



International Reform of OTC Derivative Regulation: How Level Is the Playing Field?

Background

Increased regulation of derivatives has been a key element of international efforts to strengthen the global financial regulatory framework. Following the bailout of AIG, primarily due to its massive exposure under credit default swaps, the initial focus of regulators was in relation to increased regulation of credit default swaps, including greater standardization of contract terms and more central clearing of standardized CDS contracts. Although there is little evidence that over-the-counter derivatives (“**OTC derivatives**”) were a material factor in the causes of the financial crisis, the focus moved quickly to OTC derivatives more generally, following the failure of Lehman Brothers with concerns over the interconnectedness of large financial institutions, and fears that the failure of a firm with large derivative positions had the potential to cause significant systemic problems to the global financial markets. In addition, concerns were raised that a lack of transparency meant that regulators and market participants did not have the information necessary to assess the full extent of parties’ exposures to each other.

In response to the crisis, the G-20 leaders made the following commitment in Pittsburgh in September 2009:

“All standardised OTC derivative contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties by end-2012 at the latest. OTC derivative contracts should be reported to trade repositories. Non-centrally cleared contracts should be subject to higher capital requirements. We ask the FSB and its relevant members to assess regularly implementation and whether it is sufficient to improve transparency in the derivatives markets, mitigate systemic risk, and protect against market abuse.”

Further to the commitment made by the G-20 leaders, there have been many regulatory developments and initiatives worldwide to comply with the stated requirements. On April 15, 2011, the Financial Stability Board (the “**FSB**”) published a report (the “**2011 Report**”),¹ which sets out a progress report on the implementation of OTC derivatives reforms around the world, discusses the need for an internationally consistent approach, and highlights the importance of a measured pace of reform. The 2011 Report also examines progress against the 21 recommendations set out in the FSB’s earlier report published in October 2010² (the “**2010 Report**”) for implementing reforms in an internationally consistent and non-discriminatory way. In the 2010 Report, the FSB

¹ The report is available at: http://www.financialstabilityboard.org/publications/r_110415b.pdf.

² The report is available at: http://www.financialstabilityboard.org/publications/r_101025.pdf.

recommended that appropriate international bodies with relevant expertise carry out the necessary work for the coordination of the implementation of OTC derivatives market reforms in accordance with such recommendations.

Challenges to Creating a Level Playing Field

Even with the overarching objectives of the G-20 and the more detailed recommendations of the FSB, achieving an international coordinated approach to the regulation of OTC derivatives and achieving the aim of a more level playing field was always going to be challenging in the extreme, with significant regulatory changes required at the local level in a large number of jurisdictions. Not only is the nature and sophistication of the OTC derivatives market very different across the G-20 group of nations but those pushing through regulatory changes need to take into account varying national and international considerations, including the size and nature of the derivatives market in the relevant jurisdiction and the participants in such market, local market practice, political considerations, bankruptcy and tax law, and many other issues.

In seeking to find an appropriate metaphor to measure the progress in international derivative regulation to date, an unkind observer might consider water polo a good place to start. The surface as envisaged by the G-20 looks calm and flat. However, once the participants enter the pool and start thrashing around and vying for position, the picture looks very different.

It is not therefore surprising that as set out further below, concerns have been raised as to whether different jurisdictions are enacting changes in a way that creates a level playing field and whether differences in approaches to regulation could give rise to competitive imbalances and/or regulatory arbitrage opportunities between different jurisdictions. Even differences that may appear relatively minor can in practice give rise to major problems and therefore be a significant hurdle to meeting the G-20 objectives.

The following factors, among others, have arisen from the various global regulatory proposals in relation to OTC derivatives:

- Many jurisdictions will seek to have at least some extraterritorial effect in relation to their regulations relating to derivatives. For example, in relation to the regulation of derivatives under Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “**Dodd-Frank Act**”) in the U.S., it is stated that the provisions will not apply to activities outside the U.S. unless they (i) have a direct and significant connection with activities in, or effect on, commerce of the U.S. or (ii) they contravene such rules or regulations as may be prescribed under the Act necessary or appropriate to prevent the evasion of the relevant provisions of the Act. Further clarity will be given in rule making to be undertaken by regulatory agencies in the U.S. as to when activities will be regarded as having a direct and significant connection with activities in, or effect on, commerce of the U.S. Concerns have been raised as to the extent the potential extraterritorial reach of Dodd-Frank in the circumstances specified will have on parties that undertake derivatives activities within the U.S. or outside the U.S. with a counterparty that is the branch or subsidiary of a U.S. bank or financial institution.
- Banks and other financial institutions that undertake significant cross-border activities are particularly concerned that they may be subject to overlapping regulatory requirements in different jurisdictions and may need to comply with two or more different regimes. Areas of concern include duplication of registration and licensing requirements, clearing obligations, transaction and position reporting, collateral and margining requirements, and prudential obligations. There is also the possibility that it may be impossible for an institution to comply with conflicting requirements in different jurisdictions. Even where compliance with two or more overlapping requirements is possible, this is likely to lead to additional administrative and compliance costs.

- In addition, concerns have also been raised that there are differences in approach in the regulation enacted or proposed in different jurisdictions to date, including the definition of derivatives, those classes of derivatives subject to a clearing requirement, exemptions to the clearing obligation and recognition of foreign clearing systems and trade repositories.
- The above concerns can also be an issue for nonfinancial entities. The proposed legislation in many jurisdictions including the U.S. and the EU can subject nonfinancial entities that are active in derivatives in the course of their business (including energy companies and airlines) to clearing and reporting requirements in respect of their derivative transactions. There are, however, some significant differences in approach such as the fact that nonfinancial entities will not be required to clear swaps under the draft European Market Infrastructure Regulation (“**EMIR**”) in the EU unless a clearing threshold is exceeded. Such threshold is not included in the Dodd-Frank legislation. Although both the U.S. and EU contain a commercial hedging exemption for certain transactions by non-financial entities, there are currently differences in the way these operate in the EU currently even commercial hedges will be subject to clearing if the institution is above the clearing threshold.

The issues highlighted above have the potential to cause competitive imbalances in the international derivatives markets with market participants structuring their businesses and making decisions in relation to dealings in particular jurisdictions or with particular counterparties based on regulatory considerations rather than normal commercial grounds. The effect of such imbalances is also likely to have an effect on counterparty and ultimately consumer choice and lead to increased costs. If differences are material, many firms are likely to gravitate away from an integrated global approach to business and structure their businesses around specific products with local counterparties in the relevant jurisdiction.

Conclusions of the FSB Reports and Subsequent Developments

The FSB highlights the large number of ongoing implementation projects and workstreams in relation to the G-20 and FSB recommendations by global regulatory bodies in connection with the increased regulation of OTC derivatives, including:

- Basel Committee on Banking Supervision regarding the creation of incentives to centrally clear and higher capital charges for non-centrally cleared OTC derivatives (included in its Basel III paper published in December 2010)³ and the capitalisation of bank exposures to central counterparties (“**CCPs**”).⁴
- The Committee on Payment and Settlement Systems (“**CPSS**”) and the International Organisation of Securities Commissions (“**IOSCO**”) consultative report on harmonized principles for financial market infrastructures, covering payment systems, central securities depositories, securities settlement systems and CCPs, including guidance on trade repositories.⁵
- IOSCO report on trading of OTC derivatives,⁶ analyzing benefits and challenges associated with the implementation of measures targeted at increasing exchange and electronic trading.
- OTC Derivatives Supervisors Group (the “**ODSG**”) development of a roadmap and commitments covering standardization of contracts by the largest derivatives dealers and other major market participants.⁷

³ The Basel III rule text is available at: <http://www.bis.org/publ/bcbs189.pdf>.

⁴ See the Basel Committee’s consultative document at: <http://www.bis.org/publ/bcbs190.pdf>.

⁵ Consultation report published March 2011 and to be finalized by early 2012 available at: <http://www.bis.org/publ/cpss94.htm>.

⁶ Published February 2011, available at: <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD345.pdf>.

⁷ See commitment letter dated 31 March 2011, available at: <http://www.newyorkfed.org/newsevents/news/markets/2011/an110405.html>.

In the 2011 Report, the FSB provides an analysis of progress in relevant jurisdictions to meet the G-20 requirements, which are summarized below.

General Implementation Progress

Following a survey of its members and an analysis of progress reports from international bodies, the FSB states that it is concerned as to many jurisdictions' likelihood of meeting the G-20 end-2012 deadline and believes jurisdictions need to take substantial and concrete steps towards implementation immediately. The FSB also states that it is concerned with the substantial variation in the speed of reform between jurisdictions, with the U.S., the EU, and Japan well underway but other jurisdictions having no clear timetable for completion or being at a very early stage of developing regulations:

- In the U.S., legislation in the form of the Dodd-Frank Act was enacted in July 2010. A large number of implementing rules are required to be put in place by the Securities and Exchange Commission (the "SEC"), the Commodity Futures Trading Commission ("CFTC"), and other agencies. Although the process is likely to be delayed from the initial timetable, drafts of many of these rules have now been published.
- In the EU, legislation has been proposed under EMIR and is expected to be adopted by the end of 2011, although some important issues still need to be resolved, not least whether it should apply to only OTC derivatives (in accordance with the G-20 agreement) or all derivatives, including those that are exchange traded. In addition, some of the EU proposals in relation to derivative regulation, in particular rules relating to exchange trading of derivatives and pre-and-post trade transparency, will be contained in amendments to the Market in Financial Instruments Directive ("MiFID"). The EU Commission published a consultation paper in relation to its review of MiFID⁸ in December 2010 but its legislative proposal is not expected to be published until October 2011 at the earliest.
- In Japan, legislation has been enacted and implementing regulation is proceeding with respect to clearing and reporting to trade repositories.
- In Hong Kong the legal framework for a regulatory regime, including clearing derivatives through CCPs and reporting of transactions to a trade repository, is expected to progress through 2011.
- In Korea, the government has finalized plans for requiring mandatory clearing, and a CCP is to be established by mid-2012. The government will propose legislation for approval by the Korean National Assembly in the second half of 2011.
- In Australia, Canada, India, Mexico, Saudi Arabia, South Africa, and Switzerland, financial authorities have begun an assessment of the derivatives markets operating within their jurisdictions and plan to decide upon future regulatory initiatives implementing the G-20 commitments during 2011.
- In other jurisdictions, including China, India, Russia, and Singapore, steps are underway in relation to derivative reform, including requiring central clearing for standardized derivatives but, firm timetables for completion have not been established. Some jurisdictions such as Brazil and Argentina do not consider material legislation needs to be put in place to meet the G-20 requirements while work towards regulation in nascent markets, including Indonesia and Turkey, is at an early stage.

⁸ EU Commission public consultation: Review of the Markets in Financial Instruments Directive (MiFID) (8 December 2010), http://ec.europa.eu/internal_market/consultations/docs/2010/mifid/consultation_paper_en.pdf; see also Morrison & Foerster client alert: European Commission Consultation on the Review of MiFID (21 December 2010), <http://www.mofo.com/files/Uploads/Images/101221-European-Commission-Consultation-on-the-Review-of-MiFID.pdf>.

Standardization

The FSB states that bodies such as the ODSG and the International Swaps and Derivatives Association (“**ISDA**”) have made significant progress in standardizing contractual terms for the derivatives market facilitating the increased use of electronic processing. Several jurisdictions noted other initiatives in their markets to increase standardization of products and operational processes.

The FSB reports that many respondents stated that implementation of the G-20 commitments would tend to lead to standardization of OTC derivatives products and operational procedures and higher risk-weightings for non-centrally cleared OTC derivatives would be likely to further incentivize the use of standardized products. Certain respondents, such as Australia and Canada, submitted that they have not yet decided whether increased standardization is necessary in their respective jurisdictions to achieve the G-20 commitments.

Central Clearing

As noted above, the FSB reports that many jurisdictions have made progress towards meeting the G-20 requirement in relation to central clearing of standardized derivatives, although the amount of progress differs significantly between jurisdictions. The FSB also notes that different approaches to central clearing appear to be emerging. The frameworks for central clearing in Japan, the U.S., and proposed in the EU would provide for both “bottom-up” (where regulators decide which contracts currently being cleared should be subject to a clearing obligation) and “top-down” (where the regulators determine which contracts should be subject to a clearing requirement irrespective of whether they are currently being cleared) approaches to establishing whether a contract is required to be cleared while some other jurisdictions have not yet determined which approach to use. To aid the alignment of international regulations in this area, the IOSCO report on international standards is expected to address coordination of these requirements.

The FSB states that it believes ensuring fair and open access to CCPs, subject to sound risk management, is essential for achieving the G-20 objectives in relation to OTC derivatives. The Committee on the Global Financial System (the “CGFS”), CPSS, and IOSCO held a forum in January 2011 to explore the issues concerning CCP interoperability and access to CCPs and work is continuing in this area to seek to improve access to central clearing and further considering the macro-financial implications of increased access to CCPs.

In relation to transactions that will not be subject to central clearing, the FSB states that good progress is being made to strengthen bilateral counterparty risk management practices. Additional capital requirements and collateral requirements and other measures are included in both the U.S. Dodd-Frank legislation and the current EMIR draft in the EU.

Exchange or electronic platform trading

The FSB states that the G-20 commitment to increase the level of trading on exchanges or other electronic platforms was designed to foster greater market confidence by moving the trading of suitable products to those venues able to offer fair, orderly, and transparent markets. In the U.S., the Dodd-Frank Act takes a mandatory approach and requires that any swap that is subject to a clearing requirement be traded on a registered platform unless no registered trading platform makes such derivative available to trade. In Europe the issue is considered in the EU Commission’s consultation paper in relation to MiFID, referred to above. The Commission proposes a requirement that all trading in sufficiently liquid derivatives (which is likely to be determined by ESMA) that are eligible for clearing be effected through a regulated market, multilateral trading facility, or an organized trading facility.

The FSB notes that IOSCO’s February 2011 report on the trading of OTC derivatives concludes that a flexible approach to defining what constitutes an organized platform would maximize the number of standardized derivatives products that can be appropriately traded on these venues. Additionally, the report identifies

characteristics that organized platforms should fulfill to comply with the G-20 objectives, which include access, transparency, operational efficiency and resilience, market surveillance, and clear and non-discriminatory trading processes. The FSB states that it has requested that IOSCO undertake further analysis on market use of multi-or-single dealer platforms. Concerns have, however, been expressed by market participants that seeking to push too much of the market onto exchange trading risks damaging liquidity in certain products and the focus should instead be on identifying those derivatives transactions most suitable to exchange trading.

Reporting to trade repositories

The FSB states that it believes a coordinated international approach of transactions being reported to trade repositories is essential for such information to be readily aggregated on a global basis. It notes that although a number of jurisdictions, including the U.S., Japan, Hong Kong, and the draft EMIR legislation in the EU have enacted or are proposing a requirement for reporting of OTC derivatives transactions to registered trade repositories, other jurisdictions, including China and Korea, provide for reporting to governmental authorities. It also notes there are discrepancies in the depth and breadth of data to be reported to trade repositories, with some favoring a more limited data set, whereas others, in line with the discussion in the 2010 Report, provide for more substantial reporting.

The FSB notes that only a few jurisdictions have undertaken work to identify barriers to the collection and dissemination of trade data by repositories and begun to take steps to address them. The FSB states that jurisdictions should undertake work to identify any such barriers and address them as a matter of urgency, and supports further analysis and assessment of this issue as part of the work of the ODSG. It identifies confidentiality as a particular issue. In this regard the draft EMIR legislation addresses this issue in the EU in connection with the reporting of counterparty names to trade repositories, and Canada, Hong Kong, and Mexico have stated that legislative changes will be necessary to tackle confidentiality concerns in relation to information sharing.

Overall assessment and next steps

The FSB states that it believes differences are emerging in some areas that could diminish the effectiveness of international efforts to coordinate the regulation of derivatives, create opportunities for regulatory arbitrage, or subject market participants and infrastructures to conflicting regulatory requirements. The FSB states that it will continue to monitor developments through its OTC Derivatives Working Group as implementation progresses, and identify any further emerging inconsistencies that should be addressed. The FSB states that it will publish a further progress report by October 2011.

Responses to FSB 2011 Report and International Coordination in Relation to Derivatives Reform

A number of concerns have been raised by some market participants and trade organizations as to the pace of regulatory reform in relation to derivatives and, in particular, the need for a more coordinated approach between regulators and legislators in different jurisdictions to avoid or at least mitigate as far as possible some of the potential problems highlighted above.

On May 13, 2011, ISDA published its response⁹ to the 2011 Report, which stressed the need to ensure both regulatory consistency and a measured approach to achieving the G-20's 2012 deadline. ISDA recognizes that although some divergence in respect of reforms is inevitable between jurisdictions, given the differences in market composition, but it submits that a far greater degree of convergence is essential to the long-term health of the global financial system. While it believes that the G-20 end-2012 deadline is achievable, ISDA states that to ensure the transition to the new regime does not create instability or give rise to new risks, implementation of the

⁹ <http://www2.isda.org/search?keyword=Financial+Stability+Board+report>.

new rules should not be rushed. It advises that creating a roadmap elaborating the timescale for full implementation of the new regime would be of benefit to both the industry and regulators. In connection with the proposals for central clearing of derivatives, ISDA is concerned that a measured approach be taken so that regulation does not force the central clearing of derivatives that CCPs are not able to risk-manage effectively. In relation to exchange trading of derivatives, ISDA welcomes IOSCO's conclusion that a flexible approach to defining what constitutes an organized platform would maximize the number of standardized products that can be appropriately traded on these systems. In respect of reporting to trade repositories it believes there should be a measured approach to what information needs to be reported to them and an avoidance of the proliferation of local trade repositories, as well as a consideration of the contractual and legal obligations concerning confidentiality of client information.

On July 5, 2011, eight trade associations, including the Investment Management Association (“**IMA**”), the European Banking Federation (“**EBF**”), ISDA, and the Futures and Markets Association (“**FMA**”) wrote to Michel Barnier, the EU Commissioner for Internal Markets & Services, and Timothy Geithner, the U.S. Treasury Secretary, raising concerns about differences in approach in the international regulation of derivatives, particularly between the EU and the U.S., and concerns that this could create conditions that the G-20 have expressly stated they want to avoid, including the fragmentation of markets, protectionism, and regulatory arbitrage. The concern is expressed that, as things currently stand, the global derivatives business will be left with ambiguity and extraterritorial challenges, as well as legal uncertainty.

The signatories to the letter urge the relevant authorities to seek to coordinate requirements to ensure that entities do not face duplicative regimes, and to seek a coherent and complementary approach so that market participants do not face potentially conflicting regulatory requirements. In particular, in the context of clearing requirements, regulators are urged to seek to agree on standards for equivalence or recognition of CCPs in different jurisdictions, to avoid conflicting requirements and the potential for parties to a transaction to face the impossibility of complying with two sets of contradictory rules. In relation to trade repositories, particular concerns are raised over the requirement in Dodd-Frank that U.S.-based swap data repositories obtain indemnification from foreign regulators as a precondition to data sharing which indemnification is believed to be unnecessary and to undermine the ability of trade repositories to provide coherent information on risk in the derivatives market to international regulators.

The signatories to the letter urge regulators to draft provisions in consultation and cooperation with other international regulators and for regulators to seek to limit the damaging effects of divergence, either by consultation with other regulators in the preparation of legislation or by resolving differences in the course of implementing legislation. It is noted that there has been a recent establishment of a Trans-Atlantic regulatory working group to address differences between EU and U.S. regulators in relation to derivatives regulation.

A Level Playing Field?

It is perhaps understandable and inevitable that much of the early impetus for derivative reform was undertaken largely at a national level (save for the EU, although the EU Commission has also pushed forward its reforms largely in isolation of other international developments). Seeking a detailed international consensus prior to putting in place the framework for reform would probably have been unrealistic and risked long delay.

As jurisdictions, particularly the EU and the U.S., are developing the new framework and setting out detailed rules, there does, however, seem to be an increasing realization that a significant amount of international coordination and cooperation is necessary as the rules are finalized to minimize the risks highlighted above that could otherwise arise. It appears that there is an increasing dialogue between the EU Commission and the U.S. Treasury and relevant agencies in the U.S. to seek to address potential issues, including those raised in the trade association letter of July 5. At the same time, banks and other financial institutions will inevitably look very closely at the relevant provisions as they are finalized and seek to ensure their businesses are structured in a way

that will mitigate costs arising from the new regulatory framework and, in particular, to avoid so far as possible having their operations subject to overlapping and inconsistent regulation.

Contacts

Peter J. Green
+44 20 7920 4013
pgreen@mofo.com

Jeremy C. Jennings-Mares
+44 20 7920 4072
jjenningsmares@mofo.com

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