

EVENT REPORT

EUROPEAN CAPITAL MARKETS INSTITUTE



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Over the counter (OTC) derivatives account for 95% of total derivatives and in 2012 reported a global outstanding value of around \$640 trillion. Derivative transactions are global and routinely subject to multiple set of rules, as they tend to involve various jurisdictions for any given transaction. Regulatory cooperation at international level is therefore cornerstone to ensuring both financial stability and market efficiency. The US Securities and Exchange Commission (SEC) released on May 1st 2013 its proposal on cross-border OTC regulation¹. Associate Directors at the SEC, Brian Bussey and Eric J. Pan, met ECMI members and the specialised press in Brussels to discuss the main lines of the release, including notably the concept of *substituted compliance*.

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Speakers

- Brian Bussey, Associate Director for Derivatives Policy and Trading Practices, Division of Trading and Markets, US Securities and Exchange Commission
- Eric J. Pan, Associate Director, Office of International Affairs, US Securities and Exchange Commission
- Karel Lannoo, ECMI General Manager and Senior Research Fellow [moderator]

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Over the counter (OTC) derivatives account for 95% of total derivatives and in 2012 reported a global outstanding value of around \$640 trillion. Derivative transactions are global and routinely subject to multiple set of rules, as they tend to involve various jurisdictions for any given transaction. A typical transaction could comprise a Brazilian institutional client and a sales and trading desk in New York who will book the transaction in a London branch or subsidiary and then book it back in the US for a combination of business, tax and compliance issues.

¹ "Cross-Border Security-Based Swap Activities; Re-Proposal of Regulation SBSR and Certain Rules and Forms Relating to the Registration of Security-Based Swap Dealers and Major Security-Based Swap Participants". Available at <http://www.sec.gov/rules/proposed.shtml>.

The SEC release² submits to public consultation a proposed set of rules that implement the *Dodd-Frank Wall Street Reform Act* with respect to cross-border derivatives activity, together with the full cost-benefit analysis that the SEC carried out for the purpose of devising the proposed rules. The release implements Dodd-Frank and the G20 consensus on the regulation and oversight of OTC derivative transactions.³ While in Europe, the regulatory role corresponds exclusively to the European Securities and Markets Authority (ESMA). In the US, it is a shared responsibility between the CFTC (Commodities Futures and Trading Commission) and the SEC. The release by the SEC comes after the CFTC issued interpretative guidance on June 29th, 2012⁴.

In the pursuit of international coordination, the SEC participates in the group that brings together the regulators from the ten most important jurisdictions in OTC derivative markets. This is of particular importance, not only to preserve financial stability by limiting potential arbitrage across jurisdictions, but also to avoid the inefficient disruptions to OTC derivative markets that can be derived from the extra-territorial application or national rules. In effect, the accumulation of compliance requirements can inefficiently raise costs while conflicts of laws can inhibit operations altogether.

With regard to regulatory arbitrage, the SEC is particularly concerned about risks originated outside (that is, originated outside the US by branches or subsidiaries of US-domiciled firms) falling back into the US financial system and potentially tax-payers, by not being subject to appropriate regulation and oversight in accordance with the provisions of *Dodd-Frank*. Any operations by subsidiaries that are guaranteed by a US-based undertaking would therefore need to comply with the rules proposed by the SEC to implement *Dodd-Frank*. From a transatlantic perspective, the SEC sees any requirement for US subsidiaries in Europe to be registered locally as a matter belonging to EU discretion. But getting the regulatory framework for branches and subsidiaries right at global level is cornerstone to avoiding gaps and enforcing a level playing field. The US experience with AIG illustrates the importance of protecting against risks that initially materialise in alien jurisdictions but ultimately borne by parent undertakings.

To avoid the accumulation of local requirements and costs, the SEC release proposes the concept of *substituted compliance* whereby intermediaries would be understood to comply with US regulation if they comply with local rules in a manner that the SEC would deem *substitutive* upon an outcomes-based comparative assessment of the similarities of compliance with both regulatory frameworks. The emphasis is placed on compliance outcomes rather than on the rules themselves. From a transatlantic perspective, the SEC understands that US and EU rules, while sometimes different in wording, tend to achieve similar outcomes. The SEC finds however a limit to *substituted compliance* in the segregation of client assets, which needs to be enforceable in accordance to local bankruptcy laws to be effective in practice. As the EU is also looking for an outcomes-based equivalence determination, the SEC would invite both parties to maximise the transparency of the assessment to reduce regulatory uncertainty and increase understanding in markets, in the pursuit of best outcomes.

Finally, the SEC welcomed the recent consensus by G20 leaders on the importance of developing a global database for derivative transactions. The feasibility study requested by the G20⁵ will have need to address not only technical issues but also obstacles related to data protection and privacy laws.

Find more information about this research seminar at www.eurocapitalmarkets.org

² <http://www.sec.gov/news/press/2013/2013-77.htm>

³ In the Pittsburgh Summit of September 2009, the G20 agreed that i) all standardised OTC contracts should be traded on exchanges or electronic platforms; ii) mandatory clearing through central counterparties should be foreseen where appropriate; and iii) all OTC transactions should be reported to trade repositories.

⁴ <http://www.cftc.gov/PressRoom/PressReleases/pr6293-12>