Chairman Scott, Ranking Member Scott, and members of the Subcommittee, thank you for the opportunity to testify about Brexit and various cross-border matters that impact derivatives markets and market participants.

I am the President and Chief Executive Officer of FIA. FIA is the leading global trade organization for the futures, options and centrally cleared derivatives markets, with offices in London, Brussels, Singapore and Washington, D.C. FIA’s membership includes clearing firms, exchanges, clearinghouses, trading firms and commodities specialists from more than 48 countries as well as technology vendors, law firms and other professionals serving the industry.

FIA’s mission is to support open, transparent and competitive markets, protect and enhance the integrity of the financial system, and to promote high standards of professional conduct. As the principal members of derivatives clearinghouses worldwide, FIA’s clearing firm members help reduce systemic risk in global financial markets. Equally important, our clearing firm members provide access to the commodity futures markets, which allows a wide range of companies in the commodity supply chain to manage their price risks.

Prior to serving as the President and CEO of FIA, I had the honor of serving as a Commissioner of the Commodity Futures Trading Commission from August 2002 to June 2009. During that time, I served as the Acting Chairman from June 2007 to January 2009.

Earlier this month, a separate House Agriculture Subcommittee held a hearing titled “The State of U.S. Agricultural Products in Foreign Markets.” There was agreement from Members on both sides of the aisle that American farmers, growers, and ranchers, and the farm economy more broadly, benefit from fair access to foreign markets.

The same holds true when it comes to our financial markets. The American farm economy benefits from open and fair access to global derivatives markets. Without this access, the costs to hedge risk become greater. Ultimately, this would be felt by American consumers when they visit their local grocery stores or order food at a restaurant.

Dating back to my time as a CFTC Commissioner, and even prior, the derivatives markets have been global in nature. Transactions, clearing and settlement often take place in different countries and across different time zones and continents.

Ultimately, market participants benefit from the global nature of the markets. The more participants, the stronger the market for those seeking to hedge risks. Open markets improve competition, keep costs affordable for customers and grow the economy. Our markets are not defined by borders—they are defined by the ingenuity and determination of buyers and sellers—no matter their location.
Cross-Border Trading Statistics

To illustrate the global nature of the markets, FIA has polled several of its member exchanges regarding the percentage of their volume that comes from foreign counterparties. The results are notable.

![Cross-Border Trading Chart]

As made clear by these statistics, the ability to access customers on a cross-border basis strengthens markets. CME Group reports 42 percent of its metals contract volume originating in jurisdictions outside the U.S. ICE Futures US data shows that approximately 35 percent of the volume in its agricultural business comes from overseas. Without access to global markets, end-users—including farmers and ranchers seeking to hedge their risks in the derivatives markets—are harmed.

A Cause of Global Market Fragmentation

At the time of the financial crisis in 2008, I was serving as the Chairman of the CFTC. I vividly remember the panic and pain felt by so many Americans. The entire financial system was on the brink of collapse, and I was being called to the White House weekly as the President, the Treasury Secretary and policymakers of the highest levels searched for answers.

In the aftermath of the crisis, the member nations of the Group of Twenty (G20) engaged in a fundamental restructuring of the regulatory framework for OTC derivatives markets. The goal was simple: to improve transparency, mitigate systemic risk and protect against market abuse.

When the G20 held a summit in Pittsburgh in 2009, jurisdictions from across the globe were on the same page. They agreed on general principles and reforms, including mandates to clear all standardized over-the-counter derivatives.

For a time following the summit, implementation of the core principles and reforms agreed upon at the summit was going smoothly. There was an understanding that global implementation of identical rules,
on a line-by-line basis, was impracticable. Rather, the G20 sought to ensure the principles and reforms agreed upon in Pittsburgh would be implemented to achieve equivalent regulatory outcomes.

Unfortunately, intervening political events have caused this alignment to be tested over time. The best example is Brexit. Now, we find ourselves with a radically different situation in Europe with the financial center of Europe soon to be located outside the EU. This will make it even more difficult to have consistent implementation of those G20 standards.

**FIA Advocacy Related to Brexit**

Since the United Kingdom voted to leave the European Union (EU) in 2016, FIA has worked tirelessly to inform and work with our members, policymakers, and the general public about the operational and market impact of a possible no-deal Brexit scenario on the listed and cleared derivatives market.

Unless the U.K. and the EU reach an agreement that delivers a smooth transition in the Brexit process, market participants will be faced with the prospects of significant disruption, financial instability, and regulatory uncertainty. Preparations for Brexit are continuing in the EU and U.K. and FIA firms have taken significant steps to ensure continued access to financial services in the EU and U.K after Britain leaves the EU.

As we set out to address these challenges, our focus at FIA has remained on:

- Minimizing disruption
- Avoiding fragmentation of liquidity by regulatory actions
- Maintaining global access to markets and counterparties

FIA worked extensively with our member firms and other trade associations to secure a commitment from the European Commission to allow U.K. clearinghouses temporary continued access to the EU in the event of a no-deal Brexit. This commitment by the European Commission was announced in December 2018 and was an enormous success for market participants across the globe, including in the United States. In response, the European Securities and Markets Authority (ESMA) followed suit by adopting recognition decisions for three U.K. CCPs.

FIA, however, is closely monitoring several areas of concern that could impact access to European and U.S. markets as the Brexit debate continues. Recent revisions to the European Market Infrastructure Regulation legislation (EMIR 2.2) on clearinghouse supervision may require direct compliance with substantial elements of EU law and supervision by EU regulators for U.S. clearinghouses deemed systemic unless EU regulators find U.S. supervision to be equivalent.

If implemented without the proper recognition of home country supervision, this could lead to contradictory requirements, duplicative supervision and counter-reactions by global regulatory authorities. These EU consultations, which are currently out for public comment, may impact access to global markets if not properly clarified and implemented. The current Chairman of the CFTC has also announced his intention to strengthen the CFTC’s ability to recognize and defer to home country supervision for foreign CCPs. FIA stands ready to comment on all these proposals to ensure the proven regulatory deference and recognition approach remains the standard for cross-border regulation.

**Additional Examples of Cross-Border Challenges**

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1 Due to the extension of the Article 50 of the Treaty of the European Union deadline, an amended equivalence decision in relation to the U.K. CCPs was adopted by the European Commission on April 3, 2019
The listed and cleared derivatives markets are facing potential regulatory change driven by a range of geopolitical developments that pose a threat to the global markets.

As jurisdictions around the world implement G20 principles from the 2009 summit, they sometimes vary, overlap or contradict with the implementation of other jurisdictions.

I’d like to highlight some specific examples of problematic approaches which have taken place or been proposed in recent years:

**Clearing:** Japan requires certain transactions to be cleared within its borders, rather than by a third country CCP. In this case, the level of local compliance is such that a local entity must be established, which is costly and inefficient for many market participants. These requirements greatly impact the number of market participants available to offer clearing services in a specific jurisdiction.

**Reporting:** The EU and the U.S. have introduced similar but separate derivatives trade reporting rules. Although the goals are the same, they did not coordinate the substance of what is reported nor the timing of the implementation. As a result, regulators in these two jurisdictions have imposed highly operationally intensive rules that require firms to devote significant operational resources on multiple separate occasions to ensure effective compliance with the separate rule sets.

**Capital:** Divergence in capital requirements across jurisdictions is not uncommon. However, in the world of the listed and cleared derivatives markets, this type of divergence can have vast implications.

Responding to the financial crisis, the Basel Committee for Banking Supervision adopted a leverage ratio as a backstop that requires banks to hold capital against actual exposures to loss. The Federal Reserve Board, the Federal Deposit Insurance Corporation (FDIC), and the Office of the Comptroller of the Currency (OCC) have implemented the Basel supplementary leverage ratio (SLR) in the United States.

FIA strongly believes that capital requirements need to be recalibrated so that it reflects the true amount of risk in this activity. Unfortunately, the SLR fails to recognize the collection of customer initial margin in the central clearing process as an offset to a bank’s exposures. Other jurisdictions such as the EU have recognized client cleared initial margin as exposure reducing under the leverage ratio. If the U.S. does not correct course and do the same, capital costs associated with central clearing in the U.S. will not be competitive with the EU’s. This impacts end users and businesses across a wide variety of industries that rely on derivatives for risk management purposes, including agricultural businesses and manufacturers.

It has also left end-users with less competition and access to clearing services. The number of firms providing client clearing services in the U.S. has dropped from 84 in 2008 to 55 in 2018. This result runs counter with the clearing mandates contained in Title VII of the Dodd-Frank Act. This tax on clearing places clearing firms and their customers in the U.S. at a disadvantage relative to their foreign competitors as jurisdictions outside of the U.S. have offered or plan to offer an offset for client margin.

FIA was pleased to learn that last week the Basel Committee on Banking Supervision agreed on allowing client initial margin to offset the exposure amounts under the leverage ratio. We look
forward to the U.S. prudential regulators implementing this global revision. FIA thanks Chairmen Peterson and Scott, and Ranking Members Conaway and Scott, along with the current Commissioners of the CFTC for their leadership on this issue. FIA also thanks the Commissioners for their recent bipartisan comment letter to the prudential regulators supporting this needed recalibration.

The U.S. prudential regulators are currently consulting on a rulemaking related to implementation of the standardized approach for counterparty credit risk (SA-CCR) capital framework. FIA has responded seeking an offset for client cleared margin. In addition, FIA believes that this rulemaking raises several concerns with FIA members, including its commodity members.

Among the concerns are the very limited recognition of margin under the risk weighted asset (RWA) capital requirements and the punitive treatment of commodities trading. It is not certain when and in what form SA-CCR will be adopted in other jurisdictions that participate in the Basel Committee process. If mandatory compliance with SA-CCR is required prior to its adoption in other jurisdictions, U.S.-based commercial end users may be susceptible to significant competitive disadvantages. FIA is also concerned, broadly, that the SA-CCR proposal in its current form may have a significant adverse impact on the liquidity of derivatives markets, especially commodities markets.

**FIA Recommendations to Reduce Market Fragmentation**

To better identify and address these growing concerns and the cross-border uncertainty driven by a range of geopolitical developments, FIA published a white paper in March 2019 titled: Mitigating the Risk of Market Fragmentation. To summarize, we encouraged regulators around the world to:

- Rely on counterparts in other jurisdictions to supervise certain cross-border activity through “deference” or “substituted compliance”;
- Work collectively to develop international standards and implementation guidelines while recognizing local flexibility and conditions; and
- Put in place mechanisms for cross-border cooperation, information-sharing, and crisis-management planning, which is critical for the day-to-day supervision of cross-border business.

As noted in our March white paper, FIA strongly supports the regulatory recognition and deference model that has been the foundation of the futures industry for years. Deference raises standards in global markets as it is used to assess whether jurisdictions have adopted comparable rules to those in the U.S. This tested tool is one way to bring other countries into compliance with global standards and make the markets safer.

We were excited to see that earlier this month, the Financial Stability Board (FSB) published a report, which was delivered to G20 Finance Ministers and Central Bank Governors ahead of their meetings in Fukuoka, Japan on June 8 and 9, 2019. The report lays out approaches and mechanisms to improve international cooperation and mitigate market fragmentation.

Additionally, we are pleased to see that the issues of market fragmentation will be discussed at the highest levels of government as it will be on the agenda for the upcoming G20 Summit in Osaka, Japan later this

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3 [https://fia.org/sites/default/files/FIA_WP_Mitigating%20Risk.pdf](https://fia.org/sites/default/files/FIA_WP_Mitigating%20Risk.pdf)
A History of the CFTC’s Approach to Cross-Border

The CFTC has been a global regulatory leader in promoting the principles of deference and regulatory recognition. In 1980, the CFTC was one of the first regulators to put in place a cross-border recognition approach for market participants. At that time, the CFTC adopted a position that, notwithstanding the potential broad scope of the CFTC’s jurisdiction under the Commodity Exchange Act (CEA), “it is appropriate at this time to focus [the CFTC’s] activities upon domestic firms and firms soliciting or accepting orders from domestic users of the futures markets and that the protection of foreign customers of firms confining their activities to areas outside of this country . . . may best be for local authorities in such areas.”

Congress also deserves credit for the agency's historical support for the principles of recognition and deference.

In 1982, Congress amended the CEA to authorize the CFTC to adopt rules governing the offer and sale of foreign futures to persons located in the U.S. Congress was careful to limit the CFTC’s authority to the regulation of intermediaries that deal directly with persons located in the U.S., while expressly prohibiting the CFTC from adopting any rule that “(1) requires [CFTC] approval of any contract, rule, regulation, or action of any foreign board of trade, exchange, or market or clearinghouse for such board of trade, exchange or market, or (2) governs in any way any rule or contract term or action of any foreign board of trade, exchange, market or clearinghouse for such board of trade, exchange or market.”

The CFTC has allowed U.S. participants direct electronic access to foreign markets if the non-U.S. entities have rules that are comparable with the CFTC’s. That process was formalized by Congress in the Dodd-Frank Act, which authorized the CFTC to register Foreign Boards of Trade (FBOT) that wish to permit direct access from the U.S. but deferring to the home country regulator and rules where the rules are comparable. Today, there are 18 registered FBOTs with the CFTC.

Finally, earlier this month, at FIA’s annual International Derivatives Expo conference in London, CFTC Chairman Christopher Giancarlo highlighted the principles of his cross-border policy. Specifically, he stated “the CFTC should act with deference to non-U.S. regulators in jurisdictions that have adopted comparable G20 swaps reforms.” He went on to say, “Mutual commitment to cross-border regulatory deference ideally should mean that market participants can rely on one set of rules—in their totality—without fear that another jurisdiction will seek to selectively impose an additional layer of particular regulatory obligations that reflect differences in policy emphasis, or application of local market-driven policy choices beyond the local market. This approach is essential to ensuring strong and stable derivatives markets that support economic growth both in the U.S. and around the globe.”

FIA agrees with Chairman Giancarlo and looks forward to working with the CFTC on future cross-border rulemakings.

The CFTC has for decades, under Chairs from both parties, understood that market fragmentation created though a patchwork of international regulation undermines the resilience of the clearing derivatives system and therefore weakens the safety mechanisms built into the clearing system.
Cross-Border Fintech Challenges

With the international focus of this hearing, I would like to take a moment to recognize an area where the CFTC is lagging other international regulators, by no fault of its own.

According to CFTC Chairman Giancarlo, the agency has limitations in its ability to test, demo, and generate proof of concepts around emerging technologies and systems. At a recent hearing before this committee he said, “Specifically, the CFTC lacks the legal authority to partner and collaborate with outside entities engaging directly with fintech within a research and testing environment, including when the CFTC receives something of value absent a formal procurement.”

This is problematic and prevents the CFTC from keeping pace with emerging technologies and puts the U.S. at a competitive disadvantage relative to its overseas counterparts. For example, the U.K. offers regulatory sandboxes where fintech firms can work with the regulator and receive feedback and answer questions about their products.

Given the global nature of our markets, it is important that regulators in the U.S. have access to the same emerging technology available to regulators in the U.K. and elsewhere.

That is why I would like to recognize and thank Ranking Member Austin Scott (R-GA) for his legislative efforts to provide the CFTC with the necessary transaction authority to engage in public-private partnerships with financial technology developers. FIA stands ready to work with the committee on solutions that provides the tools needed by the CFTC and market participants alike.

Conclusion

FIA greatly appreciates the Subcommittee’s interest in these critical topics that affect the global financial markets and the end-users who rely on derivatives products for price certainty and to hedge their risks.

FIA strongly supports the regulatory recognition and deference model that has been the foundation of the futures industry for years. Identical rules, on a line-by-line basis, implemented globally across jurisdictions is impracticable. Rather, the goal we should strive to achieve is ensuring equivalent regulatory outcomes.

The good news is we have a window of opportunity to reset the global approach to cross-border regulation. It is imperative we get these cross-border issues right, especially with Brexit looming. The stakes are incredibly high. Without common ground, we may find ourselves with fragmented markets and regulation. That doesn’t benefit anyone, especially customers and end-users.

I appreciate the Committee’s attention to this important topic.

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5 https://www.cftc.gov/PressRoom/SpeechesTestimony/opagiancarlo70
Mitigating the Risk of Market Fragmentation

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About FIA

FIA is the leading global trade organization for the futures, options and centrally cleared derivatives markets, with offices in Brussels, London, Singapore and Washington, D.C.

FIA's mission is to:

■ support open, transparent and competitive markets,
■ protect and enhance the integrity of the financial system, and
■ promote high standards of professional conduct.

As the leading global trade association for the futures, options and centrally cleared derivatives markets, FIA represents all sectors of the industry, including clearing firms, exchanges, clearing houses, trading firms and commodities specialists from more than 48 countries, as well as technology vendors, lawyers and other professionals serving the industry.
INTRODUCTION

Cleared derivatives markets today are grappling with the challenge of market fragmentation caused by regulation.

In modern derivatives markets, cross-border regulatory cooperation is a necessity. Post-financial crisis reforms by the G-20 nations acknowledged as much when they enacted central clearing mandates and put a vision of pragmatic oversight and regulatory deference above a patchwork, country-by-country approach to derivatives regulation.

Lately, however, markets have become increasingly fragmented as different jurisdictions have moved to implement G-20 reforms on their own. Some policymakers are exerting their national or regional authority on third-country exchanges, clearinghouses, market participants and transactions. The unfortunate result is market fragmentation caused by regulation such that the original goal of holistic cross-border solutions has been replaced by a siloed regulatory and commercial landscape.

We see several types of regulatory issues causing market fragmentation.

- First, there has been divergence in the content of implementation as policymakers have adapted the reforms to local conditions and political priorities. The resulting variations have made it more difficult for regulators to make a determination that foreign financial institutions are subject to equivalent regulation.

- Second, there has been divergence in the pace of implementation, causing some early-adopter nations to justify imposing extra-territorial requirements on activity or participants in jurisdictions that have not yet implemented these reforms.

- Third, new issues have arisen, such as Brexit, which have caused policymakers to reconsider their implementations of the G-20 reforms and rethink their views on cross-border cooperation.

As a result, we have seen a growing trend toward more direct regulation of foreign activity and participants rather than reliance on a foreign regulator to supervise that activity when such jurisdiction has implemented a regulatory regime that achieves comparable outcomes (an approach sometimes referred to as "deference" or "substituted compliance"). This issue is not unique to the derivatives markets, but it is particularly acute because of the cross-border nature of this industry.

More disturbingly, fragmented derivatives markets can also create barriers to entry which, in turn, lead to a fall in the number of participants that are able to mutualize risk and collectively withstand the next adverse market event, minimizing the impact of the financial crisis market reforms.
As an example, regulation which requires a market participant active in two different jurisdictions (such as the US and a European jurisdiction) to comply with conflicting and duplicative rules limits choices and increases costs for commercial end users who are seeking to hedge marketplace risks beyond their control. With costly and limited options, market participants may choose to forgo hedging altogether further contracting markets and liquidity.

The benefits of central clearing are well recognized by policymakers. It is one of the central pillars of the G-20 post-crisis reforms to reduce the systemic risk associated with derivatives markets and market data shows these efforts are succeeding. According to the Bank for International Settlements, the use of clearing in the global interest rate derivatives market rose from 24% in 2009 to 62% by mid-year 2018. In the global credit derivatives market, the clearing level rose from 5% to 37% over the same time period.

FIA believes strongly that derivatives markets must protect and advance market participants’ access to cross-border central clearing by supporting regulatory reliance (deference), with national rules benchmarked to internationally-agreed-upon standards. Such supervisory reliance has been proven to be effective and remains a key plank in ensuring open access to global cleared markets, reducing risk and increasing market efficiency through competition.

An adherence to international standards enables pursuit of legitimate public policy goals in respect of cleared derivatives markets without causing market fragmentation. However, such an approach depends on international standards being specific enough to enable a reliance model. The CPMI-IOSCO Principles for Financial Market Infrastructures (PFMIs) are a good example of international standards that are sufficiently detailed, allowing for a reliance model by national regulators.

To be effective, a reliance approach also requires a high level of cooperation and information-sharing among regulators. If the host supervisor requires a right to supervise the entity, home and host supervisors should coordinate their supervisory activities to improve the effectiveness and efficiency of supervision of entities with a cross-border footprint. In addition, periodic evaluations must take place to ensure that regulatory regimes continue to pass the test of equivalence.

In Part I of this paper, we describe the issue of market fragmentation in cleared derivatives markets, explain why it is a threat and provide examples. In Part II of this paper, we explain the meaning of reliance, as our preferred solution to the risk of market fragmentation. In Part III of this paper, we outline our recommendations.

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1. [https://www.bis.org/cpmi/info_pfmi.htm](https://www.bis.org/cpmi/info_pfmi.htm)
on the best approaches to reliance, building on the work carried out so far by IOSCO, multilateral arrangements and the bilateral achievements of regulators, and we set out specific substantive recommendations for regulators.

**PART I – WHAT IS FRAGMENTATION AND WHY DOES IT MATTER?**

For the purpose of this paper, market fragmentation is where participants in an organic, shared market which crosses jurisdictions are less able to interact freely with one another in one or more of such jurisdictions. Thus, market participants are limited to interacting in silos that are less liquid, less diverse and less competitive.

Market fragmentation can be caused by regulation—either purposefully or inadvertently. Regulation that conflicts or overlaps will necessarily require differing forms of compliance from the same market participants (or even be impossible to comply with) and thus may cause participants to operate in silos in order to meet their regulatory requirements rather than operate in a shared market.

This is a particular concern in the cleared derivatives markets, due to their cross-border nature. In the context of cleared derivatives markets, fragmentation results in both short-term economic costs, with reduced levels of liquidity, and long-term threats to financial stability thanks to inefficient risk management. Cleared derivatives are an essential product in today’s financial markets and comprise a significant proportion of global financial activity.\(^2\)\(^3\) As stated by the President of the European Central Bank Mario Draghi: “open markets are conducive to freeing human potential, expanding opportunities, and improving well-being.”\(^4\)

One measure of cross-border activity is the amount of trading on derivatives exchanges that originates from outside their home countries. Derivatives markets benefit from network effects; the more participants, the stronger the market. Open markets improve competition, keep costs affordable for customers, and

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2 [https://www.bis.org/statistics/about_derivatives_stats.htm?m=6%7C32](https://www.bis.org/statistics/about_derivatives_stats.htm?m=6%7C32)
3 [https://www.bis.org/publ/qtrpdf/r_qt1612b.htm](https://www.bis.org/publ/qtrpdf/r_qt1612b.htm)
grow the economy. Our markets are not defined by borders—they are defined by the ingenuity and determination of buyers and sellers—no matter their location. To illustrate, FIA has polled several major exchanges regarding the percentage of

A second measure of cross-border derivatives activity comes from a set of statistics published by the Commodity Futures Trading Commission ("CFTC"), the primary regulator of derivatives markets in the US. These statistics track the amount of customer funds held at clearing firms, known in the US as futures commission merchants ("FCMs"). The funds are collected from customers for the purpose of meeting the margin requirements set by US clearinghouses for their derivatives clearing. They represent one of the core protections against

![Cross-Border Trading](cross-border-trading-graph.png)

Trading originating outside the home jurisdiction as a percentage of total volume during Q2 2018

Source: Data provided by each exchange upon the conclusion of Q2 2018.
systemic risk in the US derivatives markets. These CFTC-registered FCMs can be subsidiaries of banks or other financial companies that can be headquartered anywhere in the world. FIA has conducted an analysis of the market share held by all FCMs, using data published by the CFTC as well as other sources of information. Our analysis shows that foreign institutions are an important part of the FCM community in the US.

As of December 2018, there were 54 FCMs holding a total of $295.3 billion in customer funds, of which $203.6 billion was held in segregated customer accounts for exchange-traded futures and options and $91.7 billion for cleared swaps. Non-US owned FCMs held 33% of the futures-related customer funds and 21% of the swap-related customer funds.

This data shows cross-border activity is important to intermediaries as well as to end-users. Customers rely on clearing firms to provide access to markets as well as the services they need to meet the requirements of central clearing. In the US, the population of intermediaries includes a large number of institutions that are headquartered in Europe and Asia-Pacific. The impact for the world economy of fragmenting cleared derivatives markets will be significant since a reduction in the efficiency and/or liquidity of these markets will not only drive up costs for economic actors (including non-financial services firms) but reduce financial stability.

![Market share of customer funds in futures accounts](chart)

> Source: U.S. Commodity Futures Trading Commission

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5 [https://fia.org/fcm-tracker](https://fia.org/fcm-tracker)
Due to the cross-border nature of the global financial crisis, there is considerable public policy interest by regulators in cleared derivatives markets. Although the CFTC’s data on FCMs active in the US shows the global nature of derivatives markets, the challenge is that local regulators may deal with issues relating to cleared derivatives markets in different ways and at different times. Market fragmentation results when separate regulations deal with the same type of activity differently, because regulators narrowly concern themselves with the impact of such activity in their own jurisdiction. Conflicting and overlapping regulations discourage or even prevent deep, efficient and liquid derivative markets from functioning and direct market activity to national silos.

Complete consistency between all major jurisdictions is not possible, and regulators have legitimate public policy reasons for their national approaches. However, FIA believes this must be balanced against the clear risks of market fragmentation caused by divergent, overlapping or conflicting rules.
Mitigating the Risk of Market Fragmentation

Regulation causing market fragmentation can be seen to emerge in three key ways.

First, regulators may deal with existing, known issues in a market in different ways from one another – even where there is agreement at a global level as to the broad outline of how the issue should be dealt with. This form of divergence is in respect of the content of regulatory implementation. It may be caused by regulators fitting global standards to existing national rules and law; by some regulators prioritizing certain aspects of global standards while other regulators take a contrary position; regulators choosing to deviate from global standards for public policy reasons; or, regulators in different countries developing different rules in respect of existing issues where global standards do not exist or are insufficiently detailed to form a basis for national rules.

Second, regulators may diverge on the timing of national implementation of some or all parts of otherwise agreed global standards. This form of divergence is in respect of the pace of regulatory implementation. It may be caused by regulators attributing different levels of priority to agreed global standards or simply different levels of capacity on the part of regulators in different jurisdictions.

Third, regulators may react differently to novel issues where global standards or agreements have not been agreed. This form of divergence is in respect of new issues that require a regulatory response. It may be caused by political change that results in governments or legislators demanding action for public policy reasons or it may be caused by developments in the market, such as technological change, which have occurred before consensus between different regulators can form.

Here are examples of problematic approaches which have been taken or proposed in recent years:

- An example of content driven divergence relates to requirements for offering clearing services in a specific jurisdiction; for instance, Japan requires certain cleared transactions to be cleared within its borders, rather than by a third-country CCP—in this case the level of local compliance is such that a local entity must be established which is costly and inefficient for many market participants.

- An example of pace driven divergence relates to requirements for trade reporting; the EU and the US have introduced derivatives trade reporting rules, but they did not coordinate the timing of the implementation. As a result, regulators have imposed highly operationally intensive rules that cover the same general topic but that ultimately required firms to devote significant operational resources on multiple separate occasions to ensure effective compliance with the separate rule sets.
An example of a new issue driving divergence is Brexit. Brexit has in the eyes of some policymakers necessitated changes to current regulations and even market structures. Thus, several EU proposals in response to Brexit, such as EMIR 2.2 and the Investment Firm Review, have included elements requiring direct compliance with substantial elements of EU law or supervision by EU entities in order for UK market participants to be able to continue with their existing business models, even where UK law would be substantively equivalent to EU law.

PART II - THE VALUE OF CO-OPERATION AND THE IMPORTANCE OF RELIANCE BY REGULATORS IN PREVENTING FRAGMENTATION

Regulatory reliance can prevent fragmentation by averting overlaps and conflicts. In the context of clearing and derivatives regulation, we view supervisory reliance as a decision by one regulatory authority not to seek to apply its regulations to activities conducted in another jurisdiction, but, instead, to depend on the regulatory authorities in the latter jurisdiction.

The process of supervisory reliance should comprise several steps:

- First, a regulator should consider whether it has a genuine need to oversee an activity or entity in another jurisdiction.
- Second, if such a need is identified, then there should be an assessment of the rules of the foreign regulator to determine whether they are comparable in the outcomes they achieve.
- Third, if the rules are comparable, the regulator should recognize those host country requirements as sufficient and that oversight of such compliance by the relevant foreign regulator is appropriate. This process will necessarily avoid regulatory conflicts and overlaps where the two regulators have comparable rules.

A regulatory authority seeking to rely on another authority will thus need a basis to conclude that regulatory regime of the other jurisdiction is comprehensive and achieves comparable outcomes, such that the supervision and regulation of activities in accordance with such regime’s rules would be appropriate.

In coming to this conclusion, a jurisdiction’s analysis should center on an outcomes-based approach rather than a line-by-line examination of the other jurisdiction’s rules. Such an analysis can be driven by a comparison of the foreign jurisdiction’s regulatory objectives, goals and outcomes to those of the domestic jurisdiction. This approach has been applied successfully to a number of areas, such as the EU’s efforts with respect to EMIR equivalence and the CFTC’s Part
Mitigating the Risk of Market Fragmentation

30 process for FCM registration exemptions, a longstanding model dating to the late 1980s. Alternatively, the analysis can be driven by a comparison of the foreign jurisdiction's approach to international standards, such as the CPMI-IOSCO PFMI.

The principal benefit of the reliance model is that it avoids the market fragmentation that can arise when two authorities attempt to regulate the same activity in different ways and ultimately create legal complexity, operational risk, and added compliance costs. In addition, the reliance model can strengthen the resilience of the cleared derivatives markets by reducing the barriers to accessing market infrastructure.

The market fragmentation created by the direct regulatory model also undermines cooperation among regulatory authorities, weakening the ability of the regulatory community to respond collectively to unexpected market events such as the collapse of a globally significant financial institution.

The most direct impact of duplicative rules that characterize a fragmented market is the risk that compliance with one applicable set of rules will nonetheless result in a violation of the other set of rules. This results in increased cost borne by firms that need to comply with more than one set of rules as the outcome often can be that firms are forced to always comply with the “worst of” each rule set in all circumstances to ensure there is never a material regulatory breach; in the worst case, a particular market activity will cease when a route to compliance is not apparent. The consequences of duplicative and conflicting rules can create legal complexity, operational risk and compliance costs for market participants both due to the inherent costs of compliance with two sets of rules (seeking legal advice, developing compliant operational processes, compliance function activities) but also the costs generated through conflicts and inconsistencies in the rules. In a survey of financial services executives published by the International Federation of Accountants in February 2018, 75% said that the costs of divergent regulations were a material cost to their business.  

It should also be noted that reliance will result in savings for regulatory authorities themselves. When government authorities are faced with finite regulatory resources, those resources can be deployed more cost-effectively to its own market.

Supervisory reliance cannot exist in a vacuum, however. For the reliance model to work properly, it must take place within a framework of cooperation among regulators.

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PART III – RECOMMENDATIONS FOR COOPERATION AND RELIANCE

In light of the international nature of cleared markets, supervisory reliance is the ideal approach for avoiding market fragmentation. As set out in Part II above, the benefits of reliance are considerable both for ensuring stable, effective markets and in assisting regulators fulfill their goals.

FIA sets out below proposals for enabling and improving supervisory reliance. The proposals relate to:

1. Use of International Standards; and
2. Agreements between Regulatory Authorities.

Use of International Standards

The key plank for supervisory reliance and preventing market fragmentation, in the view of FIA, is recognition of rules that meet international standards (or where those are not available, national laws). Use of agreed international standards by regulatory authorities will limit conflicts of rules between different jurisdictions. FIA believes clear and effective standards will increase consistency and predictability for market participants, reduce market fragmentation and ultimately result in deep, efficient, and liquid derivatives markets.

Both the US and EU, to varying degrees, currently recognize rules of other jurisdictions (US rules for foreign boards of trade, foreign futures intermediaries, and swaps exemptive approach and, in the EU, EMIR equivalence) and we encourage these authorities to continue doing so. We also note that the EU and Singapore have deemed each other to be equivalent in relation to the regulation and supervision of CCPs and have announced plans for a common approach to trading venues that will result in mutual recognition of each other’s venues.

FIA recommends that international standards be set through a dialogue between peer regulators in an effort to achieve better results than rules set by one country alone. The varying perspectives and experience of regulators ensure proposed rules endure greater scrutiny and do not inadvertently result market fragmentation. It is critical that these international standards go through rigorous public comment and an opportunity for input given the importance of the standards and principles in regulation.
The governance and rule-making processes for international standard-setters may need to improve if regulatory authorities are to place greater reliance on this collaborative method of rulemaking. Furthermore, buy-in from local authorities is essential if greater reliance on international standards is to occur. It should also be noted that if international standards are to form the basis for supervisory reliance, some existing international standards will need to be improved: they must be specific and granular, not simply statements of principle but provisions that can be used for outcomes-based equivalence determinations. Specificity and granularity in international standards play an important role in preventing content driven regulatory divergence, caused by regulatory authorities attempting to fill in the gaps where a relevant standard lacks sufficient detail.

International standard setters should also consider increasing their focus on monitoring implementation of standards, and benchmarking jurisdictions against best-practices set out in agreed-upon international standards. This could build on the Financial Stability Board’s Thematic Reviews7 and IOSCO’s Assessment Committee. The level of cross-border cooperation that a jurisdiction engages in could be treated as a benchmark. The timing of implementation is also significant and should be benchmarked; coordinated implementation of standards in different jurisdictions can play an important role in preventing pace-driven regulatory divergence, caused by regulatory authorities implementing rules at different times and thus subjecting market participants to different rules as the same point in time.

**Arrangements Between Regulatory Authorities**

In modern derivatives markets, information sharing and cross-border crisis-management are crucial to market integrity. FIA believes that regulatory authorities should widely adopt memoranda of understanding (MOUs) in respect of information sharing.

Though the use of the standard MOU produced by IOSCO8 is welcomed, the priority should be the substance of the MOUs in whatever form regulatory authorities are mutually comfortable. FIA believes regulatory authorities should provide a high level of information disclosure to one another in respect of regulated firms and infrastructure in their jurisdiction.

MOUs should be put in place both for general information sharing and in respect of specific firms in which authorities have an interest in for reasons of


systemic financial stability. This partnership among global regulators goes beyond information that can be used to identify possible regulatory violations.

Perhaps most importantly, MOUs should build trust and cooperation between authorities in an ongoing effort to reduce market fragmentation and increase transparency and consistency in regulation. Regulatory authorities should remain open-minded about allowing certain inspection rights in relation to critical market infrastructure in MOUs, in this spirit of transparency and cross-border cooperation.

Regulatory authorities should also put in place mechanisms for cross-border crisis-management planning. Crisis-management processes will be much more effective if they are agreed ex ante rather than authorities attempting to agree them during the early stages of a crisis. Further, the process of carrying out crisis-management plans will ensure that authorities are better prepared for dealing with a crisis, even if the permutations of the crisis deviate from those subject to the plan.

International regulators have historically recognized this benefit and formed crisis management groups for CCPs that are systemically important. The working group for crisis management in respect of LCH. Clearnet Ltd is an example of this approach.

The global financial crisis provided graphic examples of the benefits of cooperation between regulatory authorities in dealing with crisis-stricken firms. Analysis of crisis management in respect of Dexia Bank, Fortis Bank, Lehman Brothers and Kaupthing Bank has noted the impact of cooperation and coordination by authorities (or lack thereof) on the achievement of goals by authorities. The crisis management actions in respect of Dexia benefited from a high degree of cooperation by relevant supervisors, whereas the crisis management actions in respect of Kaupthing showed a lack of cooperation and coordination by the home regulatory authorities with affected host authorities.

Going back further, the collapse of Barings Bank in 1995 provides a case study in the problems that can arise due to a lack of cross-border cooperation. The cross-border nature of the bank’s trading activity in certain futures markets was not fully understood either by regulatory authorities or other market participants.

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11 https://www.bis.org/publ/bcbs169.pdf
12 https://scholarlycommons.law.northwestern.edu/cgi/viewcontent.cgi?referer=https://www.google.com/&httpsredir=1&article=1536&context=njilb
Mitigating the Risk of Market Fragmentation

a result, the collapse posed a much greater threat to the stability of those markets than the authorities were prepared for. The experience inspired regulatory authorities from 16 jurisdictions to issue the Windsor Declaration in 1995 in which they stated the need to improve “co-operative measures” among regulatory authorities and in particular the need for greater information sharing. This was followed by the Boca Declaration in 1996, an arrangement under which the occurrence of certain triggering events affecting an exchange member’s financial resources or exposures prompts the sharing of information among regulators. The Boca Declaration was developed with the help of industry representatives and trade associations, including FIA. It has also been noted by the Bank for International Settlements that cooperation between supervisors can also play a key role in averting crisis situations.\(^{13}\)

Regulatory authorities should also consider the sharing of information and best practices with both peer organizations and trade associations to a greater degree. International standard-setting and cooperation should include the joint development of best practices. Networks can be established with the industry and their representatives in an informal or *ad hoc* manner for particular subjects as a way of sharing information and practices between authorities. Such networks can act as fora for particular strategies or policy proposals to be tested, before they are raised at the level of international standard setters.

CONCLUSION

As set out above, reliance by regulatory authorities on agreed international standards and supervision by fellow regulators in other jurisdictions is the best way to prevent market fragmentation and ensure deep, efficient, liquid and competitive derivatives markets.

Reliance, and the consultation and cooperation which it necessitates, can demonstrate respect for the sovereignty of each jurisdiction while still encouraging competition and efficient risk-management in the era of global and interconnected derivative markets.

The benefits of legal certainty are tangible through lowered regulatory costs, increased competition and more efficient mutualization of market risk. However, the opportunity for local regimes to consult with peers around the world and collectively work towards market stability and regulatory certainty cannot be discounted.

\(^{13}\) [https://www.bis.org/speeches/sp170918.pdf](https://www.bis.org/speeches/sp170918.pdf)
FIA encourages all regulatory authorities to use existing international bodies such as IOSCO to further enhance international standards for the regulation of the derivatives markets. That will permit greater reliance on each other by derivatives regulators that are implementing regulations to advance the goals of the G-20 commitments following the financial crisis. Furthermore, FIA believes strongly that existing international standards should be reviewed with an eye towards practical application for outcomes-based equivalence determinations and not simply a soft statement of principles.

Reliance will result in better outcomes for both regulatory authorities and market participants than attempting to restrict cross-border activity. The current landscape of regulation for cross-border cleared derivatives markets is an opportunity for regulators to reset relations among themselves and move forwards on the basis of cooperative approaches.