OTC Derivatives Reform: Dealing with overlap of rules

Alternative Investment Management Association

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Representing the global hedge fund industry

OTC derivatives: Globally convergent rules

- In September 2009, G-20 Leaders agreed in Pittsburgh that:

  "All standardised OTC derivative contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties .... OTC derivative contracts should be reported to trade repositories. Non-centrally cleared contracts should be subject to higher capital requirements...."

- Overall, there is a **high degree of convergence** in terms of the substance of national/regional rules that have been developed in furtherance of the G20 agreement.

EU: EMIR & MiFID	US: Dodd-Frank Title VII requirements
Central clearing (EMIR)	Central clearing
Reporting (EMIR)	Reporting
Trade execution (MiFID)	Trade execution
Margin for non-cleared (EMIR)	Margin for non-cleared

But… lack of regulatory consistency

- G20 leaders also agreed on the **need to implement rules on a consistent basis:**

  "We are committed to take action at the national and international level to raise standards together so that our national authorities implement global standards consistently in a way that ensures a level playing field and avoids fragmentation of markets, protectionism, and regulatory arbitrage."

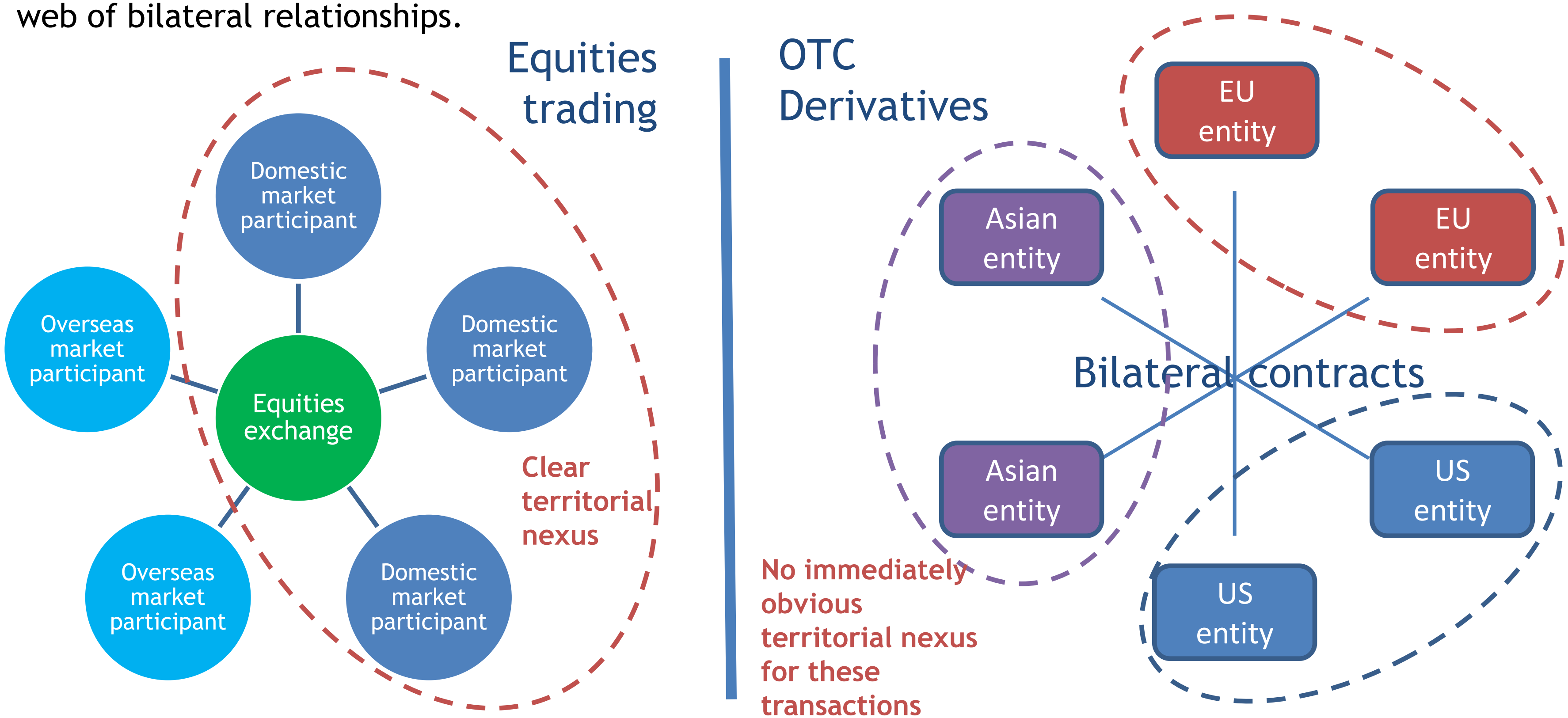
Despite rules being convergent in terms of their content, we have fundamental concerns that they have not been developed in a way that respects the overall consistency of the global regulatory framework. Specifically, there are manifest shortcomings in terms of the:

- Way in which individual jurisdictions define the scope of the rules; and

- Mechanisms available to deal with situations where the rules of one or more jurisdiction overlap (and potentially conflict).

Determining the territorial nexus

- For some products and markets, it is relatively straightforward for regulators to determine the scope of their rules. For example, regulating transactions that take place on a domestic equities exchange is relatively straightforward because there is an obvious ‘nexus’ with the jurisdiction in which the exchange is established. For other markets, it is less straightforward to define jurisdiction. This is the case for OTC derivatives markets, which were historically characterised by a web of bilateral relationships.



Scope with respect to Funds

- The inherent challenge of regulating OTC derivatives markets calls for **close cooperation between regulators** when it comes to determining the scope of their rules. Unfortunately, effective cooperation on this has been lacking.

- **Specifically, the 'entity scope' of EMIR and CFTC rules overlap in many situations. This is driven to a large degree by the broad approach taken by the CFTC in developing a US person definition:**

  - **CFTC:** A fund is treated as a US Person if it has a "principal place of business" in the US or **if it is majority-owned by US Persons.**

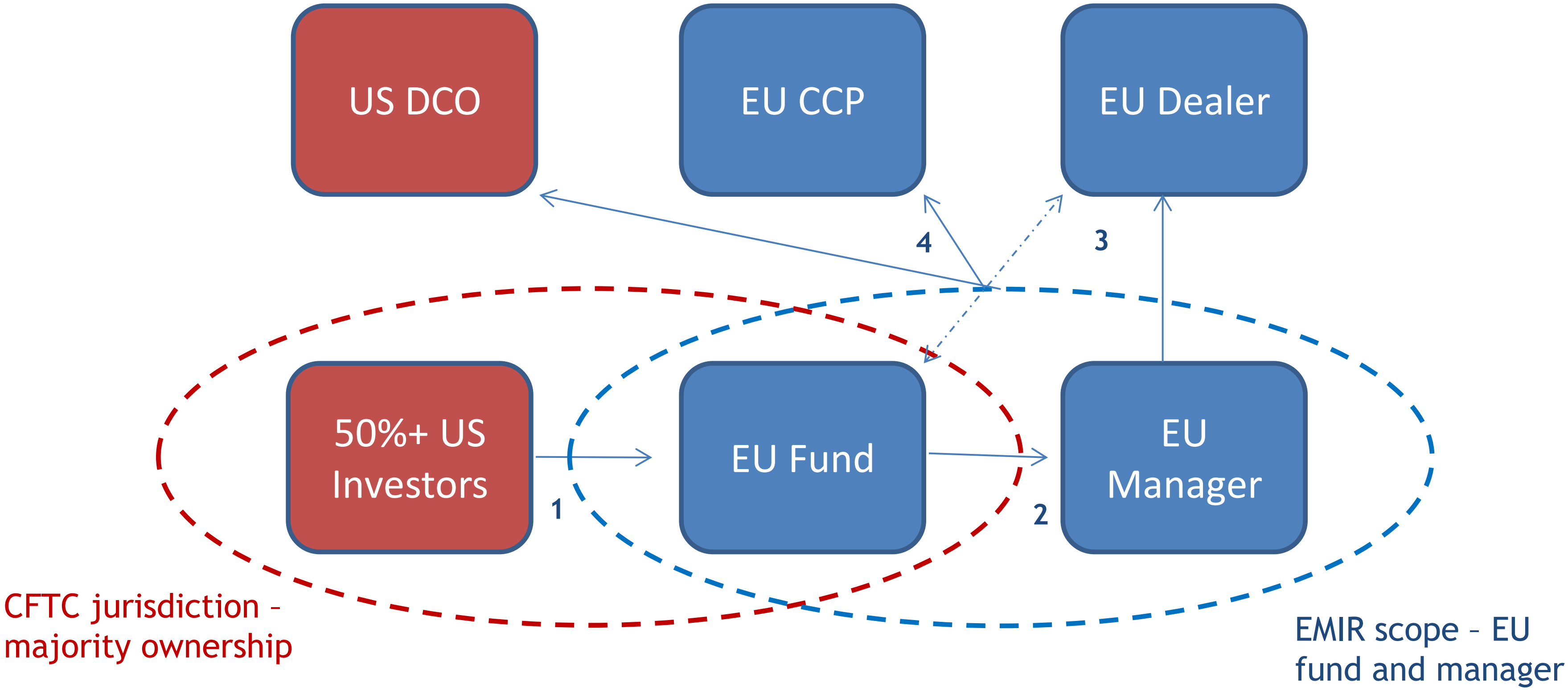
  - **EMIR:** A fund is subject to EMIR if the fund or its investment manager is domiciled in the EU.

- **Example:** A fund is domiciled in Ireland and **is majority-owned by US investors**[1]. The fund is managed by an investment manager based in London. It enters into a derivatives transaction with a European investment bank. The fund is a **US person** by virtue of being majority-owned by US Persons, making the transaction subject to CFTC rules. The transaction is also subject to EMIR by virtue of the fund having a European investment manager.

- As a result, there is significant potential for overlap with respect to the substantive obligations of such US person, who is also a European investment manager, under CFTC rules and EMIR.

1 This may be particularly difficult to determine if a fund is publicly traded or if shares are held by persons who are non-responsive or in omnibus accounts.

An illustration of overlap



1. An EU fund is majority-owned by US investors. CFTC requirements apply.
2. The EU fund has an EU investment manager. EMIR applies.
3. The investment manager enters into an OTC derivatives contract with an EU dealer bank on behalf of the fund.
4. The fund is subject to competing clearing rules – does it choose the EU or US rules?

Overlap and inconsistency

- Despite the high level of convergence between the EU and US frameworks and the near-identical regulatory outcomes (central clearing, organised trade execution, reporting etc.), this overlap is problematic because there **are many legal differences between the regimes when it comes to their detailed parameters**.

- In some instances it is possible to follow two sets of subtly different rules, although this would obviously generate unnecessary compliance costs, as well as problems for regulators to avoid double-counting. For example, a participant could report the same transaction to different trade repositories if it were required to do so.

- In other situations, the **rules might be irreconcilable**. This is the case with central clearing. Despite the overall clearing requirements being comparable, there are important differences:

  - **Segregation:** EU and CFTC rules set different segregation standards. The CFTC's regime is based on a Legally Segregated, Operationally Comingled structure (LSOC). In the EU, a higher standard of segregation is possible (individual segregation).
  - **Collateral:** EU and CFTC rules set different standards on eligible collateral for clearing.
  - **Margin requirements:** Margin requirements may be different in different jurisdictions, depending on the contract.

- Therefore, even if a clearing house is registered with both the CFTC and ESMA **("dual registration")**, it cannot necessarily provide a clearing structure that satisfies both sets of rules for an individual trade.

Existing relief mechanisms

- The CFTC framework and EMIR both recognise that overlap of rules can arise and that relief should be available for transactions that are subject to such overlap where the requirements are comparable.

- However, **neither framework is currently sufficiently comprehensive** to be able to deliver relief in all scenarios in which overlap of rules currently arises:

  - The European **equivalence** framework only provides relief when one or more parties to the trade is <u>established</u> in an equivalent jurisdiction. In the example on the previous slide, both counterparties are established in the EU.

  - The CFTC's **substituted compliance** framework is not available to US Persons.

- AIMA believes that there are a number of solutions that could be pursued. The following slides set out some possibilities.

Possible solutions

Solution	Discussion
Amend scope of EMIR and CFTC rules to reduce range of situations in which rules overlap	- AIMA has previously suggested narrowing the scope of the CFTC's US Person definition to exclude funds that are majority owned by US Persons. This would reduce the scope for overlap with EMIR or other regional legislation.
Broaden scope of substituted compliance and equivalence	- CFTC substituted compliance is not available to US Persons. It would be possible to broaden the scope of substituted compliance to include US Persons. - EMIR equivalence determinations will benefit entities established in an equivalent jurisdiction. AIMA has argued that this should extend to entities that are subject to the rules of an equivalent jurisdiction (e.g. a fund that is established in the Cayman Islands, but that is majority-owned by US Persons and therefore subject to CFTC rules)
Provide targeted (no-action) relief for funds that are subject to overlap	- In October, AIMA wrote to the CFTC requesting targeted relief for EU and offshore funds: (1) whose assets are managed by an EU investment manager; and (2) who are transacting with European dealer banks. We believe that in this situation the most meaningful regulatory nexus is with the EU. The CFTC can take comfort from the fact that the major EU CCPs will be registered as DCOs as well, so there is no additional risk associated with permitting clearing under EU rules.

Conclusions

- CFTC rules and EMIR overlap and conflict. This will potentially put asset managers in an impossible position when the EU clearing obligation goes live (Q4 2014).

- There are mechanisms to deal with overlap – EU equivalence framework and CFTC substituted compliance regime – but these are currently insufficiently used on the part of CFTC (EU is expected to deem the US rules equivalent for EMIR purposes).

- Relief from CFTC requirements should be available to firms that are subject to European requirements covering the clearing obligation, trade reporting and trade execution.

- If relief is not granted, it will have a profound impact on the global financial services industry, as well as EU affiliates of US dealer banks – clients are likely to avoid trading with affiliates of US dealers if there is no relief mechanism available for those trades.

- ISDA's recent study 'Cross-Border Fragmentation of Global OTC Derivatives: An Empirical Analysis' (January 2014) demonstrates that the market is already fragmenting along regional lines, despite the comparability of regulatory outcomes.

Contact

Alternative Investment Management Association

Tel: +44 (0)20 7822 8380

Fax: +44 (0)20 7822 8381

Web: www.aima.org