Global derivatives regulation: tough going on the path forward

By **Peter Green,** partner at **Morrison & Foerster** in London.

IT IS NOW over a year since the end of the original deadline set by the G20 leaders at their Pittsburgh summit in September 2009 for standardised derivative contracts to be traded on exchanges or electronic trading platforms where appropriate and to be cleared through central counterparties. An additional objective of international regulators has been to obtain greater transparency of the global derivatives market through reporting of derivative transactions to trade repositories.

We focus below on progress in the US and Europe. Not surprisingly, most of the implementation of the G20 objectives has been undertaken by regulators and legislators on a jurisdiction by jurisdiction basis although EU legislation has ensured a largely coordinated approach across the European economic Area. Differences in approaches in adopting the G20 objectives have led to concerns as to potential overlap, mismatches or gaps between the various international rules and the risk of market participants being subject to multiple registration, licensing or reporting obligations in different jurisdictions or derivative transactions between parties in different jurisdictions being subject to contradictory requirements. The reforms could therefore result in increased costs, market distortions and the potential for regulatory arbitrage, some of the very concerns that the G20 objectives sought to address.

Overview of legislation in EU & US

In the US, regulatory reform in relation to derivatives has largely been effected under Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act, which was enacted in July 2010. Following a significant amount of rule-making, guidance and no action letters by the US Commodity Futures Trading Commission, the obligations relating to clearing and exchange trading of many interest rate swaps and index credit default swaps are now in force and reporting obligations are in effect for swaps of numerous asset classes (the rulemakings of the Securities and Exchange Commission for "security-based swaps" are significantly less advanced than those of the CFTC). Implementation of the G20 objectives in the EEA has lagged somewhat behind the US The clearing and reporting obligations are primarily contained in the European Market Infrastructure Regulation with the exchange trading obligations intended to be included in the Markets in Financial Instruments Regulation which has not yet been finalised. Although EMIR came into force in August 2012 and significant rulemaking has been undertaken by the European Securities and Markets Authority, ESMA is yet to make its necessary determination of the classes of derivatives to be subject to the clearing obligation. It is, however, expected to do so during 2014. In relation to transaction reporting, ESMA has now authorised six trade repositories and the reporting obligation came into force in the EEA for all major asset classes on February 12, 2014.

Both Dodd-Frank and EMIR have express extra territorial effect. Under EMIR, the clearing obligation applies to relevant OTC derivative contracts entered into between entities which are both established outside the EEA if there is a "direct, substantial and foreseeable effect" within the EEA. In the US, Title VII applies to activities outside the US that have a direct and significant connection with activities in, or effect on, commerce of the US

The path forward

In July 2013, the European Commission and the CFTC announced an agreement, referred to as the "path forward". It was acknowledged that subjecting market participants to simultaneous application of EMIR/MiFIR and Title VII could lead to conflicts of law, inconsistencies and legal uncertainty. The statements set out an intention of regulators in the EU and US to seek to mitigate these effects and to seek to follow a territorial approach to the extent appropriate.

The two principal methods by which the extra territorial scope of the relevant legislation have sought to be managed in practice are through specific relief and guidance to the rules by relevant regulators and through a process of "substituted compliance" or "deemed equivalence" as described further below.

Relief and guidance

In November 2013, ESMA published a final draft of its regulatory technical standards relating to contracts having a direct, substantial and foreseeable effect within the EEA for the purpose of the EMIR clearing obligation and these have now been adopted by the European Commission. If at least one counterparty is located in a country outside the EEA that is determined to have rules equivalent to EMIR, EMIR can be disapplied through compliance with the other jurisdiction's rules, even if the contract has effect in the EEA. Contracts between two entities outside the EEA will be regarded as having EEA effect if guaranteed by an EEA financial counterparty where the guaranteed obligations are above a specified amount. Also transactions between two EEA branches of non EEA entities will be regarded as having effect in the EEA.

In the US, in July 2013, the CFTC published final guidance in relation to the cross-border effect of Title VII to Dodd-Frank. It has also issued relevant staff advisory notices. One of the key issues is the definition of "US Person". There are differences between the CFTC and SEC definitions in this regard, with market participants concerned, in particular, at the scope of the CFTC definition. Although the CFTC guidance provides that a person does not become a US Person solely by virtue of its obligations being guaranteed by a US affiliate, an entity benefiting from such a guarantee may still be regarded as a "guaranteed affiliate" or "affiliate conduit" for the purpose of the guidance and, in certain circumstances, subject to many of the CFTC's transaction level requirements. Also, to the surprise of the market, in a footnote to its final guidance, the CFTC stated that a US branch of a non-US swap dealer or major swap participant is subject to transaction level requirements of Title VII of Dodd-Frank without any possibility of substituted compliance. In a staff advisory (now subject to a request for public comment and temporary no-action relief), it also indicated that in relation to swaps arranged, negotiated or executed by personnel or agents of a non-US swap dealer located in the US, the location of the persons arranging or negotiating the swap was relevant for determining the applicability of certain transaction level requirements. This gives rise to the possibility of counterparties to a swap being subject to transaction level requirements, even if both are non-US and enter into a swap through non-US offices if one entity employs US based front office personnel or agents in relation to the swap.

Equivalence and substituted compliance

Certain provisions in EMIR, in particular the clearing obligation, contemplate the possibility of compliance with the relevant requirements in jurisdictions outside the EEA, subject an EU Commission determination that the relevant jurisdiction has equivalent requirements to those in EMIR and that ESMA has established appropriate co-operation and information sharing arrangements with the competent authority in such jurisdiction and it has reciprocal arrangements in place with the EEA.

In September 2013 ESMA published advice to the European Commission that central counterparties in the US are subject to effective supervision and enforcement in the US and the US framework is equivalent to EMIR for the supervision of CCPs provided that the relevant CCP has adopted internal policies, procedures and rules, models and methodologies which are equivalent to those applying to CCPs authorised in accordance with EMIR, including in relation to 10 specified areas where ESMA believes that EEA CCPs are subject to more stringent requirements under EMIR. Significantly, in relation to trade repository reporting requirements, ESMA's advice is that the US rules are not equivalent as they do not include a requirement to report specific data on valuation of exposures and collateralisation of exposures. The European Commission has not yet made a final determination based on ESMA's advice.

In the US, the approach of the CFTC (and the SEC in its proposed rules) is to make "substituted compliance" determinations as to whether the requirements of a non-US jurisdiction are comparable with and as comprehensive as the relevant US rules and, where they are, allow market participants to comply with the foreign jurisdiction's rules rather than the relevant US rules. On 20 December 2013, the CFTC made comparability determinations for various jurisdictions, including the EEA, Canada, Japan and Switzerland which covered various entity and transaction level requirements and largely permit substituted compliance for the specified requirements. Relevant entity level requirements include risk management and swap data recordkeeping. Transaction level requirements for which the CFTC made substituted compliance determinations in relation to the EEA include swap confirmation, swap portfolio reconciliation and compression, and certain elements of swap trading relationship documentation and daily trading records (the CFTC made more limited transaction-level substituted compliance determinations for Japan and none for any jurisdiction other than the EEA or Japan). Significantly, the CFTC has not yet made comparability determinations in relation to clearing, swap execution or real-time public reporting and substituted compliance is therefore not yet available in respect of these requirements.

Keeping the path clear?

The path forward statement was largely welcomed by market participants but subsequent action by EU and US regulators in seeking to achieve its stated aims has been regarded by many as inflexible, limited in scope, inconsistent with its objectives and having deference to the most rigorous relevant regime in relation to clearing obligations (with a "stricter rule applies" approach applying) – and there are concerns this principle could be applied in other areas. Whilst this may limit regulatory arbitrage opportunities, it could give rise to competitive disadvantages and increased costs for those firms operating across many jurisdictions which could in turn still lead to market fragmentation and loss of liquidity.

In December 2013 a number of industry groups including ISDA, SIFMA and the IIB filed a lawsuit in the US challenging the CFTC's implementation of Title VII of Dodd-Frank and its cross border guidance arguing among other things that the CFTC failed to engage in the required cost-benefit analysis, failed to provide interested persons sufficient opportunity to participate in rule making and adopted a rule applicable to activities outside the US without a sufficient connection to the US. That lawsuit is pending.

In February 2014, the CFTC provided temporary no-action relief for MTFs regulated in the EU from the requirement to register with the CFTC as a swap execution facility. It also provided relief from parties executing swaps on MTFs from the trade execution requirement under the Commodity Exchange Act and for swap dealers and MSPs executing swap transactions on MTFs meeting specified conditions from certain requirements under the CFTC's business conduct rules. At the same time the EU Commission and the CFTC released a statement affirming the path forward objectives but providing little further information. However, although the no-action relief was designed to deal with concerns raised by market participants, concerns have been raised that in practice the conditions necessary for the relief to apply may mean few MTFs seek to take advantage of it.

With the reporting requirements under EMIR having just become effective and the clearing obligation expected to be phased in during the course of 2014, the concerns of market participants as to some of the extraterritorial issues highlighted above are becoming more acute. There is therefore a growing urgency for the path forward objectives to be pursued with more vigour by regulators in the US and the EU and for a more flexible approach to be taken to equivalence and substituted compliance at least while the new rules bed down. Otherwise there is a risk of the reforms failing to meet their objectives and in some cases having a counterproductive effect. ▲