Regulating Off Key:
The State of Harmonization in Derivatives Reform

By Felix Shipkevich[1]

A global financial meltdown demands a global financial solution. That is what the world's leading finance ministers, central bankers, and heads of state thought at the 2009 G-20 summit when they adopted a directive on derivatives reform. The G-20 directive had four central goals: clear all standardized OTC derivatives, trade (where appropriate) on an electronic exchange, report all OTC derivatives to a regulator or depository, and institute higher capital requirements for uncleared derivatives. These are to be implemented no later than 2012.

In response to global financial crisis and the subsequent G-20 directive, the United States passed the Dodd-Frank Wall Street Reform and Consumer Protection Act in July of 2010. The Act has just taken effect this July 16th, an ambitious implementation time for such dramatic change. Though the U.S. Commodity Futures Trading Commission (CFTC) and Securities and Exchange Commission (SEC) have delayed several rule areas, many self-effective parts of the Act will be implemented on schedule, and the CFTC hopes to have the remainder written, finalized, and on their way to compliance officers by the end of the year.

In Europe, the G-20 directive has been split in two. OTC derivatives clearing and reporting requirements will be a part of the European Market Infrastructure Regulation (EMIR) currently being drafted by the European Commission. Though the regulation is expected be voted in this September, *The Trade News* reports that the derivatives regulations may not be in place until 2014.[2] The remainder of

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[2] Dan Barnes, "Council of European Union pushed to tackle EMIR in Q2," *The Trade News,* June 1, 2011 http://www.thetradenews.com/trading-execution/regulation/6269.

the directive will be dealt with in the European Union's review of the Markets in Financial Instruments Directive (MiFID) in 2012.

Other countries in and out of the G-20 are slowly gearing up to meet the 2012 deadline. According to a Financial Stability Board report released in April 2011, several countries, including South Korea, have already passed legislation requiring central clearing (though the clearing systems themselves will not be operational until next year). Others are still doing research and debating how to proceed. Only Brazil and Argentina, who already were operating with central clearing, are close to meeting their G-20 obligations.[3]

While new regulatory regimes blossom across the world, it is increasingly apparent that there are risks posed by the preponderance of inconsistent legislation. The G-20 directive encourages governments and regulators to coordinate their efforts in order to cut down on regulatory arbitrage. However, as a recent *Financial Times* article points out, "variations in the approaches taken on both sides of the Atlantic and in Asia can be observed and are increasingly significant."[4]

The growing rift has not escaped the notice astute international observers, and they have been quick to point out the potential for arbitrage. At the Agriculture Committee hearing on "Harmonizing Global Derivatives Reform: Impact on U.S. Competitiveness and Market Stability," Thomas Callahan, the CEO of NYSE Liffe (a subsidiary of NYSE Euronext) listed the areas of inconsistency. These include designated contract market (DCM) oversight, swap execution facility (SEF) regulation, and swap data repository (SDR) indemnification rules.[5] The Futures Industry Association president John Damgard added position limits to that list, calling the Dodd-Frank limits "without the necessary factual predicate."[6]

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[3] 3 Financial Stability Board, "OTC Derivatives Market Reforms: Progress report on Implementation" April 15th, 2011 http://www.financialstabilityboard.org/publications/r_110415b.pdf.

[4] John Nugée, "Regulation's impact on global markets," Financial Times, http://www.ft.com/intl/cms/s/0/6449ed32-888b-11e0-afe1-00144feabdc0.html#axzz1PB8fzKnh.

[5] "Testimony of Thomas F. Callahan, Chief Executive Officer NYSE Liffe U.S., LLC on behalf of NYSE Euronext before the US House of Representatives Committee on Agriculture Subcommittee on General Farm Commodities and Risk Management—Harmonizing Global Derivatives Reform: Impact on U.S. Competitiveness and Market Stability," May 25, 2011, http://agriculture.house.gov/pdf/hearings/Callahan110525.pdf.

[6] "Committee on Agriculture Subcommittee on General Farm Commodities and Risk Management—Harmonizing Global Derivatives Reform: Impact on U.S. Competitiveness and

In a speech delivered on June 3rd, Michael Barnier, head of the European Commissioner for Internal Market and Services, echoed the call for global harmony:

> "…incoherence and inconsistency between our rules will have certainly negative consequences for our markets…Trades may move where rules are laxer, and this will put us all at risk. We must make sure our rules are the same on important issues, scope and conditions for clearing, collateral and capital requirements, and importantly the recognition of each other's central counterparties and trade repositories."[7]

But consider the fate of the Basel Accords. The Basel Committee banking regulation intended to cut down on arbitrage and increase harmonization has been slow to infiltrate American regulatory code. While the rest of the developed world is in the thick of Basel III negotiations, America is still digesting Basel II. If the past performance may be used an indicator of future behavior, harmony in international derivatives regulation may be many years away.

More significantly, Commissioner Barnier addressed the other regulatory elephant in the room: extraterritoriality. This phenomenon occurs when a government requires that foreign firms doing business with their constituents comply with their rules even in trades outside their borders. The text of the Dodd-Frank Act stipulates that it only need apply to activity outside the U.S. if said activities have a "direct and significant connection with activities in, or effect on, commerce" within the States.[8]

Many have complained about the broad application of this clause. A group of New York Congressional delegates and members of the House banking committee went so far as to write a letter of complaint to the CFTC and SEC. The legislators expressed concern that such rules "will inevitably result in significant competitive disadvantages for U.S. firms operating globally" by encouraging "participants in derivatives markets to do business with non-U.S. firms" in order to

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Market Stability, Statement of John M. Damgard, President Futures Industry Association," May 25, 2011, http://agriculture.house.gov/pdf/hearings/Damgard110525.pdf.

[7] Michael Barnier, "The Shape of EU Financial Regulation and its impact on the United States and Europe," Friday June 3, 2011, http://www.brookings.edu/~/media/Files/events/2011/0603_eu_regulation/20110603_eu_regulation.pdf.

[8] Dodd-Frank Wall Street Reform and Consumer Protection Act, Sec 722 d/i/1.

avoid the extra layer of regulation.[9] Liffe CEO Callahan recommended that the CFTC limit its extraterritorial reach to specific situations, as when "look-alike" products are traded in foreign markets specifically to "circumvent important U.S regulatory objectives."[10] FIA president Damgard similarly critiqued the CFTC, arguing that the Commission's extraterritorial ambitions far exceed its budget, that there is no need to re-regulate activities already overseen by a recognized foreign counterpart, and that U.S. exercise of overseas jurisdiction will likely be met with decreased market access or extra regulation for U.S. firms abroad.[11]

Barnier was not shy about mentioning his objection to Dodd-Frank's international scope, and urged cooperation rather than a regulatory one-upmanship. "In Europe I hear fears about extraterritorial effects of Dodd-Frank. I know that that is not the intention, but you will understand, ladies and gentlemen, that Europe cannot be and will not be naïve," he cautioned his American audience. "Equality and reciprocity are not only justified, they are also necessary."[12] By shaving off extraterritorial provisions, the CFTC and others could curry favor abroad and avoid a maelstrom of retaliatory regulations likely to surface in the wake of Dodd-Frank implementation.

Especially in light of the CFTC and SEC delays, it seems likely that regulators will take the extra time to harmonize some of the grossest breaches of harmonization. But the degree to which such an impulse will shape the ultimate outcome is still unclear. And despite the legitimate economic concerns expressed by industry groups and policymakers alike, there are equally legitimate economic reasons to proceed as quickly and aggressively as possible.

Regulators are mindful of the persistence of the global financial crisis. If unemployment were in retreat, the market booming, and the housing market back to normal, it might be easier to forget the troubles of 2008-09. But in the shadow of spectacular bank failure and world-wide market collapse, huge budget shortfalls and austerity programs, there is significant pressure on regulators to finalize derivatives reform. It is with this, rather than accumulation of political capital, in his mind that Michael Bernier told the Brooking Institute

[9] "NY Lawmakers urge regulators to reconsider derivatives rule that would hurt U.S. competitiveness," http://schumer.senate.gov/new_website/record.cfm?id=332906&

[10] "Testimony of Thomas F. Callahan."

[11] "Statement of John M. Damgard."

[12] Barnier, "The Shape of EU Financial Regulation."

"Ladies and gentlemen, the world is watching. It's time to deliver on our regulatory promises."[13]

To arrive at regulatory harmony, regulators must strike a delicate balance between gross intrusion and unconscionable negligence. In response to those erring on the side of negligence, U.S. Treasury Secretary Timothy Geithner vowed to eschew "another race to the bottom around the world." [14] Geithner suggested the creation of global minimums on clearing standards. But in the mean time, any regulators invested in meaningful reform will have to face this conundrum: at what point does financial regulation become self-defeating? If an official finalizes rules in an empty market, does that rule make a difference? Dodd-Frank may in fact be its own worst enemy, thwarting the very goals it champions. Geithner said himself that aggressive regulation might unintentionally drive derivatives into "those jurisdictions with the least oversight," thereby undermining the ultimate goal of reform: creating a safer financial system.[15] Furthermore, stringent regulatory requirements may prove antithetical to Dodd-Frank's commitment to a vibrant, competitive market. Foreign clearing organizations, dealers, and other entities may not be able to bear the costs of CFTC registration, reducing market competition.[16]

But are doomsday predictions of market flight overblown? It may be too early to tell. According to a report from GC Australia, financial firms there are gearing up to register with the relevant American regulators: "There's no shying away from adopting Dodd-Frank, says Troy Rieck, managing director of capital markets at QIC. At most, there's only delaying the inevitable."[17] However, countries with well developed financial sectors are not what worries industry watch-dogs. Jurisdictions with reputation with simpler regulation and enforcement could become a haven for riskier financial products and practices.

Yet John Nugée of the *Financial Times* does not see cause for panic. Yes, he writes, regulation will look different in Asia and elsewhere. Nugée says that "it is widely expected that the regional financial centers of Hong Kong and Shanghai

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[13] Ibid.
[14] Ian Katz, "Geithner Urges Minimum Global Rules on Swaps to Avoid 'Race to the Bottom,'" Bloomberg, http://www.bloomberg.com/news/2011-06-06/geithner-urges-global-regulators-to-avoid-race-to-the-bottom-.html
[15] Ibid.
[16] Found in "Testimony of Thomas F. Callahan."
[17] "Australian Institutions Anticipate Impact of Dodd-Frank," Australia Global Custodian, http://australia.globalcustodian.com/news/Market-Infrastructure/Australian-Institutions-Anticipate-Impact-of-Dodd-Frank/40152

will seize the opportunity to develop their own banking, brokerage and asset management sectors in view of heavy-handed regulation in the West."[18] But could this be a cause of celebration? It is certainly confirmation we are moving towards a "multi-polar world, with not only competing powers but also competing ideologies and governance systems."[19] However, as "increasingly divergent economies offer investment opportunities and greater scope for diversification and risk control,"[20] the more the opportunity for arbitrage, the more the strident discord of regulators, and the greater total risk in an already overwhelmingly interconnected system.

What Nugée is striking at in his piece is that there can be a market for everyone. America is safest when it keeps its standards high. Investors should come to recognize that those companies willing to bear the extra costs and do business in a well-regulated market are the surest long-term choice, as long as they know they can be insulated from the mistakes made in riskier jurisdictions. It may not match Geithner's dream of a global financial regulatory regime, but it is also within reach.

[18] Nugée, "Regulation's impact on global markets"
[19] Ibid
[20] Ibid.