International coordination of the regulation and supervision of OTC derivatives markets

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Ladies and gentlemen,

Let me first say how happy I am to be able to address the American Bar Association here in London. However, in front of an audience full of lawyers, I feel that, in the interests of transparency I must first disclose that I was trained as an economist and early on in my career, like many other young economists, I underestimated the importance of the law. My views as a junior economist were that utility maximising individuals would find ways to cope with legal requirements, and that the shape and performance of markets were mainly driven by economic forces.

However, during my career, I learned how essential the law is for the development of markets, and that without proper legislation, securities markets cannot be successful. The financial crisis is a powerful example of how important proper regulation and supervision are in underpinning the safety and performance of financial markets. Before I move on, I should also mention that losing a few enforcement cases as a regulator in the Netherlands, in which the economic arguments for a sanction were more convincing
than the legal arguments, taught me the hard way to value the importance of the law. Nowadays, I like to work at the crossroads of economics and law, and the international coordination of financial regulation and supervision is an area where both disciplines are very important.

I will have a few simple messages in my contribution, which will focus on the international coordination of OTC derivatives regulation and supervision. While we have progressed substantially in this area, it has not been sufficient, and further steps are absolutely needed.

First, regulators need to rely more on foreign regulation when it achieves the same regulatory outcomes. This avoids overlaps, inconsistencies, and conflicts. Second, the recently published standards for bilateral clearing, which are very granular, provide a golden opportunity for consistent global implementation of this very important part of the OTC derivatives market. Thirdly, with OTC derivatives reforms now moving into the implementation phase and subsequently supervision, close cooperation between supervisors across jurisdictions becomes even more important.

But before I go to the specific topic of OTC derivatives, let me first give you a brief overview of ESMA’s international activities since its foundation two and a half years ago. Key achievements include conducting more than a dozen equivalence assessments of third countries, EU jargon for countries outside the EU, in areas such as credit rating agencies and derivatives. We have negotiated standard MOUs for hedge fund and private equity supervision, captured under the AIFMD in the EU, resulting in more than 1000
MOUs being signed between the 28 EU Member State authorities and a large number of third countries. In addition, we participate in FSB working groups on such issues as Trade Repository Data Aggregation and Benchmarks, and have recently become a permanent observer to the IOSCO Board.

**The holy grail - international coordination and consistency**

Why is consistent global regulation and supervision so important but also so difficult to achieve?

Let me try to explain that in plain language. Regulators, when regulating financial markets, not only need to regulate local market players and local transactions, but also foreign market players active in their local market and transactions with a foreign component. In today's interconnected global financial markets, these international elements are very important in all the main financial centres. Not regulating foreign market players and transactions relevant to your local market would result in a failure to meet regulatory objectives such as investor protection, stability and avoiding regulatory arbitrage.

However, these foreign market players and transactions are typically already subject to the regulation of one or even more other jurisdictions. As a result, market players and transactions may become subject to multiple regulatory regimes, which can be overlapping, inconsistent and conflicting. In sum, in interconnected financial markets, differences in regulation between important financial centres inevitably result in problems. Not regulating foreign market players, and transactions with a foreign
component, can result in regulatory arbitrage and a failure to meet objectives like investor protection and stability. However, regulating them results in market participants and transactions being subject to multiple regulatory systems.

**Obstacles to consistency**

While we are striving to achieve consistent international regulation and supervision of OTC derivatives markets, let me manage your expectations regarding the likelihood of it being achieved. Unfortunately, there are various additional reasons why we may not reach the goal of full global consistency.

First, like any other piece of financial legislation, OTC derivatives legislation is established by independent sovereign states or, in the case of the EU, a bloc of sovereign states. National political processes take local characteristics of financial markets into account, and it is no a secret that legislation sometimes reflects local private interests. Hence, local exemptions for certain market participants create consistency problems at global level.

Second, the OTC derivatives markets are undergoing a massive change from being unregulated to being fully regulated. These changes are not about tinkering around the edges but rather about a momentous regulatory step change. Coordinating a massive regulatory change is obviously more difficult than coordinating a marginal adjustment to an existing regulatory framework.
Third, OTC derivatives is an area of the financial markets where small regulatory differences matter very much. Seemingly small technical issues, like the confidence interval for determining margin requirements, can be decisive for where OTC derivatives business is conducted.

Fourth and finally, we are trying to implement and fine tune the regimes at the level of implementing rules, while the main legislative pieces, like Dodd-Frank and EMIR, were adopted without the similar kind of strong coordination mechanism being used by regulators. Legislators took the 78 words of the Pittsburgh G20 declaration and converted it into hundreds of pages of laws and acts in each jurisdiction. Therefore, as you will know better than anyone, there are some limits as to what convergence is legally feasible through cooperation between derivatives regulators when the basic laws show significant differences.

**The EU and equivalence**

Considering the problems identified above, it is remarkable what we have actually achieved in terms of the international coordination of OTC derivatives regulation and supervision in the past two years. How has this been achieved? Since December 2011, OTC derivatives regulators from the world’s main financial centres have met regularly at the highest level, in the OTC Derivatives Regulators Group, or ODRG, meetings. In addition, at staff level, there have been almost daily contacts between these regulators. ESMA and the European Commission represent the EU in this group.
In the ODRG discussions, right from the beginning, the EU has argued tirelessly that regulators should rely on foreign regulatory systems when they achieve the same regulatory outcomes. This mechanism, which implies relying on equivalent systems, is the standard European Union approach to international coordination issues in many pieces of financial regulation, and avoids the problems earlier identified of market participants and transactions being subject to multiple jurisdictions. Initially, this approach received a cold reception from our colleagues across the Atlantic. However, both the CFTC and SEC should be commended for having taken very important positive steps by introducing this regulatory concept into their system under the term ‘substituted compliance’. The work led by my US counterparts at the CFTC and SEC, Gary Gensler, Mary Schapiro, Elisse Walter and Mary Jo White, should be recognized as a big step in creating the conditions for the alignment of our respective regimes. Still, I would strongly encourage my US colleagues to go much further in the application of substituted compliance. For example, the fact that the CFTC mainly applies substituted compliance to entities, and not to transactions involving a US person, still results in too many overlaps, inconsistencies, and conflicts.

Over the past few months, ESMA staff have worked day and night to complete the equivalence advice, where we assess third country legislation against EMIR, resulting in the recent publication of assessments for nine major jurisdictions including the US, Canada, Switzerland, Japan, Hong Kong, Australia, India, Singapore and South Korea. While we have now completed all outstanding requests from the European Commission for such advice, I would expect some new mandates for equivalence advice in the coming
months. As I will discuss later, we have received CCP recognition requirements from a substantial number of countries which have yet to be assessed.

Having worked intensively with the system of equivalence, we have also learned from the experience and see possibilities for improvement. The EU mechanism was initially conceived as essentially a ‘zero-one’ system. Hence, you are either equivalent or not, and it is not possible under the current system to assess third country regulation as being partially equivalent. However, as you will understand, in major regulatory reform like OTC derivatives, and given the diversity of financial markets across the world, it is conceivable that systems are not fully equivalent across all their main elements. Therefore, I think it would be worthwhile to consider introducing more flexibility into future equivalence mechanisms.

In its recent equivalence advice to the European Commission, ESMA found that a number of jurisdictions were fully equivalent to the EU on CCP requirements, which is a very real indicator that convergence across global regimes is actually happening. ESMA has already applied a concept aimed at taking into account some of the diversity of regulatory systems. We argued that, while some other jurisdictions were strictly speaking not equivalent, similar outcomes could be met under certain conditions. These conditions relate to rules being applied by an individual CCP that would ensure that they would produce outcomes similar to EMIR’s requirements. We have proposed that those rules, to be taken as equivalent, should be binding and enforceable and therefore should be subject to regulatory oversight, not just left to the discretion of the individual CCP. Hence, to avoid any misunderstanding, these individual CCP rules should achieve
comparable results; there is no question for us about considering equivalent a regime that offers, in practice, much less protection for CCPs and non-defaulting Clearing Members, since that would not only lower the safety of the system, but would also give rise to massive regulatory arbitrage.

Besides CCPs, the equivalence “status” is also very important for the reliance on foreign jurisdictions and regulators for transaction requirements. We have recently closed our consultation on which transactions executed between non-EU firms should be subject to EMIR because of a direct, foreseeable effect in the EU. We have concluded that, besides some quantitative thresholds, in no case should the EU make subject to EMIR a transaction where one, or both, counterparties are established in an equivalent jurisdiction. The EU regime under EMIR relies fully on those jurisdictions and will not capture those transactions under our regulation.

So far, I have been silent on the role of organisations like the G20, FSB, IOSCO, BCBS, and CPSS, who, without any doubt, have all been essential in shaping the reform of OTC derivatives regulation. The G20 commitments have of course been instrumental in setting the broad requirements and timeline for OTC derivatives reform, and the FSB has been crucial in monitoring its progress. The well-known CPSS-IOSCO Principles for Financial Market Infrastructures have standardised requirements for CCPs across the world and contribute to reducing regulatory arbitrage. However, we should also admit that they were not sufficiently granular to ensure full consistency across the globe. When implementing them locally, regulators still had many choices to make which has resulted in international diversity.
A golden opportunity

Talking about international standards brings me to what I would call a golden opportunity for OTC derivatives regulators in the area of margin requirements for non-centrally cleared derivatives. In a fully harmonised fashion, all ODRG regulators have agreed to postpone the implementation of bilateral margin requirements until the BCBS-IOSCO group had finalised its work. They have published their standards this summer, which are comparatively more granular than the CPSS-IOSCO FMI Principals. Having these granular standards, and sufficient time with an agreed implementation deadline of December 2015, OTC derivatives regulators should be able to achieve global consistency regarding bilateral margins. So, with this in mind, I would call upon my colleagues in other jurisdictions to fully implement these standards in a way that achieves real international convergence and comparability.

Expanding ESMA’s supervisory role

So far I have mainly focused on the regulatory side of OTC derivatives. Let me in the last part of my contribution touch briefly on matters more related to supervision. First, regarding the CCPs from 3rd countries, we had more than 30 applications for recognition by the mid-September deadline and we have started to process these applications. As you probably know, recognition is only possible when the home country is considered to be equivalent to the EU requirements. As stated earlier, while ESMA has already completed a substantial number of equivalence assessments, and I would expect some more in the months to come, the final decision on whether or not another jurisdiction’s regime is equivalent rests with the European Commission.
Recently, ESMA opened the registration process for trade repositories. This is a challenging process for all of us as these new market infrastructures are often still defining their own business model, developing their pricing policy, recruiting their staff, adopting internal policies and procedures and setting up IT infrastructure.

ESMA is currently assessing the half dozen applications it has received so far – often containing thousands of pages. Many of the potential trade repositories are part of existing international market infrastructure groups who can leverage upon their existing know-how. With the information we have now, and assuming everything goes well on both sides, we would expect to grant the first registrations in November 2013. It is very likely that these will relate to a few trade repositories and all derivative asset classes (commodities, credit, foreign exchange, and interest rates) both exchange-traded and over-the-counter.

This means that the obligatory reporting to trade repositories would start around February 2014 since the legislation foresees a 90-calendar day phase-in between the registration of the repository and the reporting start date. This phase-in should allow counterparties sufficient time to contract with their trade repository and adjust IT systems.

As we are progressing further and further down the regulatory reform road, supervision becomes more important, and considering the global nature of OTC derivatives, good international cooperation between supervisors will be essential. In addition to the
continuation of the dialogue in the ODRG, OTC derivatives regulators also need to agree on MOUs for a mix of international supervisory relationships. ESMA needs to agree on MOUs for the recognition of third country CCPs and TRs, and national regulators need to agree on MOUs for the supervision of CCPs and swap dealers.

Without going into the many details of all these MOUs, I would like to make the following main point. While regulators have a justified interest in foreign market players active in their local market, cooperation with, and relying on, those entities’ home regulator will be important. The home regulator of a foreign market player should have a detailed knowledge of that market player, and other regulators can leverage off that. As I argued earlier on regarding the avoidance of the duplication of regulation, similar arguments can be made against duplicating supervision.

Still, I fully understand the need of a supervisor to access, and obtain information from, foreign market players when they are active in their market. However, this should be achieved through good cooperation with the home regulator of the foreign market player.

**Conclusion**

Ladies and gentlemen, I hope that I have provided you with some insight into the work we have done to try and ensure that OTC derivatives markets reform is truly global and have shown you that, just like in the legal world, negotiation and compromise, in this case between regulators, can lead to fruitful and concrete results.
Thank you for your attention.