AMERICAN BANKER®
THE FINANCIAL SERVICES DAILY

Monday July 21, 2014

BANK THINK

The Smart Way to Regulate Overseas Swaps Trading

By Timothy A. Karpoff

The U.S. and Europe have overhauled their approach to regulating swaps over the past five years, generally moving in the same direction and at similar paces. But on key issues like trading, price discovery and market structure, the U.S. and Europe are out of sync—a situation that's been creating upheaval in the cross-border swaps businesses.

The debate over how to apply U.S. swaps rules abroad has largely centered on the perceived riskiness of overseas trades. But most of the companies that are making the trades are already subject to risk management and capital requirements under both U.S. and European jurisdiction. Now the question is how the application of U.S. swaps rules abroad will impact market integrity and price formation in the derivatives market.

In the first half of this year, the U.S. trading mandate created under the Dodd-Frank Act came into effect. Most U.S. swaps must now be traded through organized trading platforms or swap execution facilities. But that's only in this country. In Europe, consultations have only just begun on the trading and market structure legislation known as the Markets in Financial Instruments Directive, or Mifid II. Realistically, it looks like there won't be a trading mandate in Europe before 2017. This gap in market structure rules means that swaps will be traded and priced very differently in the U.S. and abroad, with significant impact on how dealers compete with one another.

Banks have responded to the divergent trading rules by attempting to segregate their U.S. businesses from their overseas businesses while maintaining operational and capital efficiencies. Last fall, a number of banks, including Citigroup, sought to use U.S.-based personnel to negotiate and market dollar-related transactions booked in overseas entities. Because the banks used foreign booking entities, they believed the transactions weren't directly subject to U.S. rules, so they could still rely on U.S. employees with the requisite experience to facilitate the trades. The Commodity Futures Trading Commission issued an interpretation effectively banning this structure and the issue is now in litigation.

Timothy A. Karpoff is a partner in Jenner & Block's Government Controversies and Public Policy Litigation Practice and is a former director of the U.S. Treasury Department's Office of Financial Institutions Policy.

Responding to CFTC guidance, U.S. banks started tailoring how they trade out of their overseas affiliates. Overseas affiliates of U.S. entities that operate with a guarantee from the U.S. parent are subject to U.S. transaction level rules, albeit indirectly, when they trade with dealer counterparties overseas. Since Europe has no corresponding rules, non-U.S. dealers don't face transaction level requirements, or any other comparable requirements, creating a competitive imbalance.

U.S. bank holding companies are now in the process of de-guaranteeing their overseas affiliates, removing the legal agreements that commit the U.S. parent holding company to backing the affiliates' obligations. This maneuver is designed to remove the overseas affiliate from U.S. jurisdiction. Critics contend that this is an attempt to evade regulation and exposes the U.S. financial system to risks from an unregulated derivatives market. The companies, however, assert that they're simply following the framework laid out by the regulator and trying to compete on a level playing field with their foreign competitors. By removing the guarantee, they say, they are isolating the risks to the overseas, limited-liability affiliates.

Like most things regulatory, the truth lies in the fine print. First, many U.S. banks are not de-guaranteeing their overseas affiliates in toto, but rather only specific transactions. Other liabilities of the overseas entity remain backstopped by the U.S. parent. Overseas affiliates' losses on unguaranteed swaps can still affect the potential exposure of the U.S. parent to the overseas affiliates' guaranteed liabilities. Put simply, it's very hard to draw clean line through a company's balance sheet.

But in my view, this "risk analysis" asks the wrong set of questions. In deciding whether U.S. affiliates abroad should be subject to U.S. rules, the question isn't whether those overseas affiliates will be subject to capital and risk management requirements or mandatory clearing. Most overseas jurisdictions are meeting those commitments to reduce risk; therefore, U.S. companies' overseas affiliates are generally subject to such requirements whether under U.S. or foreign law. Instead, the main consequence of applying U.S. rules to the "de-guaranteed" overseas affiliates would be imposing U.S. trading rules abroad.

As such, risk is the wrong way to think about these cross-border issues. Factors like market integrity and the risks of market fragmentation are more relevant. Imposing U.S. trading rules abroad solely on U.S. overseas affiliates could result in U.S. and foreign participants pricing the same transactions very differently. Different pricing can create separate pools of liquidity, with the overall effect of less liquid, less efficient and likely more volatile markets abroad. If U.K. regulators have views on how swaps should be traded in the London market that differ from the views of U.S. regulators, the U.K. deserves deference as a matter of law even if that creates a less-structured, more opaque market.

The CFTC's cross-border guidance doesn't speak to this issue. The document predicated extraterritorial jurisdiction almost entirely on where the risk of trading activity ultimately flowed. It yoked together rules designed to reduce risk with rules designed to promote market transparency. Yet it provided almost no guidance about how to think about the extraterritorial application of market transparency rules independent of risk. As a result, we're deciding how to apply U.S. rules abroad based on considerations that are tangential to the purposes of those rules. It's like deciding to buy an electric car because you like the color; it's not a totally irrelevant issue, but it's not the key question.

Overseas market transparency rules are unlikely to be issued for a while. In the meantime, the CFTC will need to supplement its guidance with more nuanced advice about how its rules apply outside of the U.S. We need a concept of U.S. jurisdiction that is tailored to the specific underlying purpose of particular rules rather than only tailored to risk. To do this, the CFTC should focus on market structure and promoting liquidity and transparency in markets—concepts that turn more on the integrity of the price discovery process and avoiding market fragmentation.

Timothy A. Karpoff is a partner in Jenner & Block's Government Controversies and Public Policy Litigation Practice and is a former director of the U.S. Treasury Department's Office of Financial Institutions Policy. He can be reached at tkarpoff@jenner.com.