Written Testimony of

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"Curbing the Extraterritoriality of Dodd-Frank's Derivatives Regulation: An Examination of the Swap Jurisdiction Certainty Act"

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Summary: The Swap Jurisdiction Certainty Act embraces the worthy objective of improving certainty, efficiency and competitiveness in the cross-border derivatives market. However, the breadth of the proposed carve out would profoundly increase the potential vulnerability of U.S. financial institutions to regulatory lapses abroad. Instead, a more narrowly tailored exemption or mutual recognition program is needed to engage regulatory partners and facilitate cross-border financial transactions.

I. AIG and The Necessity of "International" Derivatives Regulation

Financial products, swaps and other derivative products largely escaped robust regulation by financial authorities prior to the financial crisis. For the most part, swaps were considered to be relatively low risk instruments. They originated as means for evading foreign exchange controls, and later evolved into insurance-like instruments offering institutions a means of spreading risk. As such, many experts viewed swaps as valuable tools for enhancing financial stability.[1] Indeed, swaps and other instruments associated with hedging activities were excluded from the kinds of prudential regulation to which other sectors of the financial economy were routinely subject.[2]

The myth of "fail-safe" swap products—as well as the potentially disastrous implications of an unregulated cross-border derivatives market—was largely revealed in the failure of AIG in 2008. Leading up to the crisis, AIG's London affiliate had sold credit protection for financial firms around the world in the form of credit default swaps on collateralized debt that had by 2008 declined in value. Due to its AAA status, it had not been required to post collateral for its positions; but as its rating fell in September 2008, AIG was required to post ever more frequent collateral with counterparties, especially in the wake of the failure of Lehman Brothers and the government takeovers of Fannie Mae and Freddie Mac.

AIG's increasing exposure was amplified by associated problems arising under its U.S.-based securities lending unit. Under the firm's securities lending program, AIG's

[1] E.g., Alan Greenspan.

[2] *Commodity Futures Modernization Act of 2000*, H.R. 5660, 106th Cong. (2000).

subsidiaries extended loans in exchange for cash collateral. To increase yield on the transaction, the collateral would then be reinvested. Usually, companies would invest their cash in highly liquid risk free assets. AIG, however, invested in the U.S. subprime mortgage market via mortgage-backed securities. When the U.S. real estate market plunged and borrowers returned their securities demanding the repayment of collateral, the firm was unable to meet the resulting call. As the firm teetered, the Fed offered AIG up to 85 billion at rates 8.5% above the rates banks were charging one another, and said the government would take 79.9% interest in the company in exchange, facilitating a government funded takeover of the firm.[3]

The AIG debacle was unique in severable notable ways. Unlike other firms like Lehman Brothers and Bear Stearns, its businesses also touched hundreds of millions of American companies and households. In addition to credit default swaps, upon which scores of financial institutions depended, it also sold insurance to hundreds of thousands of companies, pension plans and Americans.[4] Yet despite this diversity of economic stakeholders, AIG failed to net its exposure through matched books that balanced bought and sold protection to minimize its exposure. Instead, its business model and book focused on sold credit protection, even as it leveraged its rating to escape cash collateral requirements.

But AIG did reveal the extent to which unfettered swap and other complex financial product transactions could undermine international financial markets, especially as insurance objectives morphed into ones driven by speculation. AIG also highlighted the degree to which strong domestic and international oversight was needed. Perhaps ironically, the problem with AIG's regulation was not so much that of international regulators, but of U.S. regulators. AIG's default swaps business was handled by its London subsidiary, AIG Financial Products Corp., which had itself been formed by Banque AIG in France, which itself was the product of a federal savings bank subsidiary subject to federal oversight by the Office of Thrift Supervision (OTS). The French banking regulator then recognized OTS as comparable—in part because of its own weak regulation of swaps—and in doing so allowed the United States to act as the primary regulator for AIG's worldwide operations. Poor oversight by an understaffed OTS demonstrated, however, how delocalized risk associated with credit default swaps could eventually become. Regulatory lapses in one region (in this case the United States) could undermine financial stability in other parts of the world as financial institutions in far-flung parts of the world, as diverse as Banco Santander, the Bank of Montreal, Société Générale, entered into contracts with AIG that, if not honored, could have exposed them to possible insolvency.

[3] David Wessel, In Fed We Trust 193-95 (2009).
[4] *Id*. at 192.

II. The G-20 Global Agenda

In the wake of the outbreak of the 2008 global financial crisis, G-20 countries directed their attention to the task of reforming the international regulatory system and providing guidance for a range of financial entities and transactions, including derivatives products. Specifically, leaders have committed to a variety of goals, including the increased standardization and trading of over the counter (OTC) derivatives, exchange and electronic platform trading, capital requirements and reporting to trade repositories. The Basel Committee, in particular, has developed new capital weightings to better account for risk exposures generated by complex financial instruments.[5] However, relatively few prescriptive standards have been articulated by standard setters at the international level. Although a general consensus exists that OTC derivatives should be increasingly standardized and traded on exchanges or cleared through clearinghouses, there has been limited explicit agreement as to just how such objectives should be achieved, or even what kinds of granular, descriptive rules should be applied to clearinghouse ownership and membership.[6]

III. The Potential Extraterritorial Scope of Dodd-Frank

Yet even in the absence of clear prescriptive rules, most G-20 countries have set about working toward achieving the broad policy objectives expressed by the group, the United States included. The Dodd-Frank Act embodies Congressional efforts to curb, among other things, the risks generated by the expanding international derivatives markets. Among its relevant provisions, Title VII prohibits any person from acting as a swap dealer unless that person is recognized as a swap dealer. Additionally, Title VIII imposes a range of reporting, mandatory clearing, and mandatory trading requirements, including rules relating to conflicts of interest and business conduct standards. The Dodd-Frank Act has also enabled the Commodity Futures Trading Commission (CFTC) to propose capital requirements for dealers and major swap participants that would otherwise escape such requirements by prudential regulators.

The extraterritorial scope of Title VII lies in both the drafting and implications of Section 722. As a general matter, it is worth emphasizing that, as the Supreme Court noted in *Morrison v. National Australia Bank*, American law has espoused the principle that in the absence of explicit Congressional intent to the contrary, U.S. statutes are presumed to apply primarily with domestic actors.[7] But in Dodd-Frank, there is a clear intent to tackle, if necessary, regulatory challenges extraterritorially. Section 722 provides that US regulation should not apply unless activities have a significant effect on commerce in the United States or when they contravene CFTC rulemaking. Similarly, under 772, Title VII provisions do not apply unless a swap-based security transaction is conducted in

[5] *See* Chris Brummer, Soft Law and the Global Financial System 238 (2012).
[6] *See id*. at 248-49 for a more in depth discussion.
[7] Morrison v. Nat'l Austl. Bank Ltd., 130 S. Ct. 2869 (2010).

contravention of SEC rulemaking. Although these provisions were drafted as limitations on CFTC and SEC authority, they permit, at least in principle, considerable discretion for regulatory agencies to potentially engage in extraterritorial rulemaking where a "direct" connection with the United States is established. Necessarily, the provisions are operationalized via CFTC and SEC rulemaking authority, providing considerable room for both agencies to apply, interpret and implement Title VII provisions. These decisions would also enjoy considerable deference by judges under longstanding administrative law.

That said, extraterritorial exertions of regulatory power can be difficult to successfully execute. Even when domestic legislatures empower regulatory agencies to conduct extraterritorial regulation, the unilateral "exportation" of regulation by national authorities to other jurisdictions can be difficult. Regulators do not act in a vacuum, and when their actions have negative consequences for foreign regulators, they may be punished by similar actions in the future.[8] Additionally, financial globalization has made extraterritorial regulation more difficult insofar as enforcement is often dependent at least in part on cooperation with foreign regulators.

One of the most significant challenges with extraterritoriality in the derivatives space is that extraterritorial regulation can create not only onerous burdens on firms, but also potentially irreconcilable compliance obligations where foreign regulators adopt different or even *similar* obligations. For example, Section 723(a)(3) of Dodd-Frank requires that swaps entered into between parties be submitted to a clearinghouse registered with the CFTC or be exempt from registration. At the same time, the European Commission has forwarded its own Proposal on OTC Derivatives, Central Counterparties and Trade Repositories, also known as the European Market Infrastructure Regulation, which would require local clearing. If both rules were to be applied extraterritorially, a cross-border swap between a U.S. person and an EU counterparty would trigger both jurisdictions' clearing requirements, and the swap may have to be cleared twice, at both clearinghouses, if neither is registered with U.S. or EU authorities.[9] As a consequence, swap participants would potentially have to comply with potentially duplicative or even contradictory reporting, margin and even capital requirements.

Similar potential conflicts lie in the area of trade repositories. Generally, under the rules of both the CFTC and SEC, if there is at least one U.S. person participating in a swap, the swap must be reported. However, pending EU legislation also requires financial and certain non-financial counterparties established in the EU to report OTC trades to an EU-registered repository. As in the case of clearing, a swap between U.S. and EU counterparties could fall under both jurisdictions' reporting requirements, and as such require reporting to two different trade repositories, itself a duplicative and likely inefficient policy outcome.[10]

[8] Brummer, *supra note 5,* at 41-42.

[9] Robert Colby and Andrew Fei, *Potential Extraterritorial Application of Regulations Issued Under Title VII of the Dodd-Frank Act*, J. ON THE LAW OF INV. AND RISK MGMT. PROD., FUTURES AND DERIVATIVES LAW REPORT, June-July 2001.

[10] *Id*.

IV. Title VII Exemptions for Swaps Entered Into by Registered Non-U.S. Persons

The Swap Jurisdiction Certainty Act is envisioned to minimize such conflicts. Under the first major operative provision of the proposed bill, U.S. registered swap dealers engaging in swap transactions with a non-U.S. person would not be subject to the Dodd-Frank derivatives rules if each party reports the swap to an SEC registered swap repository. Meanwhile, under the second avenue, a non-U.S. person that registers as a swap dealer or security-based swap dealer with the CFTC or SEC, respectively, can be deemed to have satisfied Dodd-Frank capital requirements by complying with comparable regulatory requirements in the firm's home country, so long as such home country is a signatory to the Basel Accords. The first provision thus constitutes a carve out, and the second, a gateway for future greater regulatory acknowledgement and deference through a mutual recognition regime.

The first exclusion is rather straightforward. In short, the reforms would create a blanket exemption from Title VII in that a non-U.S. swap dealer that registers with the Commission shall only be subject to Title VII requirements with respect to swaps entered into with a U.S. person who is not a U.S. subsidiary, branch or affiliate. By implication, this indicates that a range of transactions will not be subject to Title VII. The bill would lift the requirements of Dodd-Frank for U.S. swap dealers when they engage in inter-affiliate transactions with U.S. or non-U.S. affiliates or with any non-U.S. person that is not registered as a swap dealer. The bill would also exempt a non-U.S. person registered as a swap dealer from all Dodd-Frank rules except with respect to transactions entered into with a U.S. person (but not its affiliates).

Adopting this approach achieves several noteworthy policy objectives. First, it levels the playing field for U.S. banks. A non-U.S. person facing the choice of a trade with a European bank and the foreign branch of a U.S. bank would not face the pricing incentives to deal with the European bank if in an extraterritorial regime U.S. regulations were more severe than on the European side. Second, it potentially promotes economic efficiency insofar as international subsidiaries of U.S. firms can avoid duplicative, and even potentially contradictory, rules that may in themselves undermine cross-border relationships with other regulators. Finally, it is administratively easy to apply. Even where regulators in different countries agree on standards, the timeline for implementation may differ, creating temporary distortions or competitive disadvantages for regimes in certain jurisdictions. A bright line avoids these types of logistical problems and provides clear indications as to the application of U.S. law.

There are also, however, serious risks. The only requirements for non-U.S. companies are registration and reporting. These are not, however, prudential requirements aimed at shoring up financial stability. At best, they facilitate surveillance by supervisors. This is problematic because a U.S. parent guaranteeing a trade done by a foreign subsidiary could expose itself to considerable losses in the absence of sound regulatory framework.

Indeed, under the current bill, no mechanism is available to insulate (or prohibit) a U.S. parent from trading losses of a subsidiary, even though such exposure would comprise by definition a "direct connection" to the U.S. economy. The policy rationale behind such flexibility is that foreign supervision of operations abroad is sufficient to oversee risk to both the U.S. and global financial system when coupled with sound U.S. regulation. This assumption has merit insofar as the most of the major liquid derivatives markets are located in countries participating in the G-20 process of derivatives reform, and among these countries broad conceptual agreement has been reached. However, implementation by standard setters such as the International Organization of Securities Commissions (IOSCO) and the Committee on Payment and Settlement Systems (CPSS) are not complete, much less efforts by national regulators. Thus providing a broad carve out exposes potential vulnerabilities in cross-border regulation.

Moreover, even assuming that all G-20 countries come to the same prescriptive regulatory conclusions, the exemption could nevertheless permit outlier countries to adopt weaker standards in order to draw business to their shores, much as one sees with off-shore financial centers in money laundering, tax and terrorist financing. As a result, the exemption might provide incentives for structuring transactions in ways that funnel them through foreign affiliates in order to evade U.S. law. And if a subsidiary or affiliate was free to write unregulated contracts, it could, as in the case of AIG, bring down the parent company and affiliates. Of course, the same incentives could well be at play if no flexibility was granted to U.S. persons and their overseas affiliates, and in the process additionally disadvantage U.S. firms operating abroad. And a blunt extraterritorial application of U.S. law could be difficult to enforce, or subject our firms to a variety of duplicative or even incompatible foreign regulations. Nonetheless, it is quite possible that a more narrowly tailored exemption, perhaps even a mutual recognition regime with responsible partners like the European Union, would better balance competition and financial stability objectives.

V. Mutual Recognition for Capital Requirements

The second, administratively more complicated approach applies to capital requirements and comprises what can be considered authorization for a "mutual recognition" regime for foreign swaps dealers. In its simplest form, mutual recognition means that one country recognizes the other's regulatory oversight as equivalent and thus allows the market participants of the partner country to conduct business with no additional regulatory hurdles beyond compliance with the partner's regulatory regime.

Mutual recognition is not new to the SEC. The SEC, for its part, has adopted both nationally tailored and broader-based mutual recognition programs in other fields. As early as 1990, the SEC established the Multijurisdictional Disclosure System (MJDS) program, a mutual recognition scheme adopted by the United States and Canada. Under the MJDS, Canadian foreign private issuers that meet eligibility criteria qualifying them as large, established companies are viewed as meeting certain of the SEC's securities registration and reporting requirements if they provide disclosure documents prepared according to the requirements of the relevant Canadian securities authorities.[11] Conversely, U.S. issuers also enjoy expedited access to Canadian markets, though only a fraction have chosen to do so, given the immediate advantages of U.S. markets. The program is thus largely viewed as a boon to Canadian issuers seeking to raise capital in the United States. And as late as 2008, the SEC introduced a new mutual recognition program for exchanges and broker-dealers whereby market participants from select countries became eligible to enjoy preferential access to U.S. investors if they demonstrate compliance with foreign regulations that are comparable to those of the United States. Finally, and perhaps most broadly, Regulation S excludes any agency or branch of a U.S. person located outside the United States if the agency or branch engaged in the business of insurance or banking and is subject to substantive insurance or banking regulation in the jurisdiction where it is located.

Mutual recognition is not new to the CFTC, either. Indeed, the CFTC was the first financial supervisor to originate such a program of cross-border recognition, with the Part 30 rules adopted in 1987, effective in 1988, and the first 30.10 order issued to Australia in November 1988.[12] CFTC Regulation 30.10 permits a person affected by any of the requirements contained in Part 30 governing the offer and sale of foreign futures and options contracts to petition the CFTC for an exemption from such requirements. A petition for exemption pursuant to CFTC Regulation 30.10 is typically filed on behalf of persons located and doing business outside the U.S. that seek access to U.S. customers by a governmental agency or self-regulatory organization responsible for implementing and enforcing the foreign regulatory program. If after its review the CFTC determines that compliance with the foreign jurisdiction's regulatory program would offer comparable protection as that which would be available domestically, and the CFTC is able to memorialize an information sharing agreement with the firm's home country regulator, the CFTC may issue an order to the foreign regulator or self-regulatory organization granting general relief, subject to certain conditions.[13] As implemented, orders issued under rule 30.10 have exempted foreign brokers from registering as futures commission merchants based on their "substituted compliance" with foreign regulatory regimes that have been found to be "comparable" with the CFTC's regulations.

In light of these earlier mutual recognition regimes, H.R. 3283 would constitute another step in an increasingly established process for creating an institutional framework for negotiating and mediating jurisdiction for cross-border transactions, and in doing so, elides some of the negative consequences of unilateralism. The difference here, however,

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[11] Once the Canadian securities regulator grants approval, a wrap-around document is attached to the prospectus. This document provides certain information required by the United States securities regulators such as taxes, civil liability, and GAAP reconciliation in certain circumstances. Ruth O. Kuras, *Harmonization of Securities Regulation Standards Between Canada and the United States*, 81 U. DET. MERCY L. REV. 465, 469 (2004).

[12] 17 C.F.R §30 (1988).

[13] Foreign Markets, Products, and Intermediaries, http://www.cftc.gov/international/foreignmarketsandproducts/foreignprodsales.

is that a mutual recognition regime concerns not so much registration exemptions, but capital requirements.

VI. Mutual Recognition as a Means of Extraterritorial Export

Mutual recognition programs are viewed as largely deregulatory programs because they entail reciprocal (and simultaneous) changes in national-level hard law governance structures. This means a loss of national regulatory control and authority for participating regulatory agencies. It also potentially empowers international firms to engage in forum shopping, depending on the final rules adopted by national authorities.[14]

However, mutual recognition programs can and do periodically constitute a means of regulatory export, at least insofar as they may encourage foreign countries to adopt U.S.-style regulations. In the case of the MJDS, Canadian regulators were required to institute a range of changes associated with both issuance rules and supervisory activities as a condition for participating in the program. The SEC eked out additional concessions from Canadian regulators over time. In 2000, for example, the SEC publicly considered abandoning the program outright. The agency considered two matters inadequate—the reconciliations between Canadian companies' financial statements and generally accepted U.S. accounting principles, and the oversight that Canadian regulators, particularly the Ontario Securities Commission, had exercised over prospectuses filed under the MJDS. The deliberations prompted several important reforms in the supervision of issuances, including the allocation of increased resources for that purpose. When Sarbanes Oxley was passed by the U.S. Congress, questions arose as to whether Canadian firms would be required to abide by the new U.S. legislation, which imposed a range of additional (and costly) requirements on issuers. Canadian firms and regulators felt that compliance was not warranted and resisted prospective application of such rules to Canadian firms making offerings in the United States. Partly in response to this resistance, the SEC formally considered various policy changes that would, among other things, dismantle the MJDS. After further negotiations with the United States, Canadian regulators eventually conceded to the SEC and implemented key Sarbanes Oxley provisions at home, which ultimately bolstered the cross-border arrangement.

Sarbanes Oxley's repercussions on the MJDS illustrate an important limitation of regulatory export through mutual recognition. Because mutual recognition is not legal convergence, it does not create a level playing field across borders. If the legal regimes are sufficiently similar when entering into an agreement, this lack of convergence may not be a problem. National regulatory frameworks are never static, however; they change continually with regard to their substantive intensity and breadth. This dynamism can challenge the robustness of mutual recognition when one party makes a significant change to its national regulatory regime.

[14] Chris Brummer, *Post-American Securities Regulation*, 98 CAL. L. REV. 327, 369 (2010).

Such change need not take the shape of enhanced regulatory stringency. Having entered into a substantive mutual recognition arrangement, one of the parties may decide to dramatically lower its domestic standards. By lowering its standards, it acquires a duel benefit: it can become a more attractive jurisdiction for issuers seeking low-cost regulation, and it can act as a backdoor to the partner jurisdiction when foreign issuers from a third country decide to submit to its local (weaker) regulatory jurisdiction. This type of conduct not only deflates the trust and understanding on which mutual recognition arrangements are based, but also clashes with the partner jurisdiction's regulatory philosophy and undermines the supervision of its markets and protection of investors.

Seeking to avoid the earlier shortcomings of the MJDS, the SEC modified mutual recognition strategies have been employed by the SEC—in particular, to incentivize change and liberalize markets. The most high-profile strategy has been the "substituted compliance" program (later renamed "mutual recognition") introduced by SEC officials in 2008, just before the financial crisis. Under this initiative, foreign exchanges and foreign broker-dealers from select countries are eligible to enjoy preferential access to US investors if they comply with foreign regulations that are comparable to those of the United States. The SEC must therefore seek partners that, as in typical mutual recognition arrangements, recognize one another's institutions and procedures governing market regulation as "comparable," thereby allowing market participants or products in the market segment covered by the recognition regime to operate freely in the host market. Substituted compliance departed from the earlier MJDS insofar as it required an actual application for exemptive relief from national regulatory authorities for the mutual recognition scheme to become effective, thereby creating a multi-tiered process of granting market access.[15] Among other things, "eligible market participants would need to apply for, be vetted and finally granted an exemption on a case by case basis. Thus while the home country supervisors retain ultimate authority over foreign players active in their jurisdiction, the host country, the SEC, would grant individual exemptions to market participants."[16]

To establish a framework for such exemptions, substituted compliance entails that the SEC and its chosen foreign counterpart sign a nonbinding mutual recognition "arrangement" laying out their intent to liberalize market integration. At the same time, bilateral memoranda of understanding would be signed allowing for enhanced enforcement cooperation and information sharing. This arrangement would also contain an undertaking by the foreign regulators to describe "in detail how certain regulatory preconditions required by the SEC are met, and a similar undertaking by the SEC providing for reciprocity." US regulators would then evaluate the country's regulations, determining whether they were comparable to those in the United States. Once the SEC had blessed the laws of their home jurisdictions, stock exchanges and broker-dealers in those countries would be able to apply for exemption from SEC registration based on compliance with their home countries' laws. Consequently, shares traded on or through

[15] Steffen Kern, *EU-US Financial Market Integration: A Work in Progress*, 56 EU MONITOR 1 (2008).
[16] *Id*.

those countries could be marketed and sold to US investors without compliance with US disclosure and corporate governance rules.

The first mutual recognition agreement for exchanges was signed on August 25, 2008, between the United States and the Australian financial authorities. The program has yet to be implemented in the wake of the financial crisis, and most commentators are unsure whether U.S. regulators will proceed with the initiative. Indeed, there is widespread concern that a consequence of the initiative could be regulatory arbitrage: companies could list on Australian exchanges to access U.S. investors. This concern is exacerbated by the ostensible failings of earlier deregulatory initiatives that contributed to the crisis. The program's regulatory architects nevertheless believe that it provides key incentives for foreign counterparts to adopt more U.S.-style regulatory features: although convergence might be costly or involve the adoption of rules contrary to a regulator's traditions or philosophy; the regulator's domestic market participants could benefit from a range of competitive advantages, especially over other market players in nonparticipating jurisdictions; under the initiative, securities do not have to be registered in the United States in order to access capital markets there (since compliance only with the home state regulator is required); exchanges in the complying jurisdiction could potentially enjoy greater liquidity; and foreign regulators that secure agreements could receive political payoffs (for example, raises or promotions from agency executives and political elites, or jobs in the private sector). Regulators that are supportive of the initiative hope that advantages such as these might increase regulators' net payoffs. Of course, the optimal outcome would be the importation of U.S. law, and as common or more closely related standards are adopted, positive network effects may stimulate better consensus between market participants and their regulators.

VII. Limitations of Mutual Recognition Regime for Cross-Border Derivatives Regulation

Mutual recognition is most likely to be effective as a means of raising regulatory standards in two circumstances. First, preferential market access may provide sufficient incentive for adopting new standards when a regulator of a big, capital-rich market enters into a mutual recognition policy with the regulator of a significantly smaller capital market with hungry investors. In this situation, all else being equal, the big market regulator would be reluctant to coordinate at the smaller regulator's standards since adjustment would entail high costs (more of its firms would have to make compliance changes). By contrast, the regulator of the smaller market would have greater incentive to make concessions in order to enable its firms to access clients, customers, and investors on terms that are more competitive than those available to firms in other countries.

Second, mutual recognition programs are most feasible when adjustment costs in the target jurisdiction are low.[17] That may happen, for example, when few conditions are placed on a prospective counterparty to a mutual recognition agreement (such an agreement almost entirely facilitates market access or a deregulatory program). Another example involves countries that share similar regulatory approaches, philosophies, administrative techniques, or enforcement intensity—such as the substituted compliance initiative between the United States and Australia. In these instances, regimes are comparable or even equivalent, and few adjustments are needed unless one regulator seeks convergence at a higher, more intense level than is currently the case in either jurisdiction.

Third, and this is particularly relevant for a capital regime in the derivatives space—mutual recognition programs will be most successful where the transaction costs and indeed ability to establish a comparability regime are high. Establishing an assessment usually requiring the existence of a 1) mature regulatory framework along with 2) a proven supervisory regime in both countries. At that point, an adequate assessment of regimes' strengths and weaknesses is possible.

When applied to the derivatives space, these observations suggest that mutual recognition faces an uphill battle as a means of regulatory suasion. A regulator must wield a considerable amount of market power to be able to single-handedly achieve significant regulatory change in another jurisdiction through a mutual recognition agreement. But in today's international swaps market, other jurisdictions have equally comparable and liquid derivatives markets. Today, Europe is the most important region in the global derivatives market, with 44 percent of the global outstanding volume–significantly higher than its share in equities and bonds.[18] Meanwhile, Asian derivative markets today account for one third of worldwide foreign exchange and over 40 percent of equity derivatives trading. Korea is hosting the world's largest derivatives exchange and India has the world's fastest growing exchange.[19] The United States, quite simply, is not in the position of dictating terms to the European Union.

Meanwhile, the issue of adjustment is highly uncertain, in part because even in light of the delays in the rulemaking process that have stymied regulators since Dodd-Frank, the U.S. is further along than other countries with regards to instituting rules for derivatives transactions. The European Union, importantly, has only proposed rules for derivatives transactions, and has yet to pass a comprehensive derivatives regime. Asia is even further behind. In November 2010, Singapore Exchange launched the first central-clearing platform for OTC financial derivatives in Asia. However, clearing is not yet a

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[17] Pierre-Hugues Verdier, *Transnational Regulatory Networks and Their Limits*, 34 YALE J. INT'L L. 113, 148 (2009).

[18] Deutsche Börse Group, *The Global Derivatives Market: An Introduction* (April 2008), http://math.nyu.edu/faculty/avellane/global_derivatives_market.pdf.

[19] Oliver Fratzscher, *Emerging Derivatives Markets in Asia*, ASIAN FINANCIAL MARKET DEVELOPMENT (March 2006), http://siteresources.worldbank.org/INTEAPREGTOPFINFINSECDEV/Resources/589748-1144293317827/EAFinance_bkgrnd_Derivative_Markets.pdf .

mandatory requirement for swaps transactions, and the platform currently only covers interest-rate swaps. The G-20's recommendations are, however, being examined and the Monetary Authority of Singapore will conduct a consultation by the end of this year on all aspects of the Financial Stability Board's recommendations with regard to implementing its G-20 commitments. Similarly, the Hong Kong Monetary Authority and the Hong Kong Securities and Futures Commission have only issued consultation papers on proposals for the regulation of the OTC derivatives market in Hong Kong, and these rules will likely not be given effect for at least a year. Thus although there is progress towards the creation and implementation of international standards in the derivatives space, reforms have only started, and are far from robust programs. Consequently, there is precious little data for building a robust "assessment" capable of comparing disparate regulatory regimes.

Importantly, the additional reference to the Basel Accords provides an important backstop. The Basel Accords do not comprise formal international "treaties", though a variety of disciplines are in place to help monitor countries' commitment to the various capital and prudential requirements.[20] And to be sure, G-20 countries are further in their devising of capital standards than derivatives regulation. But implementation can and will be different, from definitions of Tier 1 capital to application of various supplemental ratios. As such, the Basel Accord, though a potent means of coordination, may not definitively ensure that firms have the specific type of capital structure necessary for providing the kind of cushion optimal for firms dealing in swaps.

This is not to say, however, that mutual recognition cannot serve as a useful means of financial statecraft, or even the promotion of U.S. regulatory interests. A mutual recognition regime, when properly crafted, helps establish three conditions precedent for realizing a cross-border regulatory regime:

- First, it provides an opportunity for learning about other regimes and improving domestic regimes. Advantages and lapses of regulatory approaches can be digested and dissected, and from that learning process, domestic regimes themselves can be potentially improved, both with regard to removing inefficient regulatory burdens and implementing stronger, smarter safeguards.
- Second, it provides an opportunity to shape common approaches to regulatory challenges. Comparability assessments are generally not only means of "checking the box"; they also help forge common views and strategies with regard to standard-setting in international forums.
- Finally, as discussed above, mutual recognition can provide the incentives—at times on the margins and at times more significantly—to reform domestic practice and export U.S. policy preferences.

For this reason, a mutual recognition arrangement might be useful and even preferable for not only capital requirements, but also Title VII more generally. In this way, Congress could empower U.S. regulators to abide by and respect longstanding principles of comity,

[20] *See generally* Brummer, *supra note 5*.

but in ways that would not necessarily potentially exempt transactions taking place in regulatory environments that have eschewed regulatory reform. But mutual recognition is no magic bullet. In many cases, time and experience will be needed to determine just what kind of flexibility is warranted as other jurisdictions undertake not only the legislative and regulatory tasks of rulemaking, but also the equally important activities of supervision and oversight. Yet space for regulatory innovation is always possible even within the ambit of mutual recognition to help facilitate cross-border transactions—from pilot programs, parole periods, and framework agreements. Such efforts at "first in time cooperation" with partners will be necessary, and ultimately essential, in order to better navigate the distinctly international nature of today's financial marketplace.[21]

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[21] *See generally* Brummer, *supra note 5*, at Chapter 6.

United States House of Representatives
Committee on Financial Services

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