

On the left side of the page, there are two overlapping geometric shapes: a light green triangle pointing right and a light blue triangle pointing left, mirroring the colors in the FIA logo.

Mitigating the Risk of Market Fragmentation

March 2019

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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result is market fragmentation caused by regulation such that the original goal of holistic cross-border solutions has been replaced by a siloed regulatory and commercial landscape.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)¹ 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

1 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

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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

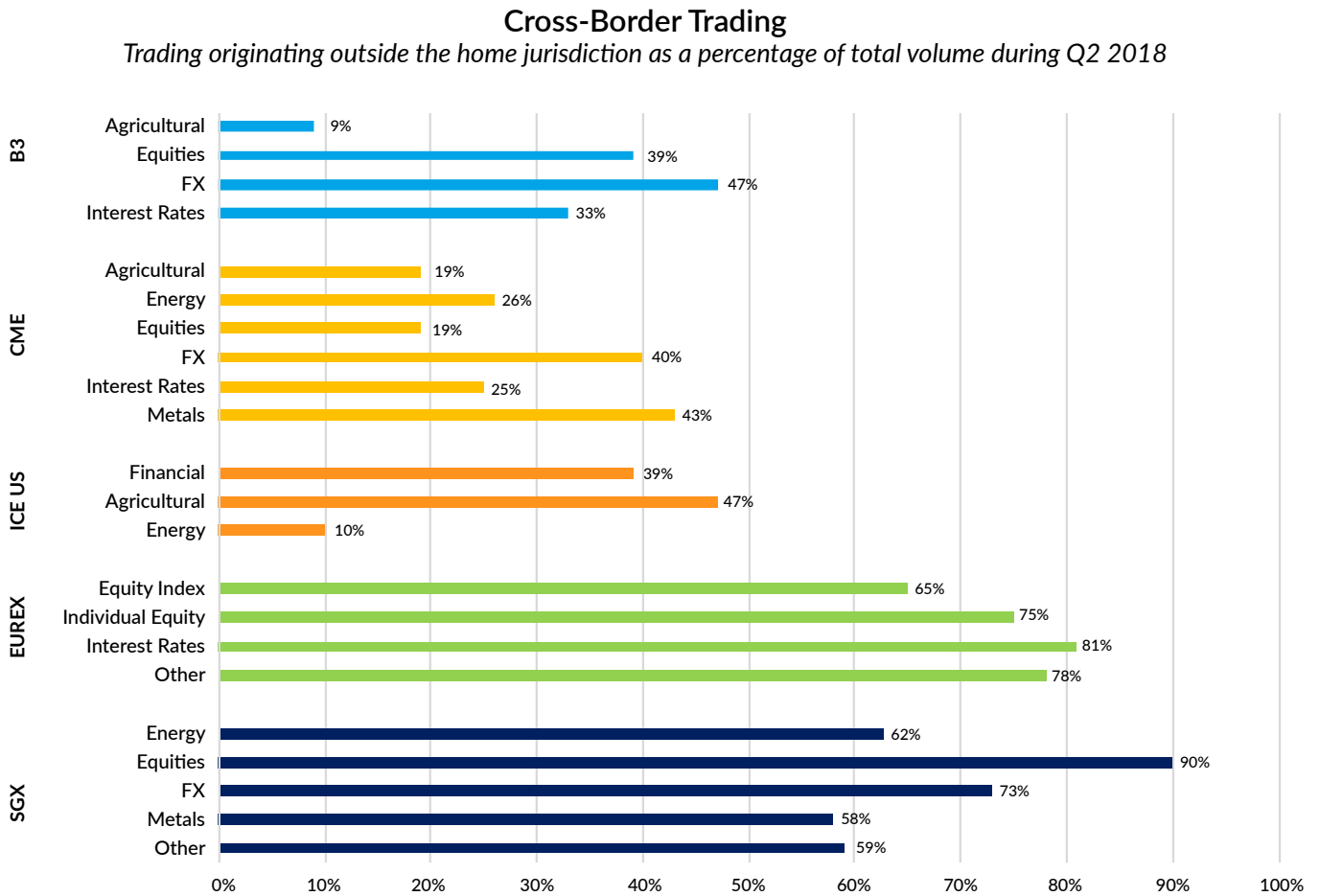
2 https://www.bis.org/statistics/about_derivatives_stats.htm?m=6%7C32

3 https://www.bis.org/publ/qtrpdf/r_qt1612b.htm

4 <https://www.ecb.europa.eu/press/key/date/2015/html/sp151111.en.html>



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



Source: Data provided by each exchange upon the conclusion of Q2 2018.

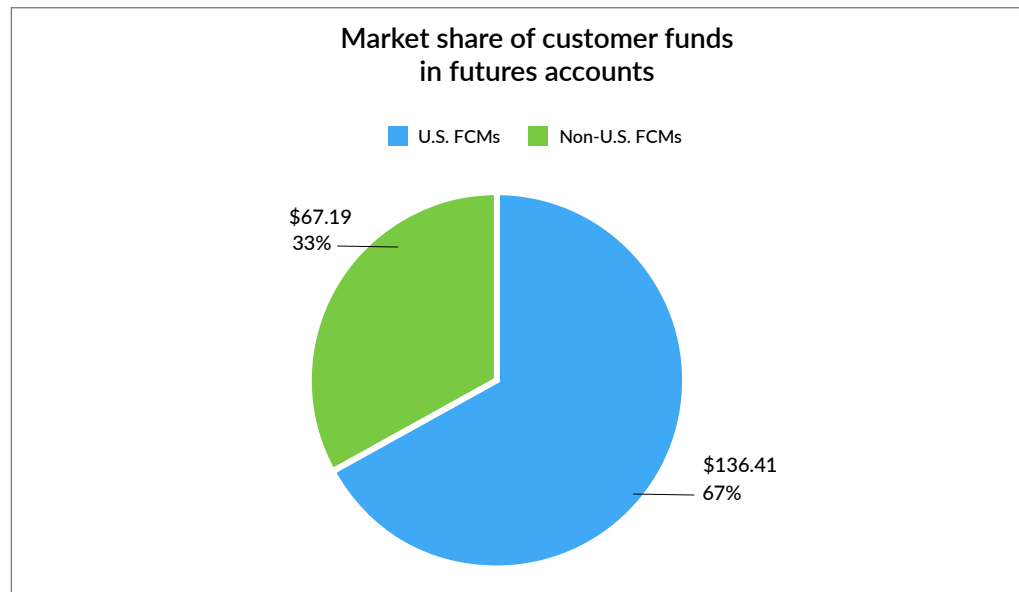
their volume that comes from foreign counterparties. The results show that cross-border trading makes up a very significant percentage of the total volume at these exchanges.

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

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.

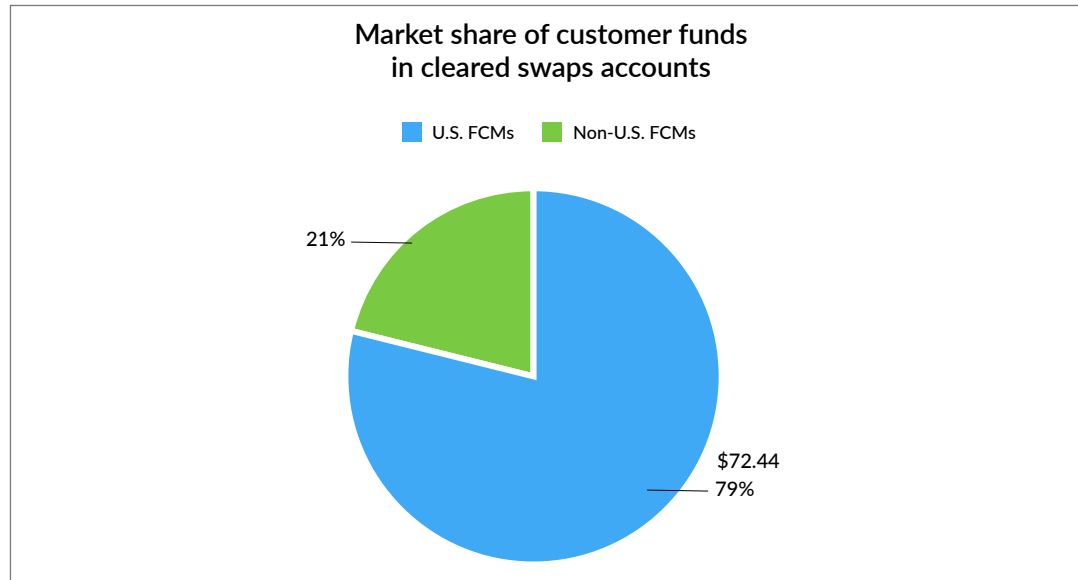
As of December 2018, there were 54 FCMs holding a total of \$295.3 billion in customer funds, of which \$203.6 billion was held in segregated customer accounts for exchange-traded futures and options and \$91.7 billion for cleared swaps. Non-US owned FCMs held 33% of the futures-related customer funds and 21% of the swap-related customer funds⁵.

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.



Source: U.S. Commodity Futures Trading Commission

⁵ <https://fia.org/fcm-tracker>



Source: U.S. Commodity Futures Trading Commission

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.

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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.

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

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.⁶

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.

⁶ <https://www.ifac.org/system/files/publications/files/IFAC-OECD-Regulatory-Divergence.pdf>

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.

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.

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

⁷ <http://www.fsb.org/2017/04/handbook-for-fsb-peer-reviews-2/>

⁸ <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD322.pdf>

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 important⁹. The working group for crisis management in respect of LCH. Clearnet Ltd is an example of this approach.¹⁰

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.¹¹ 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.¹² 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. As

9 FSB Guidance on Central Counterparty Resolution and Resolution Planning, 5 July 2017, p. 16. <http://www.fsb.org/wp-content/uploads/P050717-1.pdf>

10 <https://www.cftc.gov/sites/default/files/idc/groups/public/@internationalaffairs/documents/file/cftc-lch-arrangementmou090617.pdf>

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>

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>



Mitigating the Risk of Market Fragmentation

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 co-operative approaches.

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