1) **An effective framework should be grounded in the declarations issued by the G-20 following the Pittsburgh and Cannes meetings.**

   The five G-20 goals are the basis of derivatives regulatory reform and should be met through regional or national efforts to achieve consistency and avoid fragmentation of global markets. These goals include: clearing of standardized derivatives; exchange/electronic trading, where appropriate; reporting to trade repositories; higher capital requirements for non-cleared trades; and margin requirements for non-cleared trades.

2) **In order to minimize burdens on regulators, maintain global markets and avoid market fragmentation, regulators at international, regional and national level should evaluate individual regimes to allow for a principles-based approach to cross-border compliance.**

3) **For purposes of substituted compliance or equivalence, comparisons of one jurisdiction's requirements to another's may use a variety of analytical methods, all of which must start with identification of a set of common principles that elaborate on the G-20 regulatory goals.**

[2] http://www.mea.gov.in/Images/pdf/pittsburgh.pdf.

4) **Ultimate decisions regarding comparability require not only a bilateral dialogue between regulators, but also a transparent process.**

5) **Regulators should consult and cooperate with each other before implementing their derivatives regulations.**

ISDA believes that IOSCO can play a vital role in facilitating bilateral or multilateral inter-jurisdictional recognition efforts, which will greatly help markets to progress to a consistent international framework that avoids duplication or jurisdictional over-reach.

ISDA has (in August 2013) published examples of how these principles can apply to various areas within derivatives regulation. These examples have been developed and organized in relation to three of the five primary goals of derivatives regulation issued by the G-20[3].

3. Specific areas of conflicting regulation and impact

1) Clearing

The extraterritorial impact of US and European regulations on clearing is among the most problematic areas that needs to be addressed.

a) US rules

- The US requires foreign central counterparties (CCPs) to either register as derivatives clearing organizations (DCOs) or obtain Commodity Futures Trading Commission (CFTC) exemption from registration before clearing trades for US persons[4]. Because registration gives the CFTC direct regulatory oversight of the DCO, many overseas regulators will not allow their domestic CCPs to register. (To date in Asia, for example, only SGX in Singapore has successfully registered, and the Japan Securities Clearing Corporation and OTC Clear (HK) have been granted no-action relief from the CFTC clearing requirement.) As a practical matter, this means US banks will not be able to join non-registered or non-exempt CCPs as clearing members, and US persons will not be able to clear as clients at CCPs not registered as DCOs. US banks have a large market share in Asian markets, in particular, so the impact will be significant.

b) European rules

- Article 25 of the European Market Infrastructure Regulation (EMIR)[5] is even broader in scope than the US rules, as it applies to all clearing services – not only OTC derivatives clearing. Going forward, European bank branches will not be able to act as clearing members at any CCP that has not applied for and received recognition from the European Securities and Markets Authority (ESMA). ESMA's recognition criteria are

[3] Please see the links below, to access these examples, as well as a more detailed methodology for regulatory comparisons:
http://www2.isda.org/attachment/NTgwOA==/Common%20Principles%20-%20Examples%2020130820.pdf
http://www2.isda.org/attachment/NTgwNw==/Methodology%20for%20Regulatory%20Comparisons%2020130820.pdf

[4] Section 5b, Commodities Exchange Act

[5] Regulation (EU) No 648/2012 of the European Parliament and of the Council of July 4, 2012 on OTC derivatives, central counterparties and trade repositories.

also different from the Principles on Financial Market Infrastructures (PFMIs)[6], published by IOSCO and the Committee on Payment and Settlement Systems (CPSS) in 2012 – although, to some extent, this can be attributed to a lack of granularity in the CPSS-IOSCO principles.

- Asian regulators and CCPs, in particular, have expressed frustration with the European CCP registration process and the way the equivalence assessments are being conducted. Under this process, Asian regulators would need to sign a regulatory cooperation memorandum of understanding (MOU) with ESMA as a precondition for registration[7]. However, more than six months after the September 15, 2013 application deadline, ISDA is not aware of any MOU draft having been provided by ESMA for consideration.

- The process for Equivalence Decisions has proved a lengthy one. Equivalence assessments for the US and Japan have not yet been completed, and there are concerns that the US will not be found equivalent, with the ESMA assessment focusing on differences in the liquidation period for the calculation of customer margin to protect against default[8]. This is suggestive of a detailed equivalence-based approach rather than an outcomes-based methodology. Equivalence Decisions – should they be viewed as justified[9] – for Hong Kong, Singapore, Australia, South Korea and India will not be completed until after US and Japan assessments are completed (i.e. the third quarter of 2014 at the earliest). However, mandatory clearing is due to begin in South Korea on June 30. Absent a clear signal as to whether relevant Korean CCPs are equivalent, European bank branches cannot in confidence join as clearing members. Joining relevant Korean CCPs and then having to resign clearing memberships would mean European clearing members face potentially large losses unwinding cleared positions in a market that knows that these unwinds must take place.

- European banks have significant market share in a number of Asian clearing houses, and market impact would be significant if these banks had to withdraw from them due to regulatory conflict. A July 2013 ISDA survey found European banks make up an estimated 36-40% market share in Korean won interest rate swaps (IRS), 30-34% in Chinese renminbi IRS, 41-52% in Indian rupee IRS, 29-38% in Indian rupee forwards and 17-23% in the Indian government bond market.

- Subsidiaries of European banks may join clearing houses that are not recognized by ESMA, but must treat them as non-qualified CCPs. This is because the European Union (EU) rules under Article 497 of the fourth Capital Requirements Directive (CRD IV) refer back to Article 25 of EMIR for the determination of QCCP status rather than following the Basel III QCCP rule, which is based on the PFMI standards. This deviation from internationally agreed principles (even if necessitated by EU treaty law) inevitably creates difficulties. The difference in risk weights to determine capital requirements for exposures to default fund contributions to QCCPs and non-QCCPs is very significant – roughly 20% versus 1,250%.

[6] CPSS-IOSCO Principles for Financial Market Infrastructures, April 2012

[7] EMIR Art 25.2 (c) and 25.7.

[8] European Commission Delegated Regulation No. 153/2013 of 19 December 2012 supplementing Regulation (EU) No 648/2012 of the European Parliament and of the Council with regard to regulatory technical standards on requirements for central counterparties, Article 26.

[9] We understand that only ‘positive’ Equivalence Decisions will be taken – if it is not deemed appropriate to view a jurisdiction as equivalent for the purpose of a particular regulatory requirement, no Decision will be taken.

An extension of the CRD IV implementation deadline from June to December 2014 would allow further time for equivalence assessments to be completed. The European Commission (EC) is aware of the issue, and ISDA understands it may now be ready to adopt legislation facilitating this extension. However, there are concerns that the assessments may not be completed by December given the current pace of progress. The industry understands it will be more difficult for the EC to extend the implementation date beyond December given constraints within the legislation.

c) Other jurisdictions

- Besides the challenge for CCPs to achieve US/European recognition as defined in laws that are difficult to change, the issue of mutual recognition in the rest of the world needs to be addressed. For example, there is currently no mechanism for different Asian jurisdictions to recognize each others' adherence to the PFMI standards, and bilateral recognition processes could lead to more fragmentation. This suggests a possible role for IOSCO in CCP accreditation.

- IOSCO CCP accreditation would also address the concern that some home-country regulators may declare their domestic clearing houses are QCCPs, despite the possibility that foreign regulators disagree with this assessment and insist on non-QCCP status. This would create an unlevel playing field, as local and foreign banks would apply different risk weights to the same CCP. The informed assessment of a CCP's adherence to the PFMI standards by an independent third party, such as an IOSCO college of regulators, may have potential as a means of addressing this problem.

- Japanese banks active in other Asian markets may also face the problem of CCP recognition by their home regulator. For non-yen-denominated interest rate swaps, the Japan Financial Services Agency has allowed Japanese banks to join London-based clearing house LCH.Clearnet as clients until the end of 2014. But it has given no indication of whether it would allow Japanese banks to participate as clearing members in South Korea's KRX or Shanghai Clearing House, for example.

d) Client clearing

- One consequence of all of the various restrictions to joining a third-country CCP as a clearing member is likely to be increased demand for client clearing. However, there are regulatory impediments to client clearing, such as the statutory requirement under the US Commodities Exchange Act that any entity clearing on behalf of a swaps customer must be a registered futures commission merchant, and the statutory requirements for the protection of customers in bankruptcy. There are also concerns that OTC client clearing may not generate sufficient revenue to attract a large number of market participants to offer this service – as appears likely in some of the Asian CCPs. The result could well be that only a handful of clearing members offer client clearing services.

2) Trade reporting

- Trade reporting was a key regulatory objective to come out of the September 2009 Pittsburgh G-20 Summit. With accurate market data, regulators would be better positioned to see where risk concentrations exist.

- Implementation of the G-20 trade reporting commitment across jurisdictions has, however, lacked the necessary coordination to fully achieve this goal. The result is a disjointed and costly network of reporting obligations, with market participants reporting to a multiplicity of trade repositories on different bases. As a result, despite having access to more information than ever before, regulators may lack a completely consolidated view of the true risk picture, and they currently have no means of aggregating data.

- For example, single-sided reporting is required for OTC derivatives in the US [10]. Europe requires double-sided reporting of OTC and exchange-traded derivatives[11], as well as collateral reporting[12]. The differences between the US and European reporting requirements mean that separate systems need to be built to meet each reporting requirement. This is costly and duplicative.

- In both EU and US rules, counterparties subject to reporting requirements are required to report counterparty information, which often conflicts with rules restricting reporting of such information in other jurisdictions. The potential incompatibility of new derivatives reporting requirements has been highlighted to regulators at global level prior to drafting and enactment of EU and US reporting rules. However, ESMA officials have stated that failure to provide counterparty information in mandatory reports – even for reason of conflicting rules in non-EU jurisdictions – represents non-compliance with EMIR. Similar considerations apply under US rules. It should be noted that the CFTC has granted time-limited relief[13] from reporting (until June 30, 2014) to counterparties, subject to provision of certain information regarding applicable local restrictions to the CFTC, but there is no guarantee this relief will be extended. These conditions can discourage cross-border business and drive fragmentation of a previously global market.

- In the meantime, Hong Kong, Singapore, Australia, Malaysia, Taiwan, China, India and South Korea have all been developing their own reporting regimes. There are differences in reporting nexus, reporting fields, reportable products and other elements in each jurisdiction, and this only makes it more challenging to build an efficient data capture system. Taiwan even requires reporting via CSV files while most of the rest of the world uses Financial products Markup Language (FpML).

[10] Part 45, Dodd-Frank Wall Street Reform and Consumer Protection Act
[11] EMIR Regulation, Article 9
[12] EMIR delegated regulation (ESMA regulatory technical standard) n°148/2013, article 3 and annex I for application of EMIR regulation article 9.5.
[13] CFTC Letter No. 13-34 of June 26, 2013.

- In some jurisdictions, regulators do not appear to have faith in access to trade repositories outside their jurisdiction, and this is one reason why they are insisting on the establishment of trade repositories in their own markets. The indemnification clause in the Dodd-Frank Act is an example of an unintended consequence that has made global cooperation harder rather than easier.

- Differing treatment of central banks and other public bodies in different jurisdictions for reporting purposes is another example of an inconsistent approach to reporting that should be avoidable. The Dodd-Frank Act exempts the US central bank and government agencies from reporting, but requires it of foreign central banks and government bodies. This has led to complaints by other countries that US rules do not promote a level playing field. In contrast, jurisdictions including Australia, Singapore and Japan have exempted banks from having to report trades with central banks and governments. A consistent policy that all trades with central banks and government institutions must either be reported or exempt from reporting would promote comity.

3) Swap execution facilities/electronic trading platforms

- There has been a marked bifurcation of liquidity into US and non-US markets since the start of the swap execution facility (SEF) regime in the US on October 2, 2013[14]. ISDA research[15] has revealed that cleared euro IRS volume between European and US dealers dropped 77% since October 2013, indicating a breakdown of cross-border trading relationships.

- ISDA researchers made a comparison of euro swaps that have been made available to trade (MAT) before and after the CFTC MAT[16] rule came into effect, revealing that the average daily notional traded on SEFs declined by 30%, while the average daily trade count fell by 11%[17].

4) Resolution and recovery process

a) Contractual stay periods and comity of law issues

- The current legal and regulatory framework in the area of bank resolution consists of (i) policy recommendations such as the FSB key attributes[18] and (ii) various national special resolution regimes (SSRs) that are either standalone acts (e.g. the approximately 20 national SRR laws that have been enacted since 2009) or occasionally coordinated at regional level, such as the EU Bank Recovery and Resolution Directive (BRRD)[19]. However, there is no real guarantee that the resolution measures taken by the home jurisdiction of a bank will be recognized by

[14] CFTC core principles and other requirements for swap execution facilities: http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/federalregister051613b.pdf.
[15] Cross-border fragmentation of global OTC derivatives: an empirical analysis, January 21, 2014 http://www2.isda.org/functional-areas/research/research-notes/
[16] Process for a designated contract market or swap execution facility to make a swap available to trade: http://www.cftc.gov/ucm/groups/public/@lrfederalregister/documents/file/2013-12250a.pdf.
[17] Made-available-to-trade: evidence of further market fragmentation, April 9, 2014 http://www2.isda.org/functional-areas/research/research-notes/
[18] FSB key attributes of effective resolution regimes for financial institutions: http://www.financialstabilityboard.org/publications/r_111104cc.pdf.
[19] Framework for the recovery and resolution of credit institutions and investment firms – text as adopted by the European Parliament on 15 April 2014: BRRD text_15 April.

a host country where the bank has significant assets. As a result, there are risks that the host jurisdiction may take actions that are inconsistent with the resolution measures taken by the home jurisdiction. This creates big issues for resolving a systemically important financial institution (SIFI) operating on a cross-border basis.

b) Inadequacies in the regional/national resolution regimes

- The EU BRRD and some national SRR laws allow for recognition of third-country resolution measures. However, such recognition is not automatic or mutual in every case. It always depends on a positive act of recognition. There may be different criteria that apply when assessing resolution measures from different countries. In some cases, there are MOUs in place between various national authorities that may allow for some reciprocal resolution measures by peers in another country. These MOUs are not binding in any way, nor are they fully reciprocal in many cases. For example, there is no automatic recognition of a UK resolution by the US Federal Deposit Insurance Corporation. Therefore, much will still depend on political negotiations at the time of an event.

c) Contractual amendments to ISDA documents

- ISDA is currently discussing with the Legal Experts Group of the FSB's Resolution Steering Group potential contractual amendments to include a stay in the ISDA Master Agreement that would apply if a G-SIFI was subject to resolution action. ISDA maintains that a contractual solution can never be as far-reaching as a statutory solution that follows certain globally agreed standards (e.g. the FSB key attributes), and has urged supervisors to work on such global statutory solutions even as ISDA and its members consider contractual amendments.

d) Cross-border effect of ring-fencing

- US intermediate bank holding company requirements will ring-fence a great deal of capital in the US. There is some concern that other jurisdictions will retaliate in kind. Locking up capital in this way inhibits the flow of capital across an organization and may reduce recovery potential.

- Increased ring-fencing of assets will increase costs. The move from branch to subsidiary structure is complex, time-consuming and expensive. ISDA hopes that the current reflection being undertaken by regulators in various international organizations as regards the causes and effects of harmful extraterritorial regulation, as well as appropriate solutions, can result in a financial system that meets regulatory and commercial objectives in terms of availability of capital (ensuring, for example, that regulators in different jurisdictions have confidence that capital posted in one jurisdiction will be available to cover risk incurred by branches in another jurisdiction).

5) Margining for non-cleared derivatives

- The conclusions reached by BCBS-IOSCO on margining for non-cleared OTC derivatives may be seen as an example of successful global-level regulatory coordination, in an effort to avoid **fragmentation, protectionism** and regulatory **arbitrage.**

- Nevertheless, there remains potential for differences at the national and regional level, either due to insufficient granularity in the BCBS-IOSCO rules or because of differences in scope in primary legislation in different jurisdictions. For example, without an agreement on the scope of entities subject to the margin requirements, national level rules could apply to swap dealers and major swap participants in one jurisdiction or to all financial counterparties and certain non-financial counterparties in another. Similarly, the treatment of certain instruments, such as foreign exchange swaps and forwards, may be inconsistent across jurisdictions due to statutory restrictions.

- The margin requirements will also affect the market for interest rate swap products that are available for clearing, but in currencies that can't be cleared. Interest rate swaps in currencies such as the Malaysian ringgit, Thai baht and Indonesian rupiah are still in the early, less liquid, stages of development. The fear is that additional margining costs will serve to widen bid/offer spreads, which will make it more difficult for these markets to achieve critical liquidity to become clearable currency products.

6) Basel framework

- Regulatory coordination under the Basel framework is a welcome practice, dating back to long before the financial crisis and the extraterritoriality that has resulted from political and regulatory reaction to that crisis. Such coordination enables a degree of global consistency in banking regulation.

- Basel proposals are not always in sync with G-20 objectives, however. For example, initial proposals regarding the risk weighting associated with CCP default fund contributions would have acted as major disincentive to clearing. The final standard adopted in BCBS 282[20], published in April 2014, took a more risk sensitive approach, but will not apply until January 2017. An interim approach (under BCBS 253) remains in force until then.

- We further note that client clearing under the principal model – which prevails in most of the world outside the US – is rendered significantly less commercially viable under the new Basel leverage ratio[21] and single counterparty limit structures, which is (again) inconsistent with the support for clearing under the G-20 commitments.

[20] BCBS final Capital requirements for bank exposures to central counterparties (BCBS 282): http://www.bis.org/publ/bcbs282.pdf.

[21] BCBS Basel III leverage ratio framework and disclosure requirements: http://www.bis.org/publ/bcbs270.pdf.

Conclusion

Cross-border problems cause fragmentation and regionalization of markets, which is harmful to market participants, market liquidity, global capital flows and global growth. There needs to be a renewed and concerted international focus to avoid further fragmentation and to remediate existing fractures.

IOSCO is uniquely placed to facilitate resolution of disputes between jurisdictions and ISDA supports a stronger, more active role for IOSCO in this field. In certain areas of international rule-making, such as benchmarks and margin for uncleared trades, IOSCO has taken a lead in developing international standards ahead of national implementation, and we strongly support this template for future rule-making. In the case of many of the cross-border challenges, however, national rules were written ahead of international consensus, but there is a role of IOSCO here also. IOSCO should develop and implement principles-based standards for resolution of differences between jurisdictions, provide a forum for discussion of disputes and consider the institution of an arbitration or college type process for resolution of matters of international importance.

As the trade association representing the world’s most global financial business – OTC derivatives – ISDA appreciates the opportunity to comment on extraterritoriality issues. We also welcome the initiative taken by IOSCO to address extraterritoriality-related concerns in its Task Force on Cross-Border Regulation. We would be happy to elaborate on these concerns should IOSCO have any further questions on the views expressed herein.

Yours sincerely,

Stephen O’Connor
Chairman
International Swaps and Derivatives Association