McDermott Will & Emery

Trade Associations Express Concern over Risks of Diverging EU and US Derivatives Regulation

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On 5 July 2011, eight leading trade associations, including the International Swaps and Derivatives Association, the Global Financial Markets Association and the European Banking Federation, sent a letter to the US Treasury Secretary and the EU Internal Market Commissioner, warning them that diverging EU and US derivatives rules could substantially increase financing costs and "material risks" for companies and the wider global economy. The letter sets out a number of potential problems that could arise as a result of a lack of cooperation between the two regimes, and speculates on some solutions to these risks.

The Case for Non-Divergence

Counterparties based in the European Union and the United States often transact with each other, and it is therefore imperative that legal certainty and understanding imbues derivative transactions affecting both sides of the Atlantic.

The letter suggests that any incompatibility between the rules in the European Union and the United States could result in the increasing complexity of global derivatives transactions, due to "ambiguity and problematic extra-territorial challenges and issues of legal uncertainty and misunderstanding which could give rise to material risk".

The letter also provides that the cross-border activities of financial institutions, such as banks, broker dealers and asset managers, must be subject to "a sufficiently stringent regulatory standard and an avoidance of conflict and overlap in regulation". In particular, central clearing counterparties (CCPs) and regulators should work to ensure "equivalence" in the clearing rules, as any divergence in clearing requirements would create a situation in which the clearing requirements "would be impossible to comply with if the rules of each two different jurisdictions require a trade to be cleared in its jurisdiction".

Risks of Divergence

In the United States, proposed rules on derivatives trading are currently contained in the Dodd-Frank Act, while the European Union is introducing a regime through freestanding legislation. As the details of the rules in both jurisdictions have been gradually released to the market, affected market participants have increasingly become aware of their divergence in substance.

The letter outlines a number of risks and concerns arising out of the aforementioned divergence in international regulation, three of the main ones being fragmentation of markets, protectionism and regulatory arbitrage.

Fragmentation of Markets

The application of one jurisdiction's rules to entities operating in another jurisdiction increases the cost of transacting in markets subject to such rules, and this (in turn) will undermine the ability of market participants to manage risk. In addition, it is thought that the extra-territorial application of rules will lead to a "more fragmented view of activity in financial markets, making it more difficult for regulators to monitor, much less prevent a build up of systemic risk".

Protectionism

The letter suggests that, in many instances, the economic effects that are often associated with protectionism will arise if the rules in the United States and the European Union continue to diverge, regardless of whether extra-territorial application of domestic rules is not intended.

Regulatory Arbitrage

Non-US subsidiaries, branches or affiliates of US financial services institutions could be subject to the extra-territorial application of margin requirements, and therefore dual (and possibly conflicting) regulatory requirements. Likewise, US subsidiaries, branches or affiliates of non-US firms could face dual (and possibly conflicting) requirements in the two jurisdictions. Licensing entities within the swaps market may also be susceptible to duplicative regulatory regimes. Arbitrage-related problems could arise as a result of local players having to comply solely with local regulations.

Proposed Solutions

The letter urges the United States and European Union to consider the following solutions, by which the harmful effects of divergence may be prevented, alleviated or limited:

- Global regulators to enter into "mutual recognition" arrangements, where each regulator would limit the extra-territorial jurisdiction of its regulation so long as a firm complies with the regulations of its home country
- Global regulators to avoid or revise regulatory approaches which apply discriminatory rules to locally regulated financial institutions dealing with foreign entities

- Global regulators to agree on the standards for “equivalence” or recognition of CCPs in each others’ jurisdictions
- Continued dialogue among global regulators regarding trade repositories and the transfer of data and work between them
- Coordination of rules for licensing entities that are significant participants in the swaps market

In order to have any reasonable prospect of achieving the G20 goal, set in September 2009, of addressing key systemic risk issues in the financial regulatory market, the letter recommends that regulators should act in accordance with these suggestions. Correspondingly, the letter urges industry participants to work together in a constructive dialogue with the regulators to take advantage of the relevant knowledge available from associations and market participants engaged in multiple jurisdictions.

"Rasha Albazaz, trainee lawyer in McDermott Will & Emery based in the London office, also contributed to this newsletter."