Cross-Border Application of OTC Derivatives Rules: Revisiting the Substituted Compliance Approach

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Thank you very much, Professor Awrey, for that introduction.

It's very good to be here at Georgetown Law and share a few concerns about the way how the international community approaches cross border issues in financial regulation.

You all know very well that Dodd-Frank derivatives reforms were complimented by anti-circumvention provisions. Congress not only introduced new trading, clearing, reporting and margining requirements for OTC derivatives, but also mandated the SEC and CFTC to develop rules that won't permit market participants to abuse regulatory arbitrage and avoid regulation by simply moving derivatives desk into a foreign jurisdiction, which hasn't yet implemented new regulations.

As derivatives market is inherently cross-border, this possibility was quite obvious, and the Dodd-Frank's goal to lock participants within the new regulatory perimeter is not surprising. But implementing rules surprised the global regulatory community. The CFTC's rule on cross-border swaps activities, proposed in 2012, deeply troubled other regulators across the globe. In simple words, the CFTC proposed rule applied virtually every single transaction-level and entity-level requirement of the Commodities Exchange Act not only to U.S. dealers but to many foreign dealers and transactions outside the CFTC's jurisdiction.

Such a far-reaching extraterritorial application of the U.S. securities laws was unprecedented, if not scandalous. The response of the global regulatory community and industry was very strong. Ministers of Finance, Central Bankers and securities regulators from all G20 nations and the financial industry united in opposition to the CFTC's approach to cross-border transactions. Letters were sent, G20 and FSB members spent many days arguing, all in vain.

The CFTC and later SEC approaches to the cross-border swaps crystallized in a slightly softer manner, as compared to the rule proposed initially, but the main idea remained unchanged: all transactions of U.S. Swap dealers, their foreign branches and affiliates must comply with transaction-level and entity-level requirements of the Commodities Exchange Act or Securities Exchange Act, as well as the CFTC and SEC rules, unless substituted compliance is available.

I apologize for this long introduction, but I thought it might be useful to set the table before moving to the substituted compliance itself. Professor Jackson has described how the substituted compliance has emerged as a regulatory concept for importing products and services into the U.S. Market. Thus, substituted compliance initially was a way to create a more open market for products coming from jurisdictions where regulators have similar mindsets. However, the new substituted compliance idea is far from creating an open market through selectively relaxing rules for incoming products with certain citizenship. To the contrary, it is exporting the U.S. regulatory model and imposing it upon other countries, without much regard to the national sovereignty concept.

So, what is substituted compliance, as being implemented by the Commissions? Under the current provisional rules, U.S. swap dealers, their branches and affiliates dealing outside the U.S. will be permitted to comply with a foreign regulatory regime, only if the SEC or CFTC made a determination that the foreign regime is comparable to the one in the U.S. Otherwise, U.S. rules apply.

Comparability determinations are made through assessing the comprehensiveness of foreign requirements towards derivatives transactions, their scope and objectives, as well as the foreign regulator's ability to supervise and enforce compliance with these requirements. There are some differences, but both Commissions use broadly similar approaches to determining comparability, which stipulate that foreign rules must achieve comparable outcomes in each of the regulatory categories. In addition, both Commissions expect to have extensive formal cooperation arrangements with a regulator from that jurisdiction.

When foreign governments realized that the Commissions would not retract on this approach, they implemented their own "substituted compliance" frameworks; and now essentially the same regimes are up and running in the EU, Canada, Japan, Australia - all major markets.

The result is devastating. The International Swaps and Derivatives Association reported a sharp decline in trading activity across the Atlantic. Volumes of cleared swaps between U.S. and EU counterparties dropped tremendously underscoring a breakdown in cross-border trading relationships. According to these studies, the global derivatives market is not global anymore; rather, it has become a fragmented system of ring-fenced liquidity pools, where risk is concentrated rather than being dispersed evenly throughout the globe.

Professor Yadav will speak about problems with clearinghouse eligibility from the point of view of the U.S. rules and EMIR, a corresponding European regulation. This is perhaps the most problematic issue right now, and as the U.S. and EU authorities are not able to resolve the issue, the whole world is caught up.

So, where are we right now? Jurisdictions with more advanced markets have adopted either substituted compliance or mutual recognition requirements, and are now forced to run complicated assessments of each others' regulatory regimes. It is impractical, if not impossible. Clearly, no regulator among the G20 members has resources to run a comprehensive analysis of all other members' regimes individually. And this is about 19 individual countries, not all 180 jurisdictions in the world. This is a totally unsustainable approach.

There are other problems with coordination as well. Like we say in Russia, I don't want to steal bread from Professor Yadav, but I wanted to mention that the CCP recognition process has also revealed that there is no agreement between authorities even as to which approach should be used: equivalence or "tougher rules apply" approach. This means that some jurisdictions believe that rules tougher then their own are okay, while some expect full equivalence, rejecting tougher rules as incomparable.

I strongly believe that such peer-to-peer approach will never work properly, and we need a substitute for a substituted compliance. I think that a sustainable alternative will require a neutral independent international organization making comparability determinations.

The post-crisis OTC derivatives reforms were agreed and approved by the global community of financial market regulators. These reforms were developed by the FSB and endorsed by the G20. Even though the goals are quite specific, no specific recipe was given in how to achieve the goals. Given the diversity of the global financial community, regulators across the globe used different tools to ensure safety and transparency of this market as it was agreed by the G20.

I believe that the FSB should take the role of developing a standard of safe and transparent derivatives regulation and making determinations whether regulatory regime and its enforcement in a particular country is up to this standard. The FSB already has vast experience in running peer reviews of global standards implementation, derivatives reforms progress reports, etc. If the duty to evaluate regulatory regimes were shifted to a neutral supranational organization, it would help individual countries to avoid falling into a trade war. This would also ensure that the evaluation process is efficient, as it would allocate the costs and burdens across the global regulatory community, compared to a peer-to-peer process that requires significant efforts from every regulator to make equivalence or comparability determinations regarding other jurisdictions.

There are a lot of tools available to compliment this work. There are IOSCO benchmarks, CPMI-IOSCO principles for financial markets infrastructures, implementation of which is already being monitored. The IMF has tons of information gathered through their Financial Sector Assessment Program.

This approach satisfies the task of tackling regulatory arbitrage while promoting a solution based on mutual trust between regulators that will allow recognizing high-quality regulatory regimes despite their differences.

In conclusion, I'd like to say that I believe that it is crucial to have an arrangement that would prohibit circumventing globally agreed rules. I believe that the substituted compliance concept is well suited to deal with this task; we just really need to tweak the process; to make it multilateral and based on trust.

I would like to thank the Journal of Financial Regulation and Georgetown Law for an opportunity to share these concerns with you. I would be happy to take any questions you may have, when Professor Awrey permits so.

Thank you very much for listening.