Market Fragmentation & Cross-border Regulation

Report

The Board
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EXECUTIVE SUMMARY

In 2015, IOSCO released a Final Report from its Task Force on Cross Border Regulation (2015 Report), which included a toolkit of three broad types of approaches for cross-border regulation:

- **National treatment**, which aims to create a level playing field between domestic and foreign firms within one jurisdiction and provides direct oversight to the host regulator. Within this context, jurisdictions may make use of exemptions from their regulatory framework or use substituted compliance to mitigate the duplication of rules a foreign entity is required to follow;

- **Recognition,** which is based on a jurisdiction's assessment of a foreign regime as equivalent to its own and therefore minimizes duplicative regulations for firms doing cross-border business; and

- **Passporting,** where one common set of rules is applicable to jurisdictions covered by the passporting arrangements and provides a single point of entry for firms wishing to operate within these jurisdictions.

Markets have continued to evolve since that time, particularly as jurisdictions continue to progress towards full implementation of the post-crisis G20 financial reforms. At the same time, there are signs of fragmentation in certain parts of the financial markets, which may undermine the effectiveness of the G20 reforms. The Japanese G20 Presidency, IOSCO, and other global bodies such as the Financial Stability Board (FSB) have accordingly begun to examine any potential adverse effects of market fragmentation, where it may arise from financial regulation.

IOSCO established a Follow-Up Group to the 2015 Task Force (Follow-Up Group) to examine market fragmentation in wholesale securities and derivatives markets, specifically as it arises as an unintended consequence of regulation. The purpose of this work is to better understand where and why regulatory-driven market fragmentation is occurring, and what action(s), if any, IOSCO and its members could pursue to minimize its adverse effects.

Among other things, this Report from the Follow-Up Group includes a discussion on the concept of deference and how the tools identified in the 2015 Report help jurisdictions defer to one another. It considers where and how IOSCO members have used these tools since 2015, and discusses the benefits and challenges they have encountered in using them. It also explores the impact these tools may have had on market fragmentation, and members' views on the lessons that can be derived from their use, four years after the 2015 Report was published.

To inform this Report, IOSCO participated in two roundtables in January 2019 and March 2019 with the public and private sector and issued a survey to its Board Members about market fragmentation and their respective experiences with cross-border regulation since 2015. Some key findings emerged from these efforts. For example, many regulators have become acutely aware of the risks associated with unintended market fragmentation and there has been increased collaboration and cooperation between IOSCO members to mitigate its effects.

Deference between regulators through the use of cross-border regulatory tools, particularly those identified in the 2015 Report, has increased significantly. Bilateral arrangements in the form of Memoranda of Understanding (MoUs) are now a common tool used by regulators, particularly with respect to information exchanges. And regulators have developed novel processes to work multilaterally to the benefit of the markets they oversee.

Despite these successes, some challenges remain and strengthening cooperation between regulatory authorities could further assist in addressing effects on the financial system stemming from market fragmentation. Accordingly, in this Report, we propose potential measures that could be explored further. These measures include ways to foster further mutual understanding of one another's legislative frameworks, deepen existing regulatory and supervisory cooperation and consider whether there are any good or sound practices which can be identified regarding deference tools, without changing the existing legislative requirements or frameworks that authorities have in place.

On fostering mutual understanding, IOSCO can make greater use of its Regional Committees to discuss cross-border regulatory issues on a regular basis. Such discussions may allow members to develop knowledge of one another's markets and legislative frameworks. In addition, IOSCO's Affiliate Members Consultative Committee (AMCC) could prepare an evidence-based report for the IOSCO Board on an annual basis to ensure that the issue of harmful fragmentation remains a regular item on the IOSCO agenda.[1]

Supervisory MoUs provide a framework for the ongoing supervisory arrangement between jurisdictions and their use has increased since 2015. In recognition of this increase, IOSCO is building a central repository of such MoUs to provide more transparency to both regulators and industry participants. To strengthen collaboration and cooperation, IOSCO could also explore, taking into account any existing work undertaken by other standard setting and supervisory bodies, whether and how existing supervisory colleges currently achieve their objectives and, if appropriate, identify ways to increase their use.

Finally, while IOSCO recognizes that deference may not be appropriate in all circumstances, its use may contribute to mitigating the risk of fragmentation for global cross-border markets. To this end, IOSCO could serve as a forum for the exchange of information among its members about each other's approaches to cross-border regulation and could consider whether there are any good or sound practices that can be identified regarding deference tools.

[1] The AMCC is comprised of 64 IOSCO affiliate members, representing securities and derivatives markets and other market infrastructures, self-regulatory organizations (SROs), investor protection funds and compensation funds, as well as other bodies with appropriate interest in securities regulation. There are currently 32 jurisdictions represented in the AMCC which also includes ten regional or international associations. The AMCC objectives are to share experiences and enhance cooperation among its members. In its capacity as a consultative committee, it provides input into the IOSCO policy and standard-setting work.

Chapter 1 – Introduction

Background

IOSCO's previous work relevant to cross-border regulation

In 2013, IOSCO established a Task Force to assist regulators with the challenges they faced in ensuring the effectiveness of domestic regulation without unduly constraining the cross-border offering of financial services or products. The Task Force released its Final Report in 2015 (2015 Report). As mentioned in that report with regard to the purposes of cross-border regulation, authorities will often seek to balance potential trade-offs between increased cross-border market access and financial activity, on the one hand, and maintaining appropriate levels of investor protection and managing the importation of potentially harmful risk, on the other.

The 2015 Report included a toolkit of three broad types of approaches for cross-border regulation:[2]

- **National treatment**, which aims to create a level playing field between domestic and foreign firms within one jurisdiction and provides direct oversight to the host regulator. Within this context, jurisdictions may make use of exemptions from their regulatory framework or use substituted compliance to mitigate the duplication of rules a foreign entity is required to follow;

- **Recognition,** which is based on a jurisdiction's assessment of a foreign regime as equivalent to its own and therefore minimizes duplicative regulations for firms doing cross-border business; and

- **Passporting,** where one common set of rules is applicable to jurisdictions covered by the passporting arrangements and provides a single point of entry for firms wishing to operate within these jurisdictions.

In the 2015 Report, the Task Force recognized the need for more refined thinking on the concept of deference. In this report (Report), we use the term "deference" as an overarching concept to describe the reliance that authorities place on one another when carrying out regulation or supervision of participants operating cross-border. This is intended to be consistent with how deference is used by others in the context of cross-border regulation. For example, the G-20 Leaders have called for "*jurisdictions and regulators ... to defer to each other when it is justified by the quality of their respective regulatory and enforcement regimes, based on similar outcomes, in a non-discriminatory way, paying due respect to home country regulation regimes*".[3] In practice, deference may also be associated with the use of different regulatory mechanisms, such as exemptions, substituted compliance, recognition/equivalence and passporting. The term is used here in a generic manner and is not intended to refer to the legal framework of any single jurisdiction.

2 https://www.iosco.org/library/pubdocs/pdf/IOSCOPD507.pdf

3 http://www.g20.utoronto.ca/2013/2013-0906-declaration.html

Setting up the Follow-Up Group and key mandate

Since 2015, some regulators and market participants have noted that certain parts of the financial markets have become fragmented, often along jurisdictional lines, which may be an unintended result of the implementation of the post-crisis regulatory reforms and their national implementation.

In 2019, the Japanese Presidency of the G-20 identified market fragmentation as a critical issue affecting the global economy. Informed by Japan's G20 agenda, IOSCO determined it was timely and relevant to explore the potentially adverse impact of market fragmentation on the global securities and derivatives markets.[4]

As a result, IOSCO formed a Follow-Up Group to its Cross-Border Task Force (Follow- Up Group) in January 2019 and mandated it to:

- examine where market fragmentation has taken place in securities and derivatives markets and the potential reasons for any such developments;[5]
- take stock of the progress and experiences of member authorities in assessing foreign regulatory regimes, including any lessons learned, policy implications and areas that could be improved; and
- establish information repositories for recognition decisions and supervisory cooperation Memoranda of Understanding (MoUs) entered into by members.

Developing this Report

To fulfil this mandate, IOSCO has taken a number of steps. First, the Follow-Up Group conducted a survey of its Board Members (including Board Observers)[6] regarding the development of fragmentation in financial markets. The survey also sought an update on the tools that Board Members had adopted or were planning to adopt to address cross-border regulatory issues since the publication of the 2015 Report.

Second, the Follow-Up Group sought input from industry members and others from the public sector and academia. IOSCO participated in a workshop organized by the FSB with external stakeholders in January 2019 and led the sessions dedicated to securities and derivatives markets. Participants were financial institutions from the securities and derivatives markets as well as infrastructure institutions such as central clearing counterparties (CCPs), industry associations and academics. In addition, the Follow-Up Group organized a roundtable with members of the regulatory community and the derivatives industry in March 2019. Participants

4 IOSCO informed the FSB of the Follow-Up Group's mandate and agreed to contribute to the FSB's corresponding project on market fragmentation to avoid duplication of the work of the Follow-Up Group. As noted, IOSCO's work is focused on market fragmentation in the securities and derivatives markets.

5 We note that the focus of the Follow-Up Group's work has been on market fragmentation in the wholesale as opposed to retail markets.

6 IOSCO Board Observers are the European Securities and Markets Authority (ESMA), Netherlands Autoriteit van Financiele Markten (AFM) and National Futures Association (NFA) as Chair of the AMCC.

included senior leaders of CCPs, trade repositories, exchanges, swap dealers and trade associations. IOSCO also received written input from market participants through its AMCC.

Based on the feedback from the survey, the input from the roundtables and the AMCC, IOSCO determined that the focus of this Report would be on market fragmentation that arises as an unintended consequence of financial regulation. This distinction is important because market fragmentation has sometimes been the intended result of local or regional regulatory reforms intended to enhance market integrity, investor protection or financial stability.

The start of the Report seeks to define market fragmentation, taking into account the work other international bodies have done in this area. It also provides examples of market fragmentation that IOSCO Board Members consider to be significant and potentially harmful to the oversight and supervision of financial markets. The Report also focuses on the progress made by IOSCO members in using the regulatory mechanisms and tools noted in the 2015 Report to facilitate cross-border regulation. In doing so, the Report seeks to identify remaining challenges that can restrict cross-border activities.

Finally, the Report draws on findings from survey respondents, offers lessons learned and suggests potential ways forward that could assist IOSCO members in reducing the occurrence, and any adverse effects, of harmful or unintended regulatory-driven market fragmentation while being mindful of existing legislative and regulatory frameworks.

Chapter 2 – Defining market fragmentation and reviewing the use of the 2015 Tools: an analysis of respondents' answers to the survey

The first part of this Chapter considers the definition of market fragmentation and discusses some of its drivers. It then explores practical instances where respondents indicated that financial regulation and supervision may have given rise to harmful fragmentation in wholesale securities and derivatives markets. The Report also explores areas where respondents believe new or further fragmentation could occur in the future.

The second part of this Chapter focuses on updates and changes to how jurisdictions have progressed in deferring to one another's regulatory frameworks for cross-border business and how they are using the three tools identified in the 2015 Report, namely national treatment, recognition and passporting.

Although the 2015 Report did not consider the OTC derivatives market, respondents to the Follow-Up Group's survey were asked to include relevant examples of their use of these tools in those markets. This discussion includes where and how respondents have used these tools since 2015 as well as a discussion of the benefits and challenges they have encountered in using them. This Chapter thus also explores the impact these tools may have had on market fragmentation and respondents' views on the lessons that can be derived from their use, nearly four years after the 2015 Report was published.

Finally, this Chapter considers respondents' views on whether any new approaches or tools could be developed to further promote international collaboration and reduce instances of harmful market fragmentation in the future.

Defining and identifying market fragmentation

A definition of fragmentation and its general features

In January 2019, the Follow-Up Group issued a survey on market fragmentation to IOSCO's 34 Board Members and 3 Board Observers and received 25 responses.[7]

While G20 Leaders committed to avoiding fragmentation of markets,[8] up to this point, there has been no commonly agreed official definition of market fragmentation as it relates to cross-border financial transactions.

Indeed, most jurisdictions do not have a definition of market fragmentation within their legal frameworks and many international bodies – including IOSCO – have not previously defined the term market fragmentation as it relates to cross-border transactions.[9] Industry participants,

7 Rather than answer the survey questions, AMCC members provided research material and input into the question relating to tools that could assist regulators in reducing harmful market fragmentation.

8 https://www.treasury.gov/resource-center/international/g7-g20/Documents/pittsburgh_summit_leaders_statement_250909.pdf

9 SRC/2019/04

on the other hand, have offered various definitions of the concept of fragmentation; however, there is no general consensus.[10]

The FSB's Standing Committee on Supervisory and Regulatory Cooperation (SRC) has also undertaken work on market fragmentation, adopting a cross-sectoral and financial stability perspective.

As part of this work, the FSB engaged with other international bodies and asked them to propose a definition. In seeking to define this concept, the FSB has offered a high-level description of market fragmentation in which the concept refers to "*global markets that break into segments, either geographically or by type of products or participants*".[11] IOSCO proposes to adopt this definition in this Report to ensure consistency with the FSB.

Beyond the threshold question of definition, there was general consensus among respondents regarding the features and indicators that could point to where market fragmentation has taken place. These features and indicators include:

i. multiple liquidity pools in market sectors or for instruments of the same economic value which reduces depth and may reduce firms' abilities to diversify or hedge their risks and result in similar assets quoted at significantly different prices;

ii. a reduction in cross-border flows that would otherwise occur to meet demand;

iii. increased costs to firms in both risks and fees; and

iv. the potential scope for regulatory arbitrage or hindrance of effective market oversight.

Sources and drivers of fragmentation

Fragmentation in the provision of cross-border wholesale financial services and activities can occur for several reasons, including market-led practices, investor preferences or domestic legislation that is not related to financial services (e.g., taxation). It can also arise from financial regulation (i.e., regulatory fragmentation).

Respondents suggested that there are inherent trade-offs when considering regulatory fragmentation. On the one hand, most respondents highlighted instances where regulatory fragmentation can lead to unintended consequences with harmful effects and limit regulators' supervisory oversight of financial markets. On the other hand, many respondents also identified benefits to fragmentation when it is tailored to account for the unique circumstances of domestic markets. Such benefits could include instances where regulatory developments may fragment markets in a way that also strengthens resilience, stability and investor protection or enhances competition to the benefit of the markets and consumers. For example, the enactment of the Markets in Financial Instruments Directive I (MIFID I) abolished the "concentration rule",

10 The Global Financial Markets Association (GFMA), an industry trade association, has defined market fragmentation as "anything that impacts the free flow of resources or information relative to the unfettered supply and demand for those resources or information" and the FIA has defined it as "where participants in an organic, shared market which crosses jurisdictions are less able to interact freely with one another in one or more of such jurisdiction. Thus, market participants are limited to interacting in silos that are less liquid, less diverse, less competitive."

11 SRC/2019/03

meaning that EU countries could no longer require investment firms to route orders only through national stock exchanges. This allowed for cross-border trading competition across the EU.

Where fragmentation arises from regulation, respondents identified several potential key drivers, including:

- **Differences in jurisdictions' implementation of financial sector reforms consistent with international standards, where these standards exist:** Where regulatory reforms have been adopted, jurisdictions have sometimes adopted variations of the relevant international standards, which has led to overlapping, differing or even conflicting requirements imposed on market participants. Where the extraterritorial effects of a jurisdiction's rules arise, some survey respondents and participants in the roundtables suggested this has worsened the impact on firms and the markets in which they operate.

- **Differences in timing of implementation:** Some survey respondents noted that this factor may have led certain jurisdictions to impose extraterritorial requirements on firms from jurisdictions that had not yet implemented reforms. The difference in timing often requires firms to comply simultaneously with different sets of rules or legislation.

- **Lack of international standards and harmonization:** Data and reporting rules were highlighted as a source of market fragmentation even though respondents acknowledged the ongoing developments within this area. Some respondents also mentioned the lack of international standards and harmonization or insufficient granularity of standards as a potential source of fragmentation in relatively new sectors such as crypto-assets and sustainable finance.

- **Lack of ability or authority to defer:** where authorities in certain jurisdictions have decided not to, or are prohibited from, using tools that allow them to defer to home jurisdictions, firms that conduct cross-border business may be unwilling to subject themselves to different types of rules and may therefore withdraw from certain markets, resulting in market fragmentation.

Market fragmentation in practice

Drawing upon the survey responses, the feedback from the FSB workshop, the IOSCO roundtable and the AMCC, the Follow-Up Group has identified key instances of potentially harmful market fragmentation. While the actual evidence as well as the degree of such market fragmentation varies across sectors and regions, respondents provided a number of examples that illustrate these harmful effects and were largely focused on issues concerning: (1) the trading and clearing of derivatives, (2) trade reporting, and (3) data privacy and location requirements.

Trading and clearing of derivatives

Many respondents noted that the trading and clearing of over-the-counter (OTC) derivatives has fragmented along jurisdictional lines, in part due to divergent national implementation of the G20 reforms in these areas. Some examples identified in the survey include:

Trading

- *Swap Execution Facilities*[12] *(SEF) rules:* while the rules promulgated by the US CFTC were designed to increase liquidity and transparency in swap markets, some respondents explained that the extraterritorial effects of the rules have led to localization of trading activities. This has meant that liquidity split between SEF pools for US members and non-SEF pools for others who did not wish to trade with US persons in order to avoid registration with the CFTC. These effects have been particularly acute in the interest rate swap market, notably for interest rate swaps denominated in Euros.[13] It may nevertheless be worth further examining the current state of this trend.

- *Trading rules:* The EU Markets in Financial Instruments Regulation (MIFIR) requires certain classes of previously OTC derivatives to be traded on venues to increase transparency in derivatives markets. Such trading can take place, in addition to EU trading venues, on certain trading venues of a specific third country subject to an equivalence decision by the European Commission. Some respondents noted this may fragment liquidity geographically, in the absence of an equivalence assessment. MIFIR also includes similar obligations in equity trading, even where a non-equivalent non-EEA venue provides more depth and liquidity in specific shares.[14]

Clearing activities and location policies for CCPs

Policies with regard to CCPs have been put in place with the aim of improving risk management and reducing systemic risk; however, in some cases the manner in which the reforms have been implemented may have led to some fragmentation. Indeed, some authorities require certain trades executed domestically to also be cleared through CCPs that are physically located within their borders. Some respondents mentioned that such location policies for CCPs restrict liquidity, increase costs and reduce financial stability by breaking up netting sets and requiring

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12 CEA Section 1a(50) defines the term "swap execution facility" as a "trading system or platform in which multiple participants have the ability to execute trades or swaps by accepting bids and offers made by multiple participants in the facility or system, through any means of interstate commerce, including any trading facility that (a) facilitates the execution of swaps between persons and (b) is not a designated contract market."

13 According to ISDA data, cleared Euro IRS activity transacted between US and European counterparties dropped from 29% to 9% when the rules took effect, between September and October 2013.

14 ESMA sought to clarify, in a Q&A published in November 2017, that "*while the Commission is preparing equivalence decisions for the non-EU jurisdictions whose shares are traded systematically and frequently in the EU, the absence of an equivalence decision taken with respect to a particular third country's trading venue indicates that the Commission has currently no evidence that the EU trading in shares admitted to trading in that third country's regulated markets can be considered as systematic, regular and frequent*." https://www.esma.europa.eu/press-news/esma-news/esma-clarifies-trading-obligation-shares-under-mifid-ii.

firms to pay into two separate default funds. Such a situation could also increase counterparty risk and does not recognize that certain participants, based on their geographic location, tend to participate in the market both as sellers or buyers. For example, despite having a framework in place to allow activities by foreign CCPs, Japan has so far only allowed its local CCP to clear local CDS and JPY IRS. This might have created fragmentation between the activities of Japanese banks which clear through the local CCP and global banks which typically clear through a global CCP although the basis between the 2 CCPs has recently been tightening, including long-term JPY IRS.

Margin requirements

Some respondents suggested that differences in the approaches adopted by national authorities when implementing the BCBS/IOSCO minimum standards on margin requirements for non-centrally cleared derivatives have led to variations in the entities and instruments subject to the requirements. These divergences were also identified by the Working Group on Margin Requirements (WGMR) Monitoring Group.[15] In particular, jurisdictions may define entity scope by type of entity, while others consider the role of the entity in the derivatives market. In the interest of orderly markets, the IOSCO Board issued a statement in February 2017 to help address some of the operational challenges facing market participants with regard to the 2017 phasing in of variation margin requirements at different times in different jurisdictions.[16] Nevertheless, differences in the timing of implementation of the BCBS-IOSCO uncleared margin requirements (UMR) may also have had an impact on fragmentation. These divergences in implementation may have led to fragmentation in trading patterns in the absence of deference to the rules of the home jurisdiction.

Trade Reporting

Trade reporting requirements are a key component of the G20 OTC derivatives reforms because they help to improve transparency, mitigate systemic risk, and protect against market abuse. Nevertheless, some respondents reported that national implementation of the G20 Leaders requirements to report derivatives trades have been implemented at different pace or in a non-harmonized way which has led to fragmentation in OTC derivatives markets.

Differences in implementation - trade reporting requirements (see case study 2 prepared by the UK FCA)

- **Scope of reporting***:* Variations in the reporting requirements between jurisdictions include: formats of data fields are not harmonized across jurisdictions; requirements on the timing of reporting (e.g., T+1 or alternative arrangements) also differ between jurisdictions; and the data fields required by national regimes differ, and have in some cases expanded over time, resulting in regulatory authorities basing their monitoring and analysis of the build-up of risks on data fields that may be inconsistent.
- **Scope of reporting entities***:* Some jurisdictions have implemented single-sided reporting (where one party to a trade is required to report the transaction) while others have implemented dual-sided reporting whereby both sides report, requiring trade repositories (TRs) to pair and match trade reports. Regulatory authorities have also set different

[15] BS/19/02 and IOSCO/Board/2019/014

[16] https://www.iosco.org/library/pubdocs/pdf/IOSCOPD556.pdf

thresholds on the size or type of activities of a firm that triggers a reporting obligation, with consequent inconsistencies between what activity needs to be reported and to whom.

These differences in implementation have resulted in higher costs for firms than if there had been consistency in the national implementation of reporting requirements, and further, may not enable regulators to monitor the build-up of systemic risks as much as intended given they may impair usability, aggregation and comparability of the data reported.

However, some regulatory efforts are currently taking place to achieve better standardization of reporting across borders. For example, the review of EMIR within the EU (EMIR Refit) has addressed some of the difficulties faced by market participants by harmonizing and simplifying some of the reporting requirements and standards (e.g., on non-financial counterparties under the clearing thresholds). International initiatives have also taken place. This includes the CPMI-IOSCO working group's effort to harmonize the key OTC derivatives data elements that are reported to TRs, such as the Unique Product Identifier and the Unique Trade Identifier[17] and the CPMI-IOSCO Critical Data Elements.[18]

Trade reporting - regulatory risks and costs produced by fragmentation (see case study 2 prepared by the UK FCA)

The ability of regulators to monitor the derivatives market for emerging cross-border risks, and understand firms' exposures in times of market stress, is a key test of whether the trade reporting obligations are fully meeting the aims of the G20 reforms.

While there are many examples of regulators using trade repository (TR) data for a wide range of tasks, including systemic risk monitoring at a national level, fragmentation among TRs or within TRs may constraint regulators' ability to develop a complete and accurate picture of counterparty credit and market risk in global derivatives markets. Data protection laws or other specific legal restrictions may discourage TRs from providing services across jurisdictions or may cause TRs to separate the infrastructure they use to serve different jurisdictions in ways that impede data aggregation. For example, certain jurisdictions can place requirements on foreign regulators or foreign TRs before TRs from foreign jurisdictions can be 'recognized' or allowed to provide services to local market participants.

Moreover, because trade repository services entail high fixed costs and low variable costs, they likely exhibit economies of scale. As a result, besides reducing the efficiency of regulation and supervision of OTC derivatives markets, fragmentation of TR services across jurisdictional lines may make it costlier for TRs to serve market participants because each TR amortizes its fixed costs over a smaller set of market activity. Moreover, such legal barriers may inhibit competition between TRs, resulting in higher costs, or lower service quality, for market participants within jurisdictions.

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17 CPMI-IOSCO (2017), Harmonization of the Unique Transaction Identifier: Technical Guidance, February; CPMI-IOSCO (2017), Harmonization of the Unique Product Identifier: Technical Guidance, September; CPMI-IOSCO (2018), Harmonization of the critical OTC derivatives data elements (other than UTI and UPI): Technical Guidance, April.

18 https://www.bis.org/cpmi/publ/d175.pdf

Data privacy and data location requirements

More generally on data, some respondents noted that certain data protection laws intended to establish a high degree of privacy (e.g., the EU's General Data Protection Regulation (GDPR)) may have led to some legal uncertainty for data transfers between domestic and third country regulators. To mitigate this impact, EU and non-EU IOSCO members have negotiated and agreed, consistent with the GDPR, an Administrative Arrangement allowing for the continuation of frequent and systematic data transfers between regulators, including under the IOSCO Multilateral Memorandum of Understanding (MMoU).[19]

These types of laws can nonetheless create legal uncertainty for data transfers between domestic firms and foreign firms and between regulators and foreign firms. This creates fragmentation of data and may result in authorities limiting or restricting foreign market participants' ability to conduct business in their jurisdiction due to their inability to receive the data they require. Firms may also be reluctant to operate in certain overseas markets if they perceive a barrier to complying with regulatory requirements which may conflict with their own home state regulator's rules. In that context, recent data localization requirements, particularly in Asia, could have the effect of limiting the internal sharing of data for risk management where global institutions are concerned. Some market participants have suggested that these developments could also increase costs for firms and increase barriers to trade and innovation, for example when it comes to cloud technologies.[20]

Other examples

Other market fragmentation examples cited by respondents include the MIFID II provisions for the reception or payment of inducements, in the absence of similar requirements in other non-EU jurisdictions, as being potentially disruptive to the supply of cross-border research.

Finally, one respondent noted potential issues related to approaches to oversight of quality in audit services. The approach to the presentation of financial results is generally similar across the world's capital markets, subject to some well-known differences in accounting principles, whether home country, IFRS or U.S. GAAP. However, the approach to oversight of quality in audit services varies, with differences in approaches in areas such as audit firm inspection activities, issuance of publications directed to auditors and audit committees, and interactions with market and other regulators. The respondent noted that investors and other market participants may assume that the approach to quality in audit services is consistent globally, when that may not be the case in fact.

Market fragmentation – possible future areas of impact

The examples highlighted above reflect respondents' views on current instances of regulatory initiatives that may have resulted in, or could potentially lead to, harmful market fragmentation as it relates to the provision of cross-border wholesale market services and activities. However,

19 https://www.iosco.org/news/pdf/IOSCONEWS525.pdf

20 Cloud computing technologies are often based on the interconnectedness of various data centres that are typically distributed in different locations or jurisdictions. Cloud can create economies of scale for firms, but can also contribute to mitigating traditional IT risks, such as the failure of systems. https://www.iif.com/Portals/0/Files/IIF%20FSB%20Fragmentation%20Report.pdf

as new products emerge or new regulatory initiatives are introduced, further fragmentation could occur in other areas, absent any strategy measures to mitigate possible adverse effects.

In this regard, respondents highlighted the following developments and markets as potential instances of fragmentation in the near to medium term:

- **Brexit**: Both European and non-European jurisdictions raised concerns about the consequences of Brexit and its effect on financial markets given that markets that had been so deeply integrated prior to Brexit may cease to be so in the future. Some respondents also noted concerns about the impact of Brexit on derivatives trading, clearing, and reporting where there is a risk that financial market infrastructure access for both financial firms and their consumers may be impacted, leading to potentially adverse consequences to market liquidity. Some respondents mentioned that Brexit could have consequences for participants' ability to address life cycle events and risk management requirements for OTC derivatives portfolios. Respondents further raised potential impacts on equity markets given the importance of multilateral trading facilities based in the UK for the European market.

- **Benchmarks:** Some respondents raised concerns both about the risks arising from the discontinuation of widely used IBOR benchmarks as well as the impact of the EU Benchmarks Regulation (EU BMR). The regulation, while largely based on the IOSCO Principles for Financial Benchmarks, will prohibit, after the end of the transitional period, EU regulated entities from using unregulated non-EU benchmarks unless they comply with the EU BMR. This can be achieved through equivalence granted at the jurisdiction level, recognition of the benchmark administrator, or endorsement of individual benchmarks.[21] This has raised concerns that EU supervised entities may be denied access to financial instruments and contracts which reference non-EU benchmarks and that it might cause liquidity, contractual, and market access issues, as well as concentration risks with regard to some benchmarks. Because the transitional period for non-EU benchmarks has been extended until January 2022, it is difficult to predict whether fragmentation will, in fact, take place but some respondents have raised concerns about the practical use of the recognition and endorsement routes under the EU BMR.[22]

21 The EU BMR provides for an equivalence framework for third country jurisdictions. Equivalence decisions can be general, relating to the legal framework and supervisory practices of a third country or more specific, relating to specific benchmark administrators. It also provides for a recognition framework. Recognition requires a benchmark administrator located in a third country to have legal representation in the EU. This legal representative will be required to carry out oversight responsibilities and be accountable for the provision of the third country benchmark(s) in the EU. Finally, through the endorsement route, third country administrators will need to engage a European administrator authorized under the EU BMR who will need to apply to its national regulator for endorsement of the third country administrator's benchmark. The EU benchmark administrator will need to demonstrate that they will supervise the administration of the endorsed third country benchmarks on an on-going basis. The endorsing administrator also needs to provide an explanation of the objective reason for the provision of the endorsed benchmark.

22 ESMA has been providing guidance through Q&As regarding the practical steps to be taken by third country market participants in regulators on an ongoing basis. These Q&As are available on ESMA's website.

- **Emerging sectors**: Many respondents noted developments in financial innovation as a potential driver of future fragmentation. In rapidly evolving areas such as crypto-assets and initial coin offerings, jurisdictions are often at different stages with respect to whether and how existing regulatory frameworks apply. As authorities in some cases implement new rules tailored to the unique circumstances of their domestic markets and their own regulatory frameworks, some of these new rules may differ from one another. In the same vein, some respondents noted developments related to sustainability issues as well as diverging requirements in cyber resilience as potential areas where fragmentation may take place despite international efforts.

- **Derivatives and market infrastructure:** Finally, while derivatives have already been identified as a market subject to fragmentation, some respondents noted concerns that new regulatory developments – in the EU, with respect to the EMIR CCP supervision amendments and the potential application in exceptional circumstances of non-recognition (also called "location policy") for substantially systemically important foreign CCPs, and in the US, with respect to the amendments to the swap execution facilities rules – may become a source of further concern in cross-border wholesale markets.

The 2015 Report's Tools

The use of the tools since 2015 – Introduction

Since the publication of the 2015 Report, IOSCO members have increased their level of deference to other jurisdictions. Indeed, of the three tools identified in the 2015 Report, respondents have noted increased uses of substituted compliance and recognition/equivalence approaches, particularly in areas such as OTC derivatives markets. For example, the EU had granted equivalence to thirty-five jurisdictions across eight securities and accounting files as of October 2018.[23] These assessments were followed by a number of entity-level recognition decisions by ESMA vis-à-vis individual, non-EU financial market infrastructure providers such as CCPs. The US CFTC, the Japan FSA and Canadian regulators (Quebec AMF and OSC Ontario) have all also undertaken assessments within the derivatives sector.

This progress is further reflected in survey responses. Only two jurisdictions have indicated they continue to rely solely on national treatment, without using any tools to defer to other jurisdictions. While some jurisdictions do retain an element of national treatment within their frameworks, the degree to which it is used is sector-specific and may depend on thresholds for the activities undertaken. For example, national treatment may respond to investor protection concerns over products potentially being offered to retail investors by entities based in foreign jurisdictions.

Overall, most respondents seem to indicate that pure national treatment in the wholesale securities and derivatives markets, without any allowance for deference to other jurisdictions, significantly raises the potential for fragmentation. As this might sometimes be necessary based on the stage of development or structure of individual members' regulatory frameworks, one respondent suggested it may be helpful if regulators set out the criteria they apply when determining whether to default to national treatment.

23 https://ec.europa.eu/info/sites/info/files/overview-table-equivalence-decisions_en.pdf

We note that, despite the progress made, some respondents noted concerns on ongoing regulatory developments in certain jurisdictions such as amendments to EMIR on CCP supervision and the Australian Foreign Financial Service Providers proposal. As of today, ESMA has recognized 34 non-EU CCPs from 16 jurisdictions under EMIR. The new amendments to EMIR on CCP supervision will create new rules under the current recognition regime for systemically important foreign CCPs, as assessed from the EU-perspective, that had up until now benefited from full reliance on the foreign, home regulator. ESMA will assess the 34 non-EU CCPs to determine which ones are systemically important CCPs. These amendments will allow the EU and ESMA in particular to have powers to supervise such systemically important non-EU CCPs. The new Australian Foreign Financial Service Providers proposals would also impose a number of local domestic requirements on a foreign entity including adequate risk management systems, breach reporting and the obligation to comply with certain Australian financial services laws.[24]

These newer developments may be a sign of the balance jurisdictions may be seeking to achieve between the need to keep some oversight of what is taking place in their markets, where the activity may be substantial in size or systemic, and their commitment not to unduly restrict financial markets that are global in nature.

Deference

As mentioned in Chapter 1, we use the term "deference" in this Report as an overarching concept that refers to the reliance authorities place on one another when carrying out regulation or supervision of participants operating cross-border. There are a number of specific considerations and challenges that authorities face when using the tools that allow them to defer to other authorities. Below, we highlight how the various tools (passporting, substituted compliance and exemptions, recognition/equivalence) have been used since 2015. We also set forth several issues identified by respondents and we offer a few lessons learned as they relate to authorities' ability to defer to one another through these approaches.

Passporting

Passporting refers to a tool that is based on a common set of rules that are applicable in the authorities covered by the passporting arrangement. Its use, as a way for jurisdictions to defer to one another, has increased since 2015.[25]

Passporting remains a core feature of EU legislation with the aim of promoting open markets between EEA jurisdictions. The EU has also begun developing passporting regimes for non-EU firms wishing to gain access to the EU through one single point of entry. This is the case, for example, under the Alternative Investment Funds Managers Directive (AIFMD) where ESMA has provided technical advice to the European Commission on which jurisdictions could be granted equivalence.[26]

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[24] https://download.asic.gov.au/media/4752740/cp301-published-1-june-2018.pdf

[25] https://www.iosco.org/library/pubdocs/pdf/IOSCOPD507.pdf

[26] https://www.esma.europa.eu/sites/default/files/library/2015/11/2015-1238_esma_advises_on_extension_of_aifmd_passport_to_non-eu_jurisdictions_0.pdf

Furthermore, the use of passporting has increased in other regions as well. A passporting regime has been created in Asia - the “Asia Regional Fund Passport”[27] - with the aim of facilitating the cross-border offering of eligible funds. Similarly, the “Pacific Alliance Initiative” as well as the Southern African “Committee of Insurance, Securities and Non-Banking Authorities” are currently exploring passporting arrangements.

Finally, passporting continues to be a mechanism used in most of Canada (although Ontario has not adopted the passport system, an interface is available in which the Ontario Securities Commission makes its own decisions but generally relies on the review by the principal regulator). For example, under this mechanism, relief from some reporting requirements with respect to Trade Repositories and Derivatives Data Reporting has been given to market participants in multiple Canadian jurisdictions.

While in theory these developments should help reduce fragmentation in the sectors in which they apply, in many cases it is too early to assess whether they have achieved their underlying goal. For example, the third country regime under AIFMD is not yet applicable and the Asia Regional Fund Passport has only been in operation since 1 February 2019.

Substituted compliance and exemptions

Substituted compliance recognizes comparability between foreign and domestic regulatory frameworks such that foreign firms operating in a host jurisdiction may continue to comply with all or part of their domestic rules while serving market participants of the host jurisdiction. Exemptions, where available, are another way that one jurisdiction can defer to another jurisdiction. In general, these accommodations relate to OTC derivatives.

In most cases, the scope or degree of deference to another jurisdiction (whether through an exemption or through substituted compliance) vary, depending on whether certain requirements are fulfilled.

Where deference is partial, host jurisdictions sometimes require the foreign entity to comply with domestic rules, such as access requirements to books and records, to ensure that they have appropriate oversight of the foreign entity’s activities within their jurisdiction.

In some cases, despite allowing for deference, some host jurisdictions still require registration by foreign firms offering services to their counterparties wherever those entities are located. This may be due, for example, to statutory obligations to register certain types of market participants that provide a service in the jurisdiction. In that instance, even where registration is required, the host jurisdiction may still decide to defer to the rules of the home jurisdiction.

To illustrate, Japan requires foreign CCPs to obtain a license to provide clearing to Japanese counterparties but may exempt these CCPs from certain requirements such as local capital requirements or having a physical presence where they have been granted a similar license by a jurisdiction with whom JFSA has a supervisory MOU. To determine whether an authority can defer to another jurisdiction, it is common for the relevant authority in the host jurisdiction to conduct an assessment of the legal requirements the foreign entity is subject to by its home jurisdiction. Further, host jurisdictions will also frequently seek to sign a MoU with the relevant authority in the home jurisdiction of the foreign firm or seek other arrangements that

[27] http://fundspassport.apec.org/

memorialize the understanding of cooperation between the relevant authorities in the host and home jurisdiction.

Since the publication of the 2015 Report, the CFTC has also expanded its application of deference to non-U.S. entities. By way of example, the CFTC has exempted four non-US CCPs from CFTC registration as a derivatives clearing organization (DCO) to allow the clearing of proprietary trades for US persons. In addition, the CFTC has created a substituted compliance framework for CCPs registered with the CFTC and also authorized in the EU to facilitate the harmonization of cross-border activities by minimizing the application of duplicative and inconsistent regulations between the CFTC and EU CCP regimes. The CFTC is continuing to explore how it can further defer to non-US authorities in the supervision of non-US CCPs that do not pose a significant risk to the US financial markets.[28] The CFTC also has issued several deference decisions to other jurisdictions regarding margin requirements and trading venues.

Deference and outcomes-based recognition: CFTC Chairman Giancarlo's proposed principles for the CFTC's approach to cross-border regulation (see case study 1 prepared by the US CFTC)

In 2018, Chairman Giancarlo released a White Paper that proposed updating the CFTC's current "entity-based" approach to cross-border application of its swaps regulatory regime with a "territorial" framework based on regulatory deference to third country regulatory jurisdictions that have adopted the G-20 reforms.

The White Paper advocates for a distinction to be drawn between the swaps reforms agreed to by the G-20 and enacted in Dodd-Frank that are designed to mitigate systemic risk, and other reforms that are intended to address market and trading practices.

Reforms that are designed to mitigate systemic risk would be subject to a stricter degree of comparability between CFTC requirements and those of the jurisdictions that have adopted the G-20 reforms. With regards to requirements that address market and trading practices instead, the CFTC would defer to regimes that produce, on aggregate, a sufficient level of comparable regulatory outcomes.

In a similar way, the Dodd-Frank Title VII regulatory regime, through which the SEC has jurisdiction over security-based swaps, includes registration requirements for entities operating as security-based swap dealers or major security-based swap participants. Any non-U.S. Person security-based swap entity, or a non-US jurisdiction supervising those entities, may apply to the SEC for substituted compliance. Any entity within a jurisdiction for which substituted compliance has been granted may comply with specified foreign requirements to satisfy certain corresponding US requirements.

[28] https://www.cftc.gov/sites/default/files/2018-10/Whitepaper_CBSR100118_0.pdf

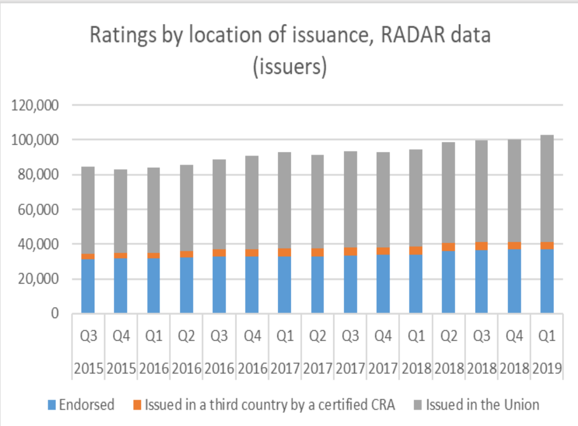
The EU Credit Rating Agency Regime (CRAR) – alternatives to national treatment (see case study 4 prepared by ESMA)

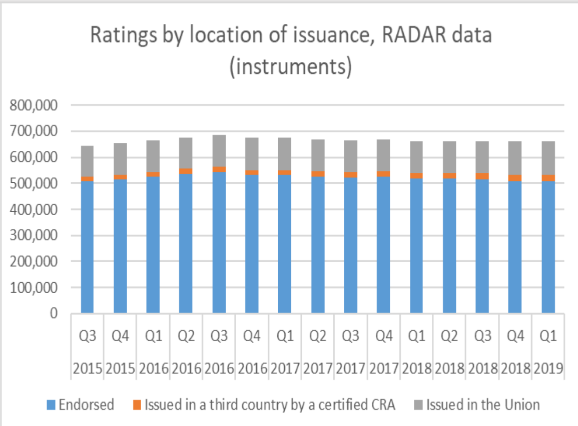
In the EU, the basic requirement is that all CRAs applying for registration require physical presence in the EU, including those that were located outside of the EU prior to the entry into force of the CRAR. Such localization requirements may have posed a risk of market fragmentation to the existing global market for rating services. In order to mitigate those risks, the CRAR allows for two alternatives which result in a more proportionate market access for non-EU CRA as well as the use of credit ratings issued by such CRAs in the EU, provided that they comply with requirements in their own jurisdiction which are as stringent as the requirements provided for in the CRAR.

- The Certification regime: It requires, in the first instance, a general equivalence assessment of the third country jurisdiction by the European Commission, based on technical advice provided by ESMA. If the European Commission declares the relevant jurisdiction equivalent to the requirements under the CRAR, a CRA from that jurisdiction can subject itself to an individual assessment by ESMA as the European supervisory authority, without being required to establish a physical presence within the EU. In determining whether that third country CRA can be certified, ESMA will take into account the size of the CRA, its nature, complexity and range of issuance of its credit ratings. Once the Certification is issued, ESMA retains some limited supervisory powers over the certified CRA on the basis of a cooperation arrangement with the responsible supervisory authority of the CRA.

- The Endorsement regime: It allows CRAs already established and registered in the EU to endorse credit ratings issued by third country CRAs, in particular where they belong to the same wider group. ESMA must complete two separate assessments, namely: an assessment of the conditions relating to the legal and supervisory framework of the third country and an assessment of certain conditions relating to the CRAs intending to endorse credit ratings. ESMA relies on the supervision of the third country CRA by the third country regulator. However, the endorsing EU CRA assumes full and unconditional responsibility towards ESMA for ensuring that all the conditions for endorsement are met on an ongoing basis.

Based upon the data below, the two models appear to have been successfully used by third country CRAs, effectively minimizing potential risks of market fragmentation resulting from the general physical presence requirement.





Recognition

Recognition, also known as "equivalence" in certain jurisdictions,[29] refers to a tool under which a host regulator "recognizes" a foreign regulatory regime, or parts thereof, following an assessment of the foreign regulatory regime.[30] This may be unilateral or mutual and is primarily used to reduce regulatory and supervisory overlaps between jurisdictions, in the interest of market participants and in support of the free flow of financial services. With respect to cross-border wholesale markets, the process typically aims to balance the benefits associated with open global wholesale financial markets with the need to mitigate any risks to market integrity, financial stability, investors and end-users.

Most jurisdictions that use recognition assessments to allow cross-border activities employ outcome-based assessments rather than equivalent rules-based assessments. In doing so, jurisdictions generally still conduct extensive analyses of the regulatory policy framework of the jurisdiction they seek to assess, sometimes on a requirement-by-requirement basis. These assessments will generally include detailed questionnaires about the regulatory, supervisory and enforcement framework of the assessed jurisdiction, as the assessing party seeks to assure itself of the effectiveness of the supervisory and enforcement arrangements of the jurisdiction under review. These questionnaires can in turn be complemented with conference calls, reviews of opinions by legal counsel related to the regulatory framework of the third country jurisdictions, and, in some cases, industry submissions. These assessments may also have regard to whether that jurisdiction has implemented relevant international standards as well as any relevant portion of a jurisdiction's International Monetary Fund Financial Sector Assessment Program (IMF FSAP) review or other international assessments.

While some jurisdictions consider proportionality in their assessments, this proportionality is often applied not on the basis of the nature of the jurisdiction itself (e.g., small versus large or emerging versus developed markets) but rather on the materiality of risks, including systemic risks, and the extent to which the assessing jurisdiction might be impacted by the activities of firms that benefit from the recognition.

All jurisdictions that engage in recognition assessments highlighted the importance of close collaboration with regulators in the jurisdiction being assessed and the importance of being able to trust their fellow regulator to assist in any supervisory or enforcement issue that may arise. This is usually achieved through MoUs. Many respondents also noted the usefulness of supervisory colleges given their experience with CCP and Credit Rating Agency colleges, suggesting that supervisory colleges offer an opportunity to gain insights into foreign authorities' supervisory practices.

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29 For the purpose of this report, recognition and equivalence are used as synonyms. However, EU legislative acts use the word "equivalence" to signify an assessment at a jurisdictional level and the word "recognition" to signify an assessment at an entity level.

30 https://www.iosco.org/library/pubdocs/pdf/IOSCOPD507.pdf

Recognition assessments – methodology and criteria: an example - Hong Kong SFC – France AMF Mutual Fund Recognition Agreement (see case study 5 prepared by AMF France and Hong Kong SFC)

To ensure the respective retail fund regimes offer comparable and adequate protection to investors in both markets, a detailed study of Hong Kong and French regulatory requirements and standards was conducted by the AMF and SFC respectively to assess whether they are substantially comparable, with an outcomes-based objective. The assessment included, among others:

- a general analysis of securities laws, regulations, requirements and standards applicable in both jurisdictions;
- a specific analysis of securities laws, regulations, requirements and standards applicable in both jurisdictions, with respect to the cross-border activity considered under the proposed mutual recognition arrangement;
- an analysis of the level of investor protection in both jurisdictions;
- an analysis of the level of supervisory oversight in both jurisdictions;
- an analysis of the enforcement capability of both jurisdictions;
- an analysis of the mechanism for the timely exchange of information between regulators; and
- an analysis of results from standardized assessments by international organizations.

During the assessment, FSAP reports were studied to obtain a general understanding of the respective regulatory regime and identify any potential issues raised in relation to IOSCO CIS principles. Questionnaires and follow-up questions were exchanged between SFC and AMF to form a better understanding of the respective regulatory regimes and facilitate the comparison of the regulatory requirements.

The SFC and AMF maintained regular dialogue and communication during the assessment for timely discussions and clarifications on regulatory requirements. A short-term secondment for relevant staff in the SFC and AMF was also arranged. Teams from each authority spent 2 weeks in the other authority to further their understanding of the local regulatory regime to facilitate the assessment.

Most jurisdictions did not mention a specific framework for keeping assessments up-to-date, noting that they were reviewed on an ad-hoc basis; in most cases there does not appear to be a formal process in place for monitoring and reviewing recognition assessments.

Others suggested the assessment's review is based on changes in their own jurisdiction, or the jurisdiction which has been granted recognition, although, once again, respondents did not identify a formal process. There was also little mention of removal of recognition and the processes put in place to ensure transparency and mitigate the impact of a negative outcome from a review on market participants.

This lack of clear processes and procedures, including in the review of whether to revoke a positive recognition decision, may create uncertainty for both the assessed jurisdictions and the firms that rely on those assessments. This is particularly true if there are no procedures in place to mitigate the impact of a review (e.g., transitional periods).

Updating legislation and the impact on assessments: the European Credit Ratings Agency Regulation (see case study 4 prepared by ESMA)

The CRAR has been amended more than once in the last decade, which has had an impact on the relevant decisions necessary to use the Equivalence and Endorsement regimes. In particular, the first equivalence decisions of the European Commission were made following assessments of third country legal and supervisory frameworks against CRA 1 and CRA 2 Regulations. This raised questions about their ongoing accuracy as the Regulation was amended. In July 2017, ESMA received a request from the European Commission for technical advice on the equivalence of certain third country frameworks with the additional requirements for equivalence introduced by the CRA 3. In November 2017, ESMA provide its advice, which is now under the consideration by the European Commission.

Deference: Challenges that arise from the assessments: an assessed jurisdiction's view

As part of our survey, we sought to identify challenges authorities face when they are the subject of assessments by a jurisdiction considering deference. In this regard, the survey responses revealed a number of common themes across jurisdictions, including:

- **Transparency, clarity and understanding of the process:** Several respondents noted the difficulty in providing the appropriate information when being assessed because they report that there often is no clarity about the criteria that will form the basis of the assessments. One jurisdiction suggested that there should be prior agreement between the assessor and the jurisdiction being assessed about which regulatory topics are deemed relevant for the assessment. This lack of clarity about the assessment criteria from the perspective of the jurisdiction being assessed can lead, and has led, to jurisdictions subjecting themselves to an assessment before realizing that an assessment was not needed. Where this occurs, it often leads to several rounds of questionnaires and calls between regulators before an assessment can be finalized. Another issue raised was the lack of a clear timeframe for making assessments. This can create risks of competitive distortions in the market. Finally, the lack of clarity about the process may also lead to a perceived lack of consistency, which could lead to questions about why certain jurisdictions have been deemed comparable but not others.

- **Degrees of regulation and definitional challenges:** Some respondents noted the challenge of developing a clear understanding of one another's regulatory frameworks, particularly where regulatory philosophies and subtleties in approaches might differ (e.g., principles-based approach versus rules-based approach). This challenge can be compounded by the fact that there is sometimes no common understanding of terms used in each jurisdiction thus leading to confusion.

- **Keeping up-to-date with foreign legislation:** Where jurisdictions must accommodate their own sets of rules to ensure other jurisdictions are willing to defer to them, it can sometimes be challenging to keep up-to-date with developments within that jurisdiction particularly where there are different levels of rules or different regulatory entities responsible for, and participating in, the equivalence process.

Operationalizing recognition – the "Platform for Equivalence Assessment by Market Authorities" in Australia, Hong Kong, Singapore and Japan for margin requirements (see case study 3 prepared by JFSA)

The Platform was established in October 2016 with three main objectives:

- Enhance mutual understanding of regulatory framework concerning margin rules;
- Make the assessment process more efficient by discussing, hearing and consulting with each other; and
- Discuss the way to streamline the approval process of Initial Margin model.

While the aim of the Platform was to make material gathering process more efficient, participants maintained full discretion for evaluation and determination of equivalence. In the process, the participants gathered information on one another's jurisdiction by using a single questionnaire and by sharing responses and follow-up clarifications with one another. The evaluation was conducted on a category-by-category basis, rather than a line-by-line-basis.

The authorities selected eight categories, in line with the elements of the international agreement and used teleconferences to discuss each category. They also discussed the timing for publication of equivalence determination to ensure they would all be aligned.

While each authority maintained full discretion for evaluating jurisdictions and deciding whether to grant equivalence, the arrangement had several advantages over bilateral or unilateral assessments:

- By agreeing a common questionnaire and sharing follow-up clarifications, participating authorities only had to provide the information once. As a result, the information exchange process became more efficient.
- The expected timeframe for decision was aligned and transparent.
- Workload was reduced and consistency improved. Transparency of time scales was also enhanced.

The 2015 tools: lessons learned and policy implications

In general, respondents were of the view that deference is helpful in mitigating fragmentation and fostering global markets, and many suggested it would be helpful to further promote deference between regulators. Despite the identified benefits, most jurisdictions noted that processes for deference were not simple. Among other things, assessments require time and resources to ensure understanding of the jurisdictional counterparty. It can also be difficult to compare regulatory systems that operate on significantly different bases (e.g., different regulatory philosophies, gaps, inconsistencies or conflicting requirements identified from comparing frameworks, differences in size and structure of the markets). Language can also be an issue, particularly where the national rulebooks in force have not been translated into English.

None of the respondents to the survey provided timelines for deference determinations but many highlighted how time-consuming the process was, suggesting it would take at least several months.

When asked about practical ways to further operationalize deference, many respondents commented on the process for assessing a foreign jurisdiction's regime. Some respondents noted the issue of clarity and the perceived absence of a clear and transparent process regarding how assessments are completed.

To solve these remaining challenges, proposals from respondents included standardizing the process for deference (irrespective of the specific tools used in each jurisdiction), requiring jurisdictions with entities that have cross-border activities to have an English version of their legal and regulatory framework, as well as encouraging jurisdictions to commission high-level comparability summaries of their requirements against international standards. One respondent also mentioned that it may be useful to share the draft assessment for comments before finalizing it.

Another key conclusion is the need to keep abreast of developments taking place in other jurisdictions particularly as they pertain to areas that affect cross-border business. To meet that challenge, some respondents noted their reliance on regulated foreign entities to keep them updated about developments in their home jurisdictions. They also emphasized the importance of a good relationship based on trust with their foreign counterparts.

After reflecting on their current set of rules and the lack of reciprocity afforded to them in recognition or deference assessments, some respondents are also considering the need to differentiate between systemic and non-systemic entities or sectors when seeking to strike the balance between deference to foreign or third country jurisdictional rules, and investor protection or other concerns in their own markets.

Chapter 3 – Observations and possible next steps

The 2015 Report noted that the supervisory responsibilities of national securities regulators over markets, trading, products and market participants needed to change to reflect the international and interconnected nature of global securities markets. At the same time, the Report recognized the challenges regulators face in balancing the benefits of increased cross-border activity with ensuring the effectiveness of domestic regulation and aimed to better equip regulators when they sought to develop, implement, and evaluate cross-border regulatory approaches.

Many regulators have become acutely aware of the risks associated with unintended market fragmentation and there has been increased collaboration and cooperation between and among IOSCO members to mitigate its effects. For example, deference between regulators through the use of tools, particularly those identified in the IOSCO toolkit, has increased significantly. Bilateral arrangements in the form of MoUs continue to be a common tool used by regulators, particularly with respect to information exchanges. And regulators have developed novel processes to work multilaterally to the benefit of the markets they oversee. At the international level, standard setting bodies also work closely together to avoid duplication and coordinate on matters that fall across one another's remit. One example is IOSCO's ongoing coordination with independent audit regulators via the International Forum of Independent Audit Regulators. Another example is IOSCO's work on liquidity management and leverage in investment funds in collaboration with the FSB.

Nevertheless, some challenges remain and strengthening cooperation between regulatory authorities could further assist in addressing risks to the financial system stemming from market fragmentation. Indeed, some of the G20 Leaders' reforms are still in the process of being implemented and new areas of financial services are emerging. This could lead to new fragmentation in the future.

While recognizing that there may be no "one-size-fits-all" approach to addressing fragmentation, this chapter proposes potential measures which could be explored further by IOSCO or by relevant authorities at the national level. These measures include ways to foster further mutual understanding of one another's legislative frameworks, deepen existing regulatory and supervisory cooperation and help make processes that aim to achieve deference more efficient, without changing the existing legislative requirements or frameworks that authorities have in place.

Fostering mutual understanding

Building trust and confidence in peer regulators is a cornerstone of any effective cross-border regulatory cooperation approach.

One approach could be a greater use of the IOSCO Regional Committees where members can discuss cross-border regulatory issues on a regular basis. Indeed, such a precedent has already been established by the meeting of the IOSCO Asia-Pacific Regional Committee (APRC) and the European Commission and ESMA during which members have met annually for the past three years to consider regulatory developments in the two regions, including emerging trends, cross-border implications of domestic and regional legislation and efforts in both regions to promote greater integration and connectivity. This forum enables authorities to discuss relevant issues in more detail and therefore gain a deeper understanding of the regulatory frameworks and environments of individual jurisdictions, as well as the objectives and intentions of their regulatory policies.

This type of engagements could be transformed into a regular fixture of the agenda of IOSCO Regional Committees which would allow members to develop knowledge of one another's markets and legislative frameworks. Indeed, this would allow authorities to reach out to their counterparts and could help with analyzing potential harmful market fragmentation. This would, in turn, help inform policy makers of possible cross-border effects of their proposals at the policy development stage. Discussions could also enable authorities to identify and give due consideration to tools that could be appropriate to minimize any potential fragmentation concerns as well as to determine the level of supervisory cooperation necessary to achieve the stated regulatory objective.

At policy level and as a result of the 2015 Report, IOSCO Committees and Task Forces are considering more explicitly the cross-border implications of their proposals and reports and highlighting those cross-border impacts to the IOSCO Board. While IOSCO policy committees will continue to consider these impacts as they develop their proposals, there should be an increasing and more specific role for IOSCO's AMCC in identifying instances where market fragmentation is taking place in wholesale securities and derivatives markets on a regular basis. IOSCO is unique among international standard setting bodies in having a committee made up largely of representatives of market participants. The AMCC could prepare an annual report to the Board, indicating where members have identified cases of harmful fragmentation that have a cross-border element. The AMCC's annual report should be supported by factual evidence and data, where available, and be comprehensive in scope. The AMCC's report would inform the Board's discussion and ensure that the risk of harmful fragmentation remains a regular item on the IOSCO agenda.

At the national level, jurisdictions could explore fostering mutual understanding of one another's framework through staff exchanges and secondments.

Strengthening collaboration and cooperation

Regular communication between regulatory authorities builds the trust and dialogue needed to ensure appropriate supervisory cooperation arrangements are followed or fully utilized. In 2010, IOSCO set out Principles for Cross-Border Supervisory Cooperation and noted that many reforms would likely prove insufficient without enhanced supervisory cooperation and information-sharing among securities regulators. [31]

Many jurisdictions have since entered into supervisory MOUs which provide a framework for the ongoing supervisory arrangement between jurisdictions and IOSCO is in the process of building a central repository of such MOUs which should provide more transparency to both regulators and industry participants.

IOSCO could explore further work to encourage supervisory cooperation and survey respondents suggested this as an area where further focus is needed. In doing so, IOSCO would be mindful of the work of other standard setting bodies and aim not to duplicate those efforts. IOSCO's work in 2010 highlighted that using various collaborative mechanisms would improve

[31] https://www.iosco.org/library/pubdocs/pdf/IOSCOPD322.pdf

the quality, scope and timeliness of the information a regulator is likely to receive from other jurisdictions. The sharing of information, in turn, can facilitate mutual understanding of each other's frameworks and increase trust between regulators and mitigate the likeliness of regulatory actions that create market fragmentation.

While mechanisms like global supervisory colleges have been implemented in different areas, including in cross-border supervision of global market infrastructures such as CCPs or CRAs, they are not yet a regular feature of securities markets. IOSCO could explore, taking account of any existing and relevant work undertaken by other standard setting and supervisory bodies, whether and how existing supervisory colleges currently achieve their stated goals and, if appropriate, identify ways to increase their use.

A process for deference

The G-20 Leaders, during their St Petersburg Summit in 2013, agreed that "*jurisdictions and regulators should be able to defer to each other when it is justified by the quality of their respective regulatory and enforcement regimes, based on similar outcomes, in a non-discriminatory way, paying due respect to home country regulation regimes.*"[32]

As noted in the 2015 Report, deference may not be appropriate in all circumstances and there is no "one-size-fits-all" solution. This is because cross-border tools often are, and need to be, tailored to local circumstances. The use of deference and the tools associated with this concept (e.g., passporting, substituted compliance, recognition/equivalence) nevertheless can contribute to mitigating the risk of fragmentation for global cross-border markets. However, the way these tools are used varies across jurisdictions.

As IOSCO members defer more to one another (irrespective of which particular cross-border tool they use), IOSCO could make use of this experience and serve as a forum for the exchange of information among IOSCO members about each other's regulatory practices and approaches to cross-border regulation, including as they develop over time, and could consider whether there are any good or sound practices which can be identified regarding deference tools.

The identification of these good or sound practices potentially could include considerations as well as an exchange of views on such things as:

- Whether and how the level of clarity around processes that aim to achieve outcomes-based deference could be further enhanced, including in relation to applicable factors;

- Facilitating regulatory and supervisory cooperation, which could support deference where possible. Such facilitation may be achieved through cooperation arrangements such as MoUs, supervisory colleges, other collaborative arrangements, and participation in international or regional fora, as appropriate;

- Encouraging the assessor and the assessee jurisdictions to explore ways to make the process more efficient. This could include various aspects, including:

[32] http://www.g20.utoronto.ca/2013/2013-0906-declaration.html

- The jurisdiction being assessed could endeavor to provide all information and updates about its regulatory framework in English, to the extent possible; and
- In collaboration with the jurisdictions acting as assessors, exploring the use of common materials on core common elements, where appropriate, by a jurisdiction being subject to concurrent deference assessment, which could be supplemented by national add-ons where necessary.

Appendix A: Case Studies

Note: Each case study in this Report has been prepared by the IOSCO member indicated. Case studies and excerpts in the Report do not necessarily reflect the views of IOSCO or of other IOSCO members.

Case Study 1: OTC Derivatives Trading (Prepared by the U.S. CFTC)

Description of the case

This case study looks at how differences in implementation of the global swaps reforms can lead to fragmentation in OTC derivatives markets. Part I considers different objectives that regulators may have in the design of national swaps regulations. Part II focuses on implementation of the swaps trading mandate by the CFTC and the fragmentary effect of these reforms on global swaps markets. Part III offers some potential lessons and insights that regulators may draw from the CFTC's experience. This case study does not purport to comment on the rules and regulations of other regulatory authorities.

One source of fragmentation in the swaps markets in the post-crisis era results from the failure of regulators to appropriately distinguish between swaps reforms that are designed to mitigate systemic risk and swaps reforms that address market and trading practices in applying swaps reforms to cross-border transactions.

Historically, trading of swaps was (and remains) conducted exclusively by institutional counterparties in the world's major financial centers. While local financial regulation applied to these professional markets, the primary trading and contractual protocol for swaps came from the private sector, the International Swaps and Derivatives Association (ISDA). The ISDA protocol provided a singular global standard that facilitated active trading across borders. Deep pools of swaps trading liquidity emerged in major regional centers based around key global currencies. Access to those regional liquidity pools was quite open and uniform based on adherence to the universal ISDA protocol.

In response to the financial crisis of 2008, the G-20 decided a year later in Pittsburgh to implement a series of reforms to global swaps markets drawn from emerging industry best practices. Those reforms included increased swaps central clearing, trade reporting, and trade execution on regulated platforms along with increased dealer capital and margin for uncleared swaps. These G-20 reforms would be implemented at the G-20 nation state level in a fashion that was "consistent," though not identical. The United States moved first to enact the Pittsburgh accords in the Dodd-Frank Act in 2011, and the U.S. CFTC moved to implement most of the swaps reforms by the end of 2014.

Although many of the CFTC's reforms seem to be working well, the swaps trading mandate, including its application outside of the United States, is not functioning optimally.

In January 2015, CFTC Chairman J. Christopher Giancarlo published a White Paper analyzing the mismatch between the CFTC's swaps trading regulatory framework, and the distinct liquidity and trading dynamics of the global swaps markets.[1] This mismatch – and the application of this framework worldwide - has driven global market participants away from transacting with entities subject to CFTC swaps regulation, resulting in fragmented global swaps markets.

Recent developments

In October 2018, Chairman Giancarlo released a second White Paper that proposed updating the CFTC's current "entity-based" approach to cross-border application of its swaps regime with a "territorial" framework based on regulatory deference to third country regulatory jurisdictions that have adopted the G-20 swaps reforms.[2]

The White Paper advocates for a distinction to be drawn between the swaps reforms agreed to by the G-20 and enacted in Dodd-Frank that are designed to mitigate systemic risk, and other reforms that are intended to address market and trading practices. Swaps reforms that are designed to mitigate systemic risk include swaps clearing, margin for uncleared swaps, dealer capital, and recordkeeping and regulatory reporting. These reforms specifically address systemic risk in several ways, including by mandating the use of central clearing counterparties (CCPs), requiring parties to collateralize positions, requiring more capital reserves, and ensuring that sufficient information is available for effective supervision and oversight. These reforms seek to mitigate the type of risk that may have a direct and significant connection with a particular jurisdiction.

By contrast, swaps reforms that are designed to address market and trading practices include public trade reporting and price transparency, trading platform design, trade execution methodologies and mechanics, and personnel qualifications, examinations and regulatory oversight. These reforms address market integrity issues and are intended to facilitate the orderly operations of the markets, such as by requiring public dissemination of trade information to promote price discovery or by mandating particular modes of trade execution. While important, these reforms generally do not have as great a direct and significant connection with a particular jurisdiction as the swaps reforms that are specifically designed to address systemic risk. Accordingly, such market structure reforms are appropriately adapted to local market characteristics, practices, and norms.

Hence, rather than trying to assert its authority to the maximum extent possible, the CFTC is focused on how best to prevent systemic risk created outside its jurisdiction from returning to that jurisdiction. Conceptualized in this manner, considerations of public transparency of trading prices (as distinct from regulatory transparency) and market structure, trading platform practices, and trade execution methodologies and mechanics are not as directly related to cross-

[1] Commissioner J. Christopher Giancarlo, pro-reform reconsideration of the CFTC swaps trading rules: return to Dodd-Frank (jan. 29, 2015), available at*:*

https://www.cftc.gov/sites/default/files/idc/groups/public/@newsroom/documents/file/sefwhitepaper012915.pdf.

[2] CFTC chairman J. Christopher Giancarlo, cross-border swaps regulation version 2.0: a risk-based approach with deference to comparable non-u.s. regulation (oct. 1, 2018), available at*:*

https://www.cftc.gov/sites/default/files/2018- 10/whitepaper_cbsr100118_0.pdf.

border risk transfer. Therefore, they should be of secondary importance when deciding on the necessity of applying swaps rules extraterritorially.

Implications of the case to market fragmentation

As discussed in Part I above, based on the ostensible purpose of insulating the United States from systemic risk, the CFTC's current cross-border framework demands that global swaps markets involving U.S. persons adopt all CFTC trading rules, including particular CFTC trading mechanics that do little to reduce counterparty risk. The past five years provide a vantage point to assess how this approach has impacted global markets – not just U.S. markets, but also markets in major financial centers around the world, from London and Singapore to Tokyo and Sydney.

Traditionally, users of swaps products chose to do business with global financial institutions based on factors such as quality of service, product expertise, financial resources and professional relationship. Under the CFTC's current framework, those criteria are secondary to the question of the institution's regulatory profile. Non-U.S. market participants avoid financial firms falling in the definition of "U.S. person" in certain swaps products to steer clear of the CFTC's regulations. Since the start of the CFTC's SEF regime in October 2013 and accelerating with mandatory SEF trading in February 2014, global swaps markets have divided into separate trading and liquidity pools: those in which U.S. persons participate and those in which U.S. persons are shunned. Liquidity has been fractured between an on-SEF, U.S. person market on one side and an off-SEF, non-U.S. person market on the other. As a result, non-U.S. market participants' efforts to escape the CFTC's swaps trading rules have fragmented global swaps trading and driven global capital into separate liquidity pools based on nothing more commercially important than entity identity.

For example, whether or not a non-U.S. trading venue has functionality that requires a request for quote to three dealers (RFQ-to-3) or thirteen dealers has little to do with the transference of counterparty risk to the U.S. financial system. Similarly, regulatory requirements for platform trade execution and real-time public trade reporting (as opposed to regulatory reporting) may be important for purposes of furthering market access and integrity (and are mandated by Title VII of the Dodd-Frank Act), but, unlike requirements for central clearing and margining for uncleared swaps, they do not serve as great a role in mitigating systemic risk.

According to a survey conducted by ISDA, the market for euro interest-rate swaps (IRS) has effectively split.[3] Beginning in October 2013 after the SEF rules' compliance date, European dealers dramatically moved away from trading with U.S. counterparties, beginning to trade almost exclusively with other European counterparties in the market for euro IRS.[4] Volumes

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[3] ISDA, cross-border fragmentation of global interest rate derivatives: the new normal? first half 2015 update 1–3 (2015) (isda update), available at:

http://www2.isda.org/functionalareas/research/research-notes/; *see also* Philip Stafford, us swaps trading rules have "split market," fin. times, jan. 21, 2014, http://www.ft.com/intl/cms/s/0/58251f84-82b8-11e3-8119-00144feab7de.html#axzz3chqbmkxu.

[4] In October 2013, 91 percent of euro IRS trades took place between two European counterparties, while only 9 percent occurred between a U.S. and a European dealer. By August 2014, these numbers moved to 96 percent and 3 percent, respectively. Recently, in June 2015, 89 percent of euro IRS trades were between two European counterparties, while 10 percent of euro IRS trades were between a European and U.S. counterparty. Compare these figures with those from a month before the SEF rules' compliance date,

between European and U.S. dealers have declined 55 percent since the introduction of the U.S. SEF regime.[5] The average cross-border volume of euro IRS transacted between European and U.S. dealers as a percentage of total euro IRS volume was twenty-five percent before the CFTC put its SEF regime in place and has fallen to just ten percent since.[6]

The fragmentation of global swaps markets means that businesses and commercial enterprises around the globe are denied access to deep, liquid, and consolidated markets for risk hedging that is necessary for business expansion, job creation, and economic development. It results in higher pricing, reduced job creation, and lower economic growth. Fragmented markets also are less resilient in the event of sudden market events, resulting in greater price and transaction volatility. This increases the potential for the systemic risk that swaps reform is premised on reducing. Such increased systemic risk from fragmentation of global swaps markets is neither prescribed by the G-20 swaps reforms nor justified as an unavoidable by-product of reform implementation. In fact, market fragmentation is not only incompatible with global swap reform efforts, but detrimental to them.

Description of regulatory actions taken or proposed to address or prevent market fragmentation

The G-20 leaders in Pittsburgh 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." As regulators continue to adopt the G-20 swaps reforms in their markets, it is important that regulators exercise deference to ensure that their rules do not unnecessarily conflict with other effective regulatory frameworks and fragment the global marketplace.

In his 2018 White Paper, CFTC Chairman Giancarlo outlined several principles that he considered should underpin the CFTC's approach to cross-border regulation.

Chairman Giancarlo advocated that, in order to avoid further fragmenting the global swaps markets, as part of exercising deference and recognizing comparable foreign (or third-country) regimes, the CFTC should recognize the key distinction discussed above between swaps reforms intended to mitigate systemic risk and reforms designed to address particular market and trading practices that may be adapted appropriately to local market conditions.

Further, for those swaps reforms designed to mitigate systemic risk, the CFTC should seek a stricter degree of comparability between local requirements and the requirements of jurisdictions that have adopted the G-20 reforms. Systemic risk reforms should be appropriately comparable across borders to mitigate the risk of cross-border contagion.

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when 71 percent of euro IRS trades were between two European counterparties and 29 percent between a U.S. and European dealer. This has been a clear shift in trading behavior for European dealers. *See* ISDA Update at 3, 15–16. This observation is also supported by an ISDA survey wherein 68 percent of non-U.S. market participant respondents indicated that they have reduced or ceased trading with U.S. persons. ISDA, footnote 88 and market fragmentation: an ISDA survey 3–4 (2013), available at: http://www2.isda.org/functional-areas/research/researchnotes/page2/.

[5] ISDA Update at 2, 18.

[6] Ibid. at 18.

Regulatory reporting is an example of a requirement that is important to addressing systemic risk, given the critical role that regulatory reporting plays in helping agencies monitor the build-up of systemic risk. For this reason, before the CFTC should grant substituted compliance (or equivalence) with respect to regulatory reporting, the foreign (or third-country) jurisdiction should show a high degree of comparability with respect to applicable data reporting fields, including use of entity identifiers, product identifiers, transaction identifiers, and critical data elements. Accordingly, with respect to swaps reforms designed to mitigate systemic risk, the CFTC's jurisdiction should continue to apply cross-border to local firms on an "entity" basis, with the availability of substituted compliance (or equivalence) for other jurisdictions that are strictly comparable.

With respect to requirements that address market and trading practices, a relevant question is whether a foreign (or third-country) regime, in the aggregate, provides a sufficient level of regulatory outcomes to justify a positive comparability assessment. Regulation and oversight of these requirements should be established and overseen locally if they achieve comparable regulatory outcomes, and such local regulation would apply to firms participating in those local markets. The CFTC may believe it has the best ideas for enhancing trading practices, market access, price transparency, and professional conduct, but ultimately it is for each individual regulator to adopt rules appropriate for its own domestic markets. The CFTC should defer in those cases if the regimes produce comparable outcomes.

Mutual commitment to cross-border regulatory deference means that market participants can rely on one set of rules – in their totality – without fear that another jurisdiction will seek to selectively impose an additional layer of regulatory obligations. This approach is essential to ensuring strong and stable derivatives markets that support economic growth around the globe. In this conception, the emphasis in carrying out a substituted compliance regime should be on deference to non-U.S. regulators and a desire to work cooperatively to achieve common regulatory aims. Deference does not mean co-regulation. Rather, it means relying on home country regulators that have primary responsibility for markets and market participants organized in their jurisdictions. The terms of a substituted compliance (or equivalence) determination should be as straightforward and unconditional as appropriate to prevent the "fragmentation of markets, protectionism, and regulatory arbitrage" that global regulators were charged to avoid.

Even where registration or regulation of foreign (or third-country) entities may be required, the CFTC should work cooperatively with other regulators in order to achieve common regulatory goals such that the actual effect of being registered or regulated is still based on deference. To make this work and ensure access to information regarding market participants that have a nexus a particular jurisdiction, the CFTC along with other market regulators should continue the practice of entering into memoranda of understanding (MOUs) with the relevant home country regulators to provide a framework for the sharing of information regarding entities relying on a substituted compliance determination.

The CFTC and its global counterparts should work together to implement a deference process (using, for example, the tools of substituted compliance and equivalence), particularly for swaps execution and the cross-border activities of swap dealers, based on common principles to increase regulatory harmonization and reduce market fragmentation.

Case Study 2: Trade Reporting (Prepared by the UK FCA)

Description of the case

The requirement to report OTC derivative transactions to trade repositories (TRs), as mandated by the 2009 G20 Pittsburgh declaration, is a worldwide regulatory initiative designed to increase transparency, improve oversight and identify and mitigate financial stability risks in the global derivatives market.

Prior to the implementation of the reforms arising from the Pittsburgh summit, OTC derivative markets by-and-large followed industry standards and any applicable jurisdictional regulatory requirements. They were not subject to overarching global regulatory obligations. Regulatory measures for those activities were designed and implemented at national level and were typically focused on that jurisdiction's regulatory risk appetite and approach.

The Pittsburgh declaration introduced requirements for transactions in standardized OTC derivatives to be traded on exchanges or electronic trading platforms; cleared through central counterparties; reported to trade repositories; and non-centrally cleared contracts to be subject to higher capital requirements. The G20 leaders' stated aims for these reforms were to improve transparency in the derivatives markets, mitigate systemic risk, and protect against market abuse. [1] This case study looks at the reporting aspects arising from the G20 reforms.

While significant progress has been made in implementing trade reporting,[2] the G20 obligations have been implemented at national/jurisdictional level which has led to different interpretations of the requirements and a lack of harmonization globally. The non-standardization of data reporting, differences in the timing of implementation, and variations in the scope of reporting requirements have all been cited by industry participants as a potential source of market fragmentation. This fragmentation has also given rise to concerns over inefficiencies and higher costs. These variations in implementation, as well as legal and technical difficulties which need to be overcome before comprehensive access to TR data can be achieved, may be perceived as a barrier to regulatory authorities undertaking systemic risk monitoring on a global level, reducing the effectiveness of the reforms.

Implications of the case to market fragmentation

When considering trade reporting requirements in the context of market fragmentation, there are two principal concerns which warrant regulators' attention. Firstly, the potential impact the implementation of the requirements is having on market efficiency. Secondly, whether variations in the outcomes from the requirements are inhibiting regulators' oversight of systemic risks in the market.

Market efficiency

The derivatives market is very much a global market; many firms trade cross-border, with group entities often subject to reporting requirements under multiple jurisdictional regimes. However,

1 http://www.g20.utoronto.ca/2009/2009communique0925.html

2 See FSB Thirteenth Progress Report on the Implementation of the OTC Derivatives Markets Reforms: http://www.fsb.org/wp-content/uploads/P191118-5.pdf

these reporting requirements differ in the details by which the reporting obligation must be met. Variations in the technical details of reporting requirements which market participants have cited as problematic include:

- **Scope of reporting:** Variations in the reporting requirements between jurisdictions include; formats of data fields are not harmonized across jurisdictions; requirements on the timing of reporting (e.g., T+1 or alternative arrangements) also differ between jurisdictions, and; the data fields required by national regimes differ, and have in some cases expanded over time, resulting in regulatory authorities basing their monitoring and analysis of the build-up of risks on data fields that may be inconsistent.

- **Scope of reportable products:** While some jurisdictions have implemented trade reporting requirements for OTC instruments only, others (e.g., the EU through EMIR) have extended their implementation beyond the G20 commitment to include exchange-traded derivatives (ETDs) as well.

- **Scope of reporting entities:** Some jurisdictions have implemented single-sided reporting (where one party to a trade is required to report the transaction) – for example, the US and Switzerland. Others (e.g., EU jurisdictions) have implemented dual-sided reporting whereby both sides report, requiring TRs to pair and match trade reports. Dual-sided reporting also increases the number and type of market participants who are subject to the reporting obligation. Regulatory authorities have also set different thresholds on the size or type of activities of a firm that triggers a reporting obligation, with consequent inconsistencies between what activity needs to be reported, as well as to whom. Different rules establishing the connection of the trade participants with a jurisdiction before a trade is required to be reportable also exist.

In addition to variations in some of the key features of trade reporting requirements, a range of other factors have contributed to difficulties in reporting trades to TRs, including variations in the timing of national implementing measures.

Firms who trade in multiple jurisdictions are therefore subject to differing obligations which may be inconsistent or duplicative. These inconsistencies can have significant implications for firms in terms of burdensome requirements,

costs, ongoing maintenance of systems and compliance risks. These operational inefficiencies may impact upon trading patterns and behaviors, creating market fragmentation if firms choose to trade only with counterparties who are subject to the same requirements as themselves. Regulators therefore need to be alive to the risks to market fragmentation caused by variations in regulatory requirements.

Regulatory oversight

The ability of regulators to monitor the derivatives market for emerging cross-border risks, and understand firms' exposures in times of market stress, is a key test of whether the trade reporting obligations are fully meeting the aims of the G20 reforms.

In addition to the risks to market fragmentation outlined above due to variations in the technical and operational details of trade reporting requirements, legal barriers to the full reporting or sharing of data across borders exist which may prevent regulators fully achieving the intended aims of the global reforms. For example, jurisdictions can place certain requirements on other regulators before TRs from their jurisdiction can be 'recognized' or allowed to provide services to their markets. Data sharing between the regulatory authorities may require formal steps such as the conclusion of 'international agreements.' Cooperation mechanisms, or other arrangements which enable deference to others' regimes before TR data can be access or shared, may also be required. Additionally, variations in data quality and availability may present a barrier to effective aggregation of TR data, thereby limiting the ability of regulators and standard setters to monitor market participants' exposures and look for the build-up of systemic risks on a holistic basis.

The lack of harmonization of reporting requirements may be seen to be adding complexity to any determination of equivalence between different national regimes, as evidenced by the limited number of determinations that have been made to date.[3] For example, not all jurisdictions require market participants to use Legal Entity Identifier (LEI) codes which could cause difficulty in recognizing equivalence of outcomes rather than equivalence of process. Additionally, firms may be reluctant to trade with other market participants whose regulatory regimes do not require LEIs if the rules they are subject to require them to obtain and report such a counterparty identifier.

Legal barriers to accessing and sharing TR data across borders has been identified as a key challenge which needs to be overcome before regulators can fully and effectively access, aggregate and analyze TR data.[4]

This example of market fragmentation can therefore be seen as directly affecting global financial stability resilience due to the constrained ability of regulatory authorities to identify global trading patterns and effectively monitor the build-up of risks on a global basis.

Description of regulatory actions taken or proposed to address or prevent market fragmentation

Non-standardization of trade reporting requirements has been widely identified by market participants, regulatory authorities and standard setters alike as an issue which may warrant further regulatory attention. Various steps have been taken at national/jurisdictional, regional and international levels to address some of the issues outlined above, with significant progress made in certain areas.

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3 See http://www.fsb.org/wp-content/uploads/P191118-5.pdf (pp. 21-22)

4 FSB (2017), Review of OTC derivatives market reforms: Effectiveness and broader effects of the reforms, available at: http://www.fsb.org/2017/06/review-of-otc-derivatives-market-reform-effectiveness-and-broader-effects-of-the-reforms/, at p. 4.

Efforts to improve data quality, and reduce the burden on firms, have, for example, included:

- **National/jurisdictional steps:**
  - o Within the EU, the European Securities and Markets Authority (ESMA) has issued guidance in the form of Q+As and guidelines to clarify certain reporting requirements and provide harmonization in how market participants interpret those requirements. A review of EMIR (EMIR Refit) is currently being finalized which aims to amend certain reporting requirements, reducing the burden for certain market participants. These include the mandatory delegation of reporting from a small Non-Financial Counterparty (NFC-) when it is trading with a Financial Counterparty and simplifying the reporting of intragroup transactions. In addition, the European Commission has launched a 'fitness check' review of the EU framework of reporting, with the aim of taking a holistic view of the reporting requirements across a number of its regulatory regimes.[5] In addition, ESMA has introduced an IT system to improve the collection and aggregation of TR data that is available to EU authorities.
  - o In the US, the CFTC has proposed a number of initiatives aimed at improving the quality of trade reporting, including requiring Swap Data Repositories to improve their data validation processes, achieving greater alignment between US and EU validation standards, and consideration of refining the reportable fields and amending the reporting timeframes.[6]
  - o In Asia, regulators have taken steps to harmonize the G20 TR requirements through a coordinated approach which has had various benefits.
- **International level steps**

Various workstreams at the international standard setters are aiming to improve data reporting by analyzing the effects of the reforms and/or providing guidance on certain aspects of derivatives reporting;

  - o IOSCO Committee 7 is undertaking work to report on the Efficient Resilience of the G20 reforms when taken as a whole. This includes a mandate to analyze and understand the practical effects of different reporting schemes and investigate whether data captured by these schemes is reliable and useful.
  - o Following a 2014 aggregation feasibility study[7] by the FSB, IOSCO and the Committee on Payments and Market Infrastructures (CPMI) established a working group on the harmonization of key OTC derivatives data elements which has produced technical guidance on a range of issues including the Unique Product Identifier (UPI) and the Unique Transaction Identifier (UTI).
  - o The FSB has established working groups to develop governance arrangements for the UPI and UTI, which are expected to be completed in 2019, and reports annually on

5 https://ec.europa.eu/info/consultations/finance-2018-companies-public-reporting_en

6 https://www.cftc.gov/sites/default/files/2018-04/oce_chairman_swapregversion2whitepaper_042618.pdf

7 FSB (2014), Feasibility study on approaches to aggregate OTC derivatives data, available at: http://www.fsb.org/wp-content/uploads/r_140919.pdf.

progress made by FSB member jurisdictions in implementing the G20 derivatives reform package.

Efforts to reduce legal barriers to full reporting and sharing of TR data have included reports by the FSB's OTC Derivatives Working Group (ODWG) on trade reporting legal barriers which detail progress made by FSB jurisdictions in implementing the FSB's 2015 recommendation for reducing certain barriers. Many jurisdictions have taken national-level steps to reduce legal barriers, although the FSB has noted that significant challenges remain to be overcome before all FSB member authorities are in a position to fully and effectively access, aggregate and analyze TR data across other FSB member jurisdictions.

In addition to the range of international level work aimed at improving the harmonization of trade reporting requirements, various private sector initiatives have also been developed. For example, ISDA's Common Domain Model[8] aims to standardize the digital representation and processing of trades in derivatives, with the goal of increasing standardization and operational efficiency.

Despite these efforts, regulators may still be constrained in their ability to develop a complete and accurate picture of counterparty credit and market risk in global derivatives markets[9] and further work is needed to develop systematic monitoring of global trading patterns and emerging risks to facilitate appropriate regulatory responses. While there are many examples of regulators using TR data for a wide range of tasks including systemic risk monitoring at a national level, there is scope to improve the way regulators use the data systematically and cross-jurisdictionally to inform their supervisory and analytical work for financial stability and market abuse prevention purposes.

At the global level, enhancements to the way regulators share their views on systemic risks arising from the derivatives market could also be made.

Conclusion and lessons learned

While significant progress is being made in harmonizing aspects of trade reporting requirements globally, many challenges remain which present risks to market fragmentation. Further work may be useful to define and standardize the scope (entity, product or geographic) of trade reporting requirements and the data fields that national authorities require to be reported in order to meet the G20 reform obligations whilst enabling the effective interchange of data.

Guidance and findings provided by international-level workstreams is welcome, and helpful in highlighting to regulatory authorities and jurisdictional legislators the path forwards for ensuring greater market efficiency and the effective monitoring of financial stability and systemic risk. The cost and operational difficulties involved in adapting national requirements *ex-post* implementation to achieve greater harmonization of TR data and enhancing regulators' ability to share and access data on a global basis, are significant challenges. Overcoming these may require sustained efforts at the highest levels, involving collaboration between regulatory

8 https://www.isda.org/a/z8AEE/ISDA-CDM-Factsheet.pdf

9 https://www.cftc.gov/sites/default/files/2018-04/oce_chairman_swapregversion2whitepaper_042618.pdf

authorities and the international standard setters, working in partnership with industry participants to achieve consensus on solutions.

The case of market fragmentation arising from variations in trade reporting requirements also presents some common themes, or 'lessons learned,' which may be applicable to other cases. For example:

- Harmonization of data reporting requirements *ex ante*, and/or greater granularity in the specification of the international standards prior to national implementing measures being determined, may be helpful in aligning regulatory requirements globally and reducing market inefficiencies caused by inconsistent or duplicative rules.

- If harmonization of national/jurisdictional requirements is not possible or desirable, mechanisms which enable a greater degree of deference to others' regimes would assist market participants who operate in multiple jurisdictions and may support enhanced alignment of systemic risk monitoring for regulatory purposes.

- Where markets are predominantly global (cross-border) in nature, risk monitoring on a global basis would be enhanced by a greater understanding of jurisdictional regulatory requirements. Forums to share and discuss national-level risk monitoring findings, and promote examples of good practices, may be helpful in facilitating this risk monitoring over a medium-term horizon.

Case Study 3: Margin Requirements (Prepared by the JFSA)

Description of the case

To reduce systemic risk and promote central clearing, the G20 agreed to add margin requirements on non-centrally cleared derivatives to its reform program at Cannes summit in 2011. The BCBS and IOSCO formed the Working Group on Margining Requirements ("WGMR"), established minimum standards for margin requirements in September 2013 and declared to implement them from December 2015, albeit it was delayed by nine months (i.e., from September 2016).[1]

This regime requires counterparties to calculate and exchange margin each other. As such, harmonization of the rules and convergence of applications in their home jurisdictions are crucial in cross-border context.

Implications of the case to market fragmentation

If there is an inconsistent implementation, transaction could be moved to jurisdictions with lenient requirements thereby causing unintended harmful effects such as impairing effectiveness of the regime as well as causing unlevel playing field.[2]

If both parties demand each other to comply with its home regulation, a single transaction end up being subject to two set of rules (duplication) thereby increasing compliance costs and impairing market efficiency.[3]

Even if systemic implication is limited, there is a concern regarding market access especially among emerging markets. If transaction in such jurisdictions is subject to additional requirements, provision of liquidity would be tightened.[4]

To mitigate these risks, the framework requires to harmonize the rules to the extent possible or to permit market participants to follow host country requirements that are assessed to be consistent with the requirements described in the framework (substituted compliance and equivalence determination).[5]

In practice, there is a challenge when conducting equivalence determination. Assessors need to gather material for evaluating whether the host regime is consistent with the requirements. However, if each country produces its own questionnaire separately and conducts assessment in its own time frame, assessee jurisdictions would end up responding similar, but different questionnaires. This would result in slow and cumbersome equivalence determination and might cause market fragmentation ultimately.

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1 BCBS-IOSCO, Margin requirements for non-centrally cleared derivatives (March 2015) 2

2 ibid 3

3 ibid 23

4 BCBS-IOSCO, Progress report on implementation of margin requirements for non-centrally cleared derivatives 8 (restricted)

5 BCBS-IOSCO (n1) 23

The challenge mentioned above has been acknowledged by various stakeholders. Indeed, there has been a longstanding call for predictable, consistent and timely comparability determination.[6]

Description of regulatory actions taken or proposed to address or prevent market fragmentation

One of the possible approaches for this issue is the method used in the arrangement named "Platform for Equivalence Assessment by For Market Authorities", which involved market authorities in in Australia, Hong Kong, Singapore and Japan.[7]

The Platform was established in October 2016 with 3 main objectives.

- Enhance mutual understanding of regulatory framework concerning margin rules;
- Make the assessment process more efficient by discussing, hearing and consulting with each other; and
- Discuss the way to streamline the approval process of IM model.

While the aim of the Platform was to make material gathering process more efficient, participants maintained full discretion for evaluation and determination of equivalence.

In the process, the participants conducted material gathering by using a single questionnaire, whose contents was largely identical with the questionnaire used by the European Commission, and by sharing responses.

Evaluation was conducted on a category-by-category basis, rather than a line-by-line-basis, i.e. the participants selected eight categories that agree with the elements of international agreement to be assessed, namely instruments subject to the requirements, covered entities, treatment of transactions with affiliate etc. At each teleconference, a couple of categories were picked up and discussed; the timing for publication of equivalence determination was also shared and aligned.

Lessons Learned

This arrangement has several advantages, compared to ordinary bilateral or unilateral assessment.

- By sharing a single set of common questionnaire, participating authorities were requested to provide information only once. Also, questions and clarification regarding the responses were made collectively so that the participants were able to identify difference between regimes. As a result, the information exchange process became far more efficient.

6 ISDA 'Regulatory Driven Market Fragmentation' 7

7 List of Participating Authorities: Australia Prudential Regulation Authority (APRA), Australian Securities and Investments Commission (ASIC), Hong Kong Monetary Authority (HKMA), Hong Kong Securities and Futures Commission (HK SFC), Monetary Authority of Singapore (MAS) and Japanese Financial Services Agency (JFSA).

- As all the participants exchanged information simultaneously, the expected timeframe for decision was aligned each other and became transparent.
- While a significant part of the process was conducted collectively, decision making authority was retained by each authority.

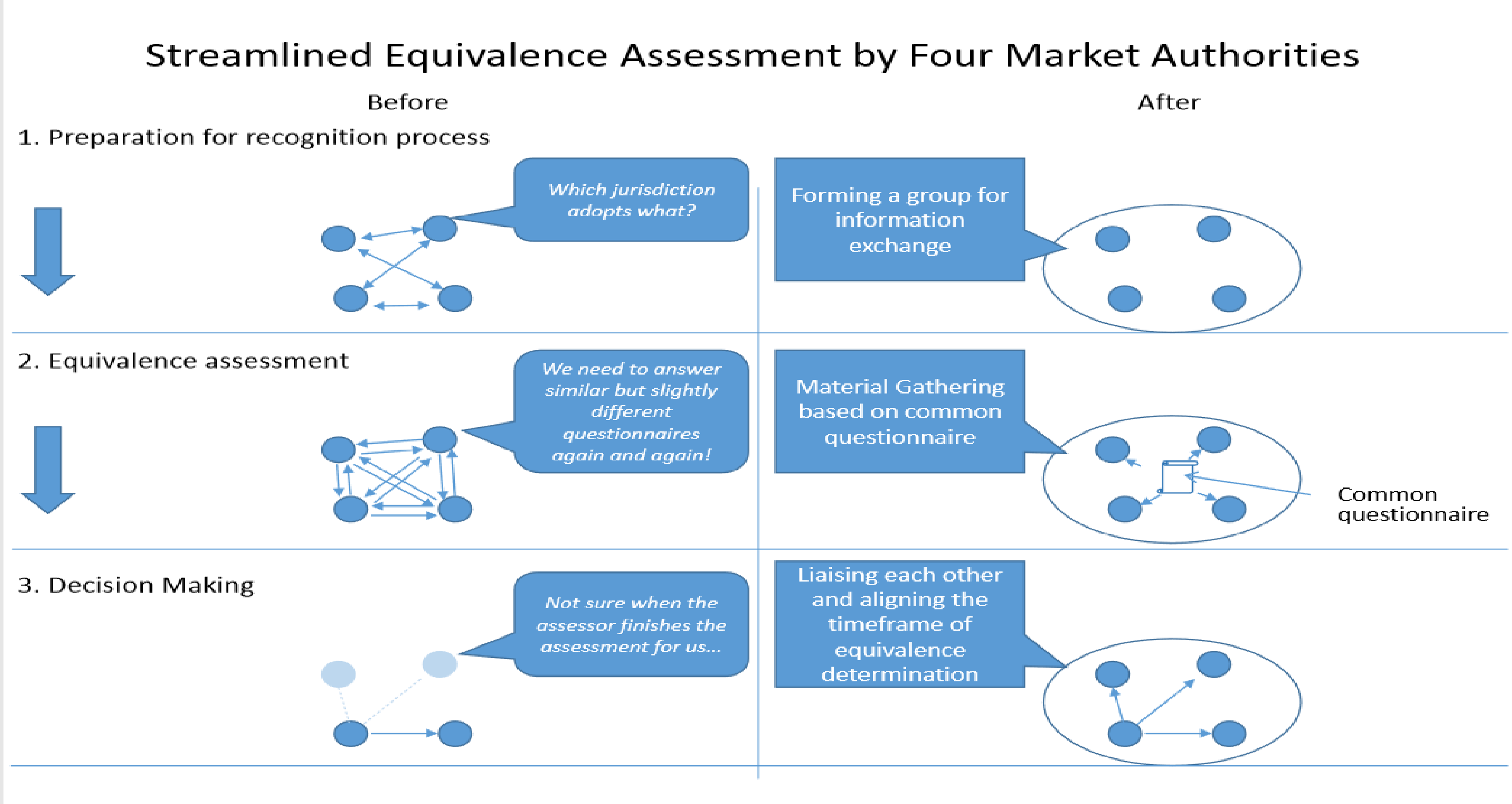
There were some elements that made the arrangement work more effectively. There is relatively limited room for domestic calibration for the sake of investor protection or market structure; in principle, the margin requirements cover “all derivatives transactions that are not cleared by CCP’s” and many other elements are equipped with certain clarity.[8] Because of these characteristics, authorities can assume the certain level of comparability in advance.

This method could be utilized for many other international standards, because such a collective arrangement will be applicable where there is a common set of minimum standards. In cases where national authorities adopt additional requirements and are willing to compare these requirements with host regulations, ordinary bi-lateral discussion could be held in addition to collective discussion.

Conclusion

Where there is a common set of minimum standards for comparability determination and three or more jurisdictions are expected to assess each other, this method could be useful to reduce workloads, improve consistency and enhance transparency of timeframe, thereby mitigating risk of unintended market fragmentation.

[8] BCBS-IOSCO (n1) 5



Streamlined Equivalence Assessment by Four Market Authorities
Before
After
1. Preparation for recognition process
Which jurisdiction adopts what?
Forming a group for information exchange
2. Equivalence assessment
We need to answer similar but slightly different questionnaires again and again!
Material Gathering based on common questionnaire
Common questionnaire
3. Decision Making
Not sure when the assessor finishes the assessment for us...
Liaising each other and aligning the timeframe of equivalence determination

Case Study 4: The EU CRA Regulation as an example of the EU equivalence model (Prepared by ESMA)

Description of the case

Credit rating agencies (CRAs) have historically played an important role in global securities and banking markets, as their credit ratings are used by investors, borrowers, issuers and governments as part of making informed investment and financing decisions.

In the EU, but also in other jurisdictions, credit institutions, investment firms, insurance undertakings, assurance undertakings, reinsurance undertakings, asset management companies ("Undertakings for collective investment in transferable securities – UCITS") and institutions for occupational retirement provision may use those credit ratings as the reference for the calculation of their capital requirements for solvency purposes or for calculating risks in their investment activity. Consequently, credit ratings have had a significant impact on the operation of the markets and on the trust and confidence of investors and consumers.

However, despite their significant importance for the functioning of the financial markets, the activities of CRAs or the conditions for the issuing of credit ratings were not regulated by most of EU Member States before the global financial crisis (GFC), i.e., pre-2008. At the same time, CRAs were subject to the EU law only in limited areas, notably under applicable rules on insider dealing and market manipulation.

During the GFC, CRAs were considered to have failed to reflect worsening market conditions at an early stage in their credit ratings and then to adjust their credit ratings in time following the deepening of the crisis. Additionally, they used wrong metrics and flawed methodologies.

The most appropriate manner, in which to correct those failures was through measures relating to conflicts of interest, the quality of the credit ratings, the transparency and internal governance of the CRAs, and the surveillance of the activities of the CRAs. Indeed, the users of credit ratings should not rely blindly on credit ratings but should take utmost care to perform own analysis and conduct appropriate due diligence at all times regarding their reliance on such credit ratings.

These corrective EU regulatory measures were introduced in three consecutive steps, establishing the EU Credit Rating Agency Regulation ("CRAR"):

- The first set of rules, which entered into force at the end of 2009, established a regulatory framework for CRAs and introduced a regulatory oversight regime, whereby CRAs had to be registered and were supervised by national competent authorities (NCAs) of individual EU Member States. In addition, CRAs were required to avoid conflicts of interest, and to have sound rating methodologies and transparent rating activities ("CRAR 1");

- In 2011, these rules were amended to take into account the creation of the European Securities and Markets Authority (ESMA), which supervised CRAs registered in the EU ("CRAR 2");

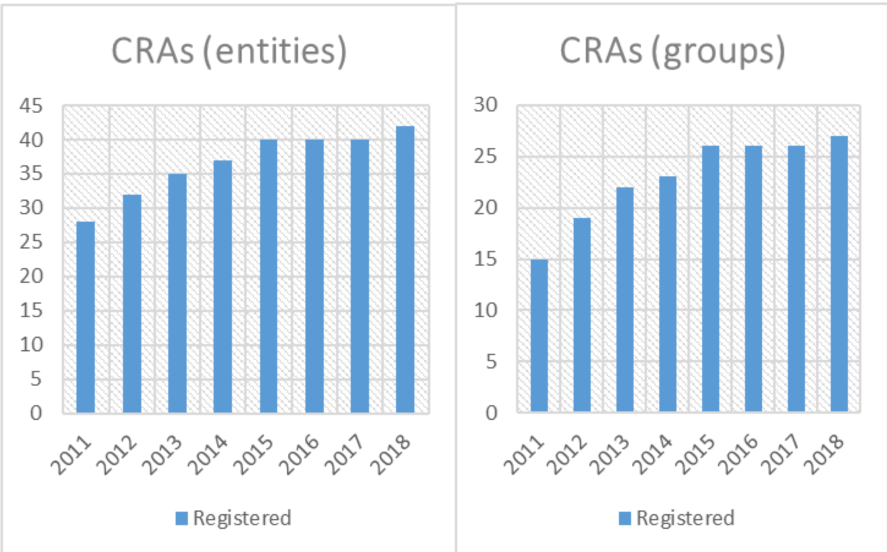
- A further amendment was made in 2013 to reinforce the rules and address weaknesses related to sovereign debt credit ratings ("CRAR 3").

Implications of the case to market fragmentation

In order to maintain a high level of investor and consumer confidence and enable the ongoing supervision of credit ratings issued in the EU, all CRAs applying for registration require physical presence in the EU. In particular, CRAs located outside the EU prior to the entry into force of the CRAR and applying for an EU registration were required to set up a subsidiary in the Union pursuant to the CRAR, in order to allow for the efficient supervision of their activities by ESMA.

It seems unavoidable that such a subsidiarity requirement may have posed a risk of market fragmentation to the existing global markets, as it is a certain form of market access limitation[1]. Also, other jurisdictions (e.g., the U.S. NRSRO regime) do not necessarily require physical presence as a pre-condition for registration.[2]

However, in line with the data evidence below, since the entry into force of the CRAR with its registration requirement the number of CRAs in the EU grew up steadily. This development was observed not only through the (regulatory-driven) creation of subsidiaries of the established global market participants (primarily in the year 2011, as before this requirement did not exist), but also through the emergence of new actors on the credit rating agency market.

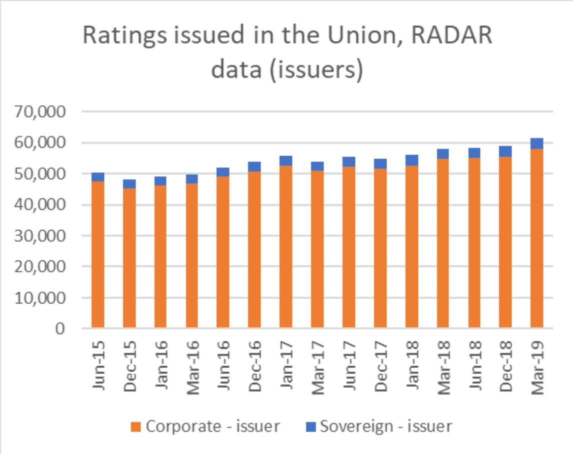


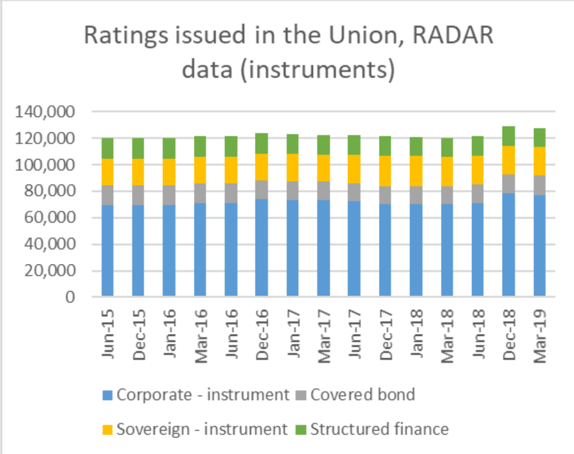
Compared to the U.S. market, the number of CRAs in the U.S. under the NRSRO regime has been steady with around 10 market participants over last years.

Looking at the number of ratings in the EU, it has also been growing steadily, which may lead to the conclusion that a potential market fragmentation resulting from physical presence requirement is not substantial, or at least does not impact negatively on the services available to investors.

1 Other ways to access EU market for non-EU CRAs are described in Section 3.

2 However, on the other hand, it should be noted that an effective supervision in case of a no physical presence can be only ensured through extra-territorial application of regulatory, supervisory and enforcement framework.





Regarding the costs of ratings and fees charged by the CRAs over the years, ESMA does not have any data available which allow to measure whether the costs/fees rose or fell following the entry into force of the CRAR, resulting in registration/physical presence requirements.

However, as stated in ESMA's "Thematic Report on fees charged by CRAs and Trade Repositories" in January 2018[3] based on the assessment of the information stored in ESMA's repositories, together with the information disclosed to the market and clients, there are limitations in the level of transparency by CRAs. Looking ahead, higher transparency and disclosure towards ESMA, for instance around CRAs' costs, price deviation and relevant internal controls established, is needed to ensure ESMA supervision is effective and based on all relevant information. Higher transparency and disclosure towards the market is also needed to empower clients to make more informed decisions based on comparable information.

Description of regulatory actions taken or proposed to address or prevent market fragmentation

As outlined in Section 2, the physical location requirement for registration as an EU CRA introduced by the CRAR may lead to some market fragmentation risks. In order to mitigate those risks, and in particular take into account the global nature of the existing credit rating market as it existed over years before the GFC, the CRAR allows for an alternative, more proportionate market access for non-EU CRAs, and use of credit ratings issued by such CRAs in the EU, provided that they comply with requirements which are as stringent as the requirements provided for in the CRAR. This alternative market access rule aims also to embrace any potential efficiency gains coming from continued use of specialized, geographically focused ratings issued in non-EU jurisdictions ("third countries") to the benefit of EU investors.

Firstly, and in particular in regard to smaller CRAs from third countries with no presence or affiliation in the EU through a specific regime of certification, in so far as they are not systemically important for the financial stability or integrity of the financial markets of one or more member states, certification should be possible after determination by the European Commission of the equivalence of the legal and supervisory framework of a particular third country to the requirements of the CRAR. ESMA, following a corresponding request for advice

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3 https://www.esma.europa.eu/sites/default/files/library/esma80-196-954_thematic_report_on_fees_charged_by_cras_and_trs.pdf

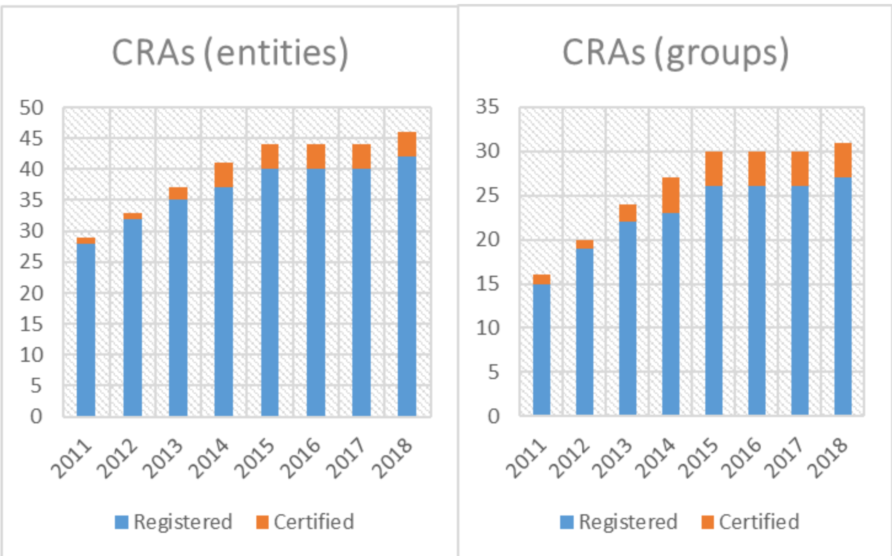
from the Commission, provides a principle-based, technical assessment of a third country framework and issues its advice before the Commission made its decision. The equivalence mechanism does not grant automatic access to the EU market and still requires a qualifying CRA from a third country to be assessed individually by ESMA. Taking into consideration the size of the individual CRA, its nature as well as complexity and range of issuance of its credit ratings, ESMA may grant an exemption from some of the organizational requirements for CRAs active in the EU, including the requirement of physical presence, before ultimately issuing the certification. Once the certification is issued, ESMA relies on the responsible supervisory authority of the relevant third country the certified CRA has been initially registered with.

So far, the European Commission has adopted equivalence decisions that the following third country regimes are equivalent to the CRAR: Argentina, Australia, Brazil, Canada, Hong Kong, Japan, Mexico, Singapore and the U.S.

Secondly, the CRAR introduces an endorsement regime allowing CRAs already established and registered in the EU to endorse credit ratings issued by third country CRAs, in particular belonging to the same group. However, an EU CRA should not begin endorsing credit ratings before ESMA has completed two separate assessments, namely: an assessment of the conditions relating to the legal and supervisory framework of the third country and an assessment of certain conditions relating to the CRAs intending to endorse credit ratings. Regarding the third country CRAs issuing endorsed ratings in question, ESMA fully relies on the supervision by the third country authority. However, importantly, an endorsement does imply that the endorsing EU CRA assumes full and unconditional responsibility for ensuring that all the conditions for endorsement are met on an ongoing basis.

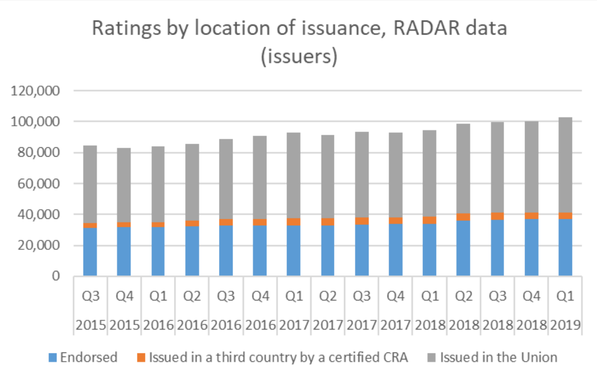
Third countries for which ESMA has assessed and concluded that their legal and supervisory framework meets the conditions for endorsement are: Argentina, Australia, Brazil, Canada, Hong Kong, Japan, Mexico, Singapore, South Africa and the U.S.

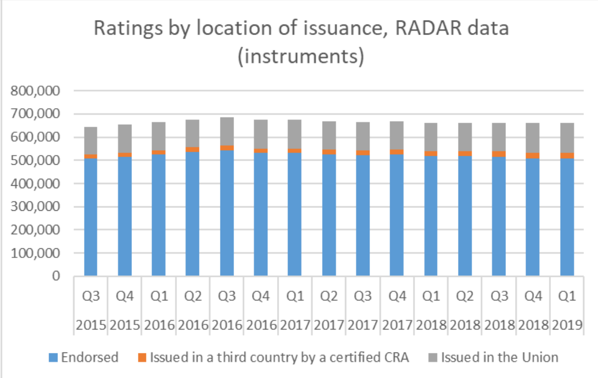
Looking first at the general data below, the certification model has been quite successfully used by third-country CRAs, which may have further limited the risk of market fragmentation:



Moreover, as the evidence below shows, the application of both equivalence/certification and endorsement regimes combined has resulted in a very significant role of non-EU issued ratings in the context of assessment of financial instruments in the EU, especially when compared to sole EU-issued credit ratings.

Consequently, this development had had a particularly positive impact on maintaining, if not expanding the global credit rating market, including a wider choice of ratings for users in the EU and increased competition.





Looking at some key challenges related to the market access solutions under the CRAR, which are also to be viewed as addressing any market fragmentation risks, the following issues have been identified:

- An important prerequisite for a sound equivalence/certification system and an endorsement regime is the existence of sound cooperation arrangements between ESMA and the relevant competent authorities of third-country CRAs. Such arrangements (MoUs) have been signed by ESMA and several non-EU authorities. The maintenance of such arrangements and related supervisory tools (e.g., global CRA colleges) require additional resources.

- The CRAR has been amended more than once, which raises the question whether the first equivalence decisions of the European Commission which have been made following assessments of third country legal and supervisory frameworks against CRA 1 and CRA 2 Regulations would still be accurate. In July 2017, ESMA received a request for technical advice on the equivalence of certain third country frameworks with the additional requirements for equivalence introduced by the CRA 3. In November 2017 ESMA provide its advice,[4] which is now under the consideration by the European Commission.

- In its "Thematic Review of fees charged by CRAs", as referred to above, ESMA has identified risks to both users of ratings and the objectives of ESMA (e.g., investor protection) and the CRAR (e.g., fees charged and possible conflicts of interest) from the business model established by the global and more complex groups. In particular, ESMA is concerned about the business practices and relationship between registered

[4] https://www.esma.europa.eu/sites/default/files/library/esma33-9-207_technical_advice_on_cra_regulatory_equivalence_-_cra_3_update.pdf

CRAs and their affiliated entities, which are used to provide the financial market with credit ratings and related information originating from the CRA, including commercialization and delivery services of credit ratings and rating content, and the licensing services for the use of credit ratings. This concern has not been observed in the context of small, EU-domiciled CRA.

Case Study 5: Mutual Fund Recognition (Prepared by the French AMF and Hong Kong SFC)

Description of the case

With the growth of financial markets globally and a corresponding increase in cross-border asset management activity and the offering, marketing and distribution of shares or units of collective investment schemes, authorities need to consider regulatory and supervisory approaches that would facilitate market development but also ensure proper and adequate investor protection.

Implications of the case to market fragmentation

One of the potential drivers for market fragmentation is where national laws and regulations in one jurisdiction may impact on a market participant's activities in another jurisdiction, due to incompatibility or overlap with the other jurisdiction's laws and regulations. The resulting financial costs and regulatory burden imposed may lead the market participant to cease offering, marketing and distributing its products in the other jurisdiction and concentrate its activities in the original jurisdiction. This would limit access to certain products in the other jurisdiction, thereby leading to fragmentation of markets.

Description of regulatory actions taken or proposed to address or prevent market fragmentation

As set out above, the expansion of cross-border asset management activities creates challenges for authorities in ensuring the efficiency and effectiveness of their regulatory and supervisory frameworks when trying to address issues of market growth and investor protection. Where more than one national authority has oversight over a market participant and its operations, the likelihood of mismatch between national laws and regulators is amplified and may potentially cause market fragmentation.

One means of addressing this potential problem is for authorities to agree a mutual recognition framework whereby each authority recognizes the other, each operating as home as well as host regulators in respect of the same cross-border activities. In implementing such a framework, the authorities can work together to ensure that their regulatory objectives are met whilst enabling a more streamlined process for market participants to operate in the different jurisdiction. The case study below sets out how the Hong Kong Securities and Futures Commission (SFC) and the French Autorité des Marchés Financiers (AMF) worked together to agree a framework for the distribution of certain funds in their respective jurisdictions.

Background

On 10 July 2017, the SFC and AMF signed a Memorandum of Understanding (MoU) on France-Hong Kong Mutual Recognition of Funds (France-HK MRF), which allows eligible Hong Kong public funds and French UCITS (collectively, Covered Funds) to be distributed to retail investors in each other's market through a streamlined authorization process. The MoU specifies the scope of eligible funds as well as the specific requirements applicable to Covered Funds and sets out the framework for the France-HK MRF, the exchange of information, regulatory assistance and cooperation between the AMF and the SFC in relation to the cross-border offering of these funds.

The distribution of Covered Funds through the France-HK MRF arrangement provides more investment choices to the public and substantially broadens the investor base of local funds in both markets[1] and hence facilitates the growth of the industry.

Framework

The France-HK MRF arrangement is premised on the principles of mutuality and respect, proper investor protection and a level playing field within each jurisdiction's market.

A key fundamental underlying principle of the France-HK MRF arrangement is to ensure that both Hong Kong and French investors receive fair and comparable treatment and protection, including investor protection, exercise of rights, compensation and disclosure of information.

Under the France-HK MRF framework,

- the eligible Covered Funds authorized by the home regulator for offering, marketing and distribution within the home jurisdiction[2] may obtain authorization from the host regulator through a streamlined process and be sold directly to the retail investors in the other market;
- the Covered Funds continue to be operated and managed in accordance with the laws and regulations applicable in their home jurisdiction as well as with their constitutive documents;
- the home regulator[3] remains responsible for regulating and supervising the Covered Funds and their fund managers under its jurisdiction; and
- the host regulator[4] is responsible for regulating and supervising the offering, marketing and distribution of the Covered Funds within its jurisdiction in compliance with the laws and regulations applicable in the host jurisdiction[5] where and to the extent that such offering, marketing and distribution of the Covered Funds are carried out in its jurisdiction.

On the basis of a comparability assessment between the regulatory frameworks in each jurisdiction, the Covered Funds are deemed to have complied with substantive requirements in the retail fund regime in the host jurisdiction. They will generally not be required to strictly observe the specific requirements in the host jurisdiction. Instead, to ensure proper investor protection and a level playing field with the fund industry in the host jurisdiction, the Covered

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1 The arrangement is limited to each jurisdiction's domestic market. In particular, under the France-Hong-Kong MRF, Hong Kong Covered Funds may not be passported throughout Europe once they have been authorized for marketing in France.

2 Home jurisdiction means the jurisdiction of the home regulator, namely Hong Kong, in the case of Hong Kong Covered Funds; or France, in the case of French Covered Funds.

3 Home regulator means SFC in the case of Hong Kong Covered Funds and their fund managers or AMF in the case of French Covered Funds and their fund managers.

4 Host regulator means AMF in the case of Hong Kong Covered Funds and their fund managers or SFC in the case of French Covered Funds and their fund managers.

5 Host jurisdiction means the jurisdiction of the host regulator, namely France, in the case of Hong Kong Covered Funds; or Hong Kong, in the case of French Covered Funds.

Funds should comply with additional rules compared to the home regulatory framework, as stipulated by the host regulators as a result of the recognition assessment.

Recognition assessment

To ensure the respective retail fund regimes offer comparable and adequate protection to investors in both markets, a detailed study of Hong Kong and French regulatory requirements and standards was conducted by the AMF and SFC respectively to assess whether they are substantially comparable, with an outcomes-based objective. The assessment included, among others:

- a general analysis of securities laws, regulations, requirements and standards applicable in both jurisdictions;
- a specific analysis of securities laws, regulations, requirements and standards applicable in both jurisdictions, with respect to the cross-border activity considered under the proposed mutual recognition arrangement;
- an analysis of the level of investor protection in both jurisdictions;
- an analysis of the level of supervisory oversight in both jurisdictions;
- an analysis of the enforcement capability of both jurisdictions;
- an analysis of the mechanism for the timely exchange of information between regulators; and
- an analysis of results from standardized assessments by international organizations.

Dedicated teams within the SFC and AMF, with the necessary knowledge and expertise, were formed to facilitate the assessment of the respective regulatory regimes.

During the assessment, FSAP reports were studied to obtain a general understanding of the respective regulatory regime and identify any potential issues raised in relation to IOSCO CIS principles. Questionnaires and follow-up questions were exchanged between SFC and AMF to form a better understanding of the respective regulatory regimes and facilitate the comparison of the regulatory requirements.

The SFC and AMF maintained regular dialogue and communication during the assessment for timely discussions and clarifications on regulatory requirements. A short-term secondment for relevant staff in the SFC and AMF was also arranged. Teams from each authority spent 2 weeks in the other authority to further their understanding of the local regulatory regime to facilitate the assessment.

Bridging the gaps identified in the assessment

The recognition assessment was not a line-by-line assessment of textual equivalence. Instead, it was a comparative analysis adopting an outcomes-driven approach in relation to the requirements and standards in Hong Kong and France, even though there could be difference in detail. Such analysis enables both SFC and AMF to address certain areas of differences with a granular approach in order to provide adequate investor protection, as well as to avoid competitive distortions and unlevel-playing fields for firms.

The SFC and AMF took a pragmatic approach to resolve regulatory gaps, inconsistencies, or conflicting requirements identified from the recognition assessment. For instance, the two authorities found common grounds to bridge such gaps in areas related to investment restrictions for funds, offering documents and financial statements, and fees.

Memorandum of understanding

Upon agreeing on the scope of eligible funds and the specific requirements applicable to Covered Funds, the SFC and AMF entered into a MoU. The MoU sets out the framework for the France-HK MRF, the exchange of information, regulatory assistance and cooperation between the home and host regulators in relation to the cross-border offering of funds.

The home regulator continues to be the primary regulator and is responsible for the ongoing regulatory supervision and monitoring of the Covered Funds and their fund managers. The host regulator may request regulatory assistance in accordance with the terms of the MoU.

Pursuant to the MoU, the SFC and AMF are required to keep each other informed of material regulatory developments in its respective jurisdictions.

Ongoing regulatory supervision and monitoring

The Covered Funds and their fund managers under the France-HK MRF arrangement are primarily regulated by the home regulators. The SFC and AMF have agreed to maintain regular dialogue and communication in relation to major breaches by or regulatory concerns of the Covered Funds and the related fund managers.

The sales and distribution of the Covered Funds under the France-HK MRF arrangement in the host jurisdiction must be conducted by intermediaries properly licensed by or registered with the host regulator and must comply with the relevant laws and regulations relating to the sale and distribution of funds in the host jurisdiction.

Appendix B: List of Follow-Up Group Members

Chairs: Mr. J. Christopher Giancarlo, Chairman, Commodities and Futures Trading Commission
Mr. Jun Mizuguchi, Deputy Commissioner for International Affairs, Financial Services Agency of Japan

Members:

Australian Securities and Investments Commission (Australia)	Mr. James Shipton, Mr. Nathan Bourne
Comissão de Valores Mobiliários (Brazil)	Mr. Marcelo Barbosa, Mr. Eduardo Manhães Ribeiro Gomes
China Securities Regulatory Commission (China)	Mr. Xinghai Fang, Mr. Bing Shen
European Securities and Markets Authority (European Union)	Mr. Steven Maijoor, Mr. Jakub Michalik
Autorité des marchés financiers (France)	Mr. Robert Ophele, Mr. Viet-Linh Nguyen
Bundesanstalt für Finanzdienstleistungsaufsicht (Germany)	Ms. Elisabeth Roegele, Mr. Jan Ole Wagner
Securities and Futures Commission (Hong Kong)	Mr. Ashley Alder, Ms. Julia Leung
Commissione Nazionale per le Società e la Borsa (Italy)	Ms. Nicoletta Giusto
Financial Services Agency (Japan)	Mr. Makoto Sonoda, Mr. Satoshi Izumihara
Ontario Securities Commission (Ontario)	Ms. Maureen Jensen, Ms. Cindy Wan
Monetary Authority of Singapore (Singapore)	Mr. Lee Boon Ngiap, Mr. Ken Nagatsuka
Comisión Nacional del Mercado de Valores (Spain)	Mr. Sebastián Albella, Mr. Santiago Yraola López
Swiss Financial Market Supervisory Authority (Switzerland)	Dr. Thomas Bauer, Mr. Thomas Lustenberger
Financial Conduct Authority (United Kingdom)	Mr. Andrew Bailey, Mr. Lee Foulger
Commodity Futures Trading Commission (United States of America)	Mr. Eric Pan
Securities and Exchange Commission (United States of America)	Mr. Jay Clayton, Ms. Katherine Martin
IOSCO Secretariat	Mr. Paul Andrews, Mr. Tajinder Singh, Ms. Kris Nathanail-Brighton

Appendix C: List of Respondents to the IOSCO Board Members Survey

Australian Securities and Investments Commission (Australia)

Financial Services and Markets Authority (Belgium)

Comissão de Valores Mobiliários (Brazil)

China Securities Regulatory Commission (China)

European Securities and Markets Authority (European Union)

Autorité des Marchés Financiers (France)

Bundesanstalt für Finanzdienstleistungsaufsicht (Germany)

Securities and Futures Commission (Hong Kong)

Securities and Exchange Board of India (India)

Commissione Nazionale per le Società e la Borsa (Italy)

Central Bank of Ireland (Ireland)

Financial Services Agency (Japan)

Comisión Nacional Bancaria y de Valores (Mexico)

Ontario Securities Commission (Ontario)

Comissao do Mercado de Valores Mobiliários (Portugal)

Autorité des Marchés Financiers (Quebec)

Monetary Authority of Singapore (Singapore)

Financial Services Board (South Africa)

Comisión Nacional del Mercado de Valores (Spain)

Swiss Financial Market Supervisory Authority (Switzerland)

Capital Markets Board (Turkey)

Financial Conduct Authority (United Kingdom)

Commodity Futures Trading Commission (United States of America)

Securities and Exchange Commission (United States of America)