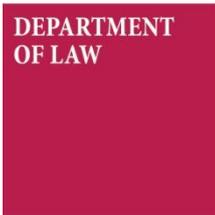




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Regulate Thy Neighbour: Competition and Conflict
in the Cross-border Regulatory Space for OTC Derivatives

Heikki Marjosola



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**REGULATE THY NEIGHBOUR: COMPETITION AND CONFLICT IN
THE CROSS-BORDER REGULATORY SPACE FOR OTC DERIVATIVES**

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European Regulatory Private Law: The Transformation of European Private Law from Autonomy to Functionalism in Competition and Regulation (ERPL)

A 60 month European Research Council grant has been awarded to Prof. Hans-Wolfgang Micklitz for the project “European Regulatory Private Law: the Transformation of European Private Law from Autonomy to Functionalism in Competition and Regulation” (ERPL).

The focus of the socio-legal project lies in the search for a normative model which could shape a self-sufficient European private legal order in its interaction with national private law systems. The project aims at a new-orientation of the structures and methods of European private law based on its transformation from autonomy to functionalism in competition and regulation. It suggests the emergence of a self-sufficient European private law, composed of three different layers (1) the sectorial substance of ERPL, (2) the general principles – provisionally termed competitive contract law – and (3) common principles of civil law. It elaborates on the interaction between ERPL and national private law systems around four normative models: (1) intrusion and substitution, (2) conflict and resistance, (3) hybridisation and (4) convergence. It analyses the new order of values, enshrined in the concept of access justice (*Zugangsgerechtigkeit*).

The research leading to these results has received funding from the European Research Council under the European Union’s Seventh Framework Programme (FP/2007–2013) / ERC Grant Agreement n. [269722].



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Abstract

The regulatory overhaul of the global OTC derivatives markets, originating from the G20, is transforming what used to be a relatively harmonised private and transnational legal regime into a public regulatory space fragmented by diverse territorial jurisdictions. In this regulatory space jurisdictional borders are elusive. Especially the United States and the European Union are applying what seems to be a novel type of regulatory strategy designed to protect their market share and curb regulatory arbitrage. The strategy, dubbed here the *Regulate Thy Neighbour* strategy, builds on unilateralist application of extraterritoriality, forms of direct and indirect protectionism, and conditional deference. Deference strategies such as the US substituted compliance and the EU equivalence regime should be regarded as carrots, applied together with the sticks of extraterritoriality and protectionism to drive regulatory convergence towards the strongest. However, the EU and US have failed to fill the leadership void in the global financial governance system, which remains soft at its core, and instead locked themselves in a regulatory turf war which has prevented them from recognising each other's regulatory frameworks or finalising their own. Meanwhile, looming risks of costly regulatory retaliation are increasing market fragmentation and deglobalisation. The emerging "titanic model" of systemic risk management, where risk is concentrated in presumably watertight national compartments rather than mutualised globally, is not the way towards a more stable global financial system. In the short term, a successful completion of the transatlantic partnership is needed in order to reach the derivative reform's ultimate goals and to counter financial fragmentation. But acknowledging the many practical and political problems involved in the exportation of rules through the Regulate Thy Neighbour strategy, which can also be manifested in a bilateral form, this paper joins the increasing number of scholars calling for more global and multilateral forms of financial governance.

Keywords

Derivatives, fragmentation, regulatory arbitrage, financial regulation, global governance

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Introduction¹

Set in motion by the Group of twenty (G20) 2009 summit in Pittsburgh, the governance of the global market for over-the-counter (OTC) derivatives is undergoing a metamorphosis. The reform programme targets various fundamental elements of OTC derivatives contracts with a view to better managing systemic risks and enhancing transparency and financial stability. The key reforms include 1) mandatory clearing of standardised derivatives in so-called central counterparties (CCPs), 2) the execution of adequately liquid contracts on transparent and organised trading venues, 3) the reporting of trades to special trade repositories, and 4) subjecting non-cleared bilateral derivatives to regulatory capital and margin requirements.

The reform was triggered by the findings about how OTC derivatives, in particular credit default swaps (CDS), contributed to the Global Financial Crisis.² The process means a sea change for a market that used to be subject to little public rules but operated instead under a system of sophisticated, transnational self-regulation. The sheer size of the market, valued notionally at USD 553 trillion at the end-June 2015³, would make a good case for getting the rules right. But the instalment of the new system has gone anything but smoothly especially where majority of the trading in derivatives takes place, that is, in the United States and Europe. In many important respects the final rules are yet to be agreed upon, or their full force postponed. In Europe, the key legislation European Market Infrastructure Regulation (EMIR)⁴ entered into force already in August 2012, but the market is still operating under a transitional regime.

A big factor behind the implementation problems is the lack of supporting changes in the global governance architecture for financial markets where soft law dominates. The fundamental problem remains: “*how to regulate cross-border business activity in a system that defines regulatory sovereignty as territorial prerogative*”.⁵ Because of this, the result has been a shift from a relatively harmonised private regime to a public regulatory space fragmented by diverse territorial jurisdictions. Consequently, regulators face a formidable task of coordinating their rulemaking procedures with their foreign colleagues whose legislative mandates, reform calendars, priorities, and even incentives are often different from their own.⁶

¹ Earlier versions of this working paper have been presented in the ERC-ERPL Workshop “The Transformation of Private Law – 4th Meeting of the Project Advisory Board” (Florence, 18 June 2015) and in the kick-off Workshop of the External Dimension of European Private Law Project, funded by the Academy on Finland (Florence, 28 January 2016). I wish to thank all the participants and commentators for their insightful feedback. I am also indebted to Emilios Avgouleas, John C. Coffee, and Hans Micklitz for their helpful comments.

² The Financial Crisis Inquiry Commission, Report (The FCIC Report), p. 50-51.

³ See Bank for International Settlements, Quarterly Review, June 2015, p. 24-25. The number and value of outstanding positions has been in significant decline, which according to BIS is due to advances made in new trade compression technologies helping to eliminate “redundant” contracts. It should also be noted that the gross market value of all reported derivatives contracts is significantly smaller. Furthermore, if legally enforceable bilateral netting agreements are taken into account, the number is significantly smaller still.

⁴ Regulation (EC) No. 648/2012 of the European Parliament and the Council on OTC derivatives, central counterparties (CCPs) and trade repositories (TRs).

⁵ Hannah L. Buxbaum, “Conflict of Economic Laws: From Sovereignty to Substance.” 42 Va. J. Int'l L. (2001): p. 931, 933. On the prevalence of territoriality as a central element in international financial law, see C. Brummer. “Territoriality as a Regulatory Technique: Notes from the Financial Crisis.” University of Cincinnati Law Review 79 (2010): p. 11-16.

⁶ The following note from a commissioner of the U.S. Securities and Exchange Commission (SEC) is revealing: “[...] at no time in the Commission’s [SEC] history have we been more engaged with the international community or more involved in collaborative work streams with our fellow regulators from around the globe. Much of this international work stems from the 2009 G20 initiatives regarding over-the-counter (OTC) derivatives reforms.” Michael S. Piwowar, Toward a Global Regulatory Framework for Cross-Border OTC Derivatives Activities, the Harvard Law School Forum on Corporate Governance and Financial Regulation (March 22, 2014).

The nature of the new rules exacerbates coordination difficulties. Rules such as capital adequacy requirements are entity-specific, but many derivatives rules apply instead to the transactions themselves. The concentration rules, which force standardised contracts into centralised clearing and on organised trading venues, are good examples of such transaction-level rules. Such rules capture, by default, both sides of the contract. For instance, when the EU mandates that all interest rate derivative contracts must be cleared in an authorised clearinghouse, this rule captures also all the non-EU counterparties to such contracts. On a market in which the parties to contracts are more often than not situated in different jurisdictions this introduces clear compliance problems. For instance, in 2012 around 80 per cent of credit derivative transactions had a cross-border element.⁷ At the time Lehman Brothers filed for bankruptcy it had hundreds of thousands of contracts outstanding with around 8,000 different counterparties around the globe.⁸ The question of whose rules to comply with is made all the more difficult by the fact that many rules have been given extraterritorial effects which means that they can capture trades which have a weak connection, if any, to the rule-issuing jurisdiction. In such a system jurisdictional conflicts are omnipresent.

As the term “cross-border regulatory space” in the title of this paper suggests, the global derivatives reforms are creating a regulatory space in which jurisdictional borders are increasingly elusive. In fact, also in cross-border dialogues the pervasive cross-border coordination problems have been labelled as “joint jurisdiction” issues.⁹ Reports such as “*EU and US aim for May deal on derivatives clearing*”¹⁰ or “*Europe and US fail to agree on derivatives rules*”¹¹ reflect well the fact like all shared regulatory spaces, the cross-border regulatory space for OTC derivatives is highly contested.¹²

This paper sheds some light on the source and nature of the implementation and coordination problems overshadowing the OTC derivatives reform. The Transatlantic derivatives dispute provides a useful laboratory for the analysis of a more general problem to which the Financial Stability Board (FSB) now habitually refers to as “Cross-Border Regulatory Issues”. To understand the problems, one needs first to understand the markets and how the new rules are affecting them. For that reason, the next section will shortly introduce financial derivatives and the regulatory reforms aimed at the OTC derivatives market.

Second, the paper assesses the present regulatory strategies available for addressing jurisdictional conflicts and disputes between regulators, as well as for exerting influence towards weaker countries. The dominant regulatory strategy, which is dubbed here the *Regulate Thy Neighbour* strategy, builds on unilateralist application of extraterritoriality, various forms of direct and indirect protectionism, and conditional deference. In the EU the so called “equivalence regime” allows for the possibility to *disapply* EU rules in favour of the rules of another jurisdiction whose regulatory and supervisory regime has been considered adequately equivalent. In the United States “substituted compliance” framework similarly makes possible deference to another jurisdiction’s rules. Such deference strategies should be seen as carrots, which are applied together with the sticks of extraterritoriality and protectionism to drive regulatory convergence towards the strongest.

⁷ See M. Barnier, International cooperation: a sine qua non for the success of OTC derivatives markets reforms, in OTC Derivatives: New Rules, New Actors, New Risks, Banque de France, Financial Stability Review, No. 17, April 2013. The SEC recently estimated that in 2011 approximately 7 per cent of the U.S. single-name CDS transactions were entered into between counterparties domiciled in the U.S. SEC, proposed rule, p. 28-29.

⁸ Hull, John C., Options, Futures, and Other Derivatives (Pearson Education India, 2006), p. 3.

⁹ See the “Path Forward” agreement announced by European Commissioner Michel Barnier and United States Commodity Futures Trading Commission (CFTC) Chairman Gary Gensler.

¹⁰ The Financial Times, April 24, 2015

¹¹ The Financial Times, May 7, 2015

¹² See Hancher, Leigh, and Michael Moran. “Organizing regulatory space.” In Baldwin, Robert, Colin Scott, and Christopher Hood (Eds.) A reader on regulation. (Oxford University Press, 1998), 153-154.

What drives the Regulate Thy Neighbour policies is the fear of regulatory arbitrage, an art of optimizing the costs of regulation via allocation of financial activities in different jurisdictions. Regulatory arbitrage is a contentious policy issue, as it can negatively impact not only the reaching of the reforms' ultimate policy objectives, but also jobs and market share. This has set the EU and US on crash course and resulted in a "transatlantic regulatory turf war".¹³ The "looming cross-Atlantic derivatives trade war" and the forms of "new 21st century protectionism"¹⁴ stand as good evidence of the shortcomings of the horizontal network model of global financial governance. Like its historical precursor *Beggar Thy Neighbour*, the Regulate Thy Neighbour strategies adversely affect cross-border trade, this time in financial instruments and services. The market response has been gradual but dramatic in magnitude. Once a very global market now faces a real risk of fragmentation and disintegration. Reports have witnessed a significant drop in international trading activity.¹⁵

Adopting a pragmatic stance, the paper argues that in the short term a successful completion of the transatlantic partnership is needed in order to reach the reform's ultimate goals.¹⁶ The transatlantic partnership can revive the transgovernmentalist idea of exporting rules to "weaker states" without hierarchy.¹⁷ This might mitigate the crucial regulatory arbitrage problems without the need to retreat to protectionism and continued financial fragmentation. However, the Regulate Thy Neighbour strategy, which can also work in through a bilateral alliance or "trade block" has various problems, both practical and political. Therefore, the paper also argues for gradual abandonment of the Regulate Thy Neighbour approach and for the simultaneous building of a regime based on embryonic forms of mutual recognition. As a first step, the key risk management standards agreed on supra-state level need to be served in a binding form. The Financial Stability Board as an increasingly important umbrella organisation and its member organisations such as IOSCO need to be upgraded and empowered in order to foster cooperation and coordination beyond the Atlantic.

The creation of cross-border regulatory space for OTC derivatives transactions

Short introduction to financial derivatives

Derivatives are financial instruments whose value depends on the performance and price of a reference asset, rate or index or some other underlying variable.¹⁸ Derivatives can offer end-users protection against market and/or credit risks. Hedging reduces risks through contracting away exposures to negative price movements or events (such as rise of fuel prices, or debtor's default). Derivatives are also used for speculation or arbitrage. Speculation basically involves taking a position in the market and thus, unlike hedging, also includes the possibly limitless upside. Arbitrageurs differ from both

¹³ See Stafford, Europe calls on US to recognise overseas clearing rules, *The Financial Times*, June 28, 2014.

¹⁴ J Christopher Giancarlo, Commissioner of the CFTC, Keynote Address at The Global Forum for Derivatives Markets, 35th Annual Burgenstock Conference, Geneva, Switzerland (24 September 2014).

¹⁵ Artamonov, Alexey. "Cross-border application of OTC derivatives rules: revisiting the substituted compliance approach." *Journal of Financial Regulation* 1.2 (2015): 206-225.

¹⁶ See also the Danger of Divergence: Transatlantic Financial Reform and the G20 Agenda", *The Atlantic Council report* (Rapporteur C. Brummer) (December 2013), 7.

¹⁷ See Kal Raustiala, "The Architecture of International Cooperation: Transgovernmental Networks and the Future of International Law", 43 *VA. J. INT'L L.* 1, 2 (2002).

¹⁸ The underlying can in principle be "anything that interests markets", such as stocks and bonds, commodities, interest rates, currency rates, stock market indices, and credit quality. Feder, Norman Menachem. "Deconstructing Over-the-Counter Derivatives." *Colum. Bus. L. Rev.* (2002): 677, 681. For various definitions of derivatives, see Partnoy, Frank. "Financial derivatives and the costs of regulatory arbitrage." *J. Corp. L.* 22 (1996): 211.

hedgers and speculators in that they seek riskless profits by identifying and exploiting opportunities, usually short-lived, created by price differentials or disparities between two or more markets.¹⁹

Options and forwards provide the ancestral building blocks of practically all derivatives.²⁰ A forward is simply “an agreement to buy or sell an asset at a certain future time for a certain price”, whereas an option holder has the right, but not the obligation, to buy (call option) or sell (put option) the underlying asset at a certain future time.²¹ Another basic derivatives contract is a future, a standardized contract traded on-exchange. Swaps are forward-based OTC contracts that have usually been traded bilaterally, i.e. off-exchange. Parties to swap contracts basically agree to exchange different sequences of cash flows.²² For example, a standard (“plain vanilla”) interest rate swap exchanges fixed interest cash flows to floating interest cash flows. Credit Default Swaps (CDS) offer protection against loan default. Swaps dominate the OTC market: based on their overwhelming success, swaps have been considered as “one of the most successful innovations in financial markets ever”.²³ At the most complex end, derivatives can themselves act as the underlying asset, which is often the case in structured or securitized financial products combining a security (usually fixed income bonds) with one or more underlying assets (often derivatives).²⁴

The structure of the market for financial derivatives is primarily shaped by the following three factors. These distinctions, though somewhat simplified, are important for grasping the on-going regulatory reforms and the policy objectives sought after:

1. The place of execution of the contract: all derivatives are either traded “over-the-counter” (OTC derivatives) or through regulated exchanges (exchange-traded derivatives). OTC derivatives dominate the global derivatives market: In June 2013, only 9 per cent of all derivatives were traded on exchange.²⁵ The exchanges offer a limited number of products, which are typically made of inflexible terms and conditions set by the exchanges themselves. Therefore, the pace of innovation is higher in the OTC market where contracts can be customized. Unlike most OTC derivatives, exchange-traded derivatives are transferable, i.e. there is a secondary market providing continuous maturity. OTC contracts can have maturities ranging from months to years and even decades. For instance, in end-2015 almost a quarter of interest rate derivatives had maturities of more than 5 years.²⁶
2. Clearing, or the use of central counterparty: derivatives cleared through a central counterparty (CCP) are distinguished from those executed bilaterally or through some alternative contractual arrangement; CCPs are a special type of clearinghouse which sit in between the derivatives deals, taking a position of a buyer to every seller and seller to every buyer. Centralized clearing effectively mitigates both payment and delivery risks.²⁷ All exchange-traded

¹⁹ See Hull, *op.cit.*, 10-16.

²⁰ See e.g. Awrey, Dan. “The dynamics of OTC derivatives regulation: bridging the public-private divide.” *European Business Organization Law Review* 11.02 (2010): 155-193.

²¹ Hull, *op. cit.*, 5, 7-8.

²² See Hu, Henry TC. “Misunderstood derivatives: the causes of informational failure and the promise of regulatory incrementalism.” *Yale Law Journal* (1993): 1457-1513, 1467; Feder, *op.cit.*, 701.

²³ Hull, *op.cit.*, 733.

²⁴ Yen, Jerome, and Kin Keung Lai. *Emerging Financial Derivatives: Understanding exotic options and structured products*. Routledge, 2014, 2-3. They lists the following “assets” that can be linked to the product: security, interest rate, currency, index, basket of assets (currencies, securities, commodities etc.), commodities, credit quality, volatility, spread, the consumer price index and other macroeconomic indicators, property price index. *Ibid.*, 5.

²⁵ Deutsche Börse, *How Central Counterparties Strengthen the Safety and Integrity of Financial Markets*, July 2014, 7

²⁶ See BIS, *Semiannual OTC derivatives statistics*, Table D9 (updated 6 December 2015).

²⁷ See Griffith, Sean J. “Substituted compliance and systemic risk: How to make a global market in derivatives regulation.” *Minn. L. Rev.* 98 (2013): 1291, 1312.

derivatives are centrally cleared, but not all centrally cleared derivatives are traded on exchanges.

3. Level of standardization: another important difference is that between standardized derivatives and non-standardized derivatives. All non-standardized, bilaterally negotiated derivative contracts are OTC derivatives. They comprise “myriad privately negotiated transactions” which can be infinitely tailored.²⁸ Standardisation of contractual terms and certain operational processes is the key requirement for any OTC derivative to be eligible for CCP clearing. In addition, there must exist an adequately liquid market with pricing sources that are fair, reliable and generally accepted.²⁹ For various reasons, many standardized derivatives have not been cleared through a CCP.

The ISDA summarizes the differences between different classes of derivatives in the following way:

Table 1: Distinctions between OTC, cleared, and listed derivatives

OTC	Cleared	Exchange-traded
Negotiated over-the-counter	Negotiated over-the-counter	Executed on organized exchanges
Traded between dealers as principals	Only standardized contracts	Only standardized contracts
Dealer normally counterparty to all trades	All trades booked with clearinghouse (counterparty to all trades)	All trades booked with exchange’s clearinghouse (counterparty to all trades)
Margin (collateral) often exchanged but subject to negotiation between counterparties	Mandatory margin requirements	Mandatory margin requirements
Customized contracts broken down by trading desk into tradable risks and hedged in liquid markets	Daily settlement (mark to market) and margin calls	Daily settlement (mark to market) and margin calls

Based on: ISDA, Product descriptions and FAQs (<http://www.isda.org/educat/faqs.html>)

Uncleared and non-exchange traded OTC derivatives were at the centre of the 2007-2009 financial crisis and thus they have been the focus of policy and regulatory action as well.

²⁸ Feder, *op.cit.*, 678.

²⁹ See Financial Stability Board, *Implementing OTC Derivatives Market Reforms*, report, 25 October 2010,

Regulation of OTC derivatives before the crisis

The problem with OTC derivatives is that they offer effective tools also for regulatory arbitrageurs, meaning that they can be used to exploit differences and disparities in different jurisdictions as well – by definition for “riskless” profits.³⁰ Second, they allow virtually endless leveraging and can accumulate and concentrate credit risks in the opaque corners of the global financial market. Third, little data has been available about the OTC market.

The AIG bailout proved just how dangerously these aspects could be combined. The AIG built up massive exposure on the OTC derivatives market through its London-based subsidiary AIG Financial Products (AIGFP). The primary business of AIGFP was selling protection against mortgage defaults by way of CDS contracts. Because of its solid credit rating (the CDS contracts were guaranteed by the parent company) AIGFP was able to do so hardly committing up-front capital (called “initial margin”). This was, and still is, the established market practice. When things started to unravel (Lehman not the least) and the infamous collateral calls amassed, the implosion of AIG and with it the entire apex of the financial system was quickly a matter of days. Ultimately, the rescue operation cost about 180 USD billion in taxpayer funds. The AIG story could be examined as an example of bad risk management practices - had there been any.³¹

OTC derivatives have traditionally been subject to minimal state intervention and light supervision. Despite the size and exponential growth of the OTC market, the regulatory framework for financial derivatives has remained piecemeal or non-existent.³² The firms that use or deal with OTC derivatives have been subject to various rules (e.g. capital rules) but the instruments themselves have managed for long to avoid fundamental regulatory scrutiny.³³ In the US, the deregulation movement gained momentum especially during the 1990s, culminating in the passing of the Commodity Futures Modernization Act (CFMA) in 2000.³⁴

It is true that the common conception of OTC derivatives markets as essentially “unregulated” neglects the extensive self-regulation by what has been called “transnational private regulators”.³⁵ The materials, terms, and standards offered by the International Swaps and Derivatives Association (ISDA) provide the dominant contractual framework for OTC transactions. Since the 1980s, the ISDA has

³⁰ See Partnoy, Frank. “Financial derivatives and the costs of regulatory arbitrage.” *J. Corp. L.* 22 (1996): 211. (“My point is not that derivatives use necessarily results in some harm to society; rather, it is that because derivatives often are used to reduce or avoid the costs of financial regulation, the question of whether increased derivatives use is “good” or “bad” depends on the particular use.”)

³¹ For a detailed plot of the entire AIG debacle, see The FCIC Report, p. 344- et seq.

³² Partnoy, Frank. “The Shifting Contours of Global Derivatives Regulation.” *U. Pa. J. Int'l Econ. L.* 22 (2001): 421, 429-426). (also noting that many unregulated derivatives are created for the purpose of avoiding regulations. *Ibid.*, 423, 432-434).

³³ Awrey, *op.cit.*, 162. For a detailed account of deregulation of swaps in the U.S., as lead by the CFTC, see Partnoy, *op.cit.*, 435-442 (describing how the OTC dealers successfully lobbied extensive exemptions in the turn of the 1990s). Rauterberg and Verstein describe the CFMA (enacted in 2000) as “the legislation that created almost two decades of de facto exclusive regulatory jurisdiction of the OTC derivatives market for ISDA”. Rauterberg, Gabriel, and Andrew Verstein. “Assessing Transnational Private Regulation of the OTC Derivatives Market: ISDA, the BBA, and the Future of Financial Reform.” *Va. J. Int'l L.* 54 (2013), 28.

³⁴ FCIC report, p. 48 (“The CFMA effectively shielded OTC derivatives from virtually all regulation or oversight.”)

³⁵ Rauterberg and Verstein, *op.cit.*, 9 (“Hundreds of trillions of dollars of OTC derivatives are governed by documents written by a single organization, the ISDA, and derive their payments from a single rate governed by another, the BBA” *Ibid.*, 13); Nystedt, Jens. “Derivative market competition: OTC markets versus organized derivative exchanges.”, IMF Working Paper WP/04/61, April 2004, 4.

developed the documentation hand in hand with market development and innovation.³⁶ The primary purpose of the ISDA Master Agreement is to provide boilerplate terms for non-economic issues (default events, governing law and jurisdiction, etc.) while leaving the determination of key economic provisions for the parties themselves (terms on interest rate, maturity, collateral etc.).³⁷ Given the overwhelming success of the market and its private law underpinnings, it is not surprising that OTC derivatives have offered a particularly fertile ground for theories of transnational law.³⁸

Despite OTC derivatives, primarily CDS contracts, are high on the list of culprits that caused the Global Financial Crisis, derivatives also offer advantages in the form of risk management (hedging) and transaction costs. Thus their regulation has been a controversial issue for decades. A prominent issue has been the disparity between regulated, exchange-traded derivatives on one hand, and unregulated (or self-regulated) over-the-counter (OTC) derivatives on the other. A sensible public policy goal has for long been to level the playing field by either deregulating exchange-traded derivatives or regulating OTC derivatives.³⁹ Twenty years ago the deregulation argument seemed sensible for many.⁴⁰ But with the experience of the Global Financial Crisis, the exact opposite is being done as the regulatory space is being expanded to cover the entire market.⁴¹

Creating the regulatory space for OTC derivatives

The on-going reforms, originating from G20, seek to mitigate systemic risk and improve market transparency.⁴² The Financial Stability Board (FSB) acting under the auspices of G20 has been tasked to coordinate the reforms between national legislators and regulators as well as international standard setting bodies such as International Organization for Securities Committees (IOSCO) and Basel Committee on Banking Supervision (BCBS). In the European Union, most of the G20 commitments concerning derivatives are implemented in the EMIR and Markets in Financial Instruments Regulation (MiFIR). The EMIR sets a mandatory clearing obligation for those classes of standardised OTC derivative contracts, which have been declared subject to clearing obligation (Articles 4 and 5 of EMIR). Furthermore, the MiFIR lays down a trading obligation requiring that all sufficiently liquid

³⁶ Feder, op. cit., 741. The ISDA employs ample expertise to track changes in market practice and to update its documentation. See Rauterberg, Verstein, op.cit. 21; Stephen J. Choi & G. Mitu Gulati, "Contract as Statute", 104 MICH. L. REV. 1129, 1144 (2006).

³⁷ Choi, and Gulati, op. cit., 1129-1173, 1140.

³⁸ Braithwaite notes that legal documentation in the OTC derivatives market "is regularly cited as the paradigmatic case of a standard form contract as transnational law." Braithwaite, Joanne P. "Standard form contracts as transnational law: evidence from the derivatives markets." *The Modern Law Review* 75.5 (2012): 779-805, 783.

³⁹ For a more detailed account on the distinction between public and private derivatives market, see Guido Ferrarini & Paolo Saguato (2013) "Reforming Securities and Derivatives Trading in the EU: From Emir to MiFIR", *Journal of Corporate Law Studies*, 13:2, 319-359

⁴⁰ Alan Greenspan stated in 1999: "The fact that the OTC markets function quite effectively without the benefits of [CFTC regulation] provides a strong argument for development of a less burdensome regime for exchange-traded financial derivatives." As quoted in the FCIC Report, p. 48. Professor Albrecht also concluded in the mid-90s that in order to move closer to a unified and efficient system, the regulation of exchanges should be reduced rather the regulation of OTC derivatives increased. Albrecht, William P. "Regulation of Exchange-Traded OTC Derivatives: The Need for a Comparative Institution Approach" *J. Corp. L.* 21 (1995): 111.

⁴¹ Here the term regulatory space is used in a way that excludes private ordering. In short, regulatory space is taken as an analytical construct defined "by the range of regulatory issues subject to *public* decision". Hancher and Moran, op. cit., 153 (emphasis added).

⁴² Group of 20, Declaration, Pittsburgh summit, September 2009. In particular, the G20 leaders declared that "all standardised OTC derivative contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties by end-2012 at the latest. OTC derivative contracts should be reported to trade repositories. Non-centrally cleared contracts should be subject to higher capital requirements."

and cleared OTC derivatives must be traded on trading venues.⁴³ For the private part of the market, those OTC derivatives that remain uncleared are subjected to capital and collateral requirements as well as to various risk mitigation obligations in order to better measure, monitor and mitigate operational risk and counterparty credit risk (Art. 11 of EMIR). Also, all derivative contracts must be reported to a registered or recognized trade repository (Art. 9 of EMIR). Titles III to V of EMIR lay down an extensive and detailed regime for CCPs, including a system for recognising third-country CCPs. Titles VI and VII do the same for Trade Repositories.

To illustrate the reach and practical effects of the new rules, let us take a closer look at rules concerning collateral and margin. The level and form of accepted collateral required from the buyer of a derivative has traditionally been set by the exchanges and clearinghouses or, in the case of uncleared and non-exchange traded derivatives, by the parties to the contracts themselves. In the first case, the exchanges and clearinghouses act as centralized sources for minimum margining terms.⁴⁴ The CCPs require margins from their clearing members, who must also make contributions to special default funds. Margins comprise a fixed component, “initial margin”, that is paid up front and a “variation margin” reflecting changes in the value of open positions.⁴⁵ Nowadays CCPs are heavily regulated, including their praised margining systems. One of the reasons for regulatory intervention is that while the regulatory push for standardization of OTC derivatives and the mandatory offloading of such contracts to the perceived safety of centralised clearing creates a lot of new business for CCPs, the competitive environment could also start pressuring CCPs to lower their risk management requirements. The European regulator has expressed the concern in clear terms: “CCPs should not reduce their margins to a level that compromises their safety as a result of the existence of a highly competitive environment”.⁴⁶

In the case of uncleared OTC derivatives, an industry association (ISDA) continues to offer the standard contractual framework for the transaction, leaving the ultimate economic choices to the parties themselves. This system has been prone to systematic undercollateralization.⁴⁷ Recall that the triple-A rating of the AIG made its counterparties feel secure enough to not require collateral up front. A logical regulatory countermeasure was therefore the introduction of mandatory collateralisation for such non-standardized OTC contracts. This means that legislators and regulatory agencies, in liaison with global standard setter organisations, will in the future determine both the eligible forms and minimum level of margins for bilateral, privately negotiated OTC derivatives. More stringent margining requirements aim at reducing systemic risk, but also set incentives for moving OTC derivatives towards centralised clearing.⁴⁸

The rationale of the policy initiatives is straightforward. In contrast to the OTC markets, derivatives clearinghouses were able to navigate through the financial crisis relatively unharmed and, most

⁴³ Article 32 of the Regulation 600/2014 of 15 May 2014 on markets in financial instruments, OJ L 173 (MiFIR).

⁴⁴ Margining is in practice carried out through various margining accounts upheld on all levels of transaction. Therefore, for instance, clearing margin posted by a clearing member is different from the margin posted by the investor with the broker. Finally, the broker has its own margin account with the clearing member (unless it is a member of the clearing organisation itself). Hull, *op. cit.*, p. 29-30.

⁴⁵ See Feder, “Deconstructing over-the-counter derivatives.” 2002 *Colum. Bus. L. Rev.*, 733–734

⁴⁶ Recital 23 of Commission Delegated Regulation 153/2013 of 19 Dec. 2012, O.J. 2012, L 52/41.

⁴⁷ See Singh, “Collateral, netting and systemic risk in the OTC Derivatives Market” IMF Working Paper 10/99; Singh and Aitken, “Counterparty risk, impact on collateral flows and role for central counterparties”, IMF Working Paper 09/173, 2009.

⁴⁸ Ingves, Stefan. “Regulatory reforms for OTC derivatives: past, present and future, ,in Banque de France, Financial Stability Review, No. 14, July 18th, 2013), 25.

importantly, meet their obligations without taxpayer support.⁴⁹ A reformed derivatives market with more centrally cleared derivatives is expected to prove more resilient in the next crisis. The reforms are biting: The FSB reports a clear general trend towards increased clearing.⁵⁰ Majority of OTC derivatives are already cleared through CCPs (60 per cent already in 2013⁵¹) and more is expected to follow after the new regulations enter into force. Progress has been made especially in the market for interest rate derivatives⁵² but also more credit default swaps are finding CCPs.⁵³

However, it would be a mistake to assume that all privately negotiated OTC derivatives will eventually be cleared through CCPs, let alone traded on exchanges. The OTC market segment will be smaller and subject to more regulation, but substantial portion of the market will remain uncleared.⁵⁴ Moreover, strict separation between OTC and exchange-based derivative markets has always been somewhat misleading, as the markets are in part complementary and in constant competition with each other.⁵⁵ The regulatory push towards centralized clearing has not terminated the competition between public and private derivatives markets: the flexibility and lighter cost structure of the OTC market can still trump the safety of exchange-based trading.⁵⁶ The OTC market will remain the primary source of innovation in the market for derivatives.

Implementation between soft multilateralism and hard unilateralism

Divergence, gaps, overlaps, and arbitrage

Much of the consensus that has been reached under the G20 umbrella has been lost in implementation, where soft principles and policy goals have been translated into hard rules. The global regulatory response has given rise to an uneven playing field characterized by conflicts, inconsistencies, overlaps and gaps.⁵⁷ The FSB's recent progress report summarises the prevailing cross-border concerns in the following way:

“Several authorities also note that *unevenness* in the pace of implementation of reforms, as well as *inconsistencies or gaps* in the application of requirements to cross-border transactions, can result in *duplicative or overlapping* requirements or lead to opportunities for *regulatory arbitrage*. Some

⁴⁹ For a brief account of the rationale behind the reform, see Marjosola, Heikki. “Missing pieces in the patchwork of EU financial stability regime? The case of central counterparties.” *Common Market Law Review* 52.6 (2015): 1491-1527, 1502-1504.

⁵⁰ The Financial Stability Board, *OTC Derivatives Market Reforms, Tenth Progress Report on Implementation*, 4 November 2015, 9.

⁵¹ Deutsche Börse, *op.cit.*, 7.

⁵² By end-2013, around 65 per cent of outstanding notional contracts had been cleared through CCPs. ISDA, *Size and Uses of the Non-Cleared Derivatives Market: An ISDA Study*, April 2014, www.isda.org.

⁵³ More than a quarter of all outstanding (notional) CDS contracts at end-June 2014. BIS Statistical Release, *op.cit.*

⁵⁴ ISDA, *Non-Cleared OTC Derivatives: Their Importance to the Global Economy*, March 2013, at 4.

⁵⁵ Nystedt, *op. cit.*, 7.

⁵⁶ See Mike Kentz, *Equity derivatives traders warm to OTC*, *Reuters.com*, 13 April 2014, reporting that a “host of market factors are driving equity traders back to the shade of OTC markets”. Chicago Board Options Exchange has reportedly submitted a letter to the SEC highlighting the fact that despite regulatory efforts, the markets are moving away from exchanges. However, at the same time, centralised clearing model is being embraced by entirely new asset classes, perhaps the most important example being the repo market, which provides the key short-term, wholesale funding mechanism for the global financial market. Liz McCormick, *Financial Firms Move Closer to Central Clearing in Repo Market*, *Bloomberg.com*, 13 April 2015.

⁵⁷ Michael Carney, *Completing the G20 reform agenda for strengthening over-the-counter derivatives markets*, in *OTC Derivatives: New Rules, New Actors, New Risks*, Banque de France, *Financial Stability Review*, No. 17, April 2013, 15 (footnote 10).

authorities note that this, in turn, could result in market *fragmentation and decreased liquidity*. In addition, some emerging market and developing economies have indicated that challenges may be presented by the potential cross-border impact of reforms, such as meeting *recognition/equivalence requirements* of major financial centres in OTC derivatives.⁵⁸

This summary nicely captures the mix of issues currently at play and also provides a road map for the rest of this article.⁵⁹

The differing scope of rulebooks causes various compatibility issues. For example, a standard scenario is that one jurisdiction requires mandatory clearing of a certain OTC derivatives transactions through a CCP and/or the execution of that trade on a regulated market while the other jurisdiction leaves the choice to the markets.⁶⁰ Also personal scopes of regulations can differ: EMIR for instance generally exempts intra-group trades from the clearing requirement⁶¹ in addition to which occupational pension providers are generally exempted, which is not the case in the US. EU rules more generally apply as a rule in a similar fashion to both financial and certain non-financial counterparties, whereas in the US the scope more limited.⁶² Inconsistencies can arise also in the context of inconsistent trade reporting requirements.⁶³

Direct regulatory conflicts represent the most challenging kind of coordination problems. They arise when one jurisdiction's rules cannot be followed without breaching the requirements of another.⁶⁴ Margin requirements offer a prominent example: the rules do not only deal with posting the required amount of margin (which could be agreed as meeting the regulatory standard, whichever is the highest), but they can set conflicting requirements with respect to division between initial and variable margins, eligible classes of collateral, as well as segregation of collateral.⁶⁵

⁵⁸ The Financial Stability Board, OTC Derivatives Market Reforms, Tenth Progress Report on Implementation, 4 November 2015, p. 13-14 (emphasis added by the author).

⁵⁹ As recently reported by IOSCO, the problem of duplicative and conflicting requirements is becoming a problem of regulated securities markets more generally. ("...the laws and regulations of the home jurisdiction may also apply to the activities of a domestic financial institution and its clients, customers, or counterparties taking place in the foreign jurisdiction, in addition to the laws and regulations of the foreign jurisdiction itself.") See IOSCO Task Force on Cross-Border Regulation Final Report, FR 23/2015 (September 2015).

⁶⁰ "...it is likely that certain OTC derivative contracts subject to the execution obligation under Title VII DFA will not be required to be traded on MTFs or OFTs in the European Union". See: CFTC AND SEC, Release No. 33-9338; 34-67453; File No. S7-16-11: Further Definition of "Swap," "Security-Based Swap," and "Security-Based Swap Agreement"; Mixed Swaps; Security-Based Swap Agreement Recordkeeping; Final Rule, Fed. Reg. 77 (2012), 48208-48366.

⁶¹ In August 2012 the CFTC also decided to release a proposal that would also allow certain intra-group trades to be exempted from the clearing requirements.

⁶² ESMA Final Report, Technical advice on third country regulatory equivalence under EMIR – USESMA/2013/115, 29 (ESMA Final Report)

⁶³ ESMA Final Report, 22-23 ("Where one regime (EU) requires certain information to be reported and a second regime (US) does not, the reporting obligation under EMIR cannot be substituted with the reporting obligation under the US regime.")

⁶⁴ Michael Carney, "Completing the G20 reform agenda for strengthening over-the-counter derivatives markets", in OTC Derivatives: New Rules, New Actors, New Risks, Banque de France, Financial Stability Review, No. 17, April 2013, 15 (footnote 10).

⁶⁵ Greene, Edward F., and Ilona Potiha. "Examining the extraterritorial reach of Dodd–Frank's Volcker rule and margin rules for uncleared swaps—a call for regulatory coordination and cooperation." *Capital Markets Law Journal* 7.3 (2012): 271-316, 281 ("Subjecting a broad range of foreign entities to posting margin requirements raises many questions about whose rules apply. For example, if a US entity enters into an OTC derivatives transaction with an EU counterparty and must post margin, must the EU entity segregate margin in accordance with the US rules as well as having to comply with EU rules? Will US rules or EU rules govern, or both?")

Divergence is a product of many factors. The implementation processes are not synchronized and they must navigate through multiple stages and levels also nationally and regionally.⁶⁶ Moreover, different political systems and regulatory cultures produce diverse outcomes, ranging from detailed rules-based approaches to flexible principles-based approaches. This has been true for OTC derivatives reforms as well.⁶⁷ Detailed rule-based systems can be difficult to combine with more flexible, principles-based approaches. On the other hand, very detailed rule-based systems are particularly prone to creating jurisdictional conflicts and inconsistencies, as evidenced by the US-EU negotiations. Lack of credible commitment can also produce divergence. In the absence of binding international agreements and organisations enforcing them, international soft law commitments are vulnerable to political reconsiderations and compromises. Though regulators can officially adopt the agreed common standards, they can also under-enforce or ignore them in the practice of supervision.⁶⁸ The commitment can also simply be missing. For instance, not every important market is located in G20 jurisdictions (e.g. Singapore). Finally, even if regulatory agencies would have the appropriate incentives and means to cooperate and coordinate the reforms, their legislative mandates can be ambiguous, incompatible and often even shared with other national regulators, imposing coordination needs also nationally.⁶⁹

The Regulate Thy Neighbour approach

The coordination and implementation problems are made all the more challenging by the fact that the lawmakers, especially in the U.S. and EU, have sought to apply their rules extraterritorially in order to curb regulatory arbitrage and protect their market share. For instance, the EMIR generally applies to contracts entered into between non-EU entities where those contracts would have a direct, substantial, and foreseeable effect in the EU or if it were necessary or appropriate to prevent the evasion of any its provisions.⁷⁰ The EU's approach to extraterritoriality was adopted apparently in response to the aggressive stance of the U.S. as evidenced by the Dodd-Frank Act (DFA) and its interpretation by the US regulators.⁷¹ The DFA in the U.S. provides that the provisions on derivatives (the DFA uses the term "swap") will apply to activities outside the United States that either (i) have a direct and significant connection with activities in, or effect on, commerce of the United States or that (ii) such activities contravene such rules or regulations as the Commission may prescribe or promulgate as are

⁶⁶ Arner, Douglas W., and Michael W. Taylor. "The Global Financial Crisis and the Financial Stability Board: Hardening the Soft Law of International Financial Regulation,." UNSWLJ 32 (2009): 488, 500 (noting that "majority of domestic financial regulation takes place not through legislation but through rules promulgated and enforced by regulatory agencies").

⁶⁷ See Griffith, Sean J. "Substituted compliance and systemic risk: How to make a global market in derivatives regulation." *Minn. L. Rev.* 98 (2013): 1291, 1317. ("The U.S. and Europe have both followed highly particularized rule-based approaches to the implementation of the central clearing mandate. Other jurisdictions have offered a more flexible standards-based approach. Still others have been slow to take any effort to regulate derivatives trading.").

⁶⁸ Brummer (2012), op.cit. 115-116, 136. On the other hand, Brummer has shown how international financial law, despite its soft law nature, works through its own sanctioning regime and has historically reached substantial (and even surprising) effectiveness. See Brummer, Chris. "Why Soft Law Dominates International Finance—and Not Trade." *Journal of International Economic Law* 13.3 (2010): 623-643.

⁶⁹ Freeman, Jody, and Jim Rossi. "Agency coordination in shared regulatory space." *Harvard Law Review* 125 (2012).

⁷⁰ See e.g. art. 11(12) on the risk management requirements for non-centrally cleared derivatives. The requirements apply extraterritorially "to OTC derivative contracts entered into between third country entities that would be subject to those obligations if they were established in the Union, provided that those contracts have a direct, substantial and foreseeable effect within the Union or where such obligation is necessary or appropriate to prevent the evasion of any provision of this Regulation." See also the final ESMA report on draft regulatory technical standards on direct, substantial and foreseeable effect in the EU, endorsed by the European Commission on 13 February 2014 (Commission Delegated Regulation (EU) No 285/2014).

⁷¹ Artomonov, op. cit., 12.

necessary or appropriate to prevent the evasion of any provision of the DFA⁷² The extraterritorial application of DFA has been further defined in various SEC and CFTC rules and guidance documents.⁷³

Realising the accumulation of grave implementation problems, and market fragmentation risks, the FSB has recurrently urged regulators to (a) identify the cross-border application of rules to infrastructure, market participants, and products; (b) identify concrete examples of any overlaps, inconsistencies and conflicts; and (c) develop options for addressing these issues.⁷⁴ Perhaps most importantly, the G20 declared in 2013 that “jurisdictions and regulators should be able to *defer to each other* when it is justified by the quality of their respective regulatory and enforcement regimes, based on similar outcomes, in a non-discriminatory way, paying due respect to home country regulation regimes”.⁷⁵

Both the EU and U.S. have introduced a regulatory framework for allowing deference. The EU Commission, assisted by ESMA, may adopt implementing acts declaring that the legal, supervisory and enforcement arrangements of a third country are equivalent to the requirements laid down in EMIR (Art. 13(2)). Upon such determination, market participants can comply with EU requirements by being compliant with the requirements of their own non-EU jurisdiction “where at least one of the counterparties is established in that third country”(Art. 13(3) of the EMIR). Upon such equivalence decision, ESMA can formally recognise a third-country CCP or a third-country Trade Repository and authorise them to provide services in the EU area. ESMA may not recognise a CCP or a trade repository unless and before the Commission adopts an implementing act determining that the legal and supervisory arrangements of the third country where the CCP is established are equivalent, and that the CCPs and Trade Repositories in that country are subject to effective supervision and enforcement procedures.⁷⁶ If circumstances change, ESMA can withdraw the recognition, or the Commission review its equivalence decision. An interesting question, especially in light of the ECJ’s recent *Safe harbour* decision⁷⁷, is whether and to what extent a national competent authority of an EU Member State in exercising its prudential supervisory mandate would have the power to assess the adequacy of a third country’s regulatory framework in an individual case. In any case, the ECJ undoubtedly has the power to review the validity of the Commission’s equivalence decisions.⁷⁸

ESMA’s equivalence assessments, preceding the actual adoption of the Commission decision, are based on an objective-based approach, in which the capability of the third country regime to meet the

⁷² See Sections 722(d) and 772(b).

⁷³ See e.g. CFTC, Further Definition of ‘Swap Dealer’, ‘Security-Based Swap Dealer’, ‘Major Swap Participant’, ‘Major Security-Based Swap Participant’ and ‘Eligible Contract Participant’, 77 Fed Reg 30,596; CFTC, Cross-Border Security-Based Swap Activities; Re-Proposal of Regulation SBSR and Certain Rules and Forms Relating to the Registration of Security-Based Swap Dealers and Major Security-Based Swap Participants, 78 Fed Reg 30,968.

⁷⁴ FSB, Meeting at November 2012, joint press statement “Operating Principles and Areas of Exploration in the Regulation of the Cross-border OTC Derivatives Market”, December 2012.

⁷⁵ G20 Leaders’ Declaration, St Petersburg 2013 Summit (6 September 2013)

⁷⁶ Art. 25(2)(a) and 25(6) of the EMIR. The same applies to trade repositories authorised in a third country (Art. 75(1)). On the other hand, the Commission’s positive equivalence determination does mean that CCPs or Trade Repositories from that country will automatically be recognised by ESMA (as emphasised in ESMA Final Report, ESMA/2013/115, 8-9).

⁷⁷ Case C-362/14, Judgment of the Court (Grand Chamber) of 6 October 2015, Maximilian Schrems v Data Protection Commissioner (not yet reported). In the case the Court confirmed that regardless of the Commission’s safe harbour decision concerning the United States data protection regime, national authorities must be able to independently examine whether the transfer of personal data to a foreign jurisdiction complies with the requirements laid down in the EU Data Protection Directive (para. 57). The Court went on to declare the Commission safe harbour decision invalid. It is noteworthy that the judgement was in large part based on various article of the Charter of Fundamental Rights of the European Union.

⁷⁸ I thank Hans-W. Micklitz for pointing out the relevance of the *Safe harbour* decision.

EU's regulatory objectives is assessed from "a holistic perspective".⁷⁹ In practice, however, the assessment is preceded by a detailed line-by-line comparison exercise. The European Commission has so far adopted nine equivalence decisions with respect to the regulatory regimes for CCPs of nine countries.⁸⁰ On the basis of these equivalence decisions ESMA has recognised eleven third-country CCPs from four different jurisdictions, thus allowing these CCPs to provide clearing services in the EU. Crucially, none of these CCPs are from the U.S. as the Commission has not adopted a decision on the equivalence of the U.S. derivatives regime.

Much like in the EU, the extraterritorial effect of U.S. regulation can be lifted in the framework of substituted compliance. In its original form substituted compliance was designed to open up the possibility for foreign actors wishing to conduct business in the US to avoid burdensome and duplicative SEC registration requirements and certain other U.S. rules.⁸¹ The more recent "second-generation" substituted compliance framework is designed more with a view to limiting the extraterritorial application of the Dodd–Frank Act.⁸² Under the substituted compliance regime, certain offshore persons and entities that might come under the scope of U.S. rules can instead comply with regulations in their home jurisdictions.

In December 2013 the CFTC issued a series of comparability determinations covering the EU, Australia, Canada, Japan, Hong Kong and Switzerland and making favourable determinations in favour of all six – nevertheless only with respect to so-called "entity-level" requirements. As to "transaction-level" requirements, the E.U. and Japan were deemed comparable only in limited cases and clearing and trade execution rules were excluded from the scope altogether.⁸³ The idea behind the distinction between "entity-level" and "transaction-level" rules is to simplify the cross-border application of the DFA's swap provisions. Entity-level rules are rules that apply to firms as a whole whereas transaction-level rules include the rules that apply to the individual transactions or trading.⁸⁴ The categorization exercise has proven complex and controversial. Moreover, the CFTC's approach has not been entirely consistent with that of the SEC.

The development of the derivatives rules by the CFTC and SEC respectively, and the related complexities and uncertainties, have been well documented and need not be dealt with in detail here.⁸⁵ In the simplest of terms, the present U.S. substituted compliance paradigm can be described in the

⁷⁹ ESMA, Final report: Technical advice on third country regulatory equivalence under EMIR – US, Final report Technical advice on third country regulatory equivalence under EMIR – US 1 September 2013, ESMA/2013/1157

⁸⁰ The countries are Canada, Mexico, South Africa, Switzerland and Republic of Korea, Australia, Hong Kong, Japan and Singapore.

⁸¹ See Ethiopis Tafara and Robert J Peterson, "A Blueprint for Cross-Border Access to U.S. Investors: A New International Framework" (2007) 48 *Harvard International L J* 31.

⁸² Jackson, Howell E. "Substituted Compliance: The Emergence, Challenges, and Evolution of a New Regulatory Paradigm." *Journal of Financial Regulation* 1.2 (2015): 169-205. ("With second-generation substituted compliance, regulatory relief is still being granted, but it is in the form of an exemption to the mandatory extraterritorial application of US laws") See also Artomonov, *op. cit.*

⁸³ Press Release, CFTC, CFTC Approves Comparability Determinations for Six Jurisdictions for Substituted Compliance Purposes (Dec. 20, 2013); CFTC, Business Conduct Rules for Swap Dealers and Major Swap Participants, Summary of Entity-Level Comparability Determinations (Dec. 20, 2013).

⁸⁴ See CFTC, Interpretive Guidance and Policy Statement Regarding Compliance With Certain Swap Regulations, 78 FR 45292 (26 July 2013), p. 45331. Under the CFTC's classification, the entity-level requirements include rules on, e.g. capital adequacy, chief compliance officer, risk management systems, and trade reporting and recordkeeping. Transaction-level rules on the other hand concern various key risk-management requirements such as clearing, margining and collateral segregation, mandatory trade execution etc. For more details, see. *ibid.*, p. 45331-45335.

⁸⁵ See especially Artomonov, *op. cit.*; Coffee Jr, John C. "Extraterritorial Financial Regulation: Why ET Can't Come Home." *Cornell L. Rev.* 99 (2014): 1259; Green and Potiha (2012) *op.cit.* and Green and Potiha, "Issues in the extraterritorial application of Dodd–Frank's derivatives and clearing rules, the impact on global markets and the inevitability of cross-border and US domestic coordination." *Capital Markets Law Journal* 8.4 (2013): 338-394. See also Griffith, *op. cit.*

following way: “Unless expressly permitted otherwise, you must comply with our rules even if you trade elsewhere in the world.”⁸⁶

The conclude, the above described conditional deference strategies, such as the US substituted compliance and the EU equivalence regime should be regarded as carrots, which are applied together with the stick of extraterritorial application of rules as well as the implicit and explicit forms of protectionism. In the following, these unilateral strategies are called the *Regulate Thy Neighbour* approach.

The Transatlantic derivatives dispute

Given that the U.S. and EU together dominate the global derivatives market and a lot of the trades take place across the Atlantic, there is a clear need to cooperate and coordinate the reforms. The parties released in 2013 the so-called Path Forward statement, laying down a road map towards mutual recognition of derivatives rules.⁸⁷ The deal outlined a package of measures for approaching common issues with cross-border derivatives. According to the statement the parties would not seek to apply their rules “unreasonably” in the other jurisdiction, but rather “rely on the application and enforcement of the rules by the other jurisdiction.”

Since the Path Forward statement the talks have been continuing in different fora, both official and unofficial. Participants have held two meetings in the context of a “Financial Markets Regulatory Dialogue” (on July 8, 2014 and January 12, 2015). The purpose of these meetings has been to exchange information on regulatory developments as part of on-going dialogue, and discuss shared interests in implementation and enforcement of financial regulatory standards.⁸⁸

However, despite comforting declarations, the deal is yet to be made and the negotiations appear to be locked in stalemate.⁸⁹ The range of transatlantic negotiation issues has been detailed in the ESMA final technical advice regarding the US regulatory framework, provided to the Commission already in September 2013. The outstanding issues were numerous.⁹⁰ With regard to the implementation and execution of the clearing obligation, ESMA recognised that the EU and US regimes are broadly comparable in their principles and objectives but that there are differences in the respective scopes of the regimes, both with regard to entities and especially contracts subject to the obligation.⁹¹

In particular, ESMA made a number of reservations about the US third country CCP regime. Perhaps most importantly, the US authorities require in practice that all third country CCPs become subject to the direct jurisdiction of the US authorities.⁹² In a more a recent comment, ESMA noted the drawback

⁸⁶ Artomonov, op. cit., 7.

⁸⁷ CFTC, press release, The European Commission and the CFTC reach a Common Path Forward on Derivatives, July 11, 2013 <<http://www.cftc.gov/PressRoom/PressReleases/pr6640-13>>.

⁸⁸ In addition to derivatives, the 2014 discussions covered insurance, money market funds, alternative investment fund managers, securitization, high-frequency trading, accounting, disclosures, audit, benchmarks, corporate governance, and data transfers, and information sharing for supervisory and enforcement purposes. In January 2015, the topics also included bank structural measures, money market funds, benchmarks, the implementation of EU’s UCITS reforms, and macro-prudential oversight. See European Union (EU) – United States (U.S.) Financial Markets Regulatory Dialogue Joint Statements, July 8, 2014 and January 12, 2015.

⁸⁹ See e.g. Philip Stafford, Market calls for US and Europe to end derivatives dispute, The Financial Times, September 2, 2015.

⁹⁰ The report identified three broad areas of concern: 1) the recognition of third country CCPs; 2) the recognition of third country Trade Repositories; and 3) the identification of potentially duplicative or conflicting requirements regarding the clearing obligation, reporting obligation, non-financial counterparties and risk-mitigation techniques for OTC derivative contracts not cleared by a CCP. ESMA Final Report

⁹¹ ESMA Final Report, 26.

⁹² ESMA Final Report, 20-21.

of the European approach to CCP recognition, which is “extremely open” and relies fully on third country rules and supervisory arrangements.⁹³ This is an anomaly in international comparison as most regulators scrutinize systemically relevant infrastructures much more closely. While the EU approach presents a “model in terms of mutual reliance” this legislative choice has clearly made the transatlantic bargaining more difficult. ESMA encouraged rethinking of the full reliance approach.⁹⁴

A number of difficult issues thus remain unsolved. At the centre of the current debate is the reluctance of ESMA and the EU Commission to declare the US regime for CCPs equivalent. One particularly difficult disagreement concerns the methodologies and approaches on CCPs’ margining systems.⁹⁵ The failure to reach the agreement could significantly reduce cross-border derivatives activity between the EU and US, primarily because trading at home would be much cheaper than abroad. The EU Capital Requirements Regulation (CRR) sets higher capital requirements for those transactions that are cleared through a “non-qualified” (i.e. non-authorised or non-recognised) CCP to offset the higher risk.⁹⁶ For the moment, EU banks continue to operate under “normal” lower capital requirements with regard to non-EU CCPs (including the U.S.) but this is only because under the present transitional regime the full effect of certain EMIR rules is regularly postponed. The US regulators have similarly postponed the application of various rules by issuing, e.g. targeted “no action letters”.⁹⁷

According to the latest reports, the parties are getting closer to agreement and the final deal is expected before a set of EU rules become effective on summer 2016. The deal, as it is envisaged, would involve both parties making concessions in terms of formal amendments in rules concerning CCP margining systems.⁹⁸

Problems with the Regulate Thy Neighbour approach

Coordination costs, domestic agency fragmentation, and incompatible mandates

Deference strategies represent an important exception to the *modus operandi* of international financial regulation where “each state prefers to address cross-border challenges simply by applying its own laws”.⁹⁹ But deference strategies also face numerous drawbacks. One is “the complexity of vetting foreign regulatory structures and devising mechanisms for ensuring that foreign supervision applies

⁹³ ESMA, EMIR Review Report no.4. ESMA input as part of the Commission consultation on the EMIR Review, paragraph 106.

⁹⁴ *Ibid.*, paras. 108-109. (“if Europe remains the only jurisdiction relying extensively on third country rules and authorities, this might put Europe at risk and does not benefit European CCPs.”)

⁹⁵ *Ibid.* See also Remarks of CFTC Chairman Timothy Massad Before The OTC Derivatives Conference, September 29, 2015, (“We have had a very constructive dialogue with the European Commission and ESMA and I have a very good relationship with Commissioner Jonathan Hill. I believe there is an ample basis for Europe to declare us equivalent, and I think this should have happened some time ago. But we are continuing to discuss some differences in our regulatory systems and, in particular, differences related to margin methodologies.”) <<http://www.mondovisione.com/media-and-resources/news/remarks-of-cftc-chairman-timothy-massad-before-the-otc-derivatives-conference-s/>>

⁹⁶ Article 382(3) of Regulation 575/2013 of 26 June 2013 on prudential requirements for credit institutions and investment firms (Capital Requirements Regulation).

⁹⁷ See for instance CFTC Letter 15-48, Extension of No-Action Relief: Transaction-Level Requirements for Non-U.S. Swap Dealers (August 13, 2015) “...the Divisions will not recommend that the Commission take an enforcement action against a Non-U.S. [Swap Dealer] (whether or not an affiliate of a U.S. person) for failure to comply with...”

⁹⁸ Stafford and Brunsdon, EU and US close in on derivatives oversight agreement, *The Financial Times* (FT.com, FT Trading Room), January 14, 2016 12:52 pm.

⁹⁹ Verdier, Pierre-Hugues. "The Political Economy of International Financial Regulation." *Ind. LJ* 88 (2013): 1405, 1438-1439.

effectively and consistently to cross-border transactions.”¹⁰⁰ ESMA’s technical advice about the equivalence of the U.S. regime serves as a good example of what kind of measures the approach entails. The advice includes a line-by-line assessment table consisting of more than 200 pages, followed by more than 1000 footnotes. The resource constraints have been noted.¹⁰¹ ESMA has itself made similar remarks:

“The process for the recognition of [a third country, TC] CCP is extremely rigid and burdensome, as demonstrated by the limited number of recognition decisions taken so far. The equivalence decision process is taking much more time than expected. - This puts at risk European clearing members and their subsidiaries clearing with these TC-CCPs and creates the potential for regulatory arbitrage between European and third country CCPs.”¹⁰²

Critical voices have been raised also in the US. One CFTC commissioner, in her dissenting opinion to the final rules on the international application of standards, stated that “the Commission has embarked on a cross-border analysis that I fear is taking us down a path of regulatory detail that is overly burdensome, complicated, and unnecessary.”¹⁰³

The second problem is domestic agency fragmentation, which can weaken the effectiveness of international cooperation. In the U.S. the competence in the field of derivatives is shared between the SEC and the CFTC. The CFTC is the primary regulator for swaps while the SEC regulates security-based swaps (mixed swaps are regulated jointly). In its final equivalence assessment, ESMA recognised the challenges related to the fact that the implementation of derivatives rules was not synchronized between the CFTC and SEC.¹⁰⁴ Research indicates that coordination tools can effectively mitigate agency conflicts in such “shared regulatory spaces” which are created by “overlapping, fragmented, and duplicative delegations”.¹⁰⁵ This undermines the popular case for consolidating agencies under one roof as a merger might simply “convert an interagency coordination problem into an intra-agency problem”.¹⁰⁶ However, multiple and overlapping delegations make it challenging to speak with one voice in cross-border negotiations. The more national regulators need to share their regulatory space also internationally, the case for consolidation should to become stronger, not least because there is a limited number of coordination tools available in the international sphere.¹⁰⁷ Brummer has also noted: “domestic divergence or fragmentation can create challenges with regard to promoting a unified “US position” across a variety of different sectors.”¹⁰⁸

¹⁰⁰ Jackson, *op.cit.*

¹⁰¹ Brummer, *The Danger of Divergence*, *op.cit.*, 5 (“In any case, operationalizing enhanced regulatory cooperation can be resource-intensive. In order to recognize another jurisdiction as essentially equivalent, for example, regulatory agencies must familiarize themselves with practices of other jurisdictions, and then relate these practices to their own domestic financial systems. The challenge to this way forward, problematically, is the lack of manpower to oversee these kinds of mutual agreements”).

¹⁰² ESMA, EMIR Review Report no.4. ESMA input as part of the Commission consultation on the EMIR Review, Paragraph 115.

¹⁰³ Statement of Commissioner Jill E. Sommers (dissenting), as annexed to the CFTC Final Rule.

¹⁰⁴ The following comment demonstrates well the inter-agency rivalry: “While the CFTC’s guidance is currently tied up in the courts for an indeterminate period of time, I can envision the SEC’s methodical approach to these issues bearing fruit in the form of a robust final rule in the coming months. Aesop, the ancient Greek story teller, would be quite happy looking at the state of Title VII regulation right now. His fabled story of the tortoise and the hare seems quite appropriate, with its overarching message that “Slow and steady wins the race.”” Piwowar, *op. cit.*

¹⁰⁵ Freeman, Jody, and Jim Rossi. “Agency coordination in shared regulatory space.” *Harvard Law Review* 125 (2012). 1209.

¹⁰⁶ *Ibid.*, 1154

¹⁰⁷ Compare the coordination tools examined by Freeman and Rossi, *ibid.*

¹⁰⁸ Brummer, *The Danger of Divergence*, *op. cit.*, 14.

The third problem concerns legislative mandates and coordination lag. In the present case there seemed to have been little coordination efforts before the derivatives legislation was tabled, thus the task was left for the executive function. But when legislators incorporate into a legislative act the possibility to defer to a foreign jurisdiction on the condition of adequate substantive equivalence or comparability of rules and supervisory practices, they also authorise the regulators in charge of the implementation to engage, within the limits of their legislative mandate, in cross-border negotiations on the final content of the rulebook. A regulator's bargaining power is constrained by the legal authority delegated to it. The problem here is that while a broad mandates would likely make reaching the agreement easier, the amount of bargaining power and discretion delegated to the executive organs correlates inversely with such values as legitimacy and democracy. In any case, for the horizontal network model to work, ambitious global projects such as the OTC derivatives reform should be better coordinated already when legislation is being drafted. Tellingly, the transatlantic negotiations on the mutual recognition of derivatives rules seem to have reached a conclusion that issues need to be taken back to the legislator.¹⁰⁹

Regulatory arbitrage, rigidity, and market fragmentation

The general problem with deference and recognition strategies such as substituted compliance is regulatory arbitrage. Unilateral export of regulatory standards works best in policy areas where regulated targets are relatively "inelastic".¹¹⁰ Financial markets are very elastic and the competitive pressures that apply in the market for financial derivatives regulation are well known.¹¹¹ If foreign jurisdictions are recognised without adequate convergence, firms and transactions can start moving to friendlier jurisdictions.¹¹² In short, regulatory arbitrage reduces costs or captures profit opportunities that are created by different regulations or laws.¹¹³ Like all mandatory rules regulating the private domain, the expansion of regulatory space in the area financial derivatives limits autonomy and choice, but the fact that the governance system is still built on the principle of regulatory sovereignty and territoriality¹¹⁴ means that regulators can only limit choice within their sovereign regulatory space (even if this regulatory space might transcend jurisdictional borders). Those subject to rules might no longer have the freedom to choose certain economic terms of their contracts, but as a second-best option they can choose the regulatory regime providing the best terms.

Regulatory arbitrage and negative regulatory competition can undermine public policy goals. One way to look at this familiar problem is assessing it against the Financial Trilemma, which indicates that (1) financial stability, (2) cross-border financial integration and (3) national financial policies are

¹⁰⁹ See section 3.3. above and Stafford and Brunson, EU and US close in on derivatives oversight agreement, *The Financial Times* (FT.com, FT Trading Room), January 14, 2016.

¹¹⁰ Bradford, Anu. "The Brussels Effect." *Nw. UL Rev.* 107 (2012): 1. "Strict domestic regulations can operate as global standards only if such strict regulations cannot be circumvented by moving the regulatory targets to another jurisdiction" *Ibid.*, 16.

¹¹¹ See e.g. Griffith, *op. cit.*, 1293 ("In the context of derivatives, if U.S. authorities impose a harsh clearing regime, banks may shift their derivatives operations to London or, if European and American regulation converge, to Hong Kong or Singapore or some less highly regulated jurisdiction.")

¹¹² Jackson, *op.cit.* See also Coffee, *op.cit.*

¹¹³ Partnoy, Frank. "Financial Derivatives and the Costs of Regulatory Arbitrage", 22J. CORP. L. 211, 227 (1997). ("Regulation that imposes costs on non-derivatives transactions creates an incentive for parties to structure economically equivalent derivatives transactions that avoid the reach of the regulation or reduce its cost". *Ibid.*) See also Riles, *op. cit.*, 63, 65.

¹¹⁴ On the prevalence of territoriality as a central element in international financial law, see C. Brummer. "Territoriality as a Regulatory Technique: Notes from the Financial Crisis." *University of Cincinnati Law Review* 79 (2010): 11-16.

incompatible objectives.¹¹⁵ The negative effects of regulatory arbitrage, i.e. the weakening of the effectiveness of regulatory measures, is a direct consequence of not giving the other two objectives, that is, national financial policies (broadly, sovereignty¹¹⁶) and financial integration, which allows capital to move (relatively) freely.

The accepted wisdom to counter the problem of regulatory arbitrage is harmonisation. This strategy has been put sternly into practice in the European Union with the “single rulebook” harmonisation agenda, backed by the empowerment of new authorities to implement the single set of rules. A common set of rules, or rulebooks without material differences, would effectively eliminate arbitrage opportunities. Also internationally arbitrage problems would not exist if everybody simply agreed on everything but the limits of this strategy are as obvious as the benefits of its successful completion: “Like Holy Grail, international consensus is more sought than discovered”.¹¹⁷ The obstacles to harmonization are numerous.¹¹⁸

If harmonisation is unfeasible, regulatory arbitrage concerns (which also include the risk of losing business and jobs) need to be addressed by other means. For now it seems that states might be more willing to give up on financial integration rather than building more global governance structures. There is abundant evidence of the on-going disruption and fragmentation especially in the transatlantic trading relationship.¹¹⁹ Artomonov concludes that “the global derivatives market is not global anymore; rather, it has become a fragmented system of ring-fenced liquidity pools, where risk is concentrated rather than being dispersed evenly throughout the global system.”¹²⁰

Regulation can promote de-globalisation in various ways. The EU for instance applies direct restrictions on cross-border provision of financial services into the jurisdiction as well as precautionary capital charges for the EU entities when they use the services of certain third country entities. The DFA grants the CFTC and SEC the authority to prohibit an entity domiciled in a foreign country from participating in the United States in derivatives transactions, if either authority considers that the regulation of derivatives in that foreign country undermines the stability of the United States financial system (Section 715 of the DFA).

The on-going fragmentation is giving way to what could be called a “titanic-model” of systemic risk management, which mitigates risk by isolating it in what are assumed to be watertight compartments

¹¹⁵ Schoenmaker, Dirk, *The Financial Trilemma* (February 10, 2011). *Economics Letters*, Vol. 111, 2011, p. 57-59. (1). The financial trilemma is related to the more famous monetary dilemma which shows that (1) a fixed exchange rate, (2) capital mobility and (3) and national monetary policy cannot all be achieved. See *ibid*.

¹¹⁶ “[U]ltimately, the trilemma boils down to the issue of sovereignty. At one extreme, policymakers can hand over part of their sovereignty to foster global banking and global financial stability. At the other extreme, policymakers can choose to impose restrictions on cross-border banking to preserve their full sovereignty.” Schoenmaker, Dirk. “Banking supervision and resolution: the European dimension.” *Law and Financial Markets Review*, January 2012, 54.

¹¹⁷ Coffee, *op. cit.*, 8.

¹¹⁸ A comprehensive account is offered in Riles, *op.cit*. She mentions at least the following: 1) Divergence: even if consensus is reached, cherry picking or incomplete implementation and enforcement nationally will result in divergence; 2. Incomplete consensus: some issues are always left for national discretion; 3. Limited scope of negotiations; 4. Extraterritorial application of national rules; 5. Overlapping work programs and mandates internationally can produce conflicts and inconsistencies; 6. Multilevel implementation exacerbates divergence; 7. Institutional complexity, both internationally and regionally; 8. Inadequate and inconsistent representation of national regulatory authorities in international negotiations (the number of authorities and their mandate diverge drastically in different countries); 9. Marginal representation (if any) of private rulemakers and transnational organizations (such as ISDA) which produce private ordering and even publicly endorsed innovations; 10. Too much focus on rulemaking at the expense of actual regulatory practices, supervision and enforcement.

¹¹⁹ ISDA has reported “clear evidence ... that liquidity has fragmented along geographic lines”. *International Swaps and Derivatives Association, Cross-Border Fragmentation of Global Derivatives: End-Year 2014 Update* (April 2015), <http://www2.isda.org/attachment/NzUzMQ==/Market%20fragmentation%20FINAL.pdf>

¹²⁰ Artomonov, *op.cit.*, 14.

of national jurisdictions. One model suggests that this might actually not be such a bad idea if the focus is solely on financial stability.¹²¹ But theory also suggests that risk is better managed when it is not concentrated and markets are more liquid. More global financial markets can do more good than harm, e.g. in terms of increased liquidity, better means of risk diversification and more means of financing beneficial innovation - insofar as we manage to regulate away the stability risks. And perhaps most importantly, financial fragmentation is a clear indication of the failure the global derivatives reform. Why bother to agree on a global reform agenda in the first place if the result is a retreat to territorialism and protectionism?

Which way forward?

Bilateral regulatory export through a transatlantic deal?

Transgovernmental networks can promote convergence without Treaties and centralization through “the export of regulatory rules and practices from major powers to weaker states”.¹²² In this way territorialism indeed “matches legal authority to market power”¹²³, meaning, in the context of financial markets, simply that “the bigger the capital market, the greater the influence of regulators.”¹²⁴ In such a view, the transatlantic derivatives dispute does not come as a surprise. The power asymmetry between the Atlantic neighbours has been in steady decline. One reason for this has been the institutional evolution and the centralization of regulatory authority within the EU.¹²⁵

On the other hand, also the globalization of finance and tightening competition from both old and emerging financial centres has shaken the status quo.¹²⁶ The importance of the U.S. and the EU as the primary locus of global capital markets activity has declined as a result of the financial crisis with diminishing cross-border capital flows,¹²⁷ as well as “the rise of the rest”, i.e. the emerging multipolar world of financial regulation.¹²⁸ One might therefore reasonably enquire what in fact are the advantages of bilateral, transatlantic cooperation. Should we not rather acknowledge the zero-sum nature of the “market for financial regulation” and the elasticity of capital, and accordingly focus less on exclusive clubs of regulators and more on building open multilateral cooperation forums?

Many have nevertheless proposed building a deeper cooperative relationship between the U.S. and EU instead of relying on global approaches. First of all, the U.S. and EU together still account for roughly 90 per cent of the market for derivatives.¹²⁹ According to Pan, the benefits of deeper cooperation stem

¹²¹ Modelling the optimal degree of financial integration Stiglitz finds that “full integration is not in general optimal” and that “faced with a choice between two polar regimes, full integration or autarky, in the simplified model autarky may be superior.” Stiglitz, Joseph E. “Risk and global economic architecture: Why full financial integration may be undesirable.” *American Economic Review: Papers & Proceedings* 100 (May 2010): 388–392, 388.

¹²² See Raustiala, *op. cit.*, 7, 8-9. See also Bradford, *op. cit.*

¹²³ Riles, *op. cit.*, 87.

¹²⁴ Brummer, *Territoriality*, *op. cit.*, 114.

¹²⁵ Posner, Elliot. “Making rules for global finance: transatlantic regulatory cooperation at the turn of the millennium.” *International Organization* 63.04 (2009): 665-699. (“[...]the move toward more regionally centralized authority bolstered the Europeans' ability to affect the behavior of U.S. regulators”, *ibid.* at 667). See also Brummer, *Territoriality*, *op. cit.*, 114-115; and Karmel, Roberta S. “The EU Challenge to the SEC”. *Fordham Int'l LJ* 31 (2007): 1692.

¹²⁶ Cox, James, “The Extraterritorial Reach of the US Financial Laws”, in Wymeersch, Eddy, Klaus J. Hopt, and Guido Ferrarini, eds. *Financial regulation and supervision: a post-crisis analysis*. Oxford University Press, 2012.

¹²⁷ Lannoo, Karel. *The New Financial Regulatory Paradigm: A transatlantic perspective*, CEPS Policy Brief, No. 287, 21 March 2013 F

¹²⁸ Brummer, *Territoriality*, *op. cit.* For concrete, numerical examples, see Brummer, *The Danger of Divergence*, 7.

¹²⁹ Philip Stafford, *Market calls for US and Europe to end derivatives dispute*, *The Financial Times*, September 2, 2015.

from general mutual understanding and familiarity as well as a degree of commonality with respect to regulatory interests and philosophies.¹³⁰ Coffee also proposes a more exclusive approach where the U.S. and the EU would take the lead. Rather than stand still and wait for the unlikely international consensus to emerge, a deeper transatlantic coordination would force other important jurisdictions to converge towards the high-quality US-EU standards.¹³¹ Game theoretic assessments further support the hypothesis that coordination between great powers can effectively promote convergence.¹³² In short, though the Regulate Thy Neighbour approach seems not to work well among equals, through cooperation between the equal powers the strategy's essence could be revived.

The EU and US have indeed recognized the need for deeper cooperation as well as the chance for joint leadership: “by coordinating our efforts, we are providing a model for other regulators and jurisdictions working to implement their G20 commitments.”¹³³

The case for mutual recognition and multilateralism

At present international standards play little role when it comes to the most important cross-border issues. Even though the G20 jurisdictions demand that for instance their CCPs comply with the CPSS-IOSCO Principles for financial market infrastructures (known as PFMIs) the international principles do not provide any kind of minimum standard for the purposes of mutual recognition. Therefore, in principle all the additional requirements imposed for instance by EMIR on CCPs need to be adopted in foreign jurisdictions should they wish their CCPs to be able to offer services for European clients (or their offshore branches). The third country CCPs cannot voluntarily opt-in to more stringent EMIR standards either.¹³⁴ An interesting outcome of such a regime is that this could increase private demand for more stringent regulation, thus causing *privately initiated* racing to the most stringent (and powerful) regulatory regimes.¹³⁵

The transatlantic partnership has the promise of fostering convergence and thus mitigating the threat of regulatory arbitrage. But the problems of the Regulate Thy Neighbour strategy (see Section 4) will not be solved simply by turning a unilateral strategy into a bilateral one. In certain respects the problems could become even worse. Joint leadership, at least an active one, would only increase the coordination demands between the Atlantic partners.

There might be more fundamental problems still. An increasing number of academics point out that simply having and applying the same rules everywhere might not secure the reaching of a more stable

¹³⁰ Pan, Eric J. “Four Challenges to Financial Regulatory Reform.” *Vill. L. Rev.* 55 (2010): 743, 770 (noting however that this is second-best after “international administrative body”, a global prudential regulator with powers that reach across jurisdictional boundaries). Herring and Litan also remarks that considering the negotiating difficulties within heterogenous groups, “it may be useful to foster cooperation first among the advanced, industrial countries and then widen the scope for cooperation as the institutional framework develops and integration proceeds.” Herring, Richard, and Robert E. Litan. *Financial regulation in the global economy*. Brookings Institution Press, 1994, 80.

¹³¹ Coffee, op. cit. (“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”)

¹³² Daniel W. Drezner, *Globalization, Harmonization, and Competition: The Different Pathways to Policy Convergence*, *Journal of European Public Policy* (2005) 12:5, 841-859. “If the great powers can coordinate their regulatory standards, then global regulatory convergence is a likely outcome. [...] When great powers can agree upon common regulatory standards, there is little that the other actors in the system can do to prevent global regulatory convergence.” (Ibid, 849)

¹³³ Path Forward; See also Brummer 2013, 5 calling to more cooperative action, and recognizing that despite the rise of especially Asia, the EU-US regulatory axis remains the most important relationship, (“The Stakes are Too High to Ignore This Opportunity for Global Leadership” at 9)

¹³⁴ Global Financial Markets Association, *Impact of EU extraterritorial legislation on Asian markets*, 11.

¹³⁵ See *ibid.*, 13: “If the legal and supervisory arrangements in their jurisdiction are not considered to be equivalent, other than lobby for changes in law, there is little that these CCPs can do to obtain recognition...”

financial system.¹³⁶ According to one (rather theoretical) view a rigid, one-size-fits-all approach could actually introduce structural weakness into the system and increase systemic fragility.¹³⁷ On the basis of such views, the present generation of substituted compliance in the U.S. has also been criticized for its general hostility towards experimentation and diversity.¹³⁸

The problem with policy prescriptions relating to harmonisation and regulatory arbitrage is the analytical difficulty of distinguishing bad regulatory competition from more beneficial forms of competition and innovation. When regulators share similar objectives and functions, regulatory competition can create positive experimentation.¹³⁹ The positive dimensions of regulatory pluralism should not be neglected.¹⁴⁰ Moreover, categorical arguments against harmonisation and the associated rigidity risks at times neglect the difference between minimum harmonisation, comprising the adoption of common minimum standards in order to prevent regulatory race to the bottom, and rigid maximum harmonisation which details the same rules for everybody and prohibits the adoption of stricter rules.

In the global market for derivatives, the first step towards mutual recognition would be to further increase the normativity of international expert standards and benchmarks such as CPMI-IOSCO Principles for Financial Market Infrastructures (PFMIs). In the shadow of unilateralism, much important work is being done in multilateral standardisation bodies.¹⁴¹ BCBS-IOSCO have also adopted joint standards for margin requirements for non-centrally cleared derivatives.¹⁴² These principles are gradually being integrated in unilateral comparability assessments, but the second, and much bigger, step would be to hand the task of making equivalence or comparability assessments to an objective international body.¹⁴³

Some academics have envisioned “managed” mutual recognition schemes (i.e. based on bilateral formal mutual recognition agreements) without a “global government.” Such mutual recognition regimes have been seen as an important part of global administrative law regimes, representing “a coordinated approach to the regulation of global market processes among diverse jurisdictions”.¹⁴⁴ But formalisation of bilateral mutual recognition schemes would seem to be an unnecessary step towards workable forms global financial governance, considering especially the resource-incentive nature of continuous comparability assessments as well as the general agility and elasticity of financial markets (adding to the incompleteness of sovereign contracts as well as to the costs of contracting). It is

¹³⁶ See e.g. Riles, *op. cit.* and Griffith, *op. cit.*;

¹³⁷ See Whitehead, Charles K. “Destructive Coordination.” *Cornell Law Review* 96.2 (2011): 323; Griffith, *op.cit.*; Taleb, Nassim Nicholas. *Antifragile: Things that gain from disorder*. Vol. 3. Random House Incorporated, 2012. See also Artomonov, *opi.cit.*

¹³⁸ Artomonov, *op. cit.*, 16.

¹³⁹ See e.g. Ethiopis and Peterson, *op.cit.*, 52; See also Griffith, *op. cit.*, 1324-1329.

¹⁴⁰ Riles, *op. cit.*, 75 (referring also to works of Pistor and Romano).

¹⁴¹ “Moreover, I think there is a better way to consider whether we need international standards on margining that are more granular than the PFMIs. That is the current CPMI-IOSCO process that is already underway. Both Europe and the U.S. are participants. That group, for example, is reviewing the practices by a number of clearinghouses on more than 100 different areas of margin methodologies.” Remarks Of CFTC Chairman Timothy Massad Before The OTC Derivatives Conference, September 29, 2015.

¹⁴² The Financial Stability Board has designated altogether 14 key standards for sound financial systems. The policy areas are macroeconomic policy and data transparency, financial regulation and supervision and institutional and market infrastructure. <http://www.fsb.org/what-we-do/about-the-compendium-of-standards/key_standards/> (last visited 3 February 2016).

¹⁴³ As suggested by Artomonov, *op. cit.*

¹⁴⁴ Nicolaidis, Kalypso, and Gregory Shaffer. “Transnational mutual recognition regimes: governance without global government.” *Law and contemporary problems* 68.3/4 (2005): 263-317, 266, 313.

probably because of the latter reason why international finance, unlike trade, has resisted more formalised forms of international governance in the first place.¹⁴⁵

There seems to be an emerging consensus that effective governance of financial markets requires the pooling of some degree of sovereignty on the supra-state level.¹⁴⁶ Cases have even been made for either a new treaty-based international financial organisation¹⁴⁷, or for channelling the global reforms through the existing international structures such as the WTO.¹⁴⁸ The coordination problems and protectionist pressures provide strong support for this case. IOSCO's track record in promulgating widely accepted principles and multilateral cooperation devices especially in the area of enforcement cooperation, would make it the most indicate international body for receiving more formal powers and responsibilities in settling international coordination issues.¹⁴⁹ A recent proposal argues for strengthening the role of the FSB.¹⁵⁰ But despite its increasing importance and the emergence of organizational hierarchies, the decisions of the FSB continue to be non-binding on its members, and its operative powers remain limited to "moral suasion and peer pressure".¹⁵¹ The crisis momentum did not lead to multilateral treaty negotiations and the governance regime for international finance remains soft at its core.¹⁵²

Conclusions

The big question behind this article could be formulated as follows: can we coordinate our way around the Financial Trilemma in the absence of hard-law based international or supranational structures? Recall that the Trilemma posits that only two of the three objectives of financial stability, national financial policies and financial integration can be achieved. Can bilateral coordination measures bring about enough convergence so that borders for capital can be kept open without at the same time enabling regulatory arbitrage and race-to-the-bottom competition, which would eventually dilute the objective of financial stability? Or do we have to give up instead on globalisation and market integration and let the present tendency of market fragmentation and new protectionism foster?

The prolonged dispute between the US and EU seems to present a case against the possible benefits of coordination-driven transgovernmentalism. The regulatory turf war is all the more disconcerting given that the communication channels and early forms of collaboration between the Atlantic neighbours were established already more than ten years ago. During 2004-2007 the Committee of European

¹⁴⁵ See Brummer, *Why Soft Law Dominates International Finance—and Not Trade*, op.cit..

¹⁴⁶ Perhaps the best example of general argumentation in favour of an evolutionary progress towards more supranational structures is Avgouleas, Emilios. *Governance of global financial markets: the law, the economics, the politics*. Cambridge University Press, 2012.

¹⁴⁷ See e.g. Lastra, Rosa M. "Do We Need a World Financial Organization?." *Journal of International Economic Law* 17.4 (2014): 787-805

¹⁴⁸ See George Jain, Abhimanyu, "Derivatives as a Test Case for International Financial Regulation through the WTO." *Journal of World Trade* 48.1 (2014): 135-165) These demands are not new, see e.g. (Rogoff, *international organization*, 1999)

¹⁴⁹ In fact, International Swaps and Derivatives Association ISDA is also in favour of increasing IOSCO's role in handling cross-border issues. See ISDA, *Public comment on the IOSCO Task Force on Cross-Border Regulation Consultation Report* (February 24, 2015). ("IOSCO should develop and implement principles-based standards for resolution of differences between jurisdictions, provide a forum for discussion of disputes and consider the institution of an arbitration or college type process for resolution of matters of international importance".

¹⁵⁰ "The decision regarding comparability must be made by a neutral international organization." Artomonov, op.cit., p. 17 (arguing that the FSB would be best suited for such a task).

¹⁵¹ <http://www.financialstabilityboard.org/about/>

¹⁵² This is not to say that nothing has happened. See e.g. Arner, Douglas W., and Michael W. Taylor. "The Global Financial Crisis and the Financial Stability Board: Hardening the Soft Law of International Financial Regulation." *UNSWLJ* 32 (2009): 488.

Securities Regulators (CESR, which later became ESMA) met several times with the CFTC in the context of what became a joint work program to facilitate the conduct and supervision of transatlantic derivatives business.¹⁵³ A number of immediate lessons can be drawn from the network failure. Perhaps the most important one is that global reforms should be coordinated better already when draft legislation is tabled. The authorities implementing the legislations should also have clear and compatible mandates.

This paper nevertheless suggests careful optimism about the short-term benefits of closing the transatlantic deal. The deal would be crucial for stopping or at least slowing down the on-going market fragmentation between the US and EU as well as to bringing much needed convergence for countering the immediate regulatory arbitrage threats in the Transatlantic context. In the longer run the present Regulate Thy Neighbour strategies, which build on extraterritoriality, protectionism and limited deference, cannot be sustained. Therefore we need simultaneous building of a more multilateral regime based on embryonic forms of mutual recognition. In what organizational form this should take place will be left for further research.

¹⁵³ See Committee of European Securities Regulators, CESR and the US CFTC Meet to Facilitate Transatlantic Derivatives Business and to Appoint Task Force to Develop Further Efforts, Press Release (Ref. 05-096), 14 February 2005 http://www.esma.europa.eu/system/files/05_096.pdf ; CESR-CFTC Communiqué, CESR-CFTC Common Work Program to Facilitate Transatlantic Derivatives Business, 28 June 2005 (available from <https://www.esma.europa.eu/page/Beyond-EU>)



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