

FIA Special Report: CFTC Discusses Cross-Border Issues
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The Commodity Futures Trading Commission's Global Markets Advisory Committee held a meeting on May 21 to discuss cross-border regulatory issues. The advisory committee, which is comprised of industry representatives and other experts, has no rule-making authority, but both of the current CFTC commissioners attended the entire meeting and the discussion provided some insights into the agency's position on several key cross-border issues.

The day-long meeting was split into two parts. In the first part of the day, the discussion focused on a proposal to provide exemptions for clearinghouses operating outside the U.S. so that they can provide clearing services for OTC derivatives to U.S. persons without having to register with the CFTC and comply with the full array of U.S. clearinghouse rules. In the second part of the day, the discussion focused on a somewhat less developed proposal to provide similar exemptions for swap trading venues operating outside the U.S.

Click [here](#) for the agenda and the list of participants
Click [here](#) for a list of the GMAC members

Clearinghouse Exemption Proposal

Phyllis Dietz, the deputy director for clearing policy in the CFTC's division of clearing and risk, started the GMAC meeting by presenting an overview of a nearly complete staff proposal for an exemption for foreign designated clearing organizations. The exemption would apply only if the foreign DCO is subject to comparable and comprehensive regulation and supervision in its home jurisdiction. She explained that rather than applying the CFTC's own requirements to make such an evaluation, the CFTC instead will consider whether the clearinghouse meets the international standards contained in the CPSS-IOSCO Principles for Financial Market Infrastructures.

Dietz said certain conditions would apply to clearinghouses that receive such an exemption, such as requirements to report certain information to the CFTC including: 1) daily reporting of initial and variation margin on deposit for U.S. clients; 2) quarterly "activity reports" of U.S. person aggregate clearing volume, average open interest, and a list of U.S. clearing members; and 3) event-specific reports including changes in the home country regulatory regimes, changes in licenses, disciplinary actions, and any defaults by futures commission merchants.

To provide an international perspective on this issue, the CFTC invited David Bailey, head of the market infrastructure and policy department at the U.K. Financial Conduct Authority, and Jun Mizuguchi, assistant commissioner for international affairs at the Japan Financial Services Agency, to speak at the meeting.

Bailey commented that more than 50% of trading in the global swap market takes place on a cross-border basis and pointed out that there are significant conflicts between U.S. and European rules for clearing swaps in such areas as customer account segregation. Bailey recommended that regulators should assess the equivalence of regulatory regimes by comparing the "outcomes" rather than the rules. He also took issue with one aspect of the CFTC's approach for assessing equivalence. He urged the CFTC to make such assessments on a jurisdictional basis, rather than looking at individual clearinghouses on a case-by-case basis.

Mizuguchi commented that conflicts between U.S. and Japanese clearing rules are creating problems for participants in the Japanese swap market. To avoid this problem, clearinghouses have to either register in both jurisdictions or obtain an exemption from one of the jurisdictions. Mizuguchi noted that Japanese CCPs have the added burden of needing to meet equivalence standards in both the U.S. and Europe and added that conforming with one set of standards does not eliminate the need to conform with the other.

Much of the subsequent discussion focused on a crucial limitation in the CFTC's proposal. As described by Dietz, the proposed exemption would allow foreign clearinghouses to provide clearing services to U.S. persons, but not customers of those persons. In other words, a foreign clearinghouse would be able to clear swaps traded by a U.S. bank for its own account, but not on behalf of the bank's U.S. customers.

This limitation was strongly criticized by several members of the advisory committee, including two representatives of buy-side institutions-Blackrock and Citadel. Adam Cooper, Citadel's general counsel, commented that one of the principles in the CPSS-IOSCO standards is fair and open access. To permit the clearing of proprietary positions and not customer positions would violate this principle, he stated. When CFTC staff explained that the proposal does not extend to client clearing because customers would lose the protections provided under U.S. bankruptcy law, Cooper commented that the solution would be to require a demonstration that the customer asset protection regime in the foreign jurisdiction is at least as strong as the CFTC's customer protections.

This limitation was also criticized by the FCA's Bailey. He discussed the importance of collaboration among regulators and said there must be "reciprocity." A regulatory regime that does not include client clearing would not be reciprocal, he added.

The limitation was defended, however, by one member of the advisory committee-Kim Taylor, the head of CME Group's clearinghouse. Taylor warned that allowing customer business to be cleared at foreign clearinghouses would result in the migration of a large portion of the U.S. dollar denominated swap market and the foreign exchange market to locations outside the oversight of the U.S. authorities.

Taylor also pointed out that there is a similar need for mutual recognition in the opposite direction. Non-EU clearinghouses such as CME have to demonstrate equivalence with EU clearing rules by Dec. 15 or EU persons will face significant economic disincentives to use those clearinghouses. Taylor complained that non-European firms are being "taken hostage" by the uncertainty over whether they will be deemed equivalent by the December 15 deadline. This is creating a competitive issue, she added, because there is no discussion right now on how to solve that problem on a faster path and the uncertainty is affecting customers.

Commissioner O'Malia expressed agreement with this concern. He noted that the deadline is only 142 days in the future and both sides should harmonize their rules as soon as possible.

Robert Klein, an associate general counsel at Citigroup Global Markets who serves on the advisory committee, commented that market participants will face an increasing number of conflicts as more rules come into effect in various jurisdictions around the world. Mutual recognition is the only way for trading to continue without violating the rules, he warned. He also suggested using the Part 30 model to handle client clearing of swaps. The Part 30 approach used for cross-border trading of futures has been tested and should not be underestimated, he commented.

Another member of the advisory committee, Emily Portney, global head of agency clearing, collateral management and execution at J.P. Morgan Securities, also called for considering the Part 30 futures approach for clearing swaps for U.S. customers.

Phyllis Dietz ended the discussion by stating that she was "happy to revisit this in light of comments today."

Trading Venues

The discussion in the second part of the day focused on the CFTC's treatment of foreign swap trading venues. In contrast to the first part of the day, the proposed approach was not described with the same clarity as the proposed exemption for foreign clearinghouses. In addition, much of the discussion centered on a basic problem; the U.S. is well ahead of the rest of the world in terms of implementing the requirement to trade swaps on swap execution facilities. Therefore a mutual recognition approach cannot work, since there are no comparable foreign trading platforms for swaps to assess for equivalence.

CFTC staff described the existing approach, which was outlined in an April 9 letter that provides relief for multilateral trading facilities that meet certain conditions. The staff explained that this letter was intended to provide relief on an interim basis for European trading venues during the transition to the new regulatory regime established under the Markets in Financial Instruments Directive. The staff noted, however, that no MTFs have requested relief under the terms of this letter.

Wetjen said the CFTC staff are now working on a more permanent solution that would provide exemptions for foreign trading venues. This solution does not appear to be ready for consideration, however; Wetjen described it as a "term sheet" rather than a fully developed proposal.

The FCA's Bailey stressed the importance of providing exemptions for foreign trading venues so that they can continue to provide access to U.S. customers. He commented that the market has already been fragmented, with U.S. customers trading on U.S. venues and the rest of the world trading elsewhere, and warned that this fragmentation could create negative impacts in times of stress.

JFSA's Mizuguchi also urged the CFTC to provide some sort of exemption. Mizuguchi pointed out that Asian regulators recently sent a letter to the CFTC expressing concern about fragmentation of markets among jurisdictional lines, and noted that the mandatory trading approach taken by U.S. regulators may not be appropriate in some jurisdictions because of differences in market practices and the amount of liquidity.

John Nixon, chief executive officer for electronic broking at ICAP, made several comments from the perspective of a SEF. He commented that the interim solution outlined in the April letter has not worked as U.S. trading is all done on SEFs, while non-U.S. trading is all done off of SEFs. He noted that his firm operates a trading venue that is dually registered, as an MTF in the U.K. and as a SEF in the U.S., but as of now it is only doing business in U.S. dollar based products.

During the discussion, Wallace Turbeville, a fellow at a public policy organization called Demos and a member of the advisory committee, raised a concern that swap dealers are removing parent company guarantees on foreign affiliates so that they can conduct trading through those affiliates without coming under the CFTC's requirements. In response, Wetjen said that the CFTC staff is looking into this practice and in particular if the foreign affiliates are using "functional equivalents" of parent company guarantees.

Several members of the advisory committee expressed frustration at the CFTC's approach and said that the agency needs to move more quickly to resolve this issue. At the end of the day, however, Wetjen admitted that the discussion had raised more questions than answers about how the CFTC should move forward. He did say, however, that the CFTC is more likely to continue relying on an interim solution, rather than finalizing a trading venue exemption, while Europe implements MIFID.

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