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Substituted Compliance and Systemic Risk: How to Make a Global Market in Derivatives Regulation

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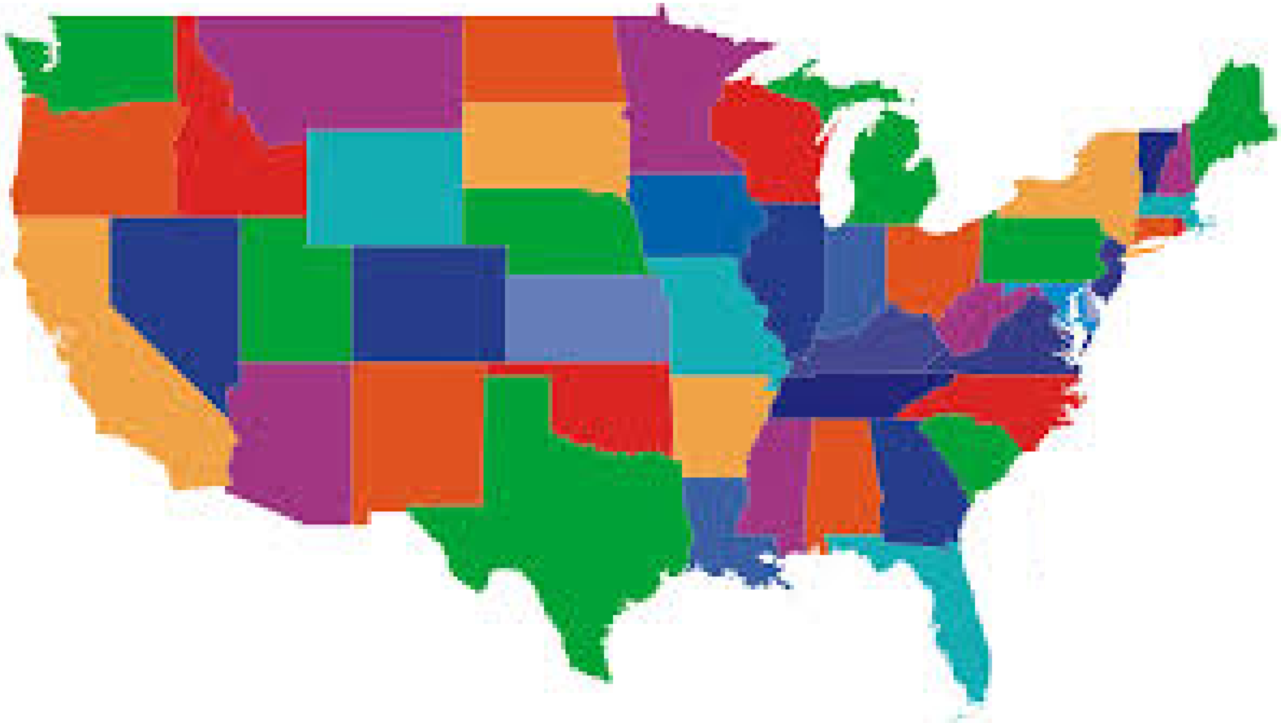
Background

Harmonize what?



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Background

How to distinguish regulatory *competition*

from regulatory *arbitrage*?

A definition of regulatory arbitrage…

A (better) definition of regulatory arbitrage…

A regulated entity's movement of business from Jurisdiction A, which has adopted *efficient* Regulatory Strategy X addressing Problem Y, to Jurisdiction B, which has *defected* from efficient Regulatory Strategy X (for reasons of moral hazard or agency costs or other) and therefore fails to adequately address Problem Y and in which it is therefore less costly to conduct business.

Why regulate Derivatives?

Two Risks of Derivatives

1. Fluctuations in value of the underlying reference asset.
2. Non-performance under the contract.

   I.e., **"counterparty credit risk"**

A negative externality/ spillover effect of the derivatives trade

Systemic risk

How *could* we regulate derivatives?

An International Standard Setting and Monitoring Body, focused on systemic risk…

E.g., G-20/ FSB.

How *are* we regulating derivatives?

The G20 Plan – Mandatory Clearing

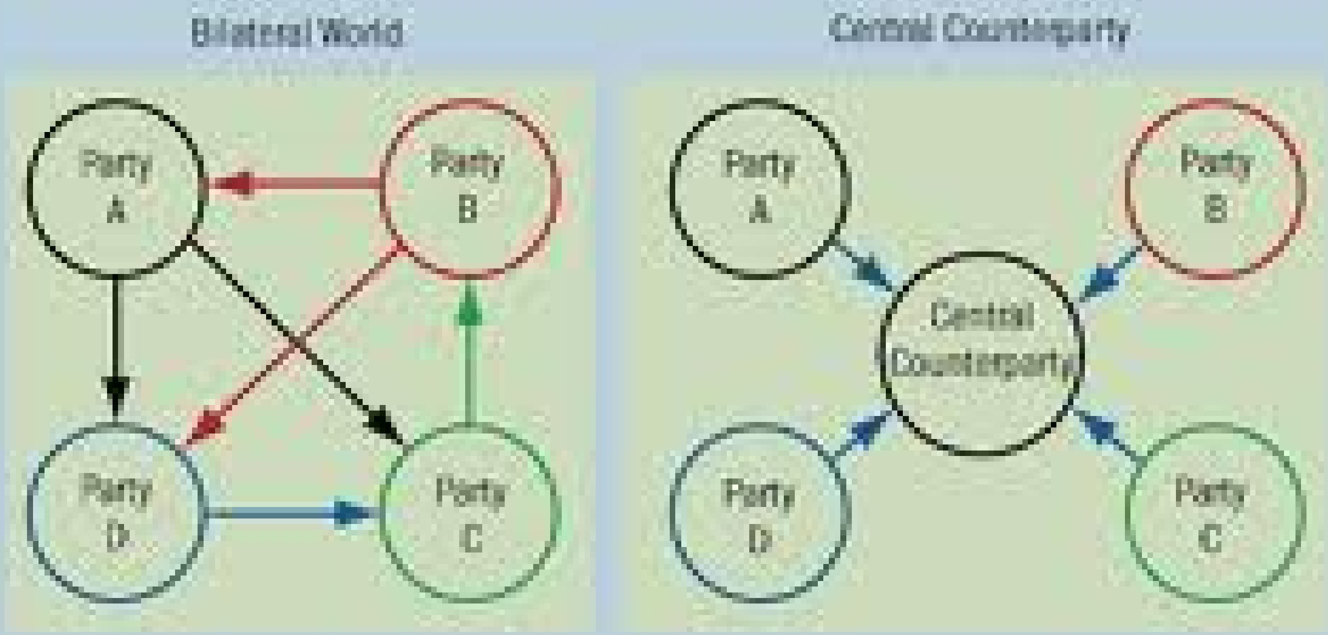
"All standardized OTC derivative contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties by end-2012 at the latest. OTC derivative contracts should be reported to trade repositories. Non-centrally cleared contracts should be subject to higher capital requirements."

Central Counterparty Clearing: the big idea

Chart 2

How trading worlds differ

In bilateral trading, parties to a contract are directly and indirectly exposed to each other, while in a centralized world a single counterparty acts as counterparty to all counterparties.



Implementation…

The U.S. charges ahead. Says: “Follow us. Or else…”

“Effective reform cannot be accomplished by one nation alone. It will require a comprehensive, international response. The response to the global financial crisis lies in efforts by governments to bring about a harmonious global regime of financial regulations.”

- Gary Gensler, *CFTC Chairman*

The U.S. needs to “protect against cross-border gamesmanship” in financial regulation.

-Timothy Geithner, *U.S. Secretary of the Treasury*

How to Implement U.S. Swap Regulation Globally?

CFTC Guidance on "Cross-Border Application of Certain Swaps Provisions of the Commodity Exchange Act" (June 29, 2012)

1. provides that foreign entities engaged in more than a de minimus level of US-facing swap dealing be subject to US regulation;
2. divides US regulation of the swaps market into entity-level regulations and transaction-level regulations and provides that all foreign dealers of swaps comply with entity-level regulations;
3. allows for "substituted compliance" of entity-level regulations for foreign swap dealers that comply with a substantially similar regulatory regime in their home jurisdiction;
4. requires that transaction-level regulations apply to all US-facing transactions, exempting from US regulation only those transactions that foreign swap dealers enters into with counterparties not guaranteed by or otherwise operating as a conduit to a US entity.

Determining Comparability

Process:

1. Interested party (a non-US Person or foreign regulator, etc.) submits a request to the CFTC.
2. Submission to state factual basis for comparability w/r/t specific U.S. requirements and to reference (and include) all relevant legislation, rules, and policies.
3. If substituted compliance approved → CFTC to enter into MOU w/ relevant foreign regulator for information-sharing and other cooperation.

Could a Non-Clearing Regime be Comparable?

NO.

- Clearing is central element of the system as a whole, integral even in determining *definition* of MSP.
- Clearing is a transaction-level rule for which Substituted Compliance is not an option.
- Comparability of clearing regimes separately discussed (and contemplated *as long as the regime has a clearing mandate*).

Two examples:

Example 1

Example 2

Is mandatory clearing really such a good idea?

- Central Counterparty Clearing has flaws…
  - Clearinghouses themselves become a dangerous too-big-to-fail entity.
  - Clearinghouse segmentation increases the systemic effect of asset bubbles.
  - Clearinghouses increase systemic risk by fragmenting netting.
    - Especially if different asset classes have different clearinghouses or if different jurisdictions demand their own clearinghouses.
    - A fractured trading environment = less effective netting.
  - Clearinghouses do not eliminate systemic risk, they merely shift it.

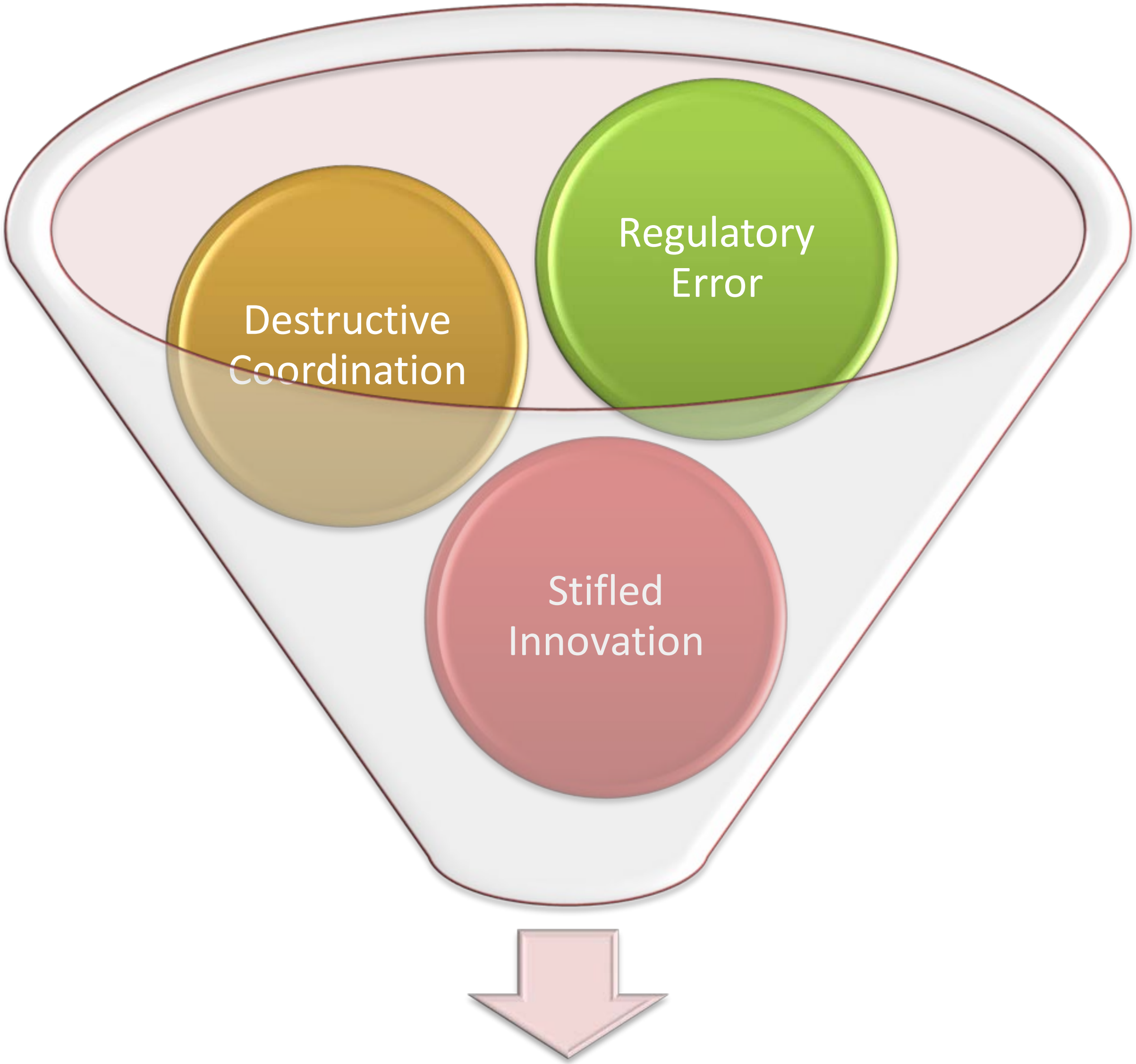
Mandatory Clearing Stifles Alternatives

Possible alternative regulatory structures:

- Conrad Voldstad : "Suppose each dealer were to use an entity licensed by regulators to collect variation margin collateral across all derivative products on a netted basis. You would retain the benefits of netting and capture the main benefits clearing. The same licensed entity could organize the liquidation of dealer portfolios in a dealer bankruptcy, perhaps by collecting some initial margin from the dealer. Surely the savings to the system would amount to hundreds of billions, if not trillions of dollars of margins."
- Manmohan Singh: institute a punitive tax on the residual derivative liabilities of systemically important financial institutions.

The above alternative approaches currently cannot be developed as a result of the uniform clearing mandate.

Uniformity *Creates* Risk…



Risk

How we could do it differently…

- A U.S. review committee to allow for "substituted compliance" with foreign regulatory regimes that are at least as effective at containing systemic risk as U.S. regulation.
  - Review committee would be housed in several different domestic institutions (e.g., the FSOC, the Fed, a court similar to the US court of international trade).
  - Neither the CFTC nor the SEC should be left to decide the reach of their own regulatory authority.
- Rubric would be the regime's similar effectiveness, rather than the similarity of the regulation.
- Enormous importance of U.S. financial markets can give U.S. a leading role.

Thank you.

Comments?

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