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ESSAY

EXTRATERRITORIAL FINANCIAL REGULATION: WHY E.T. CAN'T COME HOME

John C. Coffee, Jr.†

Introduction

This Essay begins with a deliberately off-putting title: extraterritorial financial regulation. Old-time "conflict of laws" scholars would call this an oxymoron, pointing to recent Supreme Court decisions—

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most notably, *Morrison v. National Australia Bank Ltd.*[1] and *Kiobel v. Royal Dutch Petroleum Co.*[2]—that have applied a strong presumption against extraterritoriality to curb the reach of U.S. law. Even those international law scholars who are sympathetic to the regulation of multinational financial institutions might prefer to avoid this term and talk instead of "global financial regulation" because they conceptualize international financial regulation as implemented through networks of cooperating multinational institutions applying broad principles of "soft law" on a consensual basis.[3] Both perspectives, however, miss much, and the unfashionable word—"extraterritorial"—cannot be avoided.[4]

Why not? Four basic reasons will be given: First, major financial institutions are extremely mobile and can easily park their higher-risk operations abroad and beyond the regulatory reach of their home country unless extraterritorial authority is recognized. Second, to regulate systemic risk meaningfully, one must regulate not only domestic financial institutions but often their counterparties as well. This is because major financial institutions are not only "too big to fail" but also "too interconnected to fail." Third, some nations will find it in their interest to profit from regulatory arbitrage by offering underregulated havens—i.e., "financial casinos" in this Essay's terminology.[5] These nations, the financial services industry, and still other nations that are

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1 561 U.S. 247 (2010).

2 133 S. Ct. 1659 (2013).

3 *See* David Zaring, *Finding Legal Principle in Global Financial Regulation*, 52 VA. J. INT'L L. 683, 687 (2012) ("[T]he international [financial] regulatory architecture is one that has been devised by domestic agencies acting through international networks, and can at best be characterized as 'soft'—that is, nonbinding—law."). *See also infra* note 25 and accompanying text. "Soft law" has many definitions, but a key attribute of soft law is that it is generally nonbinding (although there may be costs for noncompliance). For a good overview, see CHRIS BRUMMER, SOFT LAW AND THE GLOBAL FINANCIAL SYSTEM: RULE MAKING IN THE 21ST CENTURY 111–14 (2012).

4 Several authors have recognized that the new emphasis on "soft" law, which is implemented through international cooperation, represents an effort by national regulators to find some remaining means in a globalizing world to assert authority over mobile market participants. *See, e.g.*, Chris Brummer, *Territoriality as a Regulatory Technique: Notes from the Financial Crisis*, 79 U. CIN. L. REV. 499, 501 (2010) (suggesting a "framework for viewing the role of national regulators as sources of international financial law"). Others have argued that the new emphasis on "'mutual recognition' and 'global competition'" is often a rhetoric used to mask an agenda that advances "interest group [politics]" for the benefit of key business constituencies. Steven M. Davidoff, *Rhetoric and Reality: A Historical Perspective on the Regulation of Foreign Private Issuers*, 79 U. CIN. L. REV. 619, 620 (2010). Still others have defended the broad extraterritorial scope of the Dodd-Frank Act as necessary to protect U.S. taxpayers. *See* Michael Greenberger, *The Extraterritorial Provisions of the Dodd-Frank Act Protects U.S. Taxpayers from Worldwide Bailouts*, 80 UMKC L. REV. 965, 985 (2012). Although I share areas of agreement with each of these authors, this Essay will attempt to draw distinctions in the terms of the need for an extraterritorial approach.

5 Even proponents of soft-law rulemaking have recognized that in the case of "systemic risk" regulation, the costs and benefits of regulation fall very differently on different jurisdictions. Thus, Professor Chris Brummer writes:

essentially passive or indifferent will resist strong soft-law standards, preferring to keep soft law aspirational and ineffable. Fourth and finally, the best way to get to adequate soft-law standards may be through the assertion of extraterritorial authority by the major financial nations in order for them to gain the leverage necessary to spur the promulgation of meaningful soft-law standards by international bodies that will otherwise be slow to act in the absence of high consensus. Thus, this assertion of extraterritorial authority can be viewed as an interim stage in the eventual development of meaningful soft-law standards.

In any event, both the United States and the European Union have asserted such extraterritorial authority, particularly with regard to over-the-counter (OTC) derivatives. In the United States, this has been done by explicit congressional directions in the Dodd-Frank Act that override the presumption against extraterritoriality.[6] In so doing,

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> Some countries may, for example, be net exporters of "bad" financial products . . . to foreign investors. In such instances, countries will have few incentives to cooperate and adopt more stringent regulatory standards. Similarly, some smaller, capital-poor countries may have few other means than weak regulations to attract capital. Without a better alternative for attracting financial transactions, they may be incentivized to hope for the best and maintain weaker standards, because they have "nothing to lose" with regard to the rules they adopt.

Chris Brummer, *How International Financial Law Works (and How It Doesn't)*, 99 GEO. L.J. 257, 270 (2011) [hereinafter *How International Financial Law Works*]. This Essay agrees that many nations may prefer to maintain weak regulation (i.e., to tolerate financial casinos) because they have "'nothing to lose.'" *Id.* In general, capital-poor countries tend not to bear the risks of financial contagion and hence have less incentive to cooperate to reduce those risks.

6 In *Morrison v. Nat'l Austl. Bank Ltd.*, the Supreme Court proclaimed that "[w]hen a statute gives no clear indication of an extraterritorial application, it has none." *Morrison*, 130 S. Ct. at 2878. But the Dodd-Frank Act repeatedly indicates that it is to apply extraterritorially. In the case of swaps, Title VII contains an explicit reference to extraterritorial application in section 722(d) of the Dodd-Frank Act. *See infra* notes 51–52 and accompanying text. Moreover, the *Morrison* Court also rejected any need for a "clear statement" rule and agreed that context counts. *Morrison*, 130 S. Ct. at 2883 ("[W]e do not say . . . that the presumption against extraterritoriality is a 'clear statement rule,' if by that is meant a requirement that a statute say 'this law applies abroad.' Assuredly context can be consulted as well." (citations omitted)).

The Dodd-Frank Act also addressed the SEC's authority to sue on an extraterritorial basis for securities fraud. Section 929P(b) of the Dodd-Frank Act added both section 27(b) to the Securities Exchange Act of 1934 and section 22(c) to the Securities Act of 1933 to restore the Second Circuit's former "conduct or effects" test (but only for SEC, not private, actions). *See* Dodd-Frank Wall Street Reform and Consumer Protection (Dodd-Frank) Act, Pub. L. No. 111-203, 124 Stat. 1862–63 (2010) (spelling out these changes). To date, cases have divided on whether section 929P(b) did effectively achieve its purpose. *Compare* SEC v. Gruss, 859 F. Supp. 2d 653, 661 (S.D.N.Y. 2012) (finding that section 929P did restore SEC's jurisdiction to assert Rule 10b-5 extraterritorially), *with* SEC v. A Chi. Convention Ctr., LLC, 961 F. Supp. 2d 905, 908, 916–17 (N.D. Ill. 2013) (finding that section 929P does not necessarily restore the prior Second Circuit case law, without deciding the question). This topic is beyond the scope of this Essay, which examines only substantive financial regulation, not antifraud litigation.

Congress was responding to the challenge posed by the 2008 collapse of American International Group, Inc. (AIG), then the largest insurance company in the United States, whose sudden insolvency in 2008 in the face of margin calls from its counterparties overshadowed even the failure of Lehman Brothers and eventually necessitated a U.S.-governmental bailout of $182.5 billion in loans.[7] Operating in opaque and unregulated OTC derivatives markets, neither AIG nor its counterparties required the other to post margin as collateral for their obligations, even though (i) credit default swaps were inherently long-term obligations that exposed both sides to substantial credit risk, and (ii) much shorter-term trading transactions on exchanges often would have been subject to regulatory requirements that necessitated the posting of collateral. As a result, when AIG's position on the brink of insolvency became evident in 2008, its counterparties belatedly made margin calls that were well beyond AIG's ability to comply. Faced with the threat of a likely worldwide financial contagion if AIG was also forced into bankruptcy, the U.S. government responded by extending credit to AIG and guaranteeing its obligations to its counterparties. To an angry Congress, the lessons of the AIG debacle were multiple: (1) enormous liabilities could be hidden in nontransparent OTC markets; (2) subsidiaries and affiliates of major U.S.-based financial institutions could take on an unacceptable level of risk through offshore activities (as AIG had done through an unregulated UK subsidiary); and (3) major market participants could persist in the unrealistic perception that they were protected against risk because of de facto insurance purchased in this OTC market. In short, even more than the Lehman bankruptcy, the AIG debacle demonstrated the dangers of regulatory arbitrage and the need for controls on systemic risk.

Congress also recognized that large financial institutions would likely again pursue regulatory arbitrage (once the dust settled) and that international standards curbing systemic risk were largely lacking. Worse yet, meaningful reform on the international level faced interminable delays before a sufficient international consensus could be reached. Like the Holy Grail, international consensus is more sought than discovered, and the quest might continue indefinitely. Knowing

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7 For a good overview of this bailout, see William K. Sjostrom, Jr., *The AIG Bailout*, 66 Wash. & Lee L. Rev. 943, 945 (2009). For contemporary accounts of the federal government's intervention at AIG, which occurred just three days after Lehman's bankruptcy, see Andrew Ross Sorkin, *Bids to Halt Financial Crisis Reshape Landscape of Wall St.*, N.Y. Times, Sept. 15, 2008, at A1; Eric Dash & Andrew Ross Sorkin, *Throwing a Lifeline to a Troubled Giant: Fed's Bailout of A.I.G. Came After Frantic Search for Rescuer*, N.Y. Times, Sept. 18, 2008, at C1. For the $185 billion figure, see Joe Nocera, *Hearings That Aren't Just Theater*, N.Y. Times, July 3, 2010, at B1.

all this, Congress opted for an extraterritorial reach for much of the Dodd-Frank Act.[8]

In a much quieter fashion, the EU has reached a similar recognition and has also asserted extraterritorial authority. Here, a major irony surfaces: although the United States has received considerable criticism for its expressly extraterritorial approach, the EU has adopted a nearly equivalent position with regard to OTC derivatives, with almost identical language.[9]

This assessment does not deny that the assertion of extraterritorial authority will produce friction. Such friction was abundantly evident in recent negotiations between the United States and the EU over the implementation of the Dodd-Frank Act's reforms, particularly with respect to cross-border swaps. On the U.S. side, fear was expressed that, absent broad extraterritorial coverage, major financial institutions could simply park their higher-risk operations outside the United States and thereby effectively escape the principal reforms intended by the Dodd-Frank Act.[10] On the European side, there was

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8 *See* Greenberger, *supra* note 4, at 968–69.

9 Although U.S. banking lobbyists and other critics of U.S. policy regularly portray U.S. financial regulators as uniquely and arrogantly applying our law extraterritorially, the EU has actually done much the same over the same time period. The basic EU legal regime for cross-border swaps trading is set forth in the European Market Infrastructure Regulation (EMIR), which was adopted in 2012 and is further discussed *infra* at note 80. Much like Dodd-Frank, EMIR will also regulate trades between non-EU entities when such trading has a "'direct, substantial and foreseeable effect' within the EU or where to do so is necessary to guard against anti-evasion." Barnabas W.B. Reynolds et al., *United States: Actions Required Under Derivative Reforms*, MONDAQ (Aug. 6, 2013), http://www.mondaq.com/unitedstates/x/256316/Commodities+Derivatives+Stock+Exchanges/Actions+Required+Under+Derivatives+Reforms. This language largely parallels the language in section 722(d) of the Dodd-Frank Act. *See infra* note 52 and accompanying text. For a detailed and somewhat critical review of EMIR and related initiatives, see Guido Ferrarini & Paolo Saguato, *Reforming Securities and Derivatives Trading in the EU: From EMIR to MIFIR*, 13 J. CORP. L. STUD. 319, 357–59 (2013).

The European Securities and Markets Authority (ESMA), the European securities regulator, published a consultation paper on July 17, 2013, indicating the standards that it would use to prevent the evasion of EMIR by non-EU counterparties, which paper again parallels the issuance of similar interpretive guidance by the CFTC and the SEC. EUROPEAN SECURITIES AND MARKETS AUTHORITY, CONSULTATION PAPER: DRAFT REGULATORY TECHNICAL STANDARDS ON CONTRACTS HAVING A DIRECT, SUBSTANTIAL AND FORESEEABLE EFFECT WITHIN THE UNION AND NON-EVASION OF PROVISIONS OF EMIR (2013), *available at* http://www.esma.europa.eu/bg/system/files/2013-892_draft_rts_of_emir.pdf. ESMA's paper was open to comment and consultation until September 16, 2013.

Still, the key point here is that the EU and the United States are following very similar, parallel courses of actions, both looking to the impact of extraterritorial trading on their own jurisdiction and the potential for evasion. *See infra* note 80 and accompanying text.

10 At the open meeting of the CFTC on July 12, 2013, at which the "cross border final guidance" was approved, CFTC Chairman Gary Gensler emphasized in his initial statement the danger that large U.S. financial institutions could and did trade through offshore subsidiaries and affiliates, particularly ones organized in unregulated jurisdictions, such as the Cayman Islands. Specifically, he stressed in this statement that: (1) "the U.S.'s largest banks each have somewhere between 2,000 and 3,000 legal entities around the globe";

equivalent concern that the U.S. approach ignored national sovereignty and represented an alleged return to a prior tradition of U.S. imperialism under which the United States assumed that its preferred financial practices could be mandated for the rest of the world.[11]

Nonetheless, compromises were reached—imperfect and provisional though they were. Throughout this bruising and hard-nosed negotiation process, the major international networking institutions—the IMF, the World Bank, the Basel Committee, IOSCO, and the Financial Stability Board[12]—remained largely on the sidelines, with the real bargaining being between U.S. regulators and an EU commissioner.[13] That bargaining centered on a new concept that is still unique to this financial regulatory context: "substituted compliance."[14] Under it, the critical question becomes whether U.S. law and the host country's law are "functionally equivalent."[15] If they are, U.S.-based entities, acting extraterritorially, are deemed to comply with U.S. law by complying instead with the host country's law. Such an

(2) some U.S. banks "have hundreds of legal entities just in the Cayman Islands alone"; (3) "Lehman Brothers had [its] 3,300 legal entities"; (4) Citigroup's "structured investment vehicles . . . were set up in the Cayman Islands[ ] [and] run out of London;" and (5) Bear Stearns' "sinking hedge funds . . . were organized in the jurisdiction of the Cayman Islands." Statement of Chairman Gary Gensler, 78 Fed. Reg. 45,292, 45,371 (July 26, 2013).

11 By 2012, some in the financial press were asserting that "[t]he United States is coming to be seen as a global threat, acting unilaterally with aggressive new market rules . . . . [with] [t]he new buzzword . . . [being] 'extraterritoriality', or ET." Huw Jones, *ET, the New Alien Scaring Global Markets*, REUTERS, Feb. 5, 2012, *available at* http://www.reuters.com/article/2012/02/05/us-financial-regulation-et-idUSTRE8140DV20120205. As late as September 2013, the European press was continuing to warn that CFTC "imperialism" was threatening a global deal. Tom Braithwaite et al., *U.S. Rules "Endanger" Derivatives Reforms: CFTC 'Imperialism' Threatens Global Deal*, FIN. TIMES, Sept. 27, 2013, at 1. Some respected U.S. commentators have agreed with this assessment that the CFTC has overreached. *See* Edward F. Greene & Ilona Potiha, *Issues in the Extraterritorial Application of Dodd-Frank's Derivatives and Clearing Rules, the Impact on Global Markets and the Inevitability of Cross-Border and US Domestic Coordination*, 8 CAPITAL MARKETS L.J. 338 (2013) [hereinafter *Issues in the Extraterritorial Application of Dodd-Frank*]. I agree as to the need in particular for U.S. and European coordination but believes that the concept of "substituted compliance" is too empty of substantive content to be the guiding light for that process.

12 For a recent overview of these transnational bodies, see Stavros Gadinis, *The Financial Stability Board: The New Politics of International Financial Regulation*, 48 TEX. INT'L L.J. 157, 158–61 (2013).

13 Commissioner Michel Barnier, the European Commissioner for Internal Markets and Services, was the point person negotiating with the CFTC on behalf of Europe. *See* Press Release, CFTC, The European Commission and the CFTC Reach a Common Path Forward on Derivatives (July 11, 2013), *available at* http://www.cftc.gov/PressRoom/PressReleases/pr6640-13.

14 For articles introducing and advocating this concept, see Ethiopis Tafara & Robert J. Peterson, *A Blueprint for Cross-Border Access to U.S. Investors: A New International Framework*, 48 HARV. INT'L L.J. 31 (2007); Edward F. Greene & Ilona Potiha, *Examining the Extraterritorial Reach of Dodd-Frank's Volcker Rule and Margin Rules for Uncleared Swaps—A Call for Regulatory Coordination and Cooperation*, 7 CAPITAL MARKETS L.J. 271 (2012) [hereinafter *Examining the Extraterritorial Reach of Dodd-Frank's Volcker Rule*]; see also *Issues in the Extraterritorial Application of Dodd-Frank*, *supra* note 11.

15 *See Issues in the Extraterritorial Application of Dodd-Frank*, *supra* note 11, at 338.

approach still involves an assertion of extraterritorial authority (as U.S. law would preempt the host country's law if the two bodies of law were not deemed functionally equivalent), but it is far more palatable and has been enthusiastically supported in Europe and elsewhere. Still, its growing acceptance necessarily leads to further questions: What are the costs of substituted compliance? Despite the eager, even euphoric, acceptance of substituted compliance within the financial services community and abroad, this Essay will assert that the concept has not yet received the critical scrutiny it needs. Sometimes, its costs may outweigh its benefits.

Equally importantly, the attitude of U.S. financial regulators toward substituted compliance has been almost schizophrenic. Unlike securities and derivatives regulators, banking regulators have largely ignored or disdained substituted compliance, preferring to rely on a more traditional territorial approach.[16] This disparity also needs justification.

Beyond this initial question of the costs and benefits associated with substituted compliance, the broader issue that this Essay addresses is how successful international collaboration among nations on financial regulation can best be achieved. Unquestionably, such collaboration is needed, and an "imperialistic" approach by the United States would be resisted. For some time, the consensus among students of international relations was to rely on soft law with respect to issues of financial regulation—that is, broad, noncompulsory, and sometimes aspirational, principles that are announced by international bodies, such as the International Monetary Fund or the World Bank. But the 2008 financial crisis required quicker and more forceful action than the processes of soft law can achieve.

Today, there is an alternative: "minilateralism."[17] As opposed to "multilateralism," minilateralism asks what is the smallest number of nations needed to reach a workable solution to a specific problem. While a multilateral agreement may take a decade or more to negotiate (if the process is successful),[18] a "minilateral" solution can come

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16 See *infra* notes 115–20 and accompanying text (discussing the Volcker Rule). For a good summary of the Federal Reserve's case for a more aggressively extraterritorial approach toward foreign banks and foreign branches of U.S. banks, see Daniel K. Tarullo, Governor, Fed. Reserve Sys., Regulating Large Foreign Banking Organizations, Speech at the Harvard Law School Symposium on Building the Financial System of the Twenty-First Century: An Agenda for Europe and the United States (Mar. 27, 2014), *available at* http://federalreserve.gov/newsevents/speech/tarullo20140327a.htm.

17 This term was coined by Moisés Naím, the longtime editor of *Foreign Policy*. *See* Moisés Naím, *Minilateralism: The Magic Number to Get Real International Action*, FOREIGN POLICY (June 22, 2009), http://www.foreignpolicy.com/articles/2009/06/18/minilateralism.

18 Moisés Naím notes, for example, that the "last successful multilateral trade agreement dates back to 1994" and that the "last significant international nonproliferation agreement was in 1995." *Id.*

much quicker through bilateral or limited multilateral negotiation. This Essay will assert the superiority of a "minilateral" approach to issues of financial regulation. In its view, soft-law processes will not work when the financial services industry wishes to resist reform and when other nations benefit from regulatory arbitrage. Thus, the recent cross-border swaps drama will likely play out again—sometimes with different participants, sometimes with different results, but usually with the same clash of interests.

This preference for a "minilateral" approach and the retention of a measure of extraterritorial financial regulation rests in part on skepticism about the slow pace and imprecise generalities of soft law, which rarely will confine a determined financial services industry. Even more, it rests on the fact that only the major financial nations have the right incentives to control systemic risk.[19] The major financial nations—mainly the United States and Europe—suffered from the 2008 crisis, while other nations with less developed financial infrastructures largely escaped damage.[20] This distinction is relevant because those countries most injured in the 2008 contagion should be more motivated to prevent a repetition, while those that escaped injury may be more interested in profiting from regulatory arbitrage. To be sure, the proponents of soft law may insist that the United States can no longer rule the world, and some of them will add that even if Dodd-Frank gives U.S. regulators authority to regulate on an extraterritorial basis, the United States cannot effectively exercise that authority in the face of unified international opposition.[21] To some extent, this is true. Aggressive U.S. attempts at extraterritorial regulation have failed in the past (most notably in the antitrust context).[22]

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19 *See How International Financial Law Works*, *supra* note 5 at 309 ("[W]ealthier developed countries generally have more at stake in complex financial rule making.").

20 *See* Bruno Wenn, "*Exceedingly High Interest Rates*," DANDC.EU (Jan. 25, 2013), *http://www.dandc.eu/en/article/european-bank-regulators-would-do-well-learn-their-latin-american-counterparts* (noting that "developing countries and emerging countries [fared] surprisingly well in the [2008 financial] crisis").

21 *See, e.g.*, *Issues in the Extraterritorial Application of Dodd-Frank*, *supra* note 11, at 341–42 (explaining how the approach of the CFTC in Dodd-Frank, which was "initially perceived to be aggressive . . . led to the unusual development of countries and foreign regulators commenting publicly and critically to U.S. agencies," forcing the CFTC to respond with "updated approaches").

22 Several decades ago, the extraterritorial application of the Sherman Act (principally through private antitrust litigation) led to the passage of blocking laws and "clawback" legislation in Europe and elsewhere, which legislation was intended to nullify the extraterritorial application of U.S. antitrust law. *See, e.g.*, John H. Chung, *The International Antitrust Enforcement Assistance Act of 1994 and the Maelstrom Surrounding the Extraterritorial Application of the Sherman Act*, 69 TEMP. L. REV. 371 (1996) (summarizing the development of Sherman Act jurisdictional issues in U.S courts and critical responses); P.C.F. Pettit & C.J.D. Styles, *The International Response to the Extraterritorial Application of United States Antitrust Laws*, 37 BUS. L. 697 (1982) (surveying such legislation). *Cf. In re* Uranium Antitrust Litig., 473 F. Supp. 382, 385 (N.D. Ill. 1979) (noting that nine foreign defendants failed to

Still, the United States is not likely to attempt to ride roughshod over the rest of the world. Instead, it appears increasingly likely that a compromise will be reached through the interpretation of the new doctrine of substituted compliance. Substituted compliance remains, however, a new and elusive concept whose proper application lies largely in the eye of the beholder. At worst, it could enable the financial services industry to achieve an effective end run around the Dodd-Frank Act's requirements. Conversely, as will be seen, the Federal Reserve Board has largely disdained the concept, and the newly adopted Volcker Rule takes no note of it, relying instead on traditional territorial concepts by which to divide regulatory authority.[23]

Against this unsettled backdrop, this Essay will advance two contentions: First, for substituted compliance to work, the ground rules on what is allowable must be set by those nations with the right incentives—namely, those that are truly exposed to systemic risk. Second, because they do have the right incentives, the United States and the EU need to be proactive in opening such a "minilateral" dialogue to define what should constitute sufficient functional equivalence to satisfy "substantial compliance." Procedurally, they should first agree and then approach other major players to sign onto their standards, rather than await a global consensus and universal harmonization. Why? Economically, the United States and the EU have the best incentives for controlling systemic risk because they will likely bear the lion's share of the costs from a financial contagion (and thus they will invest more in controls to avoid one). Other nations can largely avoid those costs. As a result, if the world must wait for all nations to converge on a single, universal standard, the likely end product will be delayed, weaker, and easier to evade.[24]

The foregoing arguments for a minilateral approach that stresses bilateral negotiations and binding law rest on an economic foundation that needs to be stated at the outset. Somewhat naively, the proponents of soft law have tended to view financial regulation as simpler than other forms of international regulation and as presenting mere

appear, answer, or plead to the antitrust complaint). That episode involved, however, a more extreme clash between the substantive policies of the United States and its principal allies than anything posed by existing differences in derivatives regulation.

23 *See infra* notes 115–20 and accompanying text.

24 To this point, the United States has avoided placing the topic of financial regulation reform on the table for international negotiation, in particular by refusing to include it on the agenda for currently ongoing international trade talks. The *Financial Times* reports that the United States has resisted "including a framework for financial regulatory convergence in the talks" because of a concern that "the talks could be used by banks to circumvent tough rules stemming from the 2010 Dodd-Frank law, and as a way for Europeans to delay their own reforms." *See* James Politi & Alex Barker, *White House Set for Wall Street Clash Over Trade Talks*, FIN. TIMES, July 8, 2013, at 1.

coordination problems.[25] This overlooks the very strong incentives for regulatory arbitrage. Financial regulation has distributional consequences, and different legal rules create different winners and losers. Moreover, because nonbinding soft law is unenforceable, it is easier for an adversely affected nation to defect and ignore its prior commitments.[26] As a result, to insist that soft law be kind and gentle or give each nation an equal voice is to state rules that ensure financial regulation will be ineffective.

Ultimately, systemic risk presents a classic "public goods" problem.[27] All nations want systemic stability, but most would prefer that others pay the cost of maintaining it. Unless compelled, many nations would rather "free ride," looking to the United States and the EU in the event of a financial contagion to fund the costs of a global bailout to forestall a global depression. Clearly, a financial contagion anywhere in the world could spread across borders and affect all major markets. But not all nations need to internalize the costs of a systemic risk crisis, as its impact is uneven.[28] In addition, a nation that persists

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25 International law scholars have conceptualized international financial law as presenting simply a coordination problem because they assume that national financial regulators share the same purposes and premises. *See* Anne-Marie Slaughter & David Zaring, *Networking Goes International: An Update*, 2 ANN. REV. L. SOC. SCI. 211, 217–20 (2006). Similarly minded academics often make the assumption that international financial law is an area of "'low politics.'" Kal Raustiala, *The Architecture of International Cooperation: Transgovernmental Networks and the Future of International Law,* 43 VA. J. INT'L L. 1, 5, 28–29 (2002). But once we recognize that international financial law has distributive consequences, these premises become untenable. For a critique of these views, see *How International Financial Law Works*, *supra* note 5, at 260–61. *See also infra* notes 141–43 and accompanying text.

26 *See How International Financial Law Works*, *supra* note 5, at 271 (noting that "soft law should provide little utility as a means of making credible commitments" because nations will defect from informal commitments when it is in their interest to do so).

27 For an overview of the economics of public goods, see William H. Oakland, *Theory of Public Goods*, *in* 2 A HANDBOOK OF PUBLIC ECONOMICS 485, 485–99, 502–22 (Alan J. Auerbach & Martin Feldstein eds., 1987); see also MANCUR OLSON, THE LOGIC OF COLLECTIVE ACTION: PUBLIC GOODS AND THE THEORY OF GROUPS 14 (1971). By definition, public goods share at least two characteristics: (1) they are "nonexcludable," meaning that producers cannot provide their benefits to one consumer without providing it to others, and (2) consumption by one consumer does not reduce the supply available for others. The classic textbook example of a public good is the lighthouse: no one can be excluded from using it, and use by one does not affect the supply for others. Because those who enjoy public goods do not necessarily pay for them, public goods cannot be easily financed by the private market, as "free riders" can escape payment. To finance public goods, these free riders must be taxed. *Cf. id.* at 14–15. In our context, protection against systemic risk benefits all (to varying degrees), but the costs do not fall equally or proportionally and are avoided by the free riders.

28 Smaller nations without large financial institutions based in them have less to fear from financial contagion. Even some major nations—Australia, Canada, Brazil, Japan—suffered much less from the 2008–2009 financial contagion than did the United States and the EU. *See, e.g.*, Chris Zappone, *Australia Dodges Recession*, SYDNEY MORNING HERALD (June 3, 2009), www.smh.com.au/business/australia-dodges-recession-20090603-buyq.html. *Cf.* Bulent Gokay, *The 2008 World Economic Crisis: Global Shifts and Faultlines*, GLOBAL RESEARCH (Feb. 15, 2009), http://www.globalresearch.ca/the-2008-world-economic-crisis-global-

with laxer, more permissive rules may be able to attract business and profit as a result of the regulatory arbitrage that predictably would follow.[29] Given this asymmetry (i.e., some nations can profit from lax regulation without necessarily having to face high costs from a financial contagion), resistance can be anticipated to rules that heighten global standards to guard against systemic risk. Because any nation—developed or undeveloped—can potentially offer its jurisdiction as a forum for unregulated (or laxly regulated) trading, we can expect that underregulated markets will persist.

A key assertion of this Essay is that, under these circumstances, all the preconditions necessary for a "tragedy of the commons" are present.[30] In particular, because (1) other nations cannot be excluded from offering "financial casinos" to those desiring to trade on them, and (2) many nations do not have to internalize the costs they impose on others, some nations will behave as "free riders," preferring that others bear the costs and encouraging regulatory arbitrage when it benefits them. All this is predictable from the "tragedy of the commons" perspective, which has long been the basic paradigm by which environmental law scholars explained the depletion of natural resources.[31] More recently, legal scholars have extended this perspective to explain problems with public infrastructure (such as communication, transportation, and healthcare systems).[32] A few pioneers have even noted its applicability to financial markets.[33] Still, be-

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shifts-and-faultlines/12283 (comparing the effects of the 2008 financial crisis on different economies). In this light, CFTC Chairman Gensler's repeated focus on the Cayman Islands at least identifies a legitimate problem (even if it is unlikely that trading in OTC derivatives would migrate there). *See supra* note 10.

29 For the similar view of Professor Brummer, see *How International Financial Law Works*, *supra* note 5, at 267.

30 The tragedy of the commons is a standard law and economics problem which arises when (i) it is impossible to exclude actors from using a resource or engaging in an activity (nonexcludability), and (ii) some actors do not have to internalize the costs they impose on others. *See* Garrett Hardin, *The Tragedy of the Commons*, 162 SCIENCE 1243, 1244–45 (1968). Normally, the result of such a "tragedy" is overuse of a common resource (such as overgrazed fields, depleted fisheries, or polluted air). Here, an inability to exclude U.S.-based entities from trading in foreign markets produces a related result: risky activities increase until a financial disaster strikes. Substituted compliance can in this light be viewed as a means of excluding U.S.-based entities from a dangerous activity that is made possible because other nations do not internalize its foreseeable costs.

31 *See, e.g.*, Elinor Ostrom, GOVERNING THE COMMONS: THE EVOLUTION OF INSTITUTIONS FOR COLLECTIVE ACTION 144–57, 173–79 (1990) (examining fisheries and other natural resources).

32 *See* Carol M. Rose, *Big Roads, Big Rights: Varieties of Public Infrastructure and Their Impact on Environmental Resources*, 50 ARIZ. L. REV. 409, 413 (2008) (applying this perspective to transportation infrastructure); Brett M. Frischmann & Mark A. Lemley, *Spillovers*, 107 COLUM. L. REV. 257, 272–73, 281–82, 293–98 (2007) (applying this perspective to IP (or "innovation") and communications infrastructure, respectively).

33 *See* Steven L. Schwarcz, *Protecting Financial Markets: Lessons from the Subprime Mortgage Meltdown*, 93 MINN. L. REV. 373, 386 (2008); Kristin N. Johnson, *Things Fall Apart: Regulat-*

cause the critical economic precondition to a "tragedy of the commons" is nonexcludability, this perspective applies with the greatest force to financial markets when we move to the international context. To be sure, the participants who trade on any single market (say, the New York Stock Exchange) can exclude those among them who do not play by their rules. Governance structures (administrative agencies, such as the SEC, or liability rules) can also be devised by any single country to prevent a "tragedy of the commons" so long as they focus only on domestic activities and transactions. But once traders and other market participants can flee to a foreign jurisdiction, then (and only then) the precondition of nonexcludability is satisfied.

Once we accept the relevance of the "tragedy of the commons" perspective, a major implication is that, unless binding law can be generated, the major financial nations that most bear the costs of systemic risk will be frustrated and disarmed because they cannot bar trading outside their borders. Conversely, if the leading nations can agree on common standards, they can then effectively deal with the free riders by simply denying their own financial institutions the ability to trade in markets that do not comply with their standards. Bluntly put, the United States and the EU together have the market power to achieve this result.

One need not accept every step in this reasoning to reach the same bottom line. Assume instead that, without trying to lead a race to the bottom in regulation, some nations may simply tolerate loosely regulated markets to function within their jurisdiction,[34] either out of indifference or because they assume that the major nations would bail everyone out in the event of a financial contagion (as more or less happened in 2008). These less-regulated jurisdictions are essentially free riders, who are expecting (perhaps shrewdly) other nations to bear the costs (including the costs of massive bailouts) of preserving economic stability from systemic risk. These free riders may be aided and abetted in their resistance (or at least indifference) to the need for stronger regulation by precisely those large financial institutions that most want to escape stronger regulation. In a globalized world, market participants are extremely mobile and can escape confining regulation so long as they can delay the major financial nations from acting. Rhetorically, those opposed to financial reform can unite around a favorite defensive rallying cry, which is that international regulation must not precede consensus.

ing the Credit Default Swap Commons, 82 U. COLO. L. REV. 167, 174 (2011) (arguing throughout that "'commons' literature offers guidance for developing a governance model that better reflects normative expectations regarding the rights and responsibilities [in the] financial market system").

34 *See How International Financial Law Works*, *supra* note 5, at 267.

As with other public-goods problems, public policy needs to find a way to tax the free riders, which here include those nations willing to tolerate unregulated financial markets. This Essay will consider means to this end but will basically suggest that the major financial nations have to bar their own financial institutions (and their offshore affiliates) from trading in those foreign markets that lack adequate regulation in order to protect themselves from a systemic-risk crisis. That prescription is at odds with the sovereignty-respecting or consensus-demanding perspectives of many international law scholars.[35] Translated back into the language of international law, this prescription insists both that noncompulsory soft law is not sufficient and that the broad, aspirational general principles that international networks can develop will only allow mobile market participants to continue business as usual. Instead, harder bargaining in minilateral negotiations is needed, and only the nations that will bear the ultimate costs of contagion have the incentives to get the rules right.

Realism counsels, however, that the United States cannot unilaterally impose its policy preferences on the rest of the world. It needs therefore to be selective. When is it most necessary for it to assert itself on an extraterritorial basis? This Essay focuses on the public-goods perspective because it can supply an answer. That is, it can provide a rationale for a more aggressive approach to extraterritorial financial regulation that applies to some cases but not all. Line drawing is necessary, but it should be based on principles, and this perspective generates principled distinctions.

This Essay will focus on two very different examples of international financial regulation that each seek to curb systemic risk but otherwise contrast sharply. It will begin by surveying the recent controversy over the efforts of the Commodities Futures Trading Commission (CFTC) and the Securities and Exchange Commission (SEC) to regulate cross-border swaps trading on an extraterritorial basis. Then, it will turn to the even more controversial Volcker Rule, which bars major financial institutions (both domestic institutions and foreign ones that have a branch in the United States) from engaging in proprietary trading or owning or sponsoring a hedge fund.[36]

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35 *See, e.g.*, Raustiala, *supra* note 25, at 3 (noting that one side of the debate "asserts that . . . the state is not declining in power or importance" and government actors are "increasingly networking with their counterparts abroad").

36 The final regulations implementing the Volcker Rule were jointly issued by the Federal Reserve, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, the Securities and Exchange Commission, and the Commodity Futures Trading Commission on December 10, 2013. They became effective on April 1, 2014—subject to a conformance period ending on July 21, 2015. *See* SEC Release No. BHCA-1; File No. S7-41-11, RIN 3235-AL07 (Dec. 10, 2013) ("Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds"), 79 Fed. Reg. 5536 (Jan. 31, 2014).

These two examples were chosen because they differ in significant ways. The SEC's and CFTC's efforts at regulating swaps and other over-the-counter derivatives grew out of a G-20 summit where international consensus was achieved as to the need for such regulation.[37] In contrast, the Volcker Rule is a uniquely American innovation without any parallel rule in other major financial nations. Whether for this or other reasons, the two rules have very different extraterritorial reaches and are likely to produce very different costs and benefits.

I
The Cross-Border Swaps Dilemma

A. The OTC Derivatives Market

If the 2008 financial crisis carried any message about the necessary shape of financial reform, it was that the over-the-counter derivatives market posed special risks to global financial stability. First, the outstanding notional amount of these OTC derivatives contracts, exceeding $700 trillion as of 2011, dwarfed even the bond market.[38] Second, while all securities and derivatives carry market risk, OTC derivatives are uniquely also subject to counterparty risk: namely, the danger that a pivotal counterparty may be unable to make good on its promised performance (which was, of course, the AIG experience).[39] Third, because of the bilateral nature of these privately negotiated contracts, they are inherently opaque as to pricing, volume, and the identity of the parties involved; thus, they carry a greater risk of unforeseen financial contagion.[40] Finally, unlike exchange-traded derivatives, which are highly standardized and subject to initial- and variation-margin requirements, the collateralization of OTC derivatives is determined by individual negotiation.[41] In a competitive market, swap dealers may compete (wisely or unwisely) by reducing the margin that they require from their counterparties. Particularly during a bubble, too little margin may be required to generate an adequate safety net in later times of market stress.

All this was clear to the U.S. Congress, which by 2010 (the year of the Dodd-Frank Act) knew three things very well: (1) AIG's failure had been precipitated by margin calls from its counterparties that

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37 *See Examining the Extraterritorial Reach of Dodd–Frank's Volcker Rule*, *supra* note 14, at 271–72 & n.2.

38 For this estimate, see Jan D. Luettringhaus, *Regulating Over-the-Counter Derivatives in the European Union – Transatlantic (Dis)Harmony After EMIR and Dodd-Frank: The Impact on (Re)Insurance Companies and Occupational Pension Funds*, 18 Colum. J. Eur. L. Online 19, 20 (2012). This figure reduces, however, to $20 trillion if all such contracts were settled and closed out simultaneously. *Id.*

39 *See id.* at 20–21.

40 *See id.* at 20, 25.

41 *See id.* at 20.

could not be satisfied;[42] (2) AIG's collapse had necessitated a $182 billion bailout borne by the American taxpayer;[43] and (3) AIG's credit default swaps had been written by a foreign subsidiary (based in the U.K.) that was effectively unregulated.[44] From the outset, this AIG experience inclined the U.S. Congress toward an extraterritorial approach; Congress did not want to be burnt twice by foreign affiliates of U.S. financial institutions entering into imprudent and unregulated OTC transactions.

The G-20 leaders recognized the need to address OTC derivatives as a special priority at their 2009 summit in Pittsburgh, where they agreed to impose clearing, reporting, and risk-mitigation requirements on OTC derivative transactions.[45] The use of clearinghouses implied standardized margin levels for exchange-traded derivatives (and thus the effective elimination of counterparty risk), but specially tailored OTC derivatives are too individualized to be capable of trading on exchanges or clearing through clearinghouses. For these transactions, risk-mitigation rules (including margin levels) would have to be specified.

This was not a minor problem for at least two reasons: First, banks and other major swap dealers had profited handsomely from trading derivatives on an over-the-counter basis because such trading is opaque and hence less subject to competitive pressure.[46] Swap dealers have incentives to resist efforts to enhance transparency by converting specialized contracts into more standardized contracts that could trade openly on exchanges. Put simply, transparency implies increased competition, which would in turn erode away the economic rents that swap dealers earned on privately negotiated transactions. Second, the OTC derivatives market, centered in London, is highly international in character. By some estimates, 55–75 percent of the total derivatives exposure of U.S. banks was to foreign entities.[47] Indeed, in the extreme case of credit default swaps (CDSs), only approximately 7 percent of U.S. single-name CDS transactions in 2011 were

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42 *See* Sjostrom, *supra* note 7, at 961–62.

43 *See* Greenberger, *supra* note 4, at 976.

44 *See id.* at 976–77.

45 The G-20 nations convened their Pittsburgh Summit in September 2009 to address the 2008 financial crisis. Their Pittsburgh Summit Preamble called for "'enhanced and expanded . . . scope of regulation and oversight, with tougher regulation of over-the-counter (OTC) derivatives, securitization markets, credit rating agencies, and hedge funds.'" *Examining the Extraterritorial Reach of Dodd-Frank's Volcker Rule*, *supra* note 14, at 272 n.2 (quoting Leaders' Statement: The Pittsburgh Summit (Sept. 24–25, 2009), *available at* http://www.treasury.gov/resource-center/international/g7-g20/documents/pittsburgh_summit_leaders_statement_250909.pdf).

46 *See* FINANCIAL CRISIS INQUIRY COMM'N, THE FINANCIAL CRISIS INQUIRY REPORT 45–51 (2011) (detailing the relationship between the rising profitability of the OTC derivatives market and its lack of transparency).

47 *See* Luettringhaus, *supra* note 38, at 26 & n.57.

between two U.S.-domiciled counterparties, with the rest involving a foreign counterparty.[48] Thus, as the SEC recently noted, "cross-border transactions are the norm, not the exception."[49]

Next, regulatory reform had to address the problem of geographic uncertainty. Because OTC derivatives are not traded on exchanges, they do not have any clear-cut geographic location. Swap transactions can be between participants in two different countries, booked in a third country, and risk-managed in a fourth country. Hence, swap transactions do not need to be based in the United States and could easily be moved offshore—if such a migration would allow the swap dealer to escape regulation. Thus, the incentive to engage in regulatory arbitrage is uniquely high, and an angry Congress decided in the Dodd-Frank Act to respond by deeming U.S. law to apply if a U.S. entity was involved.[50]

B. The Congressional Response

Given this background, Title VII of the Dodd-Frank Act, which focuses on the derivatives markets, adopted several provisions aimed at foreign entities that have seldom, if ever, been seen before in U.S. financial regulation. For example, section 715 ("Authority to Prohibit Participation in Swap Activities") provides that, with certain exceptions,

> if the Commodity Futures Trading Commission or the Securities and Exchange Commission determines that the regulation of swaps or security-based swaps markets in a foreign country undermines the stability of the United States financial system, either Commission, in consultation with the Secretary of the Treasury, may prohibit an entity domiciled in the foreign county from participating in the United States in any swap or security-based swap activities.[51]

Effectively, this was a shot across the bow for other nations, and its message was blunt: mess with the United States and your financial institutions (and others) will be barred from our swaps markets!

Similarly, section 722(d) of the Dodd-Frank Act broadly amended the Commodity Exchange Act (CEA) to provide that the new Dodd-Frank Act provisions do not apply extraterritorially

> unless [swap] activities—

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48 *See* Exchange Act Release No. 34-69490 ("Cross-Border Security-Based Swap Activities; Re-Proposal of Regulation SBSR and Certain Rules and Forms Relating to the Registration of Security-Based Swap Dealers and Major Security-Based Swap Participants"), 78 Fed. Reg. 30,968, 30,976 (May 23, 2013) [hereinafter SEC Cross-Border Swaps Proposal].

49 *Id.*

50 Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) § 722(d), 7 U.S.C. § 2(i) (2012).

51 15 U.S.C. § 8304 (2012). Section 715 does contain an exception if certain findings are made under section 4 of the Commodity Exchange Act, 7 U.S.C. § 6. *Id.*

(1) have a direct and significant connection with activities in, or effect on, commerce of the United States; or
(2) contravene such rules or regulations as the Commission may prescribe or promulgate as are necessary or appropriate to prevent the evasion of any provision of this Act that was enacted by the Wall Street Transparency and Accountability Act of 2010.[52]

This statutory language represents an extreme case of the exception swallowing the rule: the Dodd-Frank Act does not apply extraterritorially, except to activities that are "significant" or "evasive." Add to this the Act's extremely broad definitions of "swap dealer" and "major swap participant," which ignore the domicile of the entities and focus instead on the size of the positions they hold, the potential exposure they create, and their degree of leverage,[53] and it becomes clear from the outset that Title VII would sweep very broadly beyond the United States. Yet, although it has received much less attention, the E.U.'s recent key trading regulation, the European Market Infrastructure Regulation (EMIR), has an equally broad sweep and uses virtually the same tests.[54]

Structurally, Title VII of Dodd-Frank sought to reduce systemic risk through a variety of strategies. First, Title VII repealed parts of the Commodities Futures Modernization Act of 2000, which had deregulated the OTC derivatives market.[55] Title VII then divided the field so as to give the CFTC jurisdiction over swaps and the SEC jurisdiction over the much smaller world of "security-based swaps."[56] Organizationally, Title VII mandated two types of rules: (1) entity-level rules (which, for example, require registration of "swap dealers" and "major swap participants") and (2) transaction-based rules, which regulate individual swap transactions (including through rules regulating capital, margin, risk management, clearing, and trading).[57] Our focus will be on these latter rules that attempt to prevent another AIG-style debacle by specifying mandatory risk-mitigation strategies for OTC derivatives markets. In that light, two provisions stand out. First, section 2(h)(1) of the CEA now requires a swap to be submitted to a clearing-

52 Pub. L. No. 111-203, 124 Stat. 1673 (2010). Section 722(d) ("Applicability") of the Dodd-Frank Act is now set forth as section 2(i) of the Commodity Exchange Act, 7 U.S.C. § 2(i). *Id.*

53 *See* Dodd-Frank Act § 721(a)(21), (16), 7 U.S.C. § 1a(49), (33) (2012).

54 *See supra* note 9 and accompanying text.

55 *See, e.g.*, Dodd-Frank Act § 725(g)(1)(A) (repealing the Commodities and Futures Modernization Act of 2000 § 407, 7 U.S.C. § 27(e)).

56 *Compare* Dodd-Frank Act § 712(a)(1), (b)(1), 15 U.S.C. § 8302(a)(1), (b)(1) (authorizing the CFTC to regulate swaps and precluding CFTC jurisdiction over security-based swaps, respectively), *with* § 712(a)(2), (b)(2), 15 U.S.C. § 8302(a)(2), (b)(2) (authorizing the SEC to regulate security-based swaps and precluding SEC jurisdiction over swaps, respectively). The SEC and CFTC jointly regulate a third hybrid category known as "mixed swaps." *See* § 712(a)(8), 15 U.S.C. § 8302(a)(8).

57 *See* Dodd-Frank Act § 731 (adding § 4s to the CEA).

house for clearing unless one of the parties was eligible for an exemption and elected not to clear the swap.[58] Although this was intended to minimize counterparty risk, its impact has been marginalized because other provisions exempt many participants and instruments in the OTC derivatives market for a variety of reasons.[59]

Second, section 4s(e) of the CEA mandates margin requirements (both initial and variation margin) for swap dealers and major swap participants that trade in uncleared swaps.[60] This provision generally ensures (with notable exceptions) that current and potential risk exposures between swap dealers and their counterparties are collateralized, thereby reducing the danger that swap dealers or major swap participants could take on excessive risk or be unable to fulfill their obligations. In addition, section 4s(l) of the CEA gives the counterparty to the swap dealer or major swap participant the right to request that such margin be segregated with a third-party custodian. The practical impact of these new margin rules was to require swap dealers to collect initial and variation margin from many counterparties that had not previously posted them, thus raising the cost of engaging in the OTC derivatives market.

Collectively, these and other new provisions were certain to be costly to swap dealers and others who could not escape them.[61] The U.S. financial services industry quickly recognized that its best hope for relief was to convince financial regulators to adopt a broad theory of substituted compliance[62]—namely, that a U.S. swap dealer would comply with Dodd-Frank's requirements if the transaction was based abroad and complied with host-country requirements that were "substantially equivalent" to U.S. requirements. If substituted compliance was sufficient, then U.S. swap dealers could largely escape the danger

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58 7 U.S.C. § 2(h)(1).

59 First, section 723 of the Dodd-Frank Act exempts commercial end-users from mandatory clearing requirements. Second, to the extent that the swap can be custom designed, it will not be tradeable on an exchange, which can trade only relatively standardized products. This creates a strong incentive for swap dealers to avoid standardization.

60 7 U.S.C. § 4s(e). The margin rules under the Dodd-Frank Act are complex and vary by the nature of the counterparty. For trades between swap entities, the rules require the posting and collection of initial and variation margin. Where the counterparty is not a swap dealer or major swap participant, but is a financial institution, the swap dealer or major swap participant must collect, but not pay, initial and variation margin. Swap entities are not required, however, to collect or pay margin to nonfinancial entities (including commercial end users). For a brief review of these rules, see *Examining the Extraterritorial Reach of Dodd-Frank's Volcker Rule*, *supra* note 14, at 277–80.

61 The International Securities Dealers Association, a trade group, has estimated that an additional $1 trillion in collateral may have to be posted as a result of proposed Dodd-Frank reforms. *See Examining the Extraterritorial Reach of Dodd-Frank's Volcker Rule*, *supra* note 14, at 280.

62 *See* Arthur E. Wilmarth, Jr., *Turning a Blind Eye: Why Washington Keeps Giving In to Wall Street*, 81 U. CIN. L. REV. 1283, 1302–07 (2013) (describing the efforts of the financial industry to convince regulators to relax cross-border swaps rules).

that Dodd-Frank would place them at a regulatory disadvantage to their foreign competitors and possibly cost them business.

C. The CFTC's Position

In June 2012, almost two years after the enactment of Dodd-Frank, the CFTC finally addressed the key issue of extraterritorial application by proposing "guidance" on when the provisions of Title VII applicable to swap dealers and major swap participants would apply to non-U.S. persons.[63] Simply put, the CFTC's proposed guidance fell far short of what the U.S. financial services industry wanted, and their predictable disappointment probably explains why the CFTC chose at the outset to call its determinations "guidance," rather than "rules."[64] Under its proposed "cross-border guidance," non-U.S. persons with significant swap positions were required to register with the CFTC as swap entities[65] (but would have been subject to only a limited set of requirements based on this registration). More substantive and demanding than these registration requirements were the proposed "transaction-level" requirements; these would have applied to transactions between (a) non-U.S. persons and U.S. persons, (b) foreign affiliates of a U.S. person and either U.S. or non-U.S. persons, and (c) U.S. branches of a non-U.S. swap dealer and U.S. or non-U.S. persons.[66] These substantive requirements would have included clearing, margin, real-time public reporting, trade execution, and sales practices.[67] To illustrate, both the London branch of Morgan Stanley transacting in London with a Hong Kong–based customer, and a Barclays subsidiary entering into a transaction with a U.S. customer anywhere in the world, would have been covered. In addition, if Barclays operated in the United States, all its branches worldwide would have been covered by the Dodd-Frank Act's rules. The regulatory burden

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63 *See* Cross-Border Application of Certain Swaps Provisions of the Commodity Exchange Act, 77 Fed. Reg. 41,214 (July 12, 2012) [hereinafter Cross-Border Application].

64 Although no CFTC document or commissioner has ever conceded this, the CFTC's insistence on calling this release "guidance" and a "policy statement," rather than issuing it as a formal rule, may have been an effort to avoid judicial review by the D.C. Circuit Court of Appeals, which has been increasingly ready to reject regulatory rules by financial regulators that were not preceded by—in its view—an adequate cost/benefit analysis. *See* Bus. Roundtable v. SEC, 647 F.3d 1144, 1148 (D.C. Cir. 2011) ("We agree with the petitioners and hold the Commission acted arbitrarily and capriciously for having failed once again . . . adequately to assess the economic effects of a new rule."). Nonetheless, this exercise in prudential semantics has not spared the CFTC from litigation challenging these rules on the same cost/benefit arguments in the D.C. Circuit. In December 2013, such a suit was brought by the major banking-industry trade groups. *See* Landon Thomas Jr., *Wall Street Challenges Overseas Swaps Rules*, N.Y. TIMES, Dec. 5, 2013, at B5. This issue of cost/benefit analysis is beyond the scope of this Essay.

65 *See* Cross-Border Application, *supra* note 63, at 41,219.

66 *See id.* at 41,228–29.

67 *See id.* at 41,225.

clearly would have been substantial, and the guidance would have exempted transactions only between a non-U.S. swap entity and a non-U.S. counterparty that was not an affiliate of a U.S. person.

Effectively, this guidance sheltered from Dodd-Frank's application only non-U.S. registered swap dealers or non-U.S. major swap participants, who could comply with comparable foreign regulatory requirements as an alternative to complying with Dodd-Frank's mandated transaction requirements when dealing with non-U.S. persons. This exemption for non-U.S. swap dealers may have exacerbated the problem for U.S. dealers, who now foresaw being placed at a competitive disadvantage at their foreign branches and subsidiaries.

Even this proposed relief for non-U.S. swap dealers was not necessarily available but would have required that the CFTC recognize that the alternative host country's requirements satisfied its tests for substituted compliance. Here, the CFTC seemed intent on a substantive review of the foreign regulations before deeming them comparable,[68] and again this heightened the industry's level of apprehension.

The CFTC's proposed guidance touched off intensive negotiations and lobbying. In Congress, the sides were quickly drawn. Republicans favored a broad definition of substituted compliance, and legislation was introduced in the Republican-dominated House to mandate that all G-20 nations automatically qualified for substituted compliance.[69] Because congressmen seldom feel pressure from foreigners (who cannot vote), this legislation seems clearly to have been the product of lobbying by the financial services industry. Conversely, in the Democrat-dominated Senate, eight liberal Democratic senators wrote to the CFTC and the SEC chairs to demand that loopholes be closed in their swaps rules and that they not "outsource" their regulations to foreign countries (i.e., that they should not recognize substituted compliance).[70]

More pressure, however, was applied from the opposite direction. In April 2013, the EU and the finance ministers from most of the major financial nations jointly sent a strongly worded letter to the U.S. Secretary of the Treasury and the CFTC, warning of a "fragmentation" of the derivatives market if proper deference was not accorded to Eu-

68 *See id.* at 41,229–34 (setting forth the CFTC's proposed substituted-compliance regime).

69 *See* H.R. REP. NO. 113-103, at 2–3 (2013).

70 *See* Letter from Senators Jeff Merkley (D-OR), Carl Levin (D-MI), Tom Harkin (D-IA), Elizabeth Warren (D-MA), Jeanne Shaheen (D-NH), Barbara Boxer (D-CA), Richard Blumenthal (D-CT), and Dianne Feinstein (D-CA), to the chairs of the SEC and CFTC (July 3, 2013), *available at* http://www.merkley.senate.gov/newsroom/press/release/?id=d452a900-e124-4c05-998f-80dbb58ea72a (urging both agencies to close perceived major loopholes in their swaps rules and not defer to foreign regulators).

ropean rules (and, in particular, EMIR).[71] Perhaps even more importantly, the SEC proposed its own corresponding rules for "security-based swaps," and the SEC—perhaps characteristically—took a more restrained position, closer to that of the financial services industry, thereby undercutting the CFTC by proposing a more expansive and deferential definition of substituted compliance.[72] Finally, a key Democratic commissioner on the CFTC began to waiver in his support for the CFTC's harder-line position.[73] With his support crumbling, CFTC Chairman Gensler began to negotiate a compromise in order to hold on to a majority.

In July 2013, in response to pressure from all sides, the CFTC modified its proposed guidance.[74] It retreated significantly, but not completely. First, to show that it was not abandoning its core position, it expanded its definition of "U.S. person" to include both foreign branches of a U.S. person and offshore hedge funds that had a majority U.S. ownership (direct or indirect) or a principal place of business in the United States.[75] Then, in a significant retreat, it conceded that foreign branches of U.S. banks could generally satisfy Dodd-Frank's requirements through substituted compliance (i.e., compliance with the comparable requirements of another jurisdiction) if the transaction had a "bona fide" connection to the non-U.S. branch.[76] But if the foreign branch of a U.S. bank entered into a swap with a U.S.

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71 Nine senior financial regulators sent an April 18, 2013 letter to Treasury Secretary Lew expressing concern about "fragmentation" in the OTC market if the United States insisted on applying its own rules extraterritorially. These included the relevant ministers from Japan, Russia, South Africa, Brazil, Switzerland, France, Germany, as well as Michel Barnier, the EU's Commissioner for Internal Markets and Services. *See* Interpretive Guidance and Policy Statement Regarding Compliance with Certain Swap Regulations, 78 Fed. Reg. 45,292, 45,392 & n.455 (July 26, 2013) (discussing the negotiations) [hereinafter Interpretive Guidance].

72 *See* SEC Cross-Border Swaps Proposal, *supra* note 48, at 31,085 ("[T]he Commission is proposing a 'comparability' standard as the basis for making a substituted compliance determination . . . [that would] ultimately focus on regulatory outcomes as a whole with respect to the requirements within the same category rather than a rule-by-rule comparison."). *See also* Andrew Ackerman, *SEC Poised to Give Overseas Firms Leeway on Swaps*, WALL ST. J. (Apr. 30, 2013, 5:53 PM), http://online.wsj.com/news/articles/SB10001424127887323798104578455263840421672.

73 The Democratic commissioner was Mark Wetjen, who was widely perceived as the swing vote on the CFTC. *See* Shahien Nasiripour, Michael Mackenzie & Tom Braithwaite, *U.S. Watchdog Set to Weaken Derivatives Rules*, FIN. TIMES (Feb. 28, 2013), http://www.ft.com/intl/cms/s/0/e3fd4f66-81d0-11e2-b050-00144feabdc0.html#axzz2uGPlXRHw; *see also* Jamila Trindle, *CFTC Delays Swaps Vote as Member Voices Concerns*, WALL ST. J. (Feb. 12, 2013, 8:51 PM), http://online.wsj.com/news/articles/SB10001424127887324880504578300772419844396.

74 *See* Interpretive Guidance, *supra* note 71, at 45,292.

75 *See id.* at 45,301–02.

76 *See id.* at 45,327–28 (viewing the foreign branch of a U.S. person as also a U.S. person). But having said that a foreign branch was a U.S. person, the Interpretive Guidance then permitted these foreign branches in most cases to substitute compliance with the rules of the location of the foreign branch. *See id.* at 45,342.

person (other than another foreign branch of a U.S. bank), then U.S. transactional rules would apply (and the foreign branch could not rely on substituted compliance).[77] The CFTC further indicated that, in determining whether a particular category of requirements of another country should be deemed comparable to Dodd-Frank's requirements, it would use an "outcomes-based approach."[78] But it did not adopt the "holistic" approach that many had urged on it and seemed prepared to closely examine the actual substantive rules of the particular jurisdiction.

Correspondingly, non-U.S. swap dealers would be required to comply with the CFTC's transaction-level requirements in dealing with U.S. persons and certain affiliates of U.S. persons.[79] Thus, Goldman Sachs's London branch would have to observe Dodd-Frank's transactional requirements in dealing with U.S. persons but could compete by the same rules as its European rivals in dealing with non-U.S. persons and certain U.S. affiliates. Similarly, a British bank would have to comply with the Dodd-Frank Act's requirements in dealing with most U.S. persons but not with non-U.S. persons (and certain affiliates of U.S. persons). Substituted compliance would not apply in these contexts where the counterparty was a U.S. person. This position leveled the playing field (so that U.S. swap dealers were at less of a competitive disadvantage) but did not necessarily alleviate the problem of systemic risk.

Equally importantly, the staff of the CFTC contemporaneously issued a no-action letter in which it indicated that certain risk-management requirements of the European Market Infrastructure Regulation (EMIR) were substantially identical to the CFTC's own rules.[80] This

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77 *See id.* at 45,348.

78 *See id.* at 45,342–43.

79 *See id.* at 45,350.

80 *See* No-Action Relief for Registered Swap Dealers and Major Swap Participants from Certain Requirements under Subpart I of Part 23 of Commission Regulations in Connection with Uncleared Swaps Subject to Risk Mitigation Techniques under EMIR, CFTC Letter No. 13-45 (July 11, 2013) at 1 [hereinafter No-Action Letter]. The EMIR was adopted on August 16, 2012 by the European Commission on behalf of the European Union. It authorized the European Securities and Markets Authority (ESMA) to develop technical standards, which were in turn adopted by the EC on March 15, 2013. One subpart of these standards were the EMIR Risk Mitigation Rules, which basically apply to over-the-counter (or "uncleared") derivatives, including swaps. The no-action letter found that the CFTC's Risk Mitigation Rules (Regulation §§ 23.501, 23.502, 23.503, and portions of 23.504, as promulgated under section 4s(i) of the CEA) were "essentially identical" with the EMIR Risk Mitigation Rules after a section-by-section comparison. *Id.* at 2.

Controversy surrounded the issuance of this advice in the form of a No-Action Letter from a single CFTC division, rather than in the form of formal CFTC regulations. In my judgment, the use of an informal no-action letter may have been preferred because it likely immunized this position from judicial review by the D.C. Circuit under the Administrative Procedure Act. *See* Bus. Roundtable v. SEC, 647 F.3d 1144 (D.C. Cir. 2011). Nonetheless, litigation has been brought on this ground. *See supra* note 64.

seemed to imply that the European rules on the key "transaction-level" issues relating to over-the-counter derivatives appeared to satisfy the substituted-compliance standard. That was critical because, as the no-action letter noted, of the eighty swap dealers currently registered with the CFTC, thirty-five were organized outside the United States, of which twenty-two were established within the EU.[81]

In an understandable effort to gain needed time, the CFTC issued an exemptive order on July 22, 2013, that effectively allowed it to delay comparability determinations until late 2013.[82] Then, on December 20, 2013, one day before the scheduled expiration of this exemptive order, the CFTC announced a series of comparability determinations covering the EU, Australia, Canada, Japan, Hong Kong, and Switzerland.[83] Basically, the CFTC made favorable comparability determinations for all six with respect to entity-level requirements, but largely reserved judgment on transaction-level requirements, approving only a limited number of such requirements for the EU and Japan.[84] The CFTC also issued two no-action letters

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81 *See* No-Action Letter, *supra* note 80, at n.1.

82 *See* Exemptive Order Regarding Compliance with Certain Swap Regulations, 78 Fed. Reg. 43,785, 43,792 (July 22, 2013). The exemptive relief granted by this order expired no later than December 21, 2013. *See id.* at 43,794.

83 These comparability determinations for the six different countries (including the EU) are set forth at 78 Fed. Reg. 78,864 (Australia), 78 Fed. Reg. 78,852 (Hong Kong), 78 Fed. Reg. 78,910 (Japan), 78 Fed. Reg. 78,899 (Switzerland), 78 Fed. Reg. 78,839 (Canada), and 78 Fed. Reg. 78,923 (European Union). All were published in the Federal Register on December 27, 2013. In addition, "transaction-level" determinations were made for the European Union and Japan. See 78 Fed. Reg. 78,878 (European Union) (Dec. 27, 2013) and 78 Fed. Reg. 78,890 (Japan) (Dec. 27, 2013). These determinations are succinctly summarized in a Davis Polk client memorandum. DAVIS POLK & WARDWELL LLP, CFTC ISSUES CROSS-BORDER SUBSTITUTED COMPLIANCE DETERMINATIONS, PROVIDES LIMITED PHASE IN FOR SOME SWAP REQUIREMENTS (2014), *available at* http://www.davispolk.com/sites/default/files/01.07.14.CFTC_.Issues.CrossBorder.Substituted.pdf [hereinafter DAVIS POLK CLIENT MEMO].

84 The CFTC made its comparability determinations for each of the six above-listed countries with respect to the following "entity-level" requirements: (1) position limit monitoring; (2) diligent supervision; (3) business continuity and disaster recovery; (4) research and clearing conflicts; and (5) availability of information for disclosure and swap data recordkeeping (subject to some exceptions). The CFTC did not, however, make comparability determinations for any jurisdiction with respect to its requirement that swap dealers provide it with compliance and risk reports. *See* DAVIS POLK CLIENT MEMO, *supra* note 83, at 2. Thus, while swap dealers can rely on substituted compliance for most entity-level requirements in these six jurisdictions, they will still need to submit some reports and records to the CFTC.

With respect to "transaction-level" requirements, the CFTC found the EU's trade confirmation, portfolio reconciliation, and portfolio compression requirements fully comparable to those in the United States. *See* 78 Fed. Reg. 78,886 (trade confirmation), 78,884 (portfolio reconciliation), 78,885 (portfolio compression). Only pretrade execution information in the EU was found less than comparable. *See* 78 Fed. Reg. 78,888. In the case of Japan, the CFTC found Japanese daily trading records comparable, but made no finding with respect to trade confirmation, portfolio reconciliation, and portfolio compression standards. 78 Fed. Reg. 78,897.

delaying the application of swap data–reporting rules for certain non-U.S. swap dealers.[85] Nonetheless, despite these steps, the *Wall Street Journal* reported that the CFTC's actions were "likely to renew criticism the U.S. is bidding to become the de facto global financial regulator" because the CFTC "only narrowly recognized overseas regulations, permitting overseas firms to fall under their home-country rules" by limiting its approval of transaction-level requirements.[86]

By the end of 2013, the CFTC was only midway through its process. It had indicated that, except in certain transactions with U.S. persons, non-U.S. swap dealers would generally be able to rely on substituted compliance, but it had not yet decided whether most transaction-level requirements (and some entity-level requirements) were adequately equivalent to satisfy its substituted-compliance standards at even the most financially developed and comparable nations.[87]

Then, everything changed with the departure in early 2014 of the CFTC's chairman, Gary Gensler, whose activist style was uncharacteristic for the CFTC.[88] Gensler's successor, acting chairman Mark P. Wetjen, moved quickly to modify Gensler's position and accept substituted compliance on a more thorough-going and deferential basis.[89] According to the *Wall Street Journal*, the timing of the CFTC's relaxation of its OTC derivatives rules in February 2014 was motivated by the February 15, 2014, deadline on which U.S. trading restrictions were to go into effect, even though Europe had "yet to set a date for the implementation of its swaps-trading rules, which . . . some fear aren't as

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More significantly, the CFTC did not make comparability determinations for any jurisdiction for transaction-level requirements with respect to clearing and trade execution.

85 *See* CFTC Letter No. 13-75 (Dec. 20, 2013) (entitled "Time-Limited No-Action Relief from Certain Requirements of Part 45 and Part 46 of the Commission's Regulations, for Certain Swap Dealers and Major Swap Participants Established under the Laws of Australia, Canada, the European Union, Japan or Switzerland"); CFTC Letter No. 13-78 (Dec. 20, 2013) (entitled "Time-Limited No-Action Relief from Certain Entity-Level Internal Business Conduct Requirements for Certain Swap Dealers and Major Swap Participants Established under the Laws of Australia, Canada, the European Union, Japan, and Switzerland").

86 *See* Andrew Ackerman, *CFTC Extends Some Swaps Rules to Overseas Firms*, WALL ST. J. (Dec. 21, 2013, 2:24 PM), http://online.wsj.com/news/articles/SB10001424052702304866904579272510388548966.

87 *See* discussion *supra*.

88 *See* Ben Protess, *Regulator of Wall Street Loses Its Hard-Charging Chairman*, N.Y. TIMES (Jan. 2, 2014, 8:46 PM), http://dealbook.nytimes.com/2014/01/02/regulator-of-wall-street-loses-its-hard-charging-chairman/?_php=true&_type=blogs&_r=0.

89 *See* Andrew Ackerman & Katy Burne, *CFTC is Set to Ease Rules on Trading Swaps Overseas*, WALL ST. J. (Feb. 10, 2014, 9:16 PM), http://online.wsj.com/news/articles/SB10001424052702303874504579375383950134254; *see also* Phillip Stafford & Gina Chon, *Regulators Reach Deal on Over-the-Counter Derivatives Rules*, FIN. TIMES, (Feb. 12, 2014), *available at* http://www.ft.com/intl/cms/s/0/1ab8840c-940a-11e3-a0e1-00144feab7de.html#axzz2vXSesM8K. For Mr. Wetjen's position, see Testimony of Mark P. Wetjen, Acting Chairman, Commodities Futures Trading Commission, before the Senate Banking, Housing and Urban Affairs Committee (Feb. 6, 2014).

strict as U.S. restrictions."[90] Thus, by allowing swap dealers to escape the new U.S. rules, this relaxation implied that swap dealers would remain largely unregulated in Europe for an interim period. Given these differences in timing and strictness, observers, according to the *Wall Street Journal*, concluded that the impact of the CFTC's decision "will encourage banks to move more swaps trading overseas to escape strict U.S. regulations intended to bring more transparency to the opaque financial products."[91]

This conclusion seems inescapable: for the United States, substituted compliance will mean a loss of market share, revenues, and jobs as trading moves overseas to marginally less-regulated markets. To be sure, the magnitude of this loss cannot now be estimated, but it is a rare policy shift that both (1) exposes the United States to greater risk and (2) costs it jobs and market share at the same time. The logic of such a policy shift needs closer scrutiny.

In any event, the CFTC's rules remain in limbo, with no final rules but only interpretive "guidance" having been adopted. Even though this guidance may shift from time to time, the CFTC's position still appears more aggressive than that of its sibling regulator, the SEC, in three respects. First, the CFTC's definition of "U.S. person" captures offshore hedge funds that are majority owned by U.S. persons or that have their principal place of business in the U.S.[92] Second, the CFTC may continue to insist that swap dealers, foreign or domestic, transacting with U.S. persons (other than a foreign branch of a U.S. bank) must comply with the CFTC's rules and not those of any other country.[93] Substituted compliance thus operates only within a lesser range for the CFTC. Third and most important, while the SEC's rules require an explicit and legally enforceable guarantee before the foreign affiliate's swap activity is attributed to the parent U.S. institution, the CFTC's "guidance" recognizes implicit guarantees also.[94]

D. The SEC's Position

Uncertain as the final shape of the CFTC's margin rules may be, the CFTC's overall approach to the topic of substituted compliance

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90 *See* Ackerman & Burne, *supra* note 89.

91 *Id.*

92 *See supra* note 76 and accompanying text. Essentially, the CFTC "looks through" the ownership of a collective investment vehicle to determine the "U.S. person" status of its owners, but the SEC does not.

93 *See supra* note 77 and accompanying text.

94 For a detailed comparison of the SEC's and the CFTC's positions on this point, see Dan Ryan, PricewaterhouseCoopers LLP, *SEC's Cross–Border Derivatives Rule*, (July 19, 2014, 9:00 AM), http://blogs.law.harvard.edu/corpgov/2014/07/19/secs-cross-border-derivatives-rule/.

clearly seems more exacting than the SEC's. In its proposed rules for cross-border swaps trading, the SEC made no effort to carve out transactions with U.S. persons as beyond the reach of substituted compliance.[95] Still, the SEC did sensibly subdivide its comparability analysis into four separate categories, indicating that it would make "substituted compliance determinations with respect to four separate categories of requirements," with the result that if a foreign jurisdiction achieved "comparable regulatory outcomes in three out of the four categories, then the Commission would permit substituted compliance with respect to those three categories of comparable requirements," but not for the fourth.[96] This means that the SEC's approach is less holistic than it first appears, as close (or even identical) comparability in one of these four categories would not spill over and bias the comparison in another category.

Still, the SEC has recognized that some issues interrelate. Thus, it has indicated that it "would expect to make a substituted compliance determination for the entire group of related requirements."[97] It added:

> For example, the core entity-level requirements relate to the regulation of an entity's capital and margin. But certain other entity-level requirements (such as risk management, general recordkeeping and reporting, and diligent supervision) are so interconnected with capital and margin oversight that we would expect to make substituted compliance determinations, where warranted with regard to capital and margin rules, on the entire package of entity-level regulations.[98]

Thus, those rules having the greatest significance from a systemic-risk standpoint (most notably, capital adequacy and margin) would typically be reviewed on an interrelated basis. This probably makes sense, but the SEC also believes that entity-level decisions as to capital adequacy and margin should not be made by it, in the case of a swap entity that is a bank, but by the appropriate banking regulator.[99] Because banks are the largest swap dealers, this leaves the SEC formally determining substituted compliance but deferring to the bank regulators to make the determination as to the most important provisions (from a systemic-risk perspective) in that calculus.

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95 *See* SEC Cross-Border Swaps Proposal, *supra* note 48, at 30,975.

96 *Id.* The four categories are: (1) requirements applicable to registered security-based swap dealers under section 15F of the Exchange Act; (2) requirements relating to regulatory reporting and public dissemination of information on security-based swaps; (3) requirements relating to clearing for security-based swaps; and (4) requirements relating to trade execution for security-based swaps. *See id.* at 31,085.

97 *Id.* at 31,088.

98 *Id.* at 31,088–89.

99 *Id.* at 31,090.

Unlike the CFTC, the SEC did adopt final rules in 2014, but in so doing it built an extraordinary loophole into its rules. Over the protests of two Democratic commissioners (Kara Stein and Luis Aguilar), the SEC's rules define a "U.S. person" to include a foreign subsidiary where its obligations to counterparties are legally guaranteed by the U.S. parent, but not a foreign subsidiary whose obligations are only implicitly guaranteed.[100] As commissioner Stein and others have noted, the result is to create a perverse incentive: U.S. banks can avoid U.S. rules by using a foreign subsidiary and only "implicitly" guaranteeing its debt.[101] Already, a trend in this direction has been detected.[102] The SEC's rules thus encourage banks to park risky activities in an offshore subsidiary (just as AIG did to start the 2008 crisis) with the only distinction being that the liability not be formally guaranteed. The bottom line is that we have come full circle back to where we were in 2007, with the regulatory seeds for the next crisis having been already sown.

E. The European Reaction and a Proposal

As of early 2014, the SEC and CFTC disagreed mainly over how much protection should be given to U.S. persons. The CFTC required all swap dealers generally to play by its rules when the transaction involves a U.S. person (but not otherwise),[103] while the SEC permitted all offshore transactions to be governed by the still emerging rules of substituted compliance (without any special exception for transactions with U.S. persons).[104] Both agencies were ready to defer in most cases to foreign regulators if they judged their rules (at differing levels of granularity) to be functionally equivalent.[105] Yet, at pre-

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100 See Exchange Act Release No. 34-72472 ("Application of 'Security-Based Swap Dealer' and 'Major Security-Based Swap Participant' Definitions to Cross-Border Security-Based Swap Activities"), 79 Fed. Reg. 39,068 (July 9, 2014).

101 *See* Andrew Ackerman, *SEC Signs Off on Foreign-Bank Swap Rules*, WALL ST. J., June 25, 2014 (discussing views on both commissioners. For the critical views of Commissioner Kara Stein, see "Open Meeting of the U.S. Securities and Exchange Commission Subject: Consideration of Rules Regarding the Application of 'Security-Based Swap Dealer' and 'Major Security-Based Swap Participant,'" June 25, 2014 (Federal News Service), *available at* http://www.sec.gov/news/openmeetings/2014/062514openmeeting.shtml. Commissioner Stein observed that the adopted rule "ignores the reality of corporate finance by assuming that the United States parent is linked to the foreign affiliate only when an explicit recourse guarantee is provided to a third party." *Id.* at 9. She then noted: "Not surprisingly, recent reports suggest that firms are restructuring their form of agreements to restrict or remove explicit contractual guarantees. But it appears that little of the substance has actually changed." *Id.* at 10.

102 For a confirmation of Commissioner Stein's views that the industry is moving to exploit this loophole, see Peter Eakins, *Wall Street's Quiet Turnabout on Swaps*, N.Y. TIMES (Dealbook) (May 2, 2014).

103 *See* Cross-Border Application, *supra* note 63, at 41,217–18.

104 *See* SEC Cross-Border Swaps Proposal, *supra* note 48, at 30,975.

105 *See id.* at 31,009; *see also* Cross-Border Application, *supra* note 63, at 41,217.

sent, no one quite knows what the applicable European rules are (for example, with regard to margin).

Europe remains undecided on many of these questions.[106] Starting, as the United States did, from the same G-20 agreement on OTC derivatives at the 2009 summit, Europe has moved more slowly, and symptomatic fissures have appeared within its regulatory structure. A "trialogue" on this issue in December 2013 among the European Parliament, the European Commission, and the Council of the European Union ended in an "acrimonious" stalemate, with the British and French delegates criticizing each other.[107] Such division is not surprising and reflects the fact that the United States has a much stronger federal structure than Europe. Intense as the debate over financial regulation may be in the United States, the individual states do not intervene in it (i.e., California does not object to the SEC or sue the CFTC). But in Europe, individual nations can and do object and delay agreement. Predictably, the delay would be even greater if global harmonization were sought, and industry groups are adept at exploiting this tendency toward fragmentation to delay reforms that are costly to them.[108]

Earlier, this Essay suggested the need for a minilateral strategy in dealing with systemic risk in order to address the underlying public-goods problem. The European difficulty with OTC rules illustrates this need. Put simply, some nations will resist or delay reform because (i) the reforms have adverse distributional consequences to them or (ii) they do not expect to bear the full costs of a systemic-risk crisis. Thus, if Europe has difficulty in acting, a global resolution seems even more infeasible in the near term (both because many nations would resist what they would see as excessive U.S. pressure and because the resulting principles would likely be too vague and general to have much impact). As a generalization, the more the parties to the negotiation, the greater the possibility that some group can exercise a minority veto, slowing or blocking the reform as a practical matter. While soft-law proponents believe in harmonization of standards, they ignore the greater vulnerability of harmonization, as a process played out on a larger stage, to deliberate obstruction by highly motivated industry groups.[109]

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106 *See* Danny Hakim, *Europeans Struggle to Set Derivatives Rules*, N.Y. TIMES, Jan. 14, 2014, at B-1.

107 *Id.* at B-2.

108 Often the resentment at U.S. "imperialism" seems to be stoked by lobbying firms representing the industry (and sometimes based in the United States). In the case of the current EU deadlock, the Commodity Markets Council (which is based in Washington) appears to be leading the opposition to the E.U.'s proposed rule. *Id.* at B-2.

109 *See id.*

Given this difficulty, how then should financial regulators escape this dilemma? Current proposals seem likely only to exacerbate the problem. In its proposed cross-border swaps rules, the SEC contemplates that swap dealers, or groups of them, would apply to it for a "substituted compliance determination" that, for example, the regulatory regime of "Country X" was functionally equivalent to that of the United States.[110] This procedure will likely result in all the major security-based swap dealers active in Country X filing a joint submission with the SEC. Arguably, this will confront the SEC with a powerful lobby, and also provide it with little opportunity to discuss and negotiate with Country X.

Instead, the better route would be for Country X to itself file the application with the SEC in order that there could be joint discussion as to what changes the U.S. regulator wanted before it would deem Country X's regulatory regime functionally equivalent. The result would be a quiet bilateral negotiation. Already, under the SEC's proposed rules, some bilateral negotiations between U.S. regulators and those in the host country are necessary, as the SEC requires that a memorandum of understanding between the United States and the host country governing supervision and enforcement have been signed.[111] The key advantages of this approach are that (i) it does not treat the host country's laws as static and fixed and (ii) it does not place the United States in the unattractive position of seemingly telling the world what its laws must say. Instead, a quieter negotiation would begin over the narrower issue of functional equivalence.

To be sure, bilateral negotiations face problems of diplomacy. Once the United States has found some nations to be functionally equivalent (as it now has at least for entity-level requirements), it is stigmatizing and potentially humiliating for it to tell other nations that their legal regimes are not equivalent. The implication is that its laws and practices are somehow backward.

What, then, is the better strategy? Ideally, the United States (possibly in conjunction with the EU) should proactively define what the critical elements are of a functionally equivalent policy toward OTC derivatives. These criteria should focus more on those factors that truly relate to systemic risk (e.g., capital, leverage, margin, etc.) and less on rules that relate to consumer protection or business conduct. Announcement of those rules should precede negotiation. Nations eager to achieve functional equivalence could then score themselves in advance and take steps to comply. Motivating them would be an implicit threat: failure to reach an agreement with the United States would mean that U.S. swap entities (i.e., dealers and major swap par-

110 SEC Cross-Border Swaps Proposal, *supra* note 48, at 31,094.
111 *See id.* at 31,088–89.

ticipants) would be unable to trade with other swap dealers in their jurisdiction—at least without fully complying with Dodd-Frank's requirements. In effect, the trading parties would have to comply with both U.S. and foreign law, and this might well be impossible. Thus, this approach taxes the free riders who are unwilling to reach a *modus vivendi* with the United States.

Moreover, now that the United States and the EU have reached partial agreement on their rules for swaps trading (even if many blanks remain to be filled in), an opportunity for rapid legal development looms. Together, U.S. and EU entities account for a high majority of global swaps trading[112] and possess considerable leverage in encouraging other nations to play by their rules. If they could jointly agree on common criteria, they would thereby notify other countries (e.g., Japan, Singapore, Hong Kong, Canada, Brazil) as to the minimum requirements that they would require to consider another regulatory regime functionally equivalent. That is, rather than sitting down to multiple negotiations, each with its unique facts, or convening a global conference aimed at international harmonization, the United States and Europe could proactively declare in advance what the minimum elements were that they would require before another regulatory regime could qualify for substituted compliance. That would have impact because many nations are still slowly grappling with how to design their rules and are well behind the United States in the pace of their reforms.[113] At such a formative moment, such guidance would effectively define the path forward.

II
THE VOLCKER RULE AND STRUCTURAL REFORM

The so-called Volcker Rule is a prophylactic provision of the Dodd-Frank Act that broadly prohibits "banking entities" from "engaging in proprietary trading" or "acquiring or retaining any equity, partnership, or other ownership interest in or sponsoring a hedge fund or private equity fund," subject to a number of exceptions.[114] The statutory language of the Dodd-Frank Act applies to both (i) U.S. bank holding companies and their affiliates and (ii) non-U.S. bank holding companies licensed to do business in the United States,[115] but it ex-

112 *See* Ferrarini & Saguato, *supra* note 9, at 328.

113 *See* CFTC & SEC, Joint Report on International Swap Regulation 100 & n.429 (2012), *available at* http://www.cftc.gov/ucm/groups/public/@swaps/documents/file/df-study_isr_013112.pdf.

114 *See* Dodd-Frank Act § 619 (2010). This provision adds a new section 13 to the Bank Holding Company Act of 1956, 12 U.S.C. § 1841 et seq. The provision will be codified at 12 U.S.C. § 1851. The quoted language in the text is in section 13(a)(1)(A) and (B).

115 Section 619 of the Dodd-Frank Act uses the term "banking entity," which is defined in section 13(h)(1) of the Bank Holding Company Act to include any company that is

empts trading that "occurs solely outside of the United States" when the banking entity is not controlled "directly or indirectly" by a U.S. banking entity.[116] Thus, a foreign bank with even a single branch in the United States is subject to the Volcker Rule unless it can establish that a particular trading decision occurred "solely outside of the United States." To this extent, the Volcker Rule effectively does apply extraterritorially because at a minimum it requires banks with U.S. branches to undertake significant compliance obligations to assure that their trading stays well outside the United States.

In principle, U.S. financial regulators could have potentially pursued a substituted-compliance approach with respect to the Volcker Rule, but they did not—probably for a variety of reasons. Instead, when financial regulators jointly issued their final version of the Volcker Rule in December 2013, they elaborately expanded on this "solely outside of the United States" test.[117] Under the final rule, a foreign banking entity must satisfy the following conditions:

(i) The banking entity (including any personnel that arrange, negotiate or execute the purchase or sale) may not be located in the United States;

(ii) The banking entity (including any relevant personnel) that makes the decision to purchase or sell may not be located in the United States or organized under the laws of the United States or of any state;

(iii) The purchase or sale is not accounted for, directly or on a consolidated basis, by any branch or affiliate that is located in the

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treated as a bank holding company for purposes of section 8 of the International Banking Act of 1978 (12 U.S.C. § 3106) and any affiliate or subsidiary thereof. Bank Holding Company Act of 1956 § 13(h)(1), 12 U.S.C. § 1841 et seq.

116 Section 619 of the Dodd-Frank Act added section 13(d) ("Permitted Activities") to the Bank Holding Company Act of 1956, and section 13(d)(1)(H) thereof permits "[p]roprietary trading conducted by a banking entity . . . provided that the trading occurs solely outside of the United States and that the banking entity is not directly or indirectly controlled by a banking entity that is organized under the laws of the United States or of one or more states." Dodd-Frank Act § 619, Pub. L. No. 111-203, 124 Stat. 1625 (2010). Under the final rule, a transaction originated in the United States but executed in Europe by a foreign bank would not thus qualify under the "solely" test. *See* SEC Release No. BHCA-1, *supra* note 36, at 421–24.

117 The initial version of the Volcker Rule was jointly proposed on October 11, 2011 by the Department of the Treasury, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the Securities and Exchange Commission. *See* Press Release, FDIC, FDIC Board Passes Notice of Proposed Rulemaking on Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds (Oct. 11, 2011), *available at* www.fdic.gov/news/news/press/2011/pr11160.html; Proposed Rule ("Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds"), 76 Fed. Reg. 68,846 (Nov. 7, 2011) (codified at 12 C.F.R. pt. 44, at 3 (2014)). The final rule was adopted on December 10, 2013. *See* SEC Release No. BHCA-1, *supra* note 36.

United States or organized under the laws of the United States or of any state;

(iv) No financing for the transaction is provided by any branch or affiliate located in the United States or organized under the laws of the United States or of any state; and

(v) The purchase or sale is not conducted through any U.S. entity (with certain limited exceptions).[118]

Unlike the CFTC's and SEC's OTC regulations, the Volcker Rule's legal foundation rests on a combination of inherent sovereignty and territorialism. In its view, the United States regulates its own banks, even when they act abroad (i.e., an assertion of national sovereignty), but it oversees foreign banks only when they are acting on U.S. soil (i.e., a territorial approach). If an institution is not a U.S. bank and all the attributes of its trading transaction occur abroad, it is beyond the scope of the Volcker Rule, and functional equivalence between U.S. law and foreign law becomes irrelevant. This restricted approach was not inevitable; indeed, one can imagine cases where this territorial approach may be seriously underinclusive. For example, a bank chartered in Europe could have 45 percent of its operations in the United States (and extensive commitments to U.S. counterparties) and could permissibly engage in significant proprietary trading in Europe, which would be exempt from the Volcker Rule, but this trading could cause it to fail. Its failure could then destabilize its U.S. counterparties, but this risk has been accepted by the Volcker Rule.

Viewed from a distance, the puzzle here is why banking regulators followed an entirely different approach toward defining the extraterritorial application of U.S. law than did securities and derivatives regulators. An initial reason was probably caution. The Volcker Rule was greeted with both hostility and skepticism in Europe. As the chief executive of the Institute of International Bankers objected, the original proposed version of the Volcker Rule would "reach far beyond the shores of the U.S. and apply . . . to all of the global activities of every foreign bank that maintains even so much as a small branch in the U.S."[119] Similarly, Michel Barnier, the European Commissioner for Internal Market and Services, has insisted that it is not "acceptable that U.S. rules have such a wide effect on other nations."[120] Broad

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118 For exact language, see SEC Release No. BHCA-1, *supra* note 36, at 421–23.

119 *See* Sally Miller, Letter to the Editor, *Why Non-U.S. Regulators Are Not Happy with the "Volcker Rule,"* FIN. TIMES, February 21, 2012, *available at* http://www.ft.com/cms/s/0/50d2c224-58b5-11e1-b9c6-00144feabdc0.html#axzz2uGPlXRHw. Ms. Miller is the chief executive officer of the Institute of International Bankers.

120 *See* Yalman Onaran, *Bank Lobby Widened Volcker Rule, Inciting Foreign Outrage*, BLOOMBERG, Feb. 23, 2012, *available at* http://www.bloomberg.com/news/2012-02-23/banks-lobbied-to-widen-volcker-rule-before-inciting-foreigners-against-law.html.

extraterritorial application of the Volcker Rule might then have ignited a political firestorm.

Second, history counts. Substituted compliance is a new concept for banking regulators—one into which they have never bought. Traditionally, banking regulators view banking as an activity that can only be conducted within the terms of a license given by the state. In contrast, for securities regulators, trading (including in OTC derivatives) is something that anyone can do and does not require a special license.[121] Also, banking regulators understandably view bank failure as a serious event, one outweighing the insolvency of a broker-dealer because of likely greater externalities, and so they have taken a broader view of their entitlement to regulate their banks' activities on a global basis.

Third, it is questionable whether any functional equivalent exists to the Volcker Rule in Europe (without which it is pointless to discuss substituted compliance). The Volcker Rule is a uniquely American innovation that was not part of the package of reforms agreed upon by the G-20 nations (whereas clearinghouses, exchanges, and margin for OTC derivatives were central parts of that jointly agreed package).[122]

This third conclusion can be debated. As legal realists might expect, functional equivalence may lie in the eye of the beholder. Europe has in fact developed a functionally similar (but far from equivalent) structural protection that parallels the Volcker Rule: known as "ring-fencing," this safeguard limits who within banks may engage in proprietary trading.[123] In February 2012, EU commissioner Michel Barnier appointed a High-Level Expert Group on structural bank reform.[124] Chaired by Erkki Liikanen, it held hearings, consulted broadly, and issued its final report in October 2012 (which, of course, became known as the "Liikanen Report"). That report concluded "that it is necessary to require legal separation of certain particularly risky financial activities from deposit-taking banks within a

121 Of course, brokers must be licensed, but a broker is defined as "any person engaged in the business of effecting transactions in securities for the account of others." Securities Exchange Act of 1934 § 3(a)(4)(A), 15 U.S.C. § 78c. Active engagement in trading requires no license; only acting as an agent for others in executing transactions requires one to be a licensed broker.

122 *See Examining the Extraterritorial Reach of Dodd-Frank's Volcker Rule*, *supra* note 14, at 272–74 (explaining the G-20's usual approach to extraterritorial financial regulation).

123 *See id.* at 301–03 (discussing how European regulators were considering measures that do not allow retail banking deposits to be used for certain investments).

124 *See* FINAL REPORT OF HIGH-LEVEL EXPERT GROUP ON REFORMING THE STRUCTURE OF THE E.U. BANKING SECTOR, at i (Oct. 2, 2012) (Letter from the chairman setting forth the history of the report) [hereinafter FINAL REPORT OF HIGH-LEVEL EXPERT GROUP].

banking group."[125] According to its chairman, the objective of such reform was:

> to make banking groups, especially their socially most vital parts (mainly deposit-taking and providing financial services to the non-financial sectors in the economy), safer and less connected to high-risk trading activities and to limit the implicit or explicit stake of taxpayer [sic] in the trading parts of banking groups.[126]

Specifically, the Liikanen Report recommended that "proprietary trading and other significant trading activities should be assigned to a separate legal entity if the activities to be separated amount to a significant share of a bank's business."[127] Thus, in theory, failure of the trading subsidiary would not imperil the deposit-taking bank. This is both broader and narrower in scope than the Volcker Rule because it applies to all trading (i.e., non-proprietary trading as well) and other risky activities,[128] but it still permits the banking group to engage in some trading and contains a de minimis exclusion if the level of risky trading is low.

This idea of "ring-fencing" the deposit-taking financial institution has been taken the farthest in the UK. There, the UK's Independent Commission on Banking (ICB) recommended in 2011 that large UK banks should ring-fence their retail bank operations into separate legal subsidiaries with their own prudential safeguards.[129] The ring-fenced retail subsidiary would take deposits and engage in normal retail banking activities, but it would be generally prohibited from engaging in most other forms of risk-taking activity. Although the Liikanen Report has not yet produced any legislation seeking to codify it, the UK's ICB report has been strongly supported in the UK, with the UK government committing to have all necessary legislation in place by 2015.[130]

Real differences separate these ring-fencing proposals from the Volcker Rule. Both the ICB and Liikanen proposals seem primarily concerned with protecting customer deposits and thereby averting the need for a taxpayer-financed bailout.[131] Thus, they are prepared (to varying degrees) to allow the overall banking group to take on high-

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125 *Id.*

126 *Id.*

127 *Id.* at iii.

128 *Id.* at iv–vi. (describing other "risky financial activities" that would have to be segregated in a ring-fenced subsidiary, including derivatives and "certain other activities closely linked with securities and derivatives markets").

129 *Id.* at 85–86 (describing the history of the ICB proposal and the UK reaction to it).

130 *Id.* at 86. Although the legislation would be fully in place by 2015, full compliance would not be required until 2019.

131 *See id.* at 88 (discussing the European regulatory approach, which seeks to protect "small-and-medium sized enterprises" and individual citizens by ensuring that banks are "capable of financing the real economy").

risk activities, provided that customer deposits are protected. In contrast, the Volcker Rule seems intended to protect the "too big to fail" financial institution from insolvency, possibly on the ground that its failure might initiate a chain of falling dominoes among highly interconnected institutions that could topple the financial system as a whole. Also, proponents of the Volcker Rule may suspect that the deposit-taking bank might find ways to support its securities trading affiliate (to its own detriment), even if it could not guarantee the latter's obligations. Thus, although these ring-fencing proposals have similar aims to the Volcker Rule, they are less prophylactic and far from equivalent in their purposes or prohibitions.

Nonetheless, despite all these differences, it is not inconceivable that banking regulators could at some point accept the idea of substituted compliance. For a variety of reasons, this seems at least plausible.[132] If they did accept the concept, and deemed "ring-fencing" to be functionally equivalent to the Volcker Rule, this would permit covered U.S. financial institutions to shift their proprietary trading to London and place their proprietary trading in separate subsidiaries that would be ring-fenced from their deposit-taking arms. The consequences would then be dramatically different. For example, for institutions such as Goldman Sachs or Morgan Stanley that do not operate as standard commercial banks or generally take deposits,[133] little, if any, changes from their prior practices and business models would be required of them under either the ICB or Liikanen proposals. Under such a legal regime, compliance with the UK's rules would mean that a Morgan Stanley or Goldman Sachs would be in compliance with the U.S. law under the doctrine of substituted compliance, at least if all their proprietary trading was moved to the UK. To be sure, under the Liikanen Report's proposed standards, Morgan Stanley or Goldman Sachs might have to place their proprietary-trading operations into a separate subsidiary that would be ring-fenced from its other operations. This would be more costly, but it would be feasible. All in all, this example shows how broadly the concept of substituted compli-

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132 The Federal Reserve is particularly internationally minded and has long negotiated soft-law standards with respect to topics such as capital adequacy at banks. *See, e.g.*, Basel Regulatory Framework, FEDERALRESERVE.GOV, http://www.federalreserve.gov/bankinforeg/basel/default.htm (last visited Feb. 24, 2014). They also may not want to be caught in the position of having to enforce a "rigid" Volcker Rule that tolerated no exceptions. Hence, they may be open to the idea of substituted compliance, even if they might demand more than the SEC before they find functional equivalence.

133 Goldman Sachs does have a small commercial bank that is licensed to operate in the UK. *See* Ambereen Choudhury, *Goldman Sachs Gets U.K. Approval to Operate Bank Unit*, BLOOMBERG, Apr. 17, 2013, *available at* http://www.bloomberg.com/news/2013-04-17/goldman-sachs-gets-u-k-approval-to-operate-bank-unit.html. However, Goldman might be willing to either dispose of this unit or "ring-fence" it if doing so permitted it to engage in proprietary trading in the UK.

ance could reach and how subversive it could be to be the goal of prudential bank supervision (that is, if it were read to allow U.S. banks to escape the Volcker Rule).[134]

To sum up, although it is possible to make plausible arguments that all three approaches (the U.S.'s Volcker Rule, the UK's ICB proposal, and the Liikanen Report) have similar aims, they are not functionally equivalent because the Volcker Rule alone bars the parent entity from taking on specified risks (while the other two proposals demand only that depositors be protected).[135] Nonetheless, one can imagine the banking industry arguing that these different legal regimes should be deemed functionally equivalent. That frames the next and last question: how strict do systemic risk rules have to be to work? Can valid distinctions be drawn between securities and banking regulations in terms of the extraterritorial application of these rules?

III
IS THERE EXCESSIVE EXTRATERRITORIALITY IN DODD-FRANK?

Does U.S. law need to sweep as broadly as it seems to do under Dodd-Frank? To this point, this Essay has argued that U.S. financial regulators need to have jurisdiction over the offshore activities of the subsidiaries and affiliates of U.S. financial institutions. Banking authorities clearly have such authority, but securities and derivatives regulators are under great pressure to defer to the host-country regulator under a substituted-compliance rationale. But U.S. law sweeps even more broadly than that, as the Dodd-Frank Act sometimes applies to foreign firms with U.S. branches and to the counterparties of U.S. financial institutions as well.[136] Is this necessary?

Although the 2008 crisis certainly underlined the dangers of offshore activities, the most vivid illustration of these dangers—AIG's failure[137]—should not be overread. Anxiety-raising as the AIG example is, it can be used to prove too much. On closer inspection, it shows

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134 In fairness, a distinction can be drawn here between various types of "ring-fencing." If all that is done is to segregate the deposit-taking arm of the financial institution (but the rest of a systemically significant financial institution is exposed to the risks of proprietary trading), then the Volcker Rule and "ring-fencing" are not by any means functionally equivalent. Alone, the Volcker Rule seeks to protect the solvency of the systemically significant institution (and not just its deposit-taking arm). But if "ring-fencing" were to require that the unit that engages in proprietary trading be isolated from the rest of the financial institution (with no direct or even implicit guarantees from parents or affiliates), then the case can be made that the two regimes achieve much the same result—and are, loosely speaking, equivalent. Negotiations between the United States and the UK could focus on how large this segregated unit that engaged in proprietary trading could be.

135 *See* FINAL REPORT OF HIGH-LEVEL EXPERT GROUP, *supra* note 124, at 87–88.

136 *See* Greenberger, *supra* note 4, at 968–69 (discussing Dodd-Frank's regulation of counterparties for swap transactions).

137 *See* Sjostrom, *supra* note 7, at 986–89 (discussing AIG's ability to pursue offshore transactions due to a lack of regulation).

only that an unregulated counterparty dealing in swaps can cause a financial meltdown. It does not show that the mere presence of a foreign bank in the United States through a branch office justifies conferring on U.S. regulators worldwide supervisory jurisdiction over the foreign bank.

More generally, a basic distinction surfaces here: the prospect of a potential "tragedy of the commons" is far less likely in this context of the Volcker Rule than in the context of OTC derivatives trading. Why? In economic terms, a defining characteristic of a "tragedy of the commons" is that an actor can escape having to internalize costs that it imposes on others. Thus, a nation that offers unregulated trading in derivatives satisfies this condition to the extent that it will not bear the costs of financial contagion but can profit by offering a dangerous "financial casino" to the world. In contrast, no nation can escape the costs of its own banks failing. If a nation permits its leading financial institutions to engage in a risky activity (such as, for example, proprietary trading), it must internalize the costs of the eventual failure of those institutions. This is very different from a jurisdiction simply permitting foreign third parties to trade within its territory (which may result in increased revenue as a result of regulatory arbitrage but no costs to that jurisdiction, even in the event of a financial failure). To illustrate, the Cayman Islands could, for example, permit foreign banks to trade swaps at low cost on its soil without posting margin or segregating collateral, but even it must regulate its own banks (or suffer the consequences). Hence, we should not expect that, absent extraterritorial regulation by the U.S., foreign banks will go unregulated. Indeed, Europe's decision to ring-fence its banks shows this. From this perspective, the United States may be justified in prohibiting the affiliates and subsidiaries of U.S. banks from engaging in proprietary trading abroad, but it has much less justification in seeking to preclude foreign banks from doing so. At most, it can assert that proprietary trading within the United States endangers its interests. Thus, the more limited reach of the Volcker Rule with respect to foreign banks may be justified.

Put differently, all nations have to worry about whether their own banks will fail. But they need not worry about the failure of a foreign financial institution simply because it operates on their soil unless its failure will injure domestic counterparties. The historic mistake in the AIG story was the failure to recognize that its insolvency could injure counterparties worldwide. But that is the exception, not the rule (as next explained). Precisely because all nations have to internalize the costs of their own banks failing, there is less of a public-goods problem here that could justify United States rules regulating offshore proprietary trading by a foreign bank simply because it has some presence in the United States.

A second and independent justification also supports this distinction between OTC swaps trading and proprietary trading and further explains why the AIG example was the exception and not the rule. Realistically, it is only in the context of over-the-counter trading (and particularly the trading of long-term contracts, such as credit default swaps) that the failure of a foreign counterparty seems capable of causing the failure of the domestic financial institution that is its counterparty. In contrast, most proprietary trading in equities will occur on exchanges. Around the world, such trading is already cleared through clearinghouses (or similar institutions) that eliminate (or at least mitigate) the counterparty risk.[138] The distinctive feature about swaps was the absence of a clearinghouse or exchange, with the result that counterparty risk was a serious problem. This was the factor that made AIG's collapse so devastating that it required a bailout. Even after Dodd-Frank, counterparty risk survives in the case of OTC trading, at least when the swap is too customized to be cleared or traded on an exchange. Thus, in the context addressed by Title VII of the Dodd-Frank Act, counterparties could impose potentially bankrupting losses on a U.S. financial institution, but that same scenario is far less likely in the case of proprietary trading, where the counterparty risk is minimal. As a generalization, in the case of proprietary trading, the securities may be risky to their owner, but one counterparty's failure could seldom, if ever, destroy the other, at least when an exchange stands between them. Thus, the United States has much less of a need to regulate the foreign counterparty in the context of proprietary trading.

To return to a central theme, the key to the public-goods problem in the international context is that some jurisdictions need not internalize the costs of a financial contagion. In the OTC-derivatives context, a small nation may sponsor a dangerous financial casino where all who trade are at risk. To be sure, we have not in the past witnessed such behavior by any nation, but that was because before the passage of the Dodd-Frank Act, swaps trading was essentially unregulated everywhere. In the future, such a scenario of smaller nations offering financial casinos because they face little downside risk remains plausible—unless the major players (i.e., the United States and the EU) bar their own financial institutions from trading in them. Nonetheless, once we move outside this context of OTC derivatives,

138 *See* Luettringhaus, *supra* note 38, at 20 ("[S]tandardized exchange-traded derivatives contracts are transparent with regard to pricing, volume, the parties involved and their respective positions . . . . [and] are subject to initial and variation margin requirements . . . .").

the United States has less reason to regulate foreign counterparties. Unquestionably, the United States still has an interest in regulating the offshore activities of its own banks (and their subsidiaries and affiliates). But, reckless activity by a non-U.S. bank offshore (even though it has some presence in the United States) seems generally unlikely to impose significant costs on the United States, unless the scale of the foreign bank's activities in the United States is very large. Here, the Dodd-Frank Act may reach too far; indeed, some have argued that the banking industry deliberately caused the overextension of the Volcker Rule in a covert attempt to make the rule unenforceable.[139]

The bottom line, then, is that the case for the extraterritorial application of the Volcker Rule to foreign banks is limited. It should extend only to the offshore activities of U.S. banks (and their subsidiaries and affiliates)—and possibly to foreign banks with a major presence in the United States. Only to the extent that a counterparty's failure can endanger a U.S. institution does a basis exist (even under the statutory language of the Dodd-Frank Act)[140] for the United States to bar the foreign entity from proprietary trading. Thus, even if the foreign bank's trading activities were planned and orchestrated in the United States, they do not seem likely to threaten the safety and soundness of the United States's financial markets. All this suggests that financial regulators largely got it right in defining the extraterritorial scope of the Volcker Rule to cover U.S. banks globally but foreign banks only on a territorial basis.

Conclusion: The Fissures Under the "Soft Law" Paradigm

Put bluntly, the efforts of both the SEC and the CFTC to regulate OTC derivatives to contain systemic risk have fallen short, frustrated

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139 *See* Onaran, *supra* note 120 ("U.S. banks pushed regulators to widen proposed restrictions on trading and hedge-fund ownership by foreign firms, then encouraged governments around the world to complain about the rule's reach. The two-pronged lobbying strategy resulted in foreign officials joining U.S. lenders to push back against the Volcker rule."). No position is taken by this Essay on this claim that banks sought to sabotage the Volcker Rule in this fashion.

140 Even under section 722(d) of the Dodd-Frank Act, an extraterritorial application of U.S. law is generally precluded unless the "activities" at issue either "(1) have a direct and significant connection with activities in, or effect on, commerce of the United States" or "(2) contravene such rules or regulations as the Commission may prescribe or promulgate as are necessary or appropriate to prevent evasion of any provision of this Act . . ." In the case of the Volcker Rule, it is difficult to argue that either precondition is satisfied simply because a foreign bank with a U.S. presence engages in some proprietary trading. To illustrate, if a non-U.S. bank with a small branch office in the United States engages in proprietary trading in Europe (with the order being originated in New York), it seems self-evident that on this basis alone one cannot conclude that such trading will have any "direct or significant connection with . . . or effect on" the U.S. Dodd-Frank Act § 722(d), 7 U.S.C. § 2(i) (2012). Nor is it clear that a rule against such trading outside the United States is needed to prevent evasion where no U.S.-domiciled bank is a party to it.

by their inability (or unwillingness) to reach extraterritorial end runs around their rules. By using foreign subsidiaries whose obligations the parent institution does not guarantee, U.S. banks have the ability to behave as recklessly as AIG did in 2008. In a panic, these "unguaranteed" subsidiaries could topple, like falling dominoes, taking their counterparts down with them.

The lesson from this regulatory shortfall is, above all, that international financial regulation cannot continue as before. In the past, financial regulation was thought best left to independent and sophisticated technocrats, who needed to be "protected from the distorting influences of politics."[141] Today, financial regulation is proving too important to be left to the technocrats. As others have described, the old model of independent technocratic expertise appears to be waning, with the shift being toward "greater political involvement in postcrisis banking regulation around the world."[142] With this shift, the traditional style of international soft law is also becoming obsolete. Once soft-law standards were framed by transnational regulatory networks, populated by independent technocrats, in which elected governments participated to only a modest degree (if at all).[143] This process typically framed broad general principles and suggested voluntary best practices, but its output was not binding. In the wake of the 2008 financial crisis, the need for binding legal rules is now clear, but their arrival has been delayed by a variety of factors. Chief among these is the claimed need for harmonization. Indeed, that need is increasingly invoked by, and has become the most effective weapon of, those seeking to delay systemic-risk reform. Harmonization is no longer the neutral goal it once seemed, but the need for international collaboration is even greater. This Essay has suggested that the best compromise is minilateralism and bilateral or small-group negotiations. From this perspective, the initial question should be: what is the minimum number of nations that need to agree? In the world of OTC derivatives, an agreement between the United States and Europe would effectively compel the rest of the world to conform to their agreed standards.

The dangers inherent in substituted compliance arise not simply because the financial services industry wishes to escape confining reg-

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141 *See* Gadinis, *supra* note 12, at 158.

142 *See* Stavros Gadinis, *From Independence to Politics in Financial Regulation*, 101 CALIF. L. REV. 327, 332 (2013).

143 *See* Gadinis, *supra* note 12, at 162. For traditional descriptions of this process of formulating voluntary transnational norms, see Anne-Marie Slaughter, *International Law in a World of Liberal States*, 6 EUR. J. INT'L L. 503, 518 (1995); David Zaring, *Rulemaking and Adjudication in International Law*, 46 COLUM. J. TRANSNAT'L L. 563, 576 (2007–2008). *See also How International Financial Law Works*, *supra* note 5, at 304–11 (analyzing international financial law in light of the hard law/soft law dichotomy).

ulation but equally because nations move at different speeds. The United States has moved more quickly than Europe (or other nations) to implement systemic-risk reforms for a variety of reasons. Given the more fragmented nature of Europe, a slower decision-making process was predictable and will likely continue. Elsewhere, some nations may wish to see what the United States does before they act; others may fear taking a bold position if the United States does not follow; still others are just stalemated or indifferent. For all these reasons, the U.S. rules will typically come first and remain stricter than those of other nations. Thus, when U.S. regulators find that another jurisdiction's rules are functionally equivalent for purposes of substituted compliance, a significant margin will still likely persist between the strictness of the U.S. rules and those of the other jurisdiction. At that point, an incentive arises for U.S. financial institutions to move operations and personnel to that other jurisdiction to operate under its more-relaxed and lower-cost regime. Over time, such regulatory arbitrage will imply job loss and a decline in market share for the United States.

The resulting injury to the United States is twofold: (1) to the extent its financial institutions can operate under less strict rules abroad, it is more exposed to systemic risk; and (2) jobs and operations will migrate from the United States. In the past, the United States has occasionally deregulated in the hopes of spurring job creation,[144] but in this instance deregulation through substituted compliance uniquely implies job loss. Eventually, this loss may become pronounced, but at that point the financial services industry will respond that the United States should deregulate more sweepingly to reduce the disparity, in effect leveling down to the lowest common denominator. Any such deregulation could place the United States back on the road to another 2008 financial crisis.

What then is the answer? A minilateral negotiation is more likely to reduce the disparity between the rules of the United States and the other jurisdictions participating in the negotiation. To be sure, this is a matter of degree, not kind. In contrast, a multilateral approach that results in nonbinding principles of soft law will likely give rise to a greater disparity between the United States's rules and the operative rules of other nations. Even worse, agreement on broad (but empty) principles of soft law may obligate the United States to recognize all those regimes that are in asserted compliance with those loose international standards as qualifying for substituted compliance.

144 The leading recent example is the JOBS Act (an acronym for "Jumpstart Our Business Startups"), which was passed in 2012. For a review, see generally Michael D. Guttentag, *Protection From What? Investor Protection and the JOBS Act*, 13 U.C. DAVIS BUS. L.J. 207 (2013).

A key virtue of the minilateral alternative is that, because the United States and the EU effectively dominate derivatives trading, they would have the leverage to specify joint criteria for derivatives trading. If they can agree, they could insist that their financial institutions (and their offshore affiliates) not trade anywhere on a basis inconsistent with their joint criteria. Here, "hard law" would vastly outperform soft law. As a second step, they could take their agreed-upon criteria to bodies such as the Financial Standards Board and the G-20, where the major financial nations dominate.[145] Here, minority vetoes and holdouts are less likely to have an impact, and thus soft law could be better shaped. Only as a final step should the issue be placed on the agenda of larger, global bodies (where passive resistance by the likely free riders is more likely).

To sum up, there are two bad policy options: First, treating consensus as a precondition to regulation arms the opponents of financial regulation with a powerful weapon by which to veto through delay.[146] Second, deferring to the rules of other legal systems simply because they are within a stone's throw of those of the United States (as a policy of substituted compliance may entail) will encourage both delay and regulatory arbitrage. Predictably, U.S. market share will decline, and U.S. jobs will move abroad. To avert this, the United States and EU need proactively to seek to shape a global consensus—without awaiting its arrival as a prerequisite.

At present, it is clear that U.S. financial regulators do not really agree but will not acknowledge the inconsistency in their diverging approaches. On one hand, the SEC favors (and the CFTC has belatedly accepted) a policy of substituted compliance. On the other hand, the Federal Reserve Board continues to disdain or ignore this policy. Indeed, the Federal Reserve Board has not only imposed the

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145 Persons on both sides of this debate have recognized that the United States and the EU should "reenergize the G-20 as the pre-eminent global forum on financial reform" and "launch a comprehensive program aimed at bilaterally coordinating implementation of their reforms across regulatory agencies." CHRIS BRUMMER, THE DANGER OF DIVERGENCE: TRANSATLANTIC FINANCIAL REFORM & THE G20 AGENDA 4 (2013). Although I would not suggest that the G-20 become a super-regulator, able to review and revise the policies of the SEC or the CFTC, agendas are important and need to be reaffirmed or revised.

146 As of the summer of 2013, the financial services industry was attacking the CFTC on precisely this ground. In early August 2013, following the CFTC's negotiations with the EU, thirty-five members of the House of Representatives wrote to urge the SEC and the CFTC to reconsider their policies on cross-border swaps trading, arguing that "unilateral application of U.S. derivatives regulations to other countries that are presently working on their own complementary derivatives regulatory regimes will result in a flight of swaps activity away from U.S. banks overseas . . . ." Jim Hamilton, *House Members Urge SEC and CFTC to Harmonize Derivatives Regulations Both Domestically and Globally*, JIM HAMILTON'S WORLD SEC. REG. (Nov. 15, 2013, 9:30 AM), http://jimhamiltonblog.blogspot.com/2013/11/house-members-urge-sec-and-cftc-to.html. This is an unsurprising example of the industry's favorite tactic of insisting on delay and complete consensus before regulation can become effective.

Volcker Rule on U.S. banks on a worldwide basis but it has also just insisted that large foreign banks meet the higher U.S. standards on capital adequacy and leverage.[147] Unlike the SEC or the CFTC, the Federal Reserve seems impervious to foreign pressure that it conform to international standards.[148] Potentially, this could also cause some foreign financial institutions to flee the U.S. market (again with consequent job loss), and that is another reason why a minilateral approach (and eventual common rules) is more desirable.

The cause of curbing systemic risk has no natural champion and many natural enemies. One of the most commonly made observations about public goods is that they tend to be underprovided (because those who use or rely on them can escape paying for them).[149]

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147 On February 18, 2014, the Federal Reserve Board published a final rule (issued pursuant to section 165 of the Dodd-Frank Act) requiring large foreign banks to keep high levels of capital in their U.S. units and to establish a U.S. intermediate holding company (which would be supervised by the Federal Reserve Board) over those units if the foreign banking organization has $50 billion or more in the United States. *See* Federal Reserve System, Regulation YY, Docket No. 1438 (RIN 7100-AD-86), Enhanced Prudential Standards for Bank Holding Companies and Foreign Banking Organizations (2014). The rule further requires covered foreign banking organizations to maintain more risk-absorbing capital and hold a minimum of 4% of total assets in equity capital. *See* Isabel Gomez & Eyk Henning, *Deutsche Bank to Cut U.S. Assets*, WALL ST. J., Feb. 24, 2014, *available at* http://online.wsj.com/news/articles/SB30001424052702304610404579402631458481904. Predictably, the Fed's action elicited European opposition, but the Federal Reserve was unmoved. *See* Francesco Guerrera, *Current Account: Banking on Move by Fed as Top Cop*, WALL ST. J., Feb. 25, 2014, *available at* http://online.wsj.com/news/articles/SB20001424052702304834704579402740494142258; Ryan Tracy, *Fed Move Rattles Global Bank Talks*, WALL ST. J., Feb. 20, 2014, *available at* http://online.wsj.com/news/articles/SB10001424052702303636404579395272228933840 (quoting Michel Barnier that Fed action was "'decided unilaterally'"). *But see* Tarullo, supra note 16 (rejecting these arguments).

148 In its February 18, 2014 order, the Federal Reserve Board did acknowledge that some commentators had urged it to rely on a system of substituted compliance for foreign banking organizations, but explained that under section 165 it was instructed to focus on the foreign banking organization's activities in the United States and their potential impact on the U.S. financial system. *See* Federal Reserve System, Regulation YY, Docket No. 1438 (RIN 7100-AD-86), Enhanced Prudential Standards for Bank Holding Companies and Foreign Banking Organizations, at § IV(A)(4)(b) (2014). But this argument applies equally well to the SEC and CFTC, as foreign regulators have not focused on how swaps trading by U.S. and foreign swap dealers might affect U.S. financial stability.

Why is the Federal Reserve uniquely able to maintain its independence and resist the pressure for substituted compliance? Possibly, the Federal Reserve Board is more independent because it is less accountable to Congress (which does not fund it). Alternatively, it also lent heavily to shore up foreign banks in 2008 and may better perceive the risks. In addition, it is also independent of other central banks. The Federal Reserve Board's recent action with respect to foreign banks was in sharp contrast to the recent decision by UK banking authorities to relax their rules for foreign banks in order to attract them back to London. *See* Margot Patrick, *U.K. Regulator Poised to Change Rules for Foreign Banks*, WALL ST. J., Feb. 24, 2014, *available at* http://online.wsj.com/news/articles/SB10001424052702303880604579403194293703128.

149 For a representative assessment, see Charlotte Hess & Elinor Ostrom, *Ideas, Artifacts and Facilities: Information As a Common Pool Resource*, 66 LAW & CONTEMP. PROBS. 111, 120 (2003) (noting that the temptation to free ride "will lead to a suboptimal investment in improving the resource, monitoring use, and sanctioning rule-breaking behavior"). Here,

Protection against systemic risk is a public good, and, for the future, the great danger is that it will be underprovided. In all likelihood, failure will not be caused by forthright opposition to reform but rather by delay, piecemeal compromise, and low-visibility decisions that eviscerate the formal rules. The public has a short memory, but the industry never forgets.

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this means too few resources will be committed to protecting against systemic risk, including through law enforcement.