Reducing Market Fragmentation through Enhanced International Regulatory Coherence
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In the aftermath of the financial crisis of 2008, regulatory reforms to strengthen the financial system were critical in enhancing market transparency and restoring confidence in global financial institutions. While the regulatory reforms have been generally supportive of international regulatory coherence, unwarranted market fragmentation remains, which has led to inefficient markets and higher transaction costs.

In recent years, market fragmentation has been a key area of focus for global policy makers, regulators and market participants, including increased collaboration and cooperation among them. We at the U.S.-Japan Business Council applaud efforts by global regulators, working through the Financial Stability Board (FSB) and the International Organization of Securities Commissions (IOSCO), to address market fragmentation and reduce gaps between global standards and national regulations, thereby promoting greater consistency internationally. These include establishing international standards on prudential requirements (e.g., capital and margin for non-centrally cleared derivatives) and technical guidance and governance arrangements for trade reporting. We also appreciate actions by global regulators to provide deference, equivalence and substituted compliance determinations that strike the right balance between global consistency and local relevance.

Despite these successes, challenges remain. Strengthening cooperation between regulatory authorities could further assist in addressing market fragmentation and achieving international regulatory coherence. In 2019, the Japanese G20 Presidency identified market fragmentation as a critical issue affecting the global economy. It proposed that the FSB examine signs of market fragmentation and explore issues and tools to address them. In January 2019, the IOSCO formed a Follow-Up Group to its Cross-Border Task Force. We welcome and strongly support the efforts of the G20, FSB, and IOSCO to examine market fragmentation as a top priority focus area.

The FSB and IOSCO published reports in June 2019 analyzing the issues of regulatory driven market fragmentation and called on the global regulatory community for a coordinated response.[1] The FSB report examines activities where supervisory and regulatory policies and practices may give rise to market fragmentation and explores possible mechanisms and approaches to tackle it. Further, the FSB issued updates to the aforementioned report in October 2019 and identified steps to be taken in four key areas to address market fragmentation (i.e., deference; pre-positioning of capital and liquidity; regulatory and supervisory coordination and information-sharing; and market fragmentation as part of the evaluation of reforms).

The IOSCO report provides lessons learned and examples of market fragmentation that are significant and potentially harmful to the financial markets. It is important that the United States and Japan look to advance thoughtful ways forward that could reduce harmful or unintended regulatory driven market fragmentation, while being mindful and respectful of existing regulatory frameworks.

In addition, the International Swaps and Derivatives Association (ISDA) published a report in January 2019 to identify where and how regulatory-driven market fragmentation has impeded risk management and imposed excessive costs and burdens on market participants.[2] The ISDA report provides examples of derivatives market fragmentation in addition to recommending potential solutions to regulatory-driven fragmentation.

Lastly, the Institute of International Finance (IIF) published a report that categorized market fragmentation in four categories (i.e., local supervisory measures and ring-fencing, diverging standards, extraterritoriality, obstacles to cross-border cooperation and information sharing) and recommended measures to address them.[3]

These reports offer thoughtful insights and recommendations for reducing fragmentation. Although notable examples exist of successful implementation of measures aimed at mitigating fragmentation, the ongoing critical importance of international regulatory coherence underscores the need for global regulators to continue prioritizing it in future G20 presidencies. In particular, we believe further cross-border recognition of foreign clearinghouses should be a priority focus area. Finally, while the need for insurance markets and supervision to be tailored to local needs is broadly acknowledged, we note that cooperation to facilitate cross-border cooperation among insurance regulators is equally important in the context of insurance.

[1] See, "FSB Report on market fragmentation" and IOSCO "Market Fragmentation and Cross-Border Regulation," both published on June 4, 2019.
[2] ISDA "Regulatory Driven Market Fragmentation" January 2019.
[3] IIF, "Addressing Market Fragmentation: the need for enhanced global regulatory cooperation."

While fully acknowledging and applauding many such examples of the progress to date, we believe the next critical task is to implement a process for consistent cooperation that can ensure deference, mutual recognition and/or equivalency determinations. We believe that the U.S. and Japanese governments themselves are best suited to decide what standards are worthy of such deference, equivalency determinations or mutual recognition. Last year the CFTC and the Japanese FSA demonstrated their capacity for deference and mutual recognition regarding derivatives trading facilities operating in their respective markets, proving that a procedure and a forum for such work can be accomplished. We strongly encourage both governments to formalize this process, which will open the way for examining other opportunities for similarly positive outcomes. Toward that end, the USJBC recommends the establishment of a U.S.-Japan Financial Regulatory Forum with a scope that includes regular assessments of opportunities for deference and equivalency.

In closing, we highlight two pressing issues in the current environment that underscore the critical need for global regulatory coherence: COVID-19 and cybercrime. As economies around the world seek to diversify sources of funding, the need for regulatory coherence is more pressing than ever. Similarly, the U.S. and Japanese governments must take a more active role coordinating closely and leading collaboration with other markets on the rapidly escalating dangers from cybercrime to avoid rule fragmentation and the associated risk it poses to the financial system.

We encourage global regulators to continue working closely with industry and stakeholders to create solutions. The U.S.-Japan Business Council and our members remain actively engaged on this important initiative and look forward to continuing to contribute to work in this area.