Since the US Dodd-Frank Act was signed into law in 2010, the derivatives industry has been wrestling with how this raft of new regulations will interact with foreign jurisdictions. Two years on, practitioners are now having to grapple with the cross-border impact of another major set of derivatives rules, this time coming from Europe.

The European Securities and Markets Authority began consulting market participants in July on how European Market Infrastructure Regulation could hit non-European Union swaps users, raising the prospect of extra-territoriality of EU derivatives regulations for the first time.

“EU participants have been preparing for the extra-territoriality effects of Dodd-Frank, and now non-EU clients are having to do this for EMIR too. Right now, there are some important differences between US and European rules, which can create confusion,” said Vladimir Maly, a partner at Latham & Watkins in London.

There has been some notable progress on cross-border co-operation recently, with US and European supervisors agreeing a common framework last month whereby they would recognise each other’s regulations.

However, concern remains over the potential for discrepancies to emerge across different regulatory frameworks. Only last week, ISDA outlined a set of principles to aid harmonisation in cross-border rules.

And despite the compromise reached in July, important differences remain between the regulatory processes on either side of the Atlantic.

For one, Dodd Frank adopted a much more pragmatic approach of identifying and regulating entities that are engaged in swap dealing activities, said Maly. He pointed out that the CFTC has aimed to categorise swaps users, introducing the concept of swap dealers and major swap participants, while the European approach relied on the existing categories of various regulated financial entities and treating everyone else as non-financial counterparties.

This means there is little difference in the eyes of European supervisors between frequent swaps users and an investment manager that only rarely uses derivatives.

The US, by contrast, focuses on the largest swaps users and forces these firms to engage directly with the CFTC through the registration process.

“In practice, the US regulators have the ability to engage in a dialogue with the swap dealers during the registration process, which does allow them to take a view on specific circumstances of a particular entity. This in turn allows them to focus on addressing systemic risk appropriately,” said Maly.

“The European approach doesn’t have that flexibility, and that can create frustration for swaps users that lack valuable dialogue with the regulator.”

No-action
This isn’t the only area in which the CFTC has shown itself to be more flexible than European regulators. The agency has issued more than 100 no-action letters to swaps users to exempt them from particular rules that are due to kick in. This piecemeal approach has drawn criticism from some industry participants, not least because the letters are often issued at the eleventh hour, creating huge uncertainty for the regulated firms.

Nonetheless, lawyers say it is still a useful tool for regulators implementing such a large and complex web of regulations. At present, ESMA must rely on question and answer papers to give the industry guidance on how the rules will be applied.

“The problem with Q&A is that it’s not a binding piece of regulation,” said Maly. “It would be a welcome development if as a result of the review of the supervisory framework at the EU level the European supervisory authorities would get a mandate to issue no-action letters that would give them flexibility to regulate the industry more effectively.”

ESMA is due to release technical advice on equivalence with the US regulatory regime at the beginning of September – a report that has already been delayed – and for Japan and Canada later in the month.

“The equivalence for clearing is the crucial area,” said Edmund Parker, co-head of the derivatives and structured products practice at Mayer Brown.

“The vast majority of the [EU and US] rules are substantially the same, we’re just hitting the roughness around the edges. US banks with European branches are the most likely to be caught out, but the differences are not insurmountable,” said Parker.

Christopher Whittall