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Extraterritorial Financial Regulation:

Why E.T. Can’t Come Home

by John C. Coffee, Jr.*

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Introduction

This Article 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—most notably, *Morrison v. National Australia Bank Ltd.* and *Kiobel v. Royal Dutch Petroleum Co.*—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

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“soft law” on a consensual basis.3 Both perspectives, however, miss much, and the 
unfashionable word—“extraterritorial”—cannot be avoided.4

3 See David Zaring, Finding Legal Principle in Global Financial Regulation, 52 VA. J. 
INT’L LAW 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 notes 
68–70 and accompanying text. “Soft law” has many definitions, but a key factor is that it 
is generally non-binding (although there may be costs for non-compliance). For a good 
overview, see Chris Brummer, Soft Law and the Global Financial System: Rule 

4 Several authors have recognized that the new emphasis on “soft” law, 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 
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 
competitiveness is often a rhetoric used to mask an agenda that advances “interest group 
[politics]” for the benefit of key business constituencies. See 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
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

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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:

“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.”

These nations, the financial services industry, and still other nations that are 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 E.U. 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 overrode the presumption against extraterritoriality. In so

Essay agrees that many nations may prefer to maintain weak regulation (i.e., to run “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. National Australia Bank Ltd., 130 S.Ct. 2869, 2878 (2010), 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 notes 31–32 infra and accompanying text. Moreover, the
doing, 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

_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.” (internal 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 Act of 2010, Pub. L. No. 111-203, 124 Stat. 1862–63 (July 21, 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 Chicago Convention Ctr., L.L.C., No. 13 C 982, 2013 U.S. Dist. LEXIS 109936 at *7, 32–33 (N.D. Ill. August 6, 2013) (finding that Section 929P does not necessarily restore the prior Second Circuit case law, without deciding the question). [ER 1] This topic is beyond the scope of this Article, which examines only substantive financial regulation, not antifraud litigation.

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necessitated a U.S. governmental bailout of $182.5 billion in loans to it. 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 would have been often 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 world-wide financial contagion if AIG were also forced into bankruptcy, the U.S. Government responded by extending credit to it 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 non-transparent 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 U.K. subsidiary); and (3) major market participants could persist

7 For a good overview of this bailout, see William K. Sjostrum, 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 and Andrew Ross Sorkin, Throwing a Lifeline to a Troubled Giant, 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.
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 all this, Congress opted for an
extraterritorial reach for much of the Dodd-Frank Act.7

In a much quieter fashion, the E.U. has reached a similar recognition and has also
asserted extraterritorial authority. Here, a major irony surfaces: although the U.S. has
received considerable criticism for its expressly extraterritorial approach, the E.U. has
adopted a nearly equivalent position with regard to OTC derivatives in almost identical
language.8

7a See Greenberger, supra note 4, at 968–69.
8 Although critics of U.S. policy and U.S. banking lobbyists regularly portray U.S.
financial regulators as uniquely and arrogantly applying our law extraterritorially, the
E.U. has actually done much the same and over the same time period. The basic E.U.
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 51. Much like Dodd-Frank, EMIR will also regulate trades between non-
This assessment does not deny that the assertion of extraterritorial authority will produce friction. Such friction was abundantly evident in recent negotiations between the U.S. and Europe 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 U.S. and thereby effectively escape the principal E.U. entities when such trading has a “‘direct, substantial and foreseeable effect’ within the E.U. or where to do so is necessary to guard against anti-evasion.” See Shearman & Sterling LLP, United States: Actions Required Under Derivative Reforms, MONDAQ.COM (Aug. 6, 2013). This language largely parallels the language in Section 722(d) of the Dodd-Frank Act. See infra note 32 and accompanying text. For a detailed and somewhat critical review of EMIR and related initiatives, see Guido Ferrarini and Paolo Saguato, Reforming Securities and Derivatives Trading in the E.U.: From EMIR to MIFIR, 13 J. CORP. L. STUD. 319, 357–59 (2013).

ESMA, the European securities regulator, published a consultation paper on July 17, 2013, regarding the standards that it would use to prevent the evasion of EMIR by non-E.U. counterparties, which action again parallels the issuance of similar interpretive guidance by the CFTC and the SEC. ESMA’s paper is open to comment and consultation until September 16, 2013. Thus, this is a continuing story.

Still, the key point here is that the E.U. and the U.S. 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 notes 29 to 34 and accompanying text.
reforms intended by the Dodd-Frank Act. On the European side, there was 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 U.S. assumed that its preferred financial practices could be mandated for the rest of the world.

9 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”; (2) some U.S. banks “have hundreds of them 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, run out of London;” and (5) Bear Stearns’ “sinking hedge funds . . . were organized in the jurisdiction of the Cayman Islands.” See U.S. COMMODITY FUTURES TRADING COMM’N, OPEN MEETING TO CONSIDER CROSS-BORDER FINAL GUIDANCE AND CROSS-BORDER PHASE-IN EXEMPTIVE ORDER 9–11 (2013).

10 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.” See Huw Jones, ET, the New Alien Scaring Global Markets, REUTERS, Feb. 5, 2012, http://www.reuters.com/article/2012/02/05/us-financial-regulation-et-idUSTRE8140DV20120205. As late as September, 2013, the European press was
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\textsuperscript{11}—remained largely on the sidelines, with the real bargaining being between U.S. regulators and an E.U. Commissioner.\textsuperscript{12} That continuing to warn that CFTC “imperialism” was threatening a global deal. See Tom Braithwaite and Michael McKenzie, \textit{U.S. Rules Endanger Derivatives Reforms}, \textit{Financial Times}, Sept. 27, 2013 at p. 1. \[ER 2\] Some respected U.S. commentators have agreed with this assessment that the CFTC has overreached. See Edward F. Greene and Ilona Potiha, \textit{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 U.S. Domestic Coordination}, 8 Capital Markets L.J. 338 (2013) [hereinafter “Issues in the Extraterritorial Application of Dodd-Frank”]. This author agrees 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.


\textsuperscript{12} 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
bargaining centered on a new concept that is still unique to this financial regulatory context: “substituted compliance.”

13 Under it, the critical question becomes whether U.S. law and the host country’s law are “functionally equivalent.”

13a 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 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 its eager, even euphoric, acceptance within the financial services community and abroad, this Article will assert that the concept has not yet received the critical scrutiny it needs. Sometimes, its costs may outweigh its benefits.


Equally important, the attitude of U.S. financial regulators towards “substituted compliance” has approached the schizophrenic. Unlike securities and derivatives regulators, banking regulators have largely ignored or disdained substituted compliance, preferring to rely on a more traditional territorial approach.\textsuperscript{14} This disparity also needs justification.

Beyond this initial question of the costs and benefits associated with substituted compliance, the broader issue that this Article addresses is how successful international collaboration among nations can best be achieved on financial regulation. Unquestionably, such collaboration is needed, and an “imperialistic” approach by the U.S. 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, non-compulsory, 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.”\textsuperscript{15} 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),\textsuperscript{16} a “minilateral” solution

\textsuperscript{14} See infra at notes 68 to 73 and accompanying text (discussing the Volcker Rule).
\textsuperscript{15} This term was coined by Moises Naim, the long-time editor of FOREIGN POLICY. See Moises Naim, “Minilateralism: The magic number to get real international action,” FOREIGN POLICY (June 18, 2009) (available at http://www.foreignpolicy.com/articles/2009/06/18/minilateralism).
\textsuperscript{16} Moises Naim notes, for example, that the “last successful multilateral trade agreement dates back to 1994” and the “last significant international nonproliferation agreement was in 1995.” \textit{Id.}
can come much quicker through bilateral or limited multilateral negotiation. This Article 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 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.\textsuperscript{13d} The major financial nations—mainly the U.S. and Europe—did suffer from the 2008 crisis, while other nations with less developed financial infrastructures largely escaped damage.\textsuperscript{13e} 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 U.S.

\textsuperscript{13d} See Brummer, \textit{How International Financial Law Works}, supra note 5 at 309 ("[W]ealthier developed countries generally have more at stake in complex financial rule making.").

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 U.S. cannot effectively exercise that authority in the face of unified international opposition.\textsuperscript{13f} To some extent, this is true. Aggressive U.S. attempts at extraterritorial regulation have failed in the past (most notably in the antitrust context).\textsuperscript{17}

\begin{footnotesize}
\begin{enumerate}
\item[\textsuperscript{13f}]See, e.g., Greene & Potiha, Issues in the Extraterritorial Application of Dodd-Frank, supra note 10, 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.”).
\end{enumerate}
\end{footnotesize}
Still, the U.S. 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.18

Against this unsettled backdrop, this Article 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 U.S. and the E.U. 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 U.S. and the E.U. 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 substantive policies of the U.S. and its principal allies than anything posed by existing differences in derivative regulation.

18 See infra notes 73–90 and accompanying text.
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.  

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 coordination problems. This overlooks the very strong incentives for regulatory

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19 To this point, the U.S. 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 U.S. 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*, FINANCIAL TIMES, July 8, 2013 at p. 1.

arbitrage. Financial regulation has distributional consequences, and different legal rules create different winners and losers. Moreover, because non-binding “soft law” is unenforceable, it is easier for an adversely affected nation to defect and ignore its prior commitments.\footnote{See Brummer, How International Financial Law Works, supra note 5, at 271 (noting that “soft law should provide little utility as a means for making credible commitments” because nations will defect from informal commitments when it is in their interest to do so).} As a result, to expect “soft law” to be kind and gentle and to give each nation an equal voice is to state rules that ensure it will be ineffective.

Ultimately, systemic risk presents a classic “public goods” problem.\footnote{For an overview of the economics of public goods, see William H. Oakland, Theory of Public Goods in 3 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).} All nations want systemic stability, but most would prefer that others pay the cost of maintaining it.

international financial law has distributive consequences, these premises become untenable. For a critique of these views, see Brummer, How International Financial Law Works, supra note 5, at 260–61. \textit{See also infra} notes 87–89 and accompanying text.
Unless compelled, many nations would rather “free ride,” looking to the U.S. and the E.U. in the event of a financial contagion to again 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. In addition, a nation that persists with laxer, more permissive rules may be able to attract business and profit as a

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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.”

result of the regulatory arbitrage that predictably would follow.\textsuperscript{23} 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 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 Article is that, under these circumstances, all the preconditions necessary for a “tragedy of the commons” are present.\textsuperscript{24} 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

\textsuperscript{23} For the similar view of Professor Brummer, see supra note 5, at 267.

\textsuperscript{24} 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 (“non-excludability”), and (ii) some actors do not have to internalize the costs they impose on others. See Garrett Hardin, \textit{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 or 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.
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. More recently, legal scholars have extended this perspective to explain problems with public infrastructure (such as communication, transportation, and healthcare systems). A few pioneers have even noted its applicability to financial markets. Still, because the critical economic precondition to a “tragedy of the commons” is “non-excludability,” this perspective applies with the greatest force to financial markets when we move to the international context. That is, the participants


26 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).

27 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: Regulating the Credit Default Swap Commons, 82 U. Colos. L. Rev. 167, 147 (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.”).
who trade on any single market (say, the New York Stock Exchange) can exclude those
market participants 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 we are focusing 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 non-excludability 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 these nations can agree bilaterally
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 U.S. and the E.U. 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,24a 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

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24a See Brummer, supra note 5, at 267.
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.

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 Article 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.\textsuperscript{24b} Translated back into the language of international law, this prescription insists both that non-compulsory 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 bear the ultimate costs have the incentives to get the rules right.

\textsuperscript{24b} See, e.g., Raustiala, \textit{supra} note 17, 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”).
Realism counsels, however, that the U.S. 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 Article will focus on two very different examples of international financial regulation, which 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 U.S.) from engaging in proprietary trading or owning or sponsoring a hedge fund.28 These two examples were

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28 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 will become effective on April 1, 2014, but are subject to a “conformance period” that ends on July 21, 2015. See SEC Release No. BHCA-1; File No. S7-41-11, RIN 3235-AL07 (December 10, 2013) (“Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds”).

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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.\textsuperscript{25a} 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 (“OTC”) 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.\textsuperscript{29} 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

\textsuperscript{25a} See Greene & Potiha, \textit{Examining the Extraterritorial Reach of Dodd–Frank’s Volcker Rule}, supra note 13, at 271–72 & n.2.

\textsuperscript{29} For this estimate, see Jan D. Luettringhaus, \textit{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. EUR. L. ONLINE 19, 20 (2012). This figure reduces, however, to $20 trillion if all such contracts were settled and closed out simultaneously. \textit{Id.}
performance (which was, of course, the AIG experience).\textsuperscript{26a} 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.\textsuperscript{26b} 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.\textsuperscript{26c} 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 date of the Dodd-Frank Act) knew three things very well: (1) AIG’s failure had been precipitated by margin calls from its counterparties that could not be satisfied\textsuperscript{26d}, (2) AIG’s collapse had necessitated a $182 billion bail-out borne by the American taxpayer\textsuperscript{26e}; and (3) AIG’s credit default swaps had been written by a foreign subsidiary (based in the U.K.) that was effectively unregulated.\textsuperscript{26f} From the outset, this AIG experience inclined the U.S. Congress towards an extraterritorial approach; Congress did not want to be burnt twice

\begin{flushright}
\textsuperscript{26a} See id. at 20–21.

\textsuperscript{26b} See id. at 20, 25.

\textsuperscript{26c} See id. at 20.

\textsuperscript{26d} See Sjostrom, supra note 7, at 961–62.

\textsuperscript{26e} See Greenberger, supra note 5, at 976.

\textsuperscript{26f} See id. at 976–77.
\end{flushright}
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. 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. In these cases, 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 profited handsomely from trading derivatives on an over-the-counter basis because such trading is opaque and hence less subject to competitive pressure. Swap dealers have incentives to resist efforts to impose transparency by converting

\[\text{\footnotesize 27a }\]

\[\text{\footnotesize See } \text{FINANCIAL CRISIS INQUIRY COMM’N, THE FINANCIAL CRISIS INQUIRY REPORT 45–51 (2011) (detailing the relationship between the rising profitability of the OTC derivatives market and its lack of transparency).} \text{[ER 6]}\]
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 to 75% of the total derivatives exposure of U.S. banks was to foreign entities. 31 Indeed, in the extreme case of credit default swaps, only approximately 7% of U.S. single-name CDS transactions in 2011 were between two U.S.-domiciled counterparties, with the rest involving a foreign counterparty. 32 Thus, as the SEC has recently noted, “cross-border transactions are the norm, not the exception.” 33

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 did not need to be based in the U.S. and could easily be moved offshore—if such a migration allowed the swaps dealer to escape regulation. Thus, the incentive to

31 See Luettringhaus, supra note 26, at 26 & n.57.
33 Id.
engage in regulatory arbitrage was 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.\footnote{Dodd-Frank Wall Street Reform and Consumer Protection Act § 722(d), 7 U.S.C. § 2(i) (2012).}

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:

"[I]f 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 country from participating in the United States in any swap or security-based swap activities."\footnote{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). \textit{Id}.}

Effectively, this was a shot across the bow for other nations, and its message was blunt: Mess with the U.S. and your financial institutions (and others) will be barred from our swap 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 did not apply extraterritorially "unless those activities—

(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."  

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 extremely broad definitions of "swap dealer" and "major swap participant," which ignore the domicile of the entity and focus instead on the size of the positions it holds, the potential exposure created, and its degree of leverage, and it was clear at the outset that Title VII would sweep very broadly beyond the U.S. Yet, although it has received much less attention, the E.U.'s recent and key trading regulation, the European Market Infrastructure Regulation ("EMIR"), has an equally broad sweep and uses virtually the same tests.

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35 Pub. L. 111-203 (July 21, 2010), 124 Stat. 1673. 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.

32a See § 721(a)(21), 7 U.S.C. § 1a(49); § 721(a)(16), 7 U.S.C. § 1a(33).

36 See supra note 8 and accompanying text.
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. 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.”

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). 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 market. In that light, two provisions stand out. First, Section 2(h)(1) of the CEA now requires a swap to be submitted to a clearinghouse for clearing, unless one of the parties was eligible for an

33a See, e.g., § 725(g)(1)(A) (repealing the Commodities and Futures Modernization Act of 2000 § 407, 7 U.S.C. § 27(e)).


38 See § 7312010) (adding § 4s to the CEA).
exemption and elected not to clear the swap.\textsuperscript{35a} Although this was intended to minimize counterparty risk, its impact is probably marginal, because many participants and many instruments in the OTC derivatives market are exempt for a variety of reasons.\textsuperscript{39}

Second, Section 4s(e) of the CEA mandated margin requirements (both initial and variation margin) for swap dealers and major swap participants that trade in uncleared swaps.\textsuperscript{40} 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

\textsuperscript{35a} 7 U.S.C. § 2(h)(1).
\textsuperscript{39} 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.

\textsuperscript{40} 7 U.S.C. § 4s(e). The margin rules under the Dodd-Frank Act are complex and vary by the nature of the counterparty. Basically, 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 non-financial entities (including commercial end users). For a brief review of these rules, see Greene & Potiha, \textit{Examining the Extraterritorial Reach of Dodd-Frank’s Volcker Rule}, supra note 13, at 277–80.
excessive risk or be unable to fulfill their obligations. In addition, Section 4s(l) of the CEA gave the counterparty to the swap dealer or major swap participant the right to request that such margin to 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 it, 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.41 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”38a—namely, that a U.S. swaps dealer complied with Dodd-Frank’s requirements if the transaction was based abroad and complied with host country requirements that were “substantially equivalent.” If “substituted compliance” was sufficient, then U.S. swaps dealers could largely escape the danger that Dodd-Frank would place them at a regulatory disadvantage to their foreign competitors and possibly cost them business.

41 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 Greene & Potiha, Examining the Extraterritorial Reach of Dodd-Frank’s Volcker Rule, supra note 13, at 280.

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.\(^{42}\) 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.”\(^{43}\) Under its proposed “cross-


\(^{43}\) 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 Business Roundtable Inc. 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,
border guidance,” non-U.S. persons with significant swap positions were required to register with the CFTC as swap entities\(^{40a}\) (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 apply 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.\(^{40b}\) These substantive requirements would include clearing, margin, real-time public reporting, trade execution and sales practices.\(^{40c}\) To illustrate, both (1) the London branch of Morgan Stanley transacting in London with a Hong Kong-based customer, and (2) 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 U.S., all its branches worldwide would be covered by the Dodd-Frank Act’s rules. The regulatory burden clearly would have been substantial, and the guidance would have only exempted transactions 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, in dealing with non-U.S. persons. This

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N.Y. TIMES, Dec. 5, 2013 at B-5. This issue of cost/benefit analysis is beyond the scope of this Essay.

\(^{40a}\) See “Cross-Border Application,” \textit{supra} note 39, at 41,219.

\(^{40b}\) See \textit{id.} at 41,228–29.

\(^{40c}\) See \textit{id.} at 41,225.
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 require that the CFTC recognize 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, 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.” Because Congressmen seldom feel pressure from foreigners (who cannot vote), this legislation seems clearly 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”).

40d See id. at 41,229–34 (setting forth the CFTC’s proposed “substituted compliance” regime).


44 See Letter, dated July 3, 2013, to the Chairs of the SEC and the CFTC, signed by Senators Jeff Merkley (D-OR), Carl Levin (D-MI), Tom Harkin (D-IA), Elizabeth
More pressure, however, was applied from the opposite direction. In April, 2013, the E.U. 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 European rules (and, in particular, EMIR).\(^{45}\) 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.”\(^{46}\) Finally, a key Democratic Commissioner on the Warren (D-MA), Jeanne Shaheen (D-NH), Barbara Boxer (D-CA), Richard Blumenthal (D-CT) and Dianne Feinstein (D-CA), urging both agencies to close perceived major loopholes in their swap rules and not defer to foreign regulators. (Copy on file with Cornell Law Review).

\(^{45}\) Nine senior financial regulators sent an April 18, 2013 letter to Treasury Secretary Lew expressing concern about “fragmentation” in the OTC market if the U.S. 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 E.U.’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”].

\(^{46}\) See SEC Cross-Border Swaps Proposal, supra note 29, at 31,085 (“[T]he Commission is proposing a ‘comparability’ standard as the basis for making a substituted compliance
CFTC began to waiver in his support for the CFTC’s harder line position.\textsuperscript{47} With his support crumbling, CFTC Chairman Gensler began to negotiate a compromise in order to hold onto a majority.

In July 2013, in response to pressure from all sides, the CFTC modified its proposed guidance.\textsuperscript{48} 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
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, \emph{SEC Poised to Give Overseas Firms Leeway on Swaps}, \textsc{Wall Street Journal Online} (Apr. 30, 2013, 5:53 p.m. ET), http://online.wsj.com/news/articles/SB10001424127887323798104578455263840421672.

\textsuperscript{47} The Democratic Commissioner was Mark Wetjen, who was widely perceived as the swing vote on the CFTC. See Shahien Nasiripour, Michael Mackenzie, & Tom Braithwaite, \emph{U.S. Watchdog Set to Weaken Derivatives Rules}, \textsc{Financial Times}, Feb. 28, 2013, available at http://www.ft.com/intl/cms/s/0/e3fd4f66-81d0-11e2-b050-00144feabdc0.html#axzz2uGPIXRHw; see also Jamila Trindle, \emph{CFTC Delays Swap Vote as Member Voices Concerns}, \textsc{Wall Street Journal} (Feb. 12, 2013, 8:51 p.m. ET), available at

\textsuperscript{48} See Interpretive Guidance, \textit{supra} note 42, at 45,292.
majority U.S. ownership (direct or indirect) or a principal place of business in the U.S.\textsuperscript{49} 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.\textsuperscript{50} But if the foreign branch of a U.S. bank entered into a swap with a U.S. 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).\textsuperscript{51} The CFTC further indicated that, in determining whether a particular category of requirements of another country were to be deemed comparable to Dodd-Frank’s requirements, it would use an “outcomes-based approach.”\textsuperscript{52} 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 transactions-level requirements in dealing with U.S. persons and certain affiliates

\textsuperscript{49} See id. at 45,301–02.

\textsuperscript{50} 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.

\textsuperscript{51} See id. at 45,348.

\textsuperscript{52} See id. at 45,342–43.
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 important, 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. This seemed to imply that the European rules on the key “transaction-level”

53 See id. at 45,350.

54 See 2013 CFTC Ltr. LEXIS 47 (July 11, 2013) (“Re: 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”) at 1 [hereinafter “No-Action Letter”]. The European Market Infrastructure Regulation (“EMIR”) was adopted on August 16, 2012 by the European Commission (“EC”) on behalf of the European Union (“EU”). 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
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 80 swap dealers currently registered with the CFTC, 35 were organized outside the United States, of which 22 were established within the E.U.\textsuperscript{55}

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.\textsuperscript{56} Then, on December 20, 2013, one day before the scheduled expiration 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. \textit{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 this author’s 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. \textit{See} Business Roundtable v. SEC, 647 F.3d 1144 (D.C. Cir. 2011). Nonetheless, litigation has been brought on this ground. \textit{See supra} note 40.

\textsuperscript{55} \textit{See} No-Action Letter at n.1.

of this exemptive order, the CFTC announced a series of comparability determinations covering the E.U., Australia, Canada, Japan, Hong Kong and Switzerland.\footnote{These comparability determinations for the six different countries (including the E.U.) 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 Davis Polk, Client Memorandum, \textit{CFTC Issues Cross-Border Substituted Compliance Determinations, Provides Limited Phase In For Some Swap Requirements} (Jan. 7, 2014), available at http://www.davispolk.com/sites/default/files/01.07.14.CFTC_Issues.CrossBorder.Substituted.pdf [hereinafter “Davis Polk Client Memo”].} 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 E.U. and Japan.\footnote{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 recording keeping (subject to some exceptions). The CFTC did not, however, make comparability determinations for any jurisdiction with respect to its requirement}
CFTC also issued two no-action letters delaying the application of swap data reporting rules for certain non-U.S. swap dealers. 59 Nonetheless, despite these steps, the Wall that swap dealers provide it with compliance and risk reports. See “Davis Polk Client Memo,” supra note 54, 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 E.U.’s trade confirmation, portfolio reconciliation, and portfolio compression requirements fully comparable to those in the U.S. See 78 Fed. Reg. 78,886 (trade confirmation), 78,884 (portfolio reconciliation), 78,885 (portfolio compression). Only pre-trade execution information in the E.U. 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.

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

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.  

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 will generally be able to rely on substituted compliance, but it had not yet decided whether most “transaction level” requirements (and some “entity-level” requirements) are adequately “equivalent” to satisfy its “substituted compliance” standards at even the most financially developed and comparable nations.  

Then, everything changed, with the departure in early 2014 of the CFTC’s chairman, Gary Gensler, whose activist style was uncharacteristic for the CFTC.  

Established under the Laws of Australia, Canada, the European Union, Japan, and Switzerland”).


57a See discussion supra.

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.\textsuperscript{61} 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 strict as the U.S. restrictions.”\textsuperscript{62} Thus, by allowing swaps dealers to escape the new U.S. rules, this relaxation implied that swaps 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 some transparency to the financial products.”\textsuperscript{63}

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 U.S. 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. Whether the CFTC will entirely abandon the Gensler insistence on

\textsuperscript{61} See Andrew Ackerman and Katy Burne, “CFTC Is Set to Ease Rules on Trading Swaps Overseas,” The Wall Street Journal, February 11, 2014 at C-5; for a similar conclusion, see Phillip Stafford and Gina Chan, “Watchdogs reach deal on OTC derivatives rules,” Financial Times, February 13, 2014 at 18. 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, February 6, 2014.

\textsuperscript{62} See Ackerman and Burne, supra note 61, at C-5.

\textsuperscript{63} \textit{Id.}
some extraterritorial application of U.S. swaps rules remains uncertain, but its rules for
the time being still appear more aggressive than those of its sibling regulator, the SEC.
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.\textsuperscript{57c} Second, the CFTC may continue to insist that, swaps 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.\textsuperscript{57d} Substituted
compliance thus operates only within a lesser range for the CFTC.

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 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.\textsuperscript{58a} 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

\textsuperscript{57c} See supra note 47 and accompanying text.

\textsuperscript{57d} See supra note 48 and accompanying text.

\textsuperscript{58a} See SEC Cross-Border Swaps Proposal, supra note 29, at 30,975.
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 does 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.” 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.”

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

64 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.

65 Id. at 31,088.

66 Id. at 31,088–89.
is a bank, but by the appropriate banking regulator. 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.

Procedurally, the SEC contemplates that swap dealers would make an application, possibly as a group, for a substituted compliance determination, but it would require as a precondition that there be a Memorandum of Understanding in force between the SEC and the foreign country, covering supervision and enforcement.

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), while the SEC permitted all off-shore transactions to be governed by the still emerging rules of substituted compliance (without any special exception for transactions with U.S. persons). 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. Yet, at present, no one quite knows what the applicable European rules are (for example, with regard to margin).

67 Id. at 31,090.

68 Id. at 31,088–89.

63a See Cross-Border Application, supra note 39, at 41,217–18.

63b See SEC Cross-Border Swaps Proposal, supra note 29, at 30,975.

63c See id. at 31,009; see also Cross-Border Application, supra note 39, at 41,217.
Europe remains undecided on many of these questions.\(^69\) Starting, as the U.S. 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.\(^70\) Such division is not surprising and reflects the fact that the U.S. has a much stronger federal structure than Europe. Intense as the debate over financial regulation may be in the U.S., 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.\(^71\)

Earlier, this Article 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


\(^{70}\) Id. at B-2.

\(^{71}\) Often the resentment at U.S. “imperialism” seems to be stoked by lobbying firms representing the industry (and sometimes based in the U.S.). In the case of the current E.U. 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.
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.\(^{66a}\)

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 U.S.\(^{66b}\) 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.”

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\(^{66a}\) See id.

\(^{66b}\) See SEC Cross-Border Swaps Proposal, \textit{supra} note 29, at 31,094.
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 (MOU) between the U.S. and the host country governing supervision and enforcement have been signed. The key advantage of this approach is that (i) it does not treat the host country’s laws as static and fixed, and (ii) it does not place the U.S. 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 U.S. 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 U.S. (possibly in conjunction with the E.U.) 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 U.S. would mean that U.S. swap entities (i.e., dealers and major swap participants) would be unable to trade.

66c See id. at 31,088–89.
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 U.S.

Moreover, now that the U.S. and the E.U. 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, the U.S. and the E.U. represent a high majority of global swaps trading 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, etc.) 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 U.S. 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 U.S. in the pace of their reforms. At such a formative moment, such guidance would effectively define “the path forward.”

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66d See Ferrarini & Saguato, supra note 8, at 328.
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.72

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,73 but it exempts 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.74 Thus, a foreign bank with even a single branch in the United States is


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72 See Section 619 of the Dodd-Frank Act. 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).

73 Section 619 of the Dodd-Frank Act uses the term “banking entity,” which is defined in Section 13(h)(1) of the Banking Holding Company Act to include any company that is 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. See Bank Holding Company Act of 1956 § 13(h)(1), 12 U.S.C. § 1841 et seq.

74 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
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 themselves 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.75 Under the final rule, a foreign banking entity must satisfy the following conditions:

“[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. 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 25, at 421–24.

75 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 Board Passes Notice of Proposed Rulemaking on Prohibitions and Restrictions on Proprietary Trading and Certain Interests In, and
i. The banking entity (including any personnel that arrange, negotiate or execute the purchase or sale) may not be located in the U.S.;

ii. The banking entity (including any relevant personnel) that make the decision to purchase or sell may not be located in the U.S. or organized under the laws of the U.S. 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 U.S. 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 U.S. 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).76

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 U.S. 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 the institution is not a U.S. bank and all the attributes of the 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% 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 did banking regulators follow an entirely different approach towards 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
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.” Broad 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 which 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. Also, banking regulators understandably view bank failure as a serious event, one


79 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.” See Securities Exchange Act of 1934 § 3(a)(4)(A), 15 U.S.C. § 78c. Active engagement in trading requires no license; only acting as agent for others in executing transactions requires one to be a licensed broker.
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).\textsuperscript{74a}

This 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.\textsuperscript{74b} In February, 2012, E.U. Commissioner Michel Barnier appointed a High-Level Expert Group on structural bank reform.\textsuperscript{80} Chaired by Erkki Liikanen, it held hearings, consulted broadly, and issued its final report in October, 2012

\textsuperscript{74a} See Greene & Potiha, Examining the Extraterritorial Reach of Dodd-Frank’s Volcker Rule, supra note 13, at 272–74 (explaining the G-20’s usual approach to extraterritorial financial regulation).

\textsuperscript{74b} 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).

(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 banking group.”\textsuperscript{81} 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.”\textsuperscript{82}

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.”\textsuperscript{83} 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,\textsuperscript{84} 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.

\textsuperscript{81} Id.
\textsuperscript{82} Id.
\textsuperscript{83} Id. at iii.
\textsuperscript{84} 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”).

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This idea of “ring-fencing” the deposit-taking financial institution has been taken the farthest in the U.K. There, the U.K.’s Independent Commission on Banking (“ICB”) recommended in 2011 that large U.K. banks should ring-fence their retail bank operations into separate legal subsidiaries with their own prudential safeguards.\(^{85}\) 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 U.K.’s ICB report has been strongly supported in the U.K., with the U.K. government committing to have all necessary legislation in place by 2015.\(^{86}\)

Real differences separate these ring-fencing proposals from the Volcker Rule. Both the ICB and Liikanen proposal seem primarily concerned with protecting customer deposits and thereby averting the need for a taxpayer-financial bailout.\(^{81a}\) Thus, they are prepared (to varying degrees) to allow the overall banking group to take on high 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, 

\(^{85}\) \textit{Id. at} 85–86 (describing the history of the ICB proposal and the U.K. reaction to it).

\(^{86}\) \textit{Id. at} 86. Although the legislation would be fully in place by 2015, full compliance would not be required until 2019. \textit{See id.}

\(^{81a}\) \textit{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”).
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.\footnote{The Federal Reserve is particularly internationally minded and has long negotiated “soft law” standards with respect to topics such as capital adequacy at banks. \textit{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.”} 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 it in a separate subsidiaries that would be “ring-fenced” from their deposit-taking arm. 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

\footnote{\textit{See \cite{ER 13}}}
generally take deposits, 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 U.K.’s rules would mean that a Morgan Stanley or Goldman Sachs was in compliance with the U.S. law under the doctrine of substituted compliance, at least if all their proprietary trading was moved to the U.K. 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 compliance 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).

88 Goldman Sachs does have a small commercial bank which is licensed to operate in the U.K. See Ambereen Choudhury, Goldman Sachs Gets U.K. Approval to Operate Bank Unit, BLOOMBERG, April 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 U.K.

89 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
To sum up, although it is possible to make plausible arguments that all three approaches (the U.S.’s Volcker Rule, the U.K.’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). 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 off-shore 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 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 U.S. and the U.K. could focus on how large this segregated unit that engaged in proprietary trading could be.

foreign firms with U.S. branches and to the counterparties of U.S. financial institutions as well. 84b Is this necessary?

Although the 2008 crisis certainly underlined the dangers of off-shore activities, the most vivid illustration of these dangers — AIG’s failure 84c — should not be overread. Anxiety-raising as the AIG example is, it can be used to prove too much. On closer inspection, it shows 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 U.S. 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

84b See Greenberger, supra note 4, at 968–69 (discussing Dodd-Frank’s regulation of counterparties for swap transactions).

84c See Sjostrom, supra note 7, at 986–89 (discussing AIG’s ability to pursue off-shore transactions due to a lack of regulation).
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 U.S. may be justified in prohibiting the affiliates and subsidiaries of U.S. banks from engaging in proprietary trading abroad, but it has much far less justification in seeking to preclude foreign banks from doing so. At most, it can assert that proprietary trading within the U.S. 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 U.S. rules regulating offshore proprietary trading by a foreign bank simply because it has some presence in the U.S.

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. 84d 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 and 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 seldom, if ever, could destroy the other, at least when an exchange stands between them. Thus, the U.S. has much less of a need to regulate the foreign counterparty in the context of proprietary trading.

84d See Luettringhaus, supra note 26, 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 . . . .”
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 have witnessed such behavior by any nation, but that was because, before the passage of the Dodd-Frank Act, swaps trading was essentially unregulated everywhere. For 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 U.S. and the E.U.) bar their own financial institutions from trading in them. Nonetheless, once we move outside this context of OTC derivatives, the U.S. has less reason to regulate foreign counterparties. Unquestionably, the U.S. 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 U.S.) seems generally unlikely to impose significant costs on the U.S., unless the scale of the foreign bank’s activities in the U.S. 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.\(^{90}\)

\(^{90}\) See “Bank Lobby Widened Volcker Rule, Inciting Foreign Outrage,”, \textit{supra} note 73 (“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.
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 U.S. Only to the extent that the counterparty’s failure can endanger a U.S. institution does a basis exist (even under the statutory language of the Dodd-Frank Act⁹¹) for the U.S. to bar the foreign entity from proprietary trading. Thus, even if the foreign bank’s trading activities were planned and orchestrated in the U.S., they do not seem likely to threaten the safety and soundness of the U.S.’s financial markets. All this suggests that financial regulators largely got it right in defining the extraterritorial scope

⁹¹ 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. Nor is it clear that a rule against such trading outside the U.S. is needed to prevent “evasion” where no U.S.-domiciled bank is a party to it.
of the Volcker Rule as they did to cover U.S. banks globally, but foreign banks only on a territorial basis.

IV. Conclusion: The Fissures Under the “Soft Law” Paradigm

War, said Clemenceau, is too important to be left to the generals. Once, financial regulation was thought best left to independent and sophisticated technocrats, who needed to be “protected from the distorting influences of politics.”92 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 towards “greater political involvement in post-crisis banking regulation around the world.”93 With this shift, the traditional style of international “soft law” is also coming under pressure. 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).94 This process

92 See Gadinis, supra note 11, at 158.


typically framed broad general principles and suggested voluntary best practices, but its output was not binding. Governments deferred to the makers of soft law for multiple reasons, but indifference and more pressing matters rank high on this list of explanations.

Today, the plea for harmonization 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 remains clear. This Article 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 regulation, but equally much because nations move at different speeds. The U.S. 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 U.S. does before they act; others may fear taking a bold position if the U.S. 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 U.S.

The resulting injury to the U.S. 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 U.S. In the past, the U.S. has occasionally deregulated in the hopes of spurring job creation,95 but in this instance deregulation uniquely implies job loss. Eventually, this loss may become pronounced, but at that point the financial services industry will respond that the U.S. should deregulate to reduce the disparity, in effect leveling down to the lowest common denominator. Any such deregulation could place the U.S. 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 U.S. and the other jurisdictions participating in the negotiation. To be sure, this is an matter of degree, not kind. In contrast, a multilateral approach that results in non-binding principles of soft law will likely give rise to a greater disparity between the U.S.’s rules and the operative rules of other nations. Even worse, agreement on broad (but empty) principles of soft law may oblige the U.S. to recognize all those regimes that are in asserted compliance with those loose international standards as qualifying for substituted compliance.

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95 The leading recent example is the JOBS Act (an acronym for “Jumpstart Our Business Startups”), which was passed in 2012. For a review, see Michael 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 U.S. and the E.U. 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. 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 seek still more delay. Second, deferring to the rules of other legal

96 Persons on both sides of this debate have recognized that the U.S. and the E.U. 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.” See 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 re-affirmed or revised.

97 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 E.U., 35 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 regulation to other countries that are presently working on
systems simply because they are within a stone’s throw of those of the U.S. (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 U.S. and E.U. 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 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. Unlike the SEC or the CFTC, the Federal

their own complimentary 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 OF SECURITIES REGULATION (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.

98 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”) (February 18, 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 and Eyk Herring, “Deutsche Bank Will Cut Its U.S. Assets,” The Wall Street Journal Europe, February 25, 2014 at p. 20. 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 Street Journal, February 25, 2014, at C-1;
Reserve seems impervious to foreign pressure that it conform to international standards.\textsuperscript{99} Potentially, this could also cause some foreign financial institutions to flee the U.S. market (again with consequent job loss), and that is why a minilateral approach (and eventual common rules) is more desirable.

Congress seems equally inconsistent. On the one hand, it passed the JOBS Act in 2012 and substantially deregulated the federal securities laws to create jobs. But on the other hand, it has pressured the CFTC to accept substituted compliance, even though it will produce the migration of jobs and market share abroad. This inconsistency approaches self-deception.

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

\textsuperscript{99} 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 U.S. and their potential impact on the U.S. financial system. See Federal Reserve System, supra note 99, at Section IV (A)(4)(b), pp. 55–56. 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 swaps 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 U.K. banking authorities to relax their rules for foreign banks in order to attract them back to London. See Margot Patrick, “U.K. Bank Regulator Poised to Change Approach to Regulating Foreign Banks,” Dow Jones Institutional News, February 24, 2014.
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.

For a representative such 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, this means too little resources will be committed to protecting against systemic risk, including through law enforcement.