Principles for Cross-Border Regulation

September 2021

CONTENTS

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 about 50 countries, as well as technology vendors, lawyers and other professionals serving the industry.

INTRODUCTION

In March 2019, FIA issued a paper to raise its concerns about the increased fragmentation of the global listed and cleared derivatives markets due to inconsistent and duplicative regulatory frameworks. FIA urged regulators to cooperate in their approaches to cross-border activity and recommended that they rely more heavily on deference to home country regulation.

Today the threat of market fragmentation is as great as ever. Even though customers continue to seek access to derivatives markets around the world, policy makers and regulators are re-examining their approaches to cross-border activity yet again and some are favoring more insulated, national approaches that favor direct oversight of both domestic and foreign entities.

These national approaches often do not recognize that another regulator is already overseeing this activity in a comparable manner. Without a model that favors deference through reliance on the home country regulator, trading and clearing becomes more complex, more costly, and less efficient for all market participants.

> Without a model that favors deference through reliance on the home country regulator, trading and clearing becomes more complex, more costly, and less efficient for all market participants.

In recent months FIA has observed several developments that are prompting policymakers and regulators to consider approaches to regulation of entities that are domiciled in or operating from foreign jurisdictions. These include:

- The separation of London's financial center from the European Union
- New concerns about the supervision of OTC markets and clearinghouses
- China's increasing integration into global financial markets
- Calls to develop new regulatory structures for digital assets

In the case of the first two, the trends are creating new threats to existing cross-border activity. The impact of Brexit on the UK relationship with the EU has forced firms to adjust to a new regulatory environment and reconsider the location of their trading desks. The impact of Brexit also has caused EU regulators to reconsider their approach to cross-border trading and clearing, particularly with respect to derivatives denominated in euros.

In the case of China, the trend toward greater integration is creating new opportunities for cross-border activity. Chinese firms are looking outward and establishing access to derivatives markets in Europe, the US and other parts of Asia-Pacific. At the same time, the Chinese authorities are allowing local derivatives exchanges to open their doors to foreign entities. This makes it increasingly important for regulators on both sides to work together and establish an effective and efficient approach to cross-border activity.

In the case of digital assets, the rapid growth of trading is a global phenomenon that demands a coordinated international response. Furthermore, the nature of the underlying technology has made it relatively easy for retail investors to bypass the regulatory structures designed to protect their interests. That makes it all the more important to develop an approach to cross-border trading that does not put unnecessary burdens on regulated entities.

FIA believes that as regulators grapple with these developments, they should include reliance on comparable home country regulation as a core element in their overall approach.

Even though each of these developments is unique, all of them raise questions about the treatment of cross-border activity. FIA believes that as regulators grapple with these developments, they should include reliance on comparable home country regulation as a core element in their overall approach.

This model, which has been applied to futures trading and clearing for generations, is a safe and effective way to regulate entities that operate at a global level as well as markets that connect buyers and sellers at a global level.

FIA is therefore taking this opportunity to restate its views on the importance of international regulatory cooperation and to urge regulators to adopt the reliance approach. To this end, FIA is proposing seven principles that regulators should consider in their regulation and supervision of cross-border activity.

These seven principles are:

1) **Determine Necessity**
2) **Define Outcomes**
3) **Use International Standards as Benchmarks**
4) **Assess Outcomes rather than Rules**
5) **Communicate with Counterparts**
6) **Adoption of Measures**
7) **Create Mechanisms for Ongoing Cooperation**

In part one of this paper, FIA discusses the reasons for taking this approach. In part two, FIA describes each principle in detail.

PART ONE

The Importance of Cross-Border Activity

As stated in our 2019 paper, FIA strongly believes that cross-border activity creates many benefits for the end-users of derivatives. These end-users include commodity producers hedging their market risks, banks hedging their interest rate risks, manufacturers hedging their foreign exchange risks, and institutional investors adjusting market exposures in their investment portfolios.

FIA recognizes, however, that cross-border activity creates challenges for regulators, given that their authorities are based on the laws of their jurisdictions. Regulators have a legitimate interest in identifying the risks that arise from cross-border activity in relation to their goals of protecting investors from fraud, preventing market manipulation and other forms of misconduct, and protecting the stability of their financial systems.

For this reason, FIA has consistently supported efforts at the international level to promote cooperation among regulators. This includes not only information-sharing and standard-setting but also the avoidance of inconsistent and duplicative rules and deference to home country regulation.

The absence of cooperation among regulators results in an increase in the cost of derivatives to all market participants.

In the absence of such cooperation, a number of negative effects arise.

First, cross-border activity becomes subject to duplicative rules, which increases the regulatory burden and the operational complexity for entities engaged in cross-border activity. In some cases, certain types of cross-border activity may become impossible due to conflicts between overlapping sets of rules.

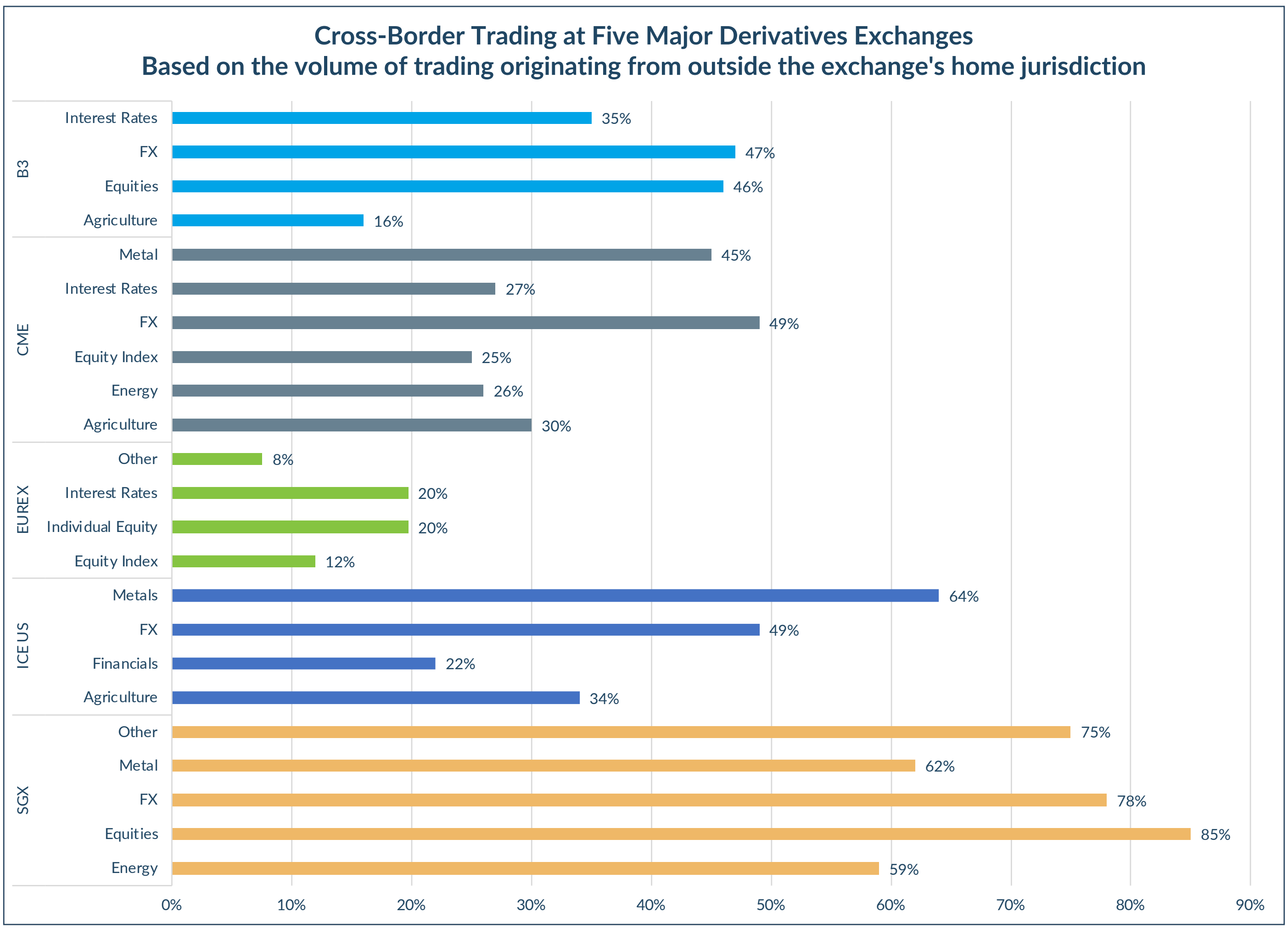
Second, markets become fragmented, with distinct pools of liquidity separated by regulatory barriers. This leads to less efficient trading given the limits on the numbers of buyers and sellers that interact on exchanges. This also leads to higher capital costs, given that there are fewer opportunities to net offsetting risk exposures in the clearing process.

The overall result is an increase in the cost of derivatives to all market participants, including the end-users that rely on these markets to hedge their risks and achieve their investment objectives.

The threat of fragmentation is especially acute for derivatives markets because they tend to be relatively global in nature. The major commodity futures markets, for example, attract buyers and sellers from around the world because the underlying commodities are produced and consumed worldwide. Likewise, foreign exchange derivatives have a global appeal because foreign exchange risk is so closely tied to the global trade in goods and services.

To demonstrate the global nature of derivatives markets, FIA asked several major exchanges to provide data on cross-border trading in their markets. As shown in the chart below, data from the second quarter of 2021 shows that a large amount of trading on each exchange originated from outside the exchange's home jurisdiction.

Chart I: Cross-Border Trading on Derivatives Exchanges.



** Note: In the case of Eurex, the home jurisdiction is the European Union.*

These data clearly show that end-users actively seek access to exchanges located outside of their home jurisdictions. To deliver this access, markets and intermediaries need permission to offer their products and services in multiple jurisdictions, and regulators need an effective and efficient way to supervise this cross-border activity.

It could be argued that this problem could be solved through greater harmonization at the international level. In other words, if all regulators followed the same standards, the rules would be the same worldwide, and cross-border activity could be regulated in the same way as purely domestic activity.

FIA is a strong supporter of international regulatory harmonization, but this alone is not sufficient to address the challenges of cross-border regulation. Many regulators have indeed adopted the standards developed by the International Organization of Securities Commissions and other international bodies, but their implementations of these standards are adapted to local conditions, and their rulebooks will never be identical.

Given the inevitability of differences in how various jurisdictions set their rules, derivatives markets need a framework for cooperation among regulators so that cross-border business can continue to grow. Such a framework should avoid duplication of regulation and encourage regulators to defer to each other when they have rules and supervision that achieve comparable outcomes.

...derivatives markets need a framework for cooperation among regulators so that cross-border business can continue to grow

PART TWO

Supporting a Recognition Approach

The International Organization of Securities Commissions (IOSCO) issued a report on Cross-Border Regulation in 2015 noting various types of cross-border regulatory regimes, including national approaches, recognition and passporting. FIA supports a recognition approach that allows the domestic regulator to permit activities of persons and entities, including the distribution of products, from recognized foreign jurisdictions, to take place within the domestic jurisdiction as long as the regulatory regime is sufficiently comparable to its own. 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. Duplication of rules is costly for the industry and the regulator and not necessary. The biggest risk is conflicting rules, where complying in one country causes a violation of the rules in the other country.

Principles of Recognition

1) **Determine Necessity:** Determine if the cross-border activity presents a significant degree of risk, and further, if this risk has a substantial effect on the local jurisdiction and needs to be addressed by requiring compliance with local rules and/or supervision by the local regulator. For example, could the cross-border activity disrupt the stability of the financial system, or expose consumers or investors to fraud, or create an avenue for market manipulation?

2) **Define Outcomes:** If such a need is identified, the regulatory authority then should define the outcomes that must be assessed. Such outcomes could include capital and margin, record-keeping and reporting, customer asset segregation, market conduct, internal controls, and public disclosure.

3) **Use International Standards as Benchmarks:** Ideally, IOSCO or another international regulatory body has established globally agreed standards for a particular area of regulatory oversight. The development of somewhat detailed standards results in harmonization or comparability of rules and among regulators in that area. Regulators may wish to make assessments against the internationally agreed standards, rather than their own local rules and regulations. The use of international standards is helpful and understandable as recognized benchmarks for global regulators.

4) **Assess Outcomes rather than Rules:** Once the outcomes are determined, the authority must conduct an assessment of the rules and potentially

supervision of the foreign regulator to determine whether the rules and supervision achieve comparable outcomes. The assessment is not a line-by-line assessment but a review of whether the regulatory outcomes are comparable, even if met by different means. The regulator should consider whether the regulatory outcomes are substantively similar to those of its own regime.

5) **Communication:** Throughout the process, the regulators must communicate with each other for optimal understanding. When a regulator is making an assessment of a foreign regulatory regime, the domestic regulator is responsible for sharing that assessment with the foreign regulator. This will avoid wasted energy and time trying to understand the basis for a rule or rule set. Additionally, it allows the foreign regulator an opportunity to provide information or further explanation. If, in the end, the regulator does not find an outcome comparable, that finding must be communicated to its counterpart.

6) **Adoption of Measures:** If there are certain outcomes not met by the domestic regulator, the domestic regulator should provide the opportunity for the regulatory regime or entity seeking recognition to adopt the measures to meet foreign regulatory outcomes.

7) **Cooperation Mechanisms:** Even though one regulator relies on the home country regulator once the assessment of comparable outcomes is made, the regulators must have information sharing arrangements for continued communication regarding the recognized entities. This is done through coordination and cooperation among regulatory authorities. Regulators must agree on how they will engage with each other through cooperation arrangements, typically achieved through regulatory memoranda of understanding (MOUs) to facilitate cooperation. Some terms that may be agreed upon include notification of any changes in regulation, notification of changes to the regulatory status of the entities, obligations or requirements imposed on the entities and any enforcement or suspicious activity regarding the entities. How on-sight inspections may be conducted is also a term for agreement upon recognition.

Ongoing cooperation will strengthen trust among regulators that information will be shared and supervision will be conducted as assessed.

CONCLUSION

A reliance regime improves capital flows and market access by reducing duplicative regulations and other barriers to market entry and reducing costs to market participants. Such a regime can bring additional liquidity to a domestic market and strengthen its capacity for price discovery and risk management.

A reliance regime also can encourage harmonization of regulatory approaches at the international level. This is especially true when regulators rely on international standards as the benchmarks for their comparability assessments.

Finally, a reliance model strengthens cooperation and coordination among regulatory authorities through the use of information sharing and dual supervisory oversight. Such a model builds mutual understanding and a network of relationships that will better position the regulatory community to identify emerging threats and deal with unexpected events and market stresses.

BRUSSELS
Office 621
Square de Meeûs 37
1000 Brussels, Belgium
+32 2.791.7572

LONDON
Level 28, One Canada Square
Canary Wharf
London E14 5AB
Tel +44 (0)20.7929.0081

SINGAPORE
One Raffles Quay
North Tower, Level 49
Singapore 048583
Tel +65 6622.5782

WASHINGTON
2001 K Street, NW
Suite 725, North Tower
Washington, DC 20006
Tel +1 202.466.5460

FIA.org