Global markets, national toolkits: extraterritorial derivatives rulemaking in response to the global financial crisis[1]

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1. Introduction

The regulation of global derivatives markets in the aftermath of the global financial crisis period has been marked by paradox. On the one hand, the attempt to rein in the risks associated with derivatives transactions has been a highly cooperative international endeavor, as demonstrated by the large number of international regulatory standards that have been negotiated within multiple international institutions such as the G20, Financial Stability Board (FSB), and International Organization of Securities Commissions (IOSCO). On the other hand, the implementation of these same international commitments at the national level has been highly conflictual. In particular, different countries have accused each other of seeking to extend their regulatory oversight over foreign firms and markets beyond their territorial remit instead of relying on the regulation and supervision provided by

[1] An earlier version of this chapter was presented at the workshop "The Politics of Regulating Global Derivatives Markets After the 2008 Crisis" at the Balsillie School of International Affairs (September 19, 2015). We would like to thank the participants for their valuable comments and feedback. This chapter is updated only up to the 16 December 2015, when this chapter was submitted.

foreign regulatory authorities that had committed to the same regulatory agenda. A number of G20 members have identified the resolution of these cross-border regulatory issues as "the most significant implementation issue" [2], while multiple international regulatory initiatives have been launched in recent years to rein in the extraterritorial application of national rules.

The emergence of these regulatory "land-grabs" within the remit of what is a rather harmonized package of global regulatory standards is particularly evident in the two most important set of rules introduced since the financial crisis, that is, the regulatory frameworks introduced in the US and EU. Both the US and EU regulatory authorities have come to encompass within their regulatory net a number of firms that are not legally domiciled in the two respective jurisdictions. In principle, both the US and EU post-crisis legislative frameworks included mutual recognition tools (called 'substituted compliance' in the US and 'equivalence and recognition' in the EU) to allow foreign actors to comply only with foreign rules if those rules were found to be substantially similar in delivering the outcomes that regulators seek. However, the analysis in this paper demonstrates how in practice the application of these mutual recognition tools has frequently failed to rein back the extraterritorial application of US and EU rules.

What explains the emergence and continuation of these extraterritorial measures in the regulation of global OTC derivatives markets? This chapter will argue that the emergence of extraterritoriality in the regulation of derivatives markets in the US and EU reflects the challenges that regulatory authorities have faced to implement the new prudential agenda in a manner that addresses the highly internationalized nature of derivatives markets. The analysis below will highlight how the attempt to implement the newly designed post-crisis prudential regulatory frameworks in a manner that pre-empts their hollowing out through regulatory

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[2] FSB, 2014, p. 26

arbitrage has led regulatory authorities to adopt different degrees of extraterritoriality in their regulatory approach. This chapter will illustrate how these concerns can explain why the degrees of extraterritoriality in the post-crisis agenda have varied not only between the rules introduced in the US and in the EU, but also across different regulatory requirements introduced by these two jurisdictions.

The chapter is structured as follows. Section 2 will review the main debates and international policy initiatives concerning the territorial reach of derivatives regulation in the implementation of the G20 agenda. The rest of the chapter will zoom in on the policies introduced in the US and EU to regulate three key sets of actors in the derivatives markets: foreign dealers (Section 3), central counterparties (Section 4), and trading platforms (Section 5).

2. Extraterritoriality and the implementation of the G20 Agenda

One of the defining features of contemporary OTC derivatives markets that differentiate these markets from other segments of the international financial system is their international nature. As Elisse Walter from the US Securities and Exchange Commission has stated, in OTC markets "cross-border transactions are the norm, not the exception".[3] In fact, BIS data on the structure of the OTC market at the peak of the post-crisis reform activity indicates that trades involving uniquely domestic counterparties account for less than half of the trading in most FSB member jurisdictions.[4]

Given the international scope of derivatives transactions, a key issue concerning the design of regulatory policies governing these markets is the jurisdictional scope of the rules. What domestic and foreign market actors (such as

[3] Walter, 2013
[4] FSB, 2014, p. 24

dealers or market infrastructures) or transactions should come under the scope of a jurisdiction's regulatory framework in order to achieve its policy objectives?

This question has become a particularly salient one in recent years. As different countries have come to introduce new regulatory frameworks in order to meet the commitments negotiated at the international level under the umbrella of the G20, these new rules and requirements have frequently included definitional and scoping provisions that result in those new rules being applied to market participants as well as market infrastructures (namely, trading venues and central counterparties) that are not legally domiciled within the territory where the rules have legal effect.

The presence of overlapping national regulatory policies has often been presented by the authorities involved in the implementation of the G20 agenda as a threat to the achievement of its policy objectives. The potential fragmentation of derivatives markets across overlapping national regulatory spaces makes both compliance by market participants and the monitoring and enforcement of compliance on a cross-border basis legally and logistically difficult. As the head of the UK Financial Conduct Authority Martin Wheatley stated in September 2013: "Does it make hard-nosed, practical sense for any one national regulator to attempt to regulate all derivatives activity with any link to its jurisdiction?" …"The clear risk is that a patchwork quilt of national and regional rules runs the risk of becoming unworkable. A mess".[5] In the meantime, the presence of overlapping regulatory policies has begun to have meaningful implications for the structure of global derivatives markets by incentivizing market actors to restructure or avoid engaging in certain cross-border transactions, which has had the effect of fragmenting particular international derivatives markets across jurisdictional lines. The FSB documented in 2014 a "reorganisation of business activities along jurisdictional lines reflecting steps

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[5] Wheatley, 2013

taken by some counterparties and infrastructure providers to minimise their own or their clients' exposure to requirements in place in certain jurisdictions".[6]

This extraterritorial application of national rules is a departure from pre-crisis trends in the international regulation of securities markets. In particular, the period of the 15 years or so preceding the crisis was a time when EU and the US authorities increasingly allowed foreign companies to operate within their jurisdiction on the basis of the regulation and supervision provided by their home-country regulators.[7] This change in the approach to the territorial boundaries of derivatives market regulations is particularly puzzling when analyzed from the perspective of some of the most prominent interpretations of the politics of financial regulation within the international political economy literature.

First, challenging perspectives that focus on the significance of international cooperation via transnational regulatory institutions, the emergence of extraterritoriality in the regulation of derivatives markets has coincided with what is arguably the peak of international regulatory coordination in the regulation of securities and derivatives markets. During this period, a variety of technocratic fora (such as the OTC Derivatives Regulators Group, IOSCO, the Basel Committee and the FSB) have produced a wide-ranging set of international standards defining how countries should meet the G20 agenda, and they have taken action to monitor the track record of different countries in implementing these standards at the domestic level. A number of these initiatives have been specifically designed to encourage national regulatory authorities to refrain from imposing rules on foreign firms by promoting greater deference to equivalent rules implemented by foreign regulators. In a key political signal, G20 leaders agreed at the St. Petersburg Summit in September 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

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[6] Financial Stability Board, 2014, p. 26

[7] Posner, 2009, p. 655

on similar outcomes, in a non-discriminatory way, paying due respect to home country regulation regimes".[8]

Following the request by the G20, the FSB's coordinating role in the implementation of the G20 agenda was expanded to include monitoring the status of its member jurisdictions' existing processes and arrangements to defer to one another's OTC derivatives regulation, and to identify issue areas where greater deference was needed.[9] Additional initiatives to achieve this objective have also been undertaken by the OTC Derivatives Regulators Group and IOSCO which established a Task Force on Cross-Border Regulation to analyze how host countries regulate the activity of foreign entities and the types of mutual recognition arrangements that could be used instead.[10] The success of these initiatives, however, has been limited, and the FSB has acknowledged in 2014 that significant differences remained "on the circumstances under which deference would be applied, and how it would be applied".[11] It is puzzling that the same domestic regulatory agencies that have been involved in these international cooperative initiatives have resorted to extraterritorial implementation of their national regulatory frameworks rather than relying on the regulatory oversight of foreign counterparts.

Second, the observation of extraterritoriality in the implementation of the G20 agenda is at odds also with what has been identified in the literature as a key force shaping the regulation of derivatives markets: the preferences of transnational financial actors.[12] Since the early stages of the domestic implementation of the G20 agenda, a number of leading international financial industry associations and firms have denounced the extension of regulatory requirements to foreign firms. These moves, they have argued, would increase the compliance burdens for firms as they needed to meet not only their home country rules but also the rules of the host-

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[8] G20, 2013
[9] Financial Stability Board, 2014
[10] IOSCO, 2013
[11] Financial Stability Board, 2014
[12] McKeen-Edwards & Porter, 2013; Tsingou, 2006

country they sought to access. As argued by a group of major derivative dealers, extraterritorial rules would force them to comply with foreign rules that may be "incompatible with home country requirements, objectionable to home country supervisors, prohibitively expensive, impossible to achieve in the necessary timeframe and impractical from an operational perspective".[13] Financial industry associations have also highlighted how the extraterritorial implementation of post-crisis commitments was at odds with the core objectives of the post-crisis regulatory agenda, in particular the G20's call in 2010 "to ensure open capital markets and avoid financial protectionism".[14] Major international financial groups have therefore supported initiatives to allow firms to rely on the regulatory oversight provided by home regulators.[15] For instance, in August 2013, ISDA released a set of principles designed to "guide the development of frameworks and processes for inter-jurisdictional recognition of derivatives regulation through a principles-based substituted compliance methodology".[16] As argued above, however, these initiatives had only limited impact in altering the course of regulators and to rein in extraterritoriality.

A third perspective on the politics of financial regulation focuses on the role of competition between the main jurisdictions in the global derivatives markets. A number of authors have theorized how the manner in which different countries implement international regulatory standards is driven by the attempt to preserve the competitive position of their respective domestic financial industry and/or to minimize domestic firms' adjustment costs.[17] For example, in a recent contribution, Knaack argued that "concerns about competitiveness have played a major role in the current spat between the United States and the EU" as both jurisdictions have been wary of the distributional consequences of accepting each others' rules for the

[13] Sullivan & Cromwell LLP, 2011
[14] EU-US Coalition on Financial Regulation, 2012
[15] Futures and Options Association et al., 2013
[16] ISDA, 2013
[17] Simmons, 2001; Drezner, 2007

position of London and New York as major trading hubs in the global derivatives markets.[18] From this perspective, an extraterritorial application of domestic regulatory requirements could be conceived as a defensive move to prevent other jurisdictions from attracting market share through the introduction of weaker regulations.

As the analysis in the cases below will illustrate, concerns about the impact of extra-territorial rules on the competitiveness of domestic firms seeking cross-border access have certainly been the main driver behind the both public and private actors' mobilization on this issue. In particular, a number of infrastructures (trading venues and central counterparties) seeking to access to foreign markets have described the introduction of extra-territorial requirements by third-country authorities as "protectionist" attempts to favour domestic champions and lobbied in favour of deference and mutual recognition. It is also worth noting that in certain instances trading platforms and CCPs have opposed agreements that would have given access to their home market to foreign competitors on the basis of laxer or unfinished regulations in the foreign platforms' jurisdictions.[19]

At the same time, the international nature of most transactions in the derivatives markets has created a vast front of market participants both in the US and in Europe who have denounced the costs imposed by these measures on their competitive position. In particular, major US banks[20], hedge funds, asset managers,[21] and non-financial end-users[22] have claimed that the attempt of US regulators to extend the scope of Dodd-Frank rules to a broad range of foreign firms doing business with US counterparts would lead foreign actors to prefer doing business with non-U.S. firms, thus causing them to lose business in key international markets. Indeed, since the crisis, a number of foreign financial institutions have reduced the

[18] Knaack, 2015
[19] Ackerman, 2014
[20] Meyer & van Duyn, 2011
[21] Rawlings, 2013; Investment Company Institute & ICI Global, 2013
[22] Coalition for Derivatives End-Users & European Association of Corporate Treasurers, 2013

volume of their trades with U.S. firms in order to avoid the burden of becoming subject to US rules.[23]

Overall, while international competitive concerns have certainly been an important issue in the implementation of the G20 commitments, the introduction of extraterritorial rules by home-country authorities has often been a burden rather than a safeguard for the competitive position of firms seeking to compete in the global derivatives markets. Market actors' interests have only rarely complemented the extraterritorial application of market rules, and where that overlap is observable, it is limited to a small cross-section of firms.

A fourth key perspective on the politics of financial regulation identifies the sources of the cross-border conflict in the regulation of derivatives markets in developments that have occurred within the major jurisdictions, rather than across them, and in particular the greater role of elected officials in the design of the post-crisis rules both in the US and EU. In particular, Knaack has highlighted how legislators lacked the same incentives and expertise of regulators to engage in cross-border harmonization. According to Knaack, the involvement of legislators has also shaped implementation, as both Dodd-Frank in the US and European Market Infrastructure Regulation (EMIR) in the EU provided regulators with a mandate to extend the perimeter of their oversight to a range of foreign market players.[24]

At the same time, as detailed more extensively in the case studies below, the primary legislation introduced in both the US and Europe has explicitly introduced provisions granting regulators the authority to curb the extraterritorial reach of their rules through the use of mutual recognition tools. What needs to be explained is why regulatory authorities have been reluctant to make use of these powers and to recognize each others' rules as equivalent. Moreover, as the cases below will

[23] Jeffs & Williams, 2012; Davies, 2013
[24] Knaack, 2015

illustrate, regulatory authorities themselves have often been the key actors driving the expanded extraterritorial scope of certain provisions, despite the opposition coming from large segments of the financial industry and their elected principals.

In order to explain regulators' extraterritorial implementation of G20 rules, the analysis in this chapter focuses instead on the incentives of these regulatory actors. A number of authors analyzing the politics of international financial regulation have theorized the role of regulators as bureaucratic entities seeking to balance the competing demands coming from the financial industry and politicians.[25] Changes in the approach of regulators are often understood as deriving from the change in the relative importance of these two forces. But the way in which regulators interpret their tools and course of action is also influenced by changes in their mandate.

From this perspective, the response to the crisis has not only expanded the scope of the regulatory intervention in the derivatives market but also introduced a strong prudential bias into the rationale for regulating a market that had previously been generally seen as raising market integrity and conduct issues, relating primarily to contract law. Since the crisis, the recognition of the systemic externalities in derivatives markets has led to the institutionalization in legislation of a new policy objective: to limit the extent to which events occurring in the derivatives markets destabilize the broader financial system. This overriding objective has influenced the choice of regulatory tools across jurisdictions, including the territorial scope of regulatory requirements needed to realize this policy goal. Indeed, while investor protection and/or market integrity issues can be addressed primarily through measures aimed at domestic firms or firms offering services to domestic clients, the international nature of derivatives markets means that systemic risk can be imported or exported across borders, leaving financial institutions exposed to disruptions affecting foreign affiliates. As the former chairman of the Commodities Futures

[25] Kapstein, 1989; Singer, 2004; Kleibl, 2013

Trading Commission (CFTC) Gary Gensler argued, a number of high profile episodes of financial instability before and after the financial crisis such as Long-Term capital Management, Bear Stearns, AIG, and the "London Whale" served as a "stark reminder of how trades overseas can quickly reverberate with losses coming back into the United States".[26]

From this perspective, the emergence of a strong prudential mandate in the regulation of derivatives markets has moved derivatives market policymakers and regulators towards the approach that has dominated the regulation of banks, where, as Coffee puts it, "unlike securities and derivatives regulators, banking regulators have largely ignored or disdained substituted compliance, preferring to rely on a more traditional territorial approach".[27] As Posner argues in this volume, unlike in the case of banking regulation, the incentives for authorities to introduce extraterritorial regulatory requirement has been enhanced by other factors such the timing of the introduction of regulatory requirements at the national level (which has preceded in many cases rather than followed the design of international standards), and the absence of granular and high-level standards in this area similar to the ones developed in the area of banking regulation by the Basel Committee over the years.[28] It is, however, important to foreground that the characteristics of the international institutional context in the derivatives markets and the lack of strong international standards only became an obstacle to the sharing of regulatory sovereignty once regulators acquired a stronger prudential mandate.

In order to probe this argument further, the chapter turns towards developments in the two major derivatives markets, the US and EU. This focus is justified in terms of the importance of the combined importance of these jurisdictions, which accounted for close to 95% of the $630 trillion global derivatives market at the

[26] Gensler, 2012
[27] Coffee, 2014, p. 13
[28] Posner, this volume. See also Knaack, 2015

time these rules were being designed and implemented,[29] as well the broader implications of their regulatory policies. The disagreements between them have been identified as having a direct impact on implementation of the G20 agenda in a number of smaller markets.[30] The next sections will investigate the regulatory frameworks introduced after the crisis by authorities in the US and EU to regulate foreign dealers and market participants, foreign clearinghouses, and foreign trading platforms, exploring the extent to which these rules have been extraterritorial in nature, as well what factors explain these outcomes.

3. Dealers and Market Participants

The first area where the implementation of the G20 commitments has been characterized by significant extraterritoriality is the definitions which firms and transactions are captured by different sets of national rules. In the United States, the territorial boundaries of the regulation, and in particular the extent to which it should cover market actors and transactions outside of the US, entered the Congressional agenda during the early stages of the drafting of the Dodd-Frank Act, when dealer banks pleaded in front of Congress to avoid "the prescriptive imposition of U.S. rules on foreign markets". In particular, banks stated that this could have the effect of "potentially curtailing U.S. access to foreign markets" and it may "invite retaliatory measures that could compromise the ability of U.S. exchanges to compete for international business".[31] This request was supported by Republican Rep. Spencer Bachus who introduced an amendment to curtail the extent to which overseas operations would come into the scope of Dodd-Frank.[32] On the other side, Democratic Rep. Barney Frank justified an extra-territorial implementation of the new rules on the grounds that "there may well be cases where non-U.S. residents are

[29] Committee on Capital Markets Regulation, 2014
[30] Financial Stability Board, 2011
[31] Rosen, 2009
[32] Bachus, 2009

engaging in transactions that have an effect on us and we would find them insufficiently regulated internationally and I would not want to prohibit our regulators from stepping in".[33] The compromise language adopted within Dodd-Frank (Section 722d) seemed to reassure the banks by explicitly stating that the new derivatives rules would not apply to their overseas trading operations. At the same time, the legislation still brought under the oversight of US authorities foreign activities that had "a direct and significant connection with activities in, or effect on, commerce of the United States" or where extraterritorial application was "necessary or appropriate to prevent the evasion of any provision of this Act". Coffee has described this provision as "an extreme case of the exception swallowing the rule".[34]

Critics of the extraterritorial language contained within Dodd-Frank turned their attention towards the CFTC, the regulatory agency in charge (together with the SEC) of interpreting and defining the scope of these provisions. Contrary to the expectations of market actors, the "Proposed Interpretative Guidance" of Dodd-Frank's cross-border regulation published by the CFTC in July 2012 further expanded the extraterritorial scope of the US regulation.[35]The proposed rules subjected any swap involving a "U.S. person" to Dodd-Frank's clearing, trade execution, and reporting requirements notwithstanding the location where the transaction was booked or the legal status of the US person's counterparty. Moreover, any foreign person (including non-US affiliates of US dealer banks) whose swap trading with US persons exceeded the same threshold applicable to US persons would be required to register with the CFTC and comply with Dodd-Frank requirements, such as capital adequacy and the risk mitigation requirements for the OTC markets.

The central issue determining the territorial scope of Dodd-Frank, therefore, concerned the definition of who should be regarded as a "US person". The CFTC provided an expansive definition that included not only resident market actors but

[33] cited in Gupta, Beck, Miller, Harper, & Holbrook, 2014
[34] Coffee, 2014
[35] CFTC, 2012a

also entities which had their "principal place of business in the United States", non-US firms where the direct or indirect owner was a US person, and the foreign branches of US banks.[36] Speaking in front of Congress in December 2012, the CFTC Chairman Gary Gensler justified the extraterritorial approach by stating that if U.S. rules did not cover also affiliates offshore of U.S. firms, this would "basically blow a hole out of the bottom" of the new rules because US dealers would structure trades through exempt foreign entities.[37]

The CFTC approach faced almost unanimous opposition from both major US banks acting as dealers in the derivatives markets,[38] as well as their foreign competitors,[39] with the major financial industry associations representing both US and foreign dealers (i.e., SIFMA, ISDA, and Institute of International Bankers) unsuccessfully challenging the CFTC cross-border rules in a federal district court.[40] In an attempt to limit the extraterritorial impact of the legislation, US and foreign derivatives dealers turned to a footnote in the CFTC's final cross-border guidance.[41] They focused on what Footnote 513 *did not say* about the application of Dodd Frank requirements, as it mentioned "branches" but not "affiliates" which are considered legally separate from the parent company. Banks interpreted the rule to mean that swap transactions could be arranged by traders in the US and escape CFTC oversight as long as they were executed or 'booked' through overseas affiliates.[42]

As a result, some of the largest banks started to change the terms of certain swap agreements made by their offshore units and remove guarantees to ensure that liabilities would formally lie entirely with the offshore operation.[43] This strategy was described as meaning that "a client might strike a derivatives deal with Goldman in New York in the morning, and that afternoon, with no disclosure, a Goldman office in

[36] CFTC, 2012b.
[37] cited in Trindle, 2012
[38] Sullivan & Cromwell LLP, 2011.
[39] Barclays Bank PLC et al., 2011.
[40] Miedema, 2014; Price & Puaar, 2013.
[41] CFTC, 2013c
[42] Schmidt & Brush, 2013
[43] Burne, 2014

London or Singapore or Hong Kong could take over the deal. With each shift, the trade could fall under different regulators".[44]

To prevent this potential regulatory arbitrage, the CFTC further expanded the extraterritorial scope of its oversight by taking two additional measures. First, the CFTC explicitly challenged the banks' interpretation of footnote 513 in a November 2013 staff advisory which clarified that all transactions "arranged, negotiated or executed" (called "ANE transactions") by U.S. agents had to come under U.S. trading rules, even if the transaction was conducted through a foreign affiliate or on behalf of an overseas client.[45] Gensler explained the change in the CFTC approach in this way: "a U.S. swap dealer on the 32nd floor of a New York building and a foreign-based swap dealer on the 31st floor of the same building have to follow the same rules when arranging, negotiating or executing a swap. One elevator bank, one set of rules".[46]

Second, in June 2015, the CFTC proposed new rules requiring foreign affiliates of US banks to adhere to US margin rules even where the US parent company had revoked its formal guarantee but the results were consolidated in the financial statements of the parent firm.[47] The new CFTC Chairman Massad justified this measure on the ground that "risk created offshore can flow back into the U.S.".[48] In October 2016, the CFTC finalized a proposed rule that further defined "US Person" and a "Foreign Consolidated Subsidiary" for the purposes of Dodd Frank. The proposed rule is consistent with the intent of the margin rules in that it reaches certain de-guaranteed foreign affiliates, and clarifies that trades with such entities also count towards the relevant Dodd Frank thresholds. Furthermore, the rule proposes to extend certain Dodd Frank conduct requirements to what it called "ANE transactions", i.e., those using U.S agents, thereby taking the interpretive guidance the CFTC gave in relation to footnote 513 by applying it to business conduct standards,

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[44] Levinson, 2015
[45] CFTC, 2013a; Schmidt & Brush, 2013
[46] Norris, 2013
[47] CFTC, 2015
[48] Ackerman, 2015

and holding out the possibility that the CFTC will eventually extend the scope of all Dodd Frank requirements to ANE transactions through a formal rule-making (rather than through less formal staff guidance alone).[49] A consultation period closed in late 2016 and the rule's final status is not certain under the CFTC's post-Massad leadership.

The extraterritoriality in the US approach towards the regulation of offshore branches and affiliates has also been reinforced by the reticence of US regulatory authorities to use the key policy tool available to limit their extraterritorial reach, namely the use of substituted compliance. In order to determine the "comparability" of foreign regulatory regimes, the CFTC stated in its cross-border guidance that it would use an outcomes-based approach in order to determine whether foreign regulatory frameworks were designed to meet the same regulatory objectives of the US regulations. In practice, however, the CFTC has only made very circumscribed use of substituted compliance.[50] The CFTC approach to determine the equivalency of these rules has been described by financial market participants as difficult to meet and too prescriptive, being based in practice on a rule-by-rule comparison with foreign jurisdictions.[51] As a result, these comparability determinations have not allowed foreign entities captured in the extraterritorial net of the CFTC to forgo compliance with most of the material US Dodd-Frank requirements. The CFTC has during this period issued a series of time-limited exemptions – including the application of the Dodd Frank transaction level requirements to so-called ANE transactions.

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[49] CFTC 2016a

[50] At the end of December 2013 approved "comparability determinations" for a series of entity-level requirements of Australia, Canada, the European Union, Hong Kong, Japan, and Switzerland CFTC, 2013f, allowing foreign swap dealers and major swap participants from these countries to rely on their home country rules for business conduct matters which included swap record keeping, risk-management policies and chief compliance officer requirements. Moreover, at the same time, comparability determinations were made with respect to certain transaction-level rules from the European Union CFTC, 2013e and Japan CFTC, 2013d, but the CFTC declined to make comparability determinations in any jurisdiction for other key transaction-level requirements, including clearing and trade execution.

[51] Ackerman, 2013.

In sum, the expansion in the scope of the regulation to offshore branches and affiliates at key junctures and the minimal use of substituted compliance demonstrates the intent of US authorities to capture a wide array of offshore transactions, despite the costs this imposed upon US banks, and the implications for broader efforts at transatlantic regulatory cooperation. Notably, the extraterritorial approach informing US rules has been heavily criticized by policymakers in Europe. Shortly after the publication of the proposed interpretative guidance in 2012, European Commissioner Michel Barnier warned of the danger that "American rules would take primacy over those in Europe", and called on the CFTC to "rely on equivalent rules in host countries".[52]

It should be noted, however, that the EU regime for dealers is, at the legislative level, remarkably similar in its intent. In particular, the provisions contained within EMIR applied where the two transacting entities are both established in non-EU jurisdictions, if the contract had a "'direct, substantial and foreseeable effect' within the E.U. or where to do so is necessary to guard against anti-evasion."[53]

While the European legislation was drafted in a manner similar to Dodd-Frank, the implementation of the EU's rules has been more constrained, particularly in terms of the types of legal guarantees that bring offshore market participants into scope. Unlike the gradual evolution in the CFTC rules discussed above, the technical standards published by ESMA in 2013 to identify when OTC transactions between foreign firms would have "direct, substantial, and foreseeable effect" in the EU considered the activities of a offshore unit to have an impact over its European parent company only in the presence of an "explicitly documented legal obligation".[54] Similar to the US framework, EMIR also included a mechanism to allow European rules to be waived when one of the counterparties was established in a non-EU jurisdiction that the European Commission had determined to have an equivalent

[52] Barnier, 2012
[53] Coffee, 2014; Helleiner, 2014
[54] ESMA, 2013a

regulatory regime (Article 13 of EMIR). At a high level, the EU rules allowed for a more holistic application of mutual recognition than the US substituted compliance approach, by potentially granting market participants a broad carve-out across their EMIR requirements if a foreign regime was equivalent rather than proceeding on a granular level. However, in practice, the process for determining which regimes were in fact equivalent has proved to be complex subject to the same administrative and procedural delays as their US counterparts.

In summary, this analysis of the rules concerning the definitions of firms and transactions captured by different national regulations reveals how both the US and EU rules have been meaningfully extraterritorial. While both frameworks made mutual recognition or substituted compliance available to market participants, the extent to which policymakers on both sides of the Atlantic have deployed this tool in a timely manner was limited. That said, in an important way the US rules have been more extraterritorial than the EU rules due to the unique anti-arbitrage CFTC staff interpretation of footnote 513 and the CFTC's efforts to combat dealers' attempts to skirt the rules through an expanding interpretation of a legal guarantee.

What explains this outcome? The approach adopted by regulators in the US and Europe both defied the imperative of international coordination and the influence of well-organized business interests. As suggested throughout this case, the primary driver for the adoption of extraterritorial measures appears to have been prudential policymaking concerns about the low exit costs facing transatlantic dealer banks. Policymakers introduced extraterritorial provisions to prevent regulatory arbitrage where the application of requirements with clear prudential effect – like swaps clearing, reporting and trading – could otherwise have been circumvented by market participants. These concerns have been particularly acute for US authorities given the presence of London as the single biggest market where US dealers could arbitrage away from US regulations with relatively ease.

4. Central Counterparties

Among the key components of the new rules governing derivatives since the crisis is the requirement that certain OTC derivatives or swaps should be centrally cleared through a central counterparty (CCP). The derivatives market is highly internationalized and features a decentralized market structure for central clearing, with multiple CCPs in multiple jurisdictions. The implementation of the clearing requirement has therefore generated a number of key questions with clear jurisdictional implications: which CCPs should be allowed to satisfy the mandatory clearing requirement? And whose rules should govern these entities?

Both the US and the EU rules required domestic market participants to use CCPs that were authorized by domestic authorities. The specific conditions under which a foreign CCP could receive such authorization so that domestic counterparties to a trade could clear through it and meet their home jurisdiction's clearing requirement have varied across the US and EU.

In the US, Section 722 of Dodd-Frank was interpreted by the CFTC as requiring CCPs wishing to clear swaps for US market participants to register in the US as a 'Derivatives Clearing Organization' (DCO).[55] This extraterritorial provision reflected the clear prudential case for regulating CCPs clearing swaps, especially in the post crisis reform period where these institutions have become the nexus of the attempts to limit systemic risk in the swap markets. This approach has differed from the rules in place for foreign clearinghouses seeking to clear derivatives products that are listed on exchanges, products that are called 'futures'. The greater transparency, level of standardization, and liquidity of futures products means that these have been not regarded as leading to the same types of opaque concentrations of risk – requiring prudential measures – as swaps. In the case of futures, the CFTC required foreign

[55] CFTC, 2012a.

CCPs to register and fully comply with its rules only when they sought to clear futures products that listed on a US exchange. On the contrary, US rules simply required that foreign CCPs clearing for US persons were compliant with the relevant international standards if those CCPs sought to clear futures products that listed on a foreign exchange – products that therefore fell outside CFTC's market integrity and prudential mandate.[56]

From the perspective of foreign CCPs seeking to offer cross-border clearing, the regime introduced by the CFTC raised the threat of having to comply with multiple and overlapping sets of regulations.[57] Market actors have therefore called upon the CFTC to mitigate this extraterritorial impact of their respective rules by recognizing foreign CCPs based on their home-country rules. In the US, Dodd-Frank (DFA S. 725(b)) granted the CFTC the authority to exempt a foreign derivatives clearing organization from registration if it determined that this CCP was subject to "comparable, comprehensive supervision and regulation" by government authorities in its home country. In August 2015, Australia's ASX was the first foreign CCP to be exempted from the requirements of full registration as a DCO (under the so-called 'exempt DCO' regime) followed by Korean and Japanese CCPs. Furthermore, the CFTC made extensive use of targeted exemptions to allow non-US CCPs to continue to clear swaps subject to mandatory clearing for US market actors on a transitional basis, while their final regulatory status under Dodd Frank was being determined.

In Europe, EMIR required covered derivatives transactions to be cleared by an EU-based CCP authorized or a non-EU domiciled CCP recognized by ESMA, without distinguishing between the types of products cleared (futures vs. swaps) as in the US. Moreover, the EU rules ensured that this rule would not be skirted by linking the new requirement to the new banking capital standards (Capital Requirement

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[56] The centrality of the clearing function in the execution chain gives the CFTC a clear interest in ensuring that CCPs (and their clearing members) are regulated appropriately in order to fulfill its market integrity mandate. This market integrity mandate, however, does not extend to transactions in futures products that are listed outside of the territorial US.
[57] Committee on Capital Markets Regulation, 2013 Brummer, 2013

Directive IV), which imposed significantly higher capital requirements for exposures to third-country CCPs not recognized under EMIR.[58]

Like Dodd-Frank, the final text of EMIR included an "equivalence" regime in Article 25, designed to allow foreign CCPs to provide their services to EU counterparties on the basis of their home-country regulation. The condition for this recognition was that the European Commission first determined that the legal and supervisory arrangements in a foreign CCP's home jurisdiction were "equivalent" to EMIR.[59]

The process for issuing those authorizations for overseas CCPs became a much more strained process in the EU than in the US. In September and October 2013, ESMA provided its advice to the Commission concerning the equivalence of Australia, Canada, Switzerland, Hong Kong, India, Japan, Singapore, South Korea and the US. ESMA did not find any of these jurisdictions to be entirely equivalent to EMIR, despite all the jurisdictions being G20 members and in the process of implementing the same G20 commitments. With regards to the US rules, the overall conclusion by ESMA was that, while on many policy matters the US rules provided for effective equivalence, on others - particularly prudential issues regarding the calculation and posting of margin - the US rules would need to be adjusted or supplemented at the CCP level in order to fully meet the conditions of access.[60] Importantly, this requirement exported the EMIR rules to CCPs located in the US. The European Commission ultimately accepted rules in nine countries (Japan, Singapore, Australia, Hong Kong, India, South Africa, South Korea, Canada, Mexico, and Switzerland) as equivalent to EMIR over 2014-2015 without attaching the same regulatory adjustments as a condition, on the basis that CCPs in those jurisdictions represented less risk to the EU market than US CCPs and a proportional approach was therefore appropriate. However, the same outcomes-based equivalence based on

[58] Pagliari, 2013
[59] Quaglia, 2015
[60] ESMA, 2013b

proportionality was not extended to the United States CFTC rules. This resulted in the emergence of a protracted and loud transatlantic dispute between the US and EU market authorities despite strong industry pressures and repeated efforts at an international agreement.

In sum, both the US and EU have introduced in response to the crisis regulatory frameworks requiring foreign clearinghouses to be recognized in their own jurisdictions before domestic counterparties may use them to comply with their mandatory clearing requirements. However, the willingness to rein in this extraterritorial requirement through mutual recognition provisions has varied significantly between the two jurisdictions, with the EU adopting a relatively higher degree of extraterritoriality in the application of its rules with regards to foreign – and particularly American – CCPs. What explains this difference?

A mix of prudential and commercial concerns informed the approach of European policymakers towards foreign CCPs during the crisis. As US authorities moved first in demanding that more derivatives transactions should be centrally cleared at the beginning of the crisis, European policymakers recognised the possibility that US incumbents could take control of the European market for clearing at the expense of smaller European competitors.[61] Commercial considerations, and in particular the need to protect European CCPs against competition on the grounds of margin costs, have also influenced the negotiations over the equivalency of foreign rules.

At the same time, European authorities also recognized the prudential implications of concentrating derivatives activity within CCPs that were outside European regulatory oversight, as this would leave European authorities with very limited powers to pre-empt the build-up of risk and to intervene should a foreign CCP used by EU firms

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[61] Jones 2009b.

come under financial stress.[62] Prudential concerns regarding the potential for CCPs under the oversight of foreign authorities to channel systemic risk in the European markets also informed the disputes over mutual recognition of US CCPs in a manner that intersected with the commercial concern about where central clearing takes place. While a number of differences among the two CCP regimes initially hindered the mutual recognition between the US and the EU regime,[63] the key issue was how the two jurisdictions calculated the margin posted by banks clearing their own derivatives trades. The EU stood firm in arguing that its standards guarded more fully against the risk of default and contagion and denounced how the US remained unwilling to “level up” its margin requirements.[64] Indeed, the US authorities agreed CCPs should make targeted amendments to their margin rules to bring them into alignment with the EMIR rules, as a condition of equivalence and EU market access.[65] It is also notable that US domiciled CCPs regulated by the Security and Exchange Commission (SEC) have not yet been recognized.

Market participants have noted how European authorities had granted unconditional recognition to Singapore, which had implemented identical margin rules as the US. This difference of treatment is, however, consistent with a prudential explanation. Unlike in the case of the regulation of dealers analyzed earlier, the opportunities for regulatory arbitrage in the clearing business are heavily influenced by the levels of clearing activity already present in a foreign jurisdiction. In particular, the presence of large futures exchanges and CCPs in the US with high levels of what is called “open interest” and liquidity enabling the capital-efficient use of market participants’ collateral produced strong network effects for EU banks as well as their US-based branches and affiliates to participate in the cleared US markets. The same opportunities for regulatory arbitrage were weaker in the case of shallower clearing markets such as Singapore.

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[62] European Commission 2009a, p. 10.
[63] Brummer, 2013
[64] Rundle, 2015
[65] CFTC 2016b.

The fact that European authorities have explicitly made their decisions on the equivalency of foreign jurisdictions on the basis of proportionality, taking a stricter line on the formal equivalence for large markets such as the US that posed greater opportunity for regulatory arbitrage, as well as significant concentrations of exposures for EU firms that result from those network effects, highlights the importance of prudential concerns informing the decision of European policymakers.

5. Trading Venues

In addition to the post-crisis requirement that sufficiently standardized derivatives be cleared through CCPs, the G20 reforms have also created new obligations to execute many types of trades on regulated trading platforms. As with the regulatory framework governing CCPs discussed in the previous section, the implementation of this commitment raised the issue of how to regulate venues where counterparties transact on a cross-border basis, and to what extent countries should impose regulatory obligations on trading venues beyond their own jurisdiction.

A particularly extraterritorial implementation of the trading requirement emerged in the US in the rules for the new types of electronic platforms created for swaps that previously traded over-the-counter, called "Swap Execution Facilities" (SEFs). In particular, a footnote ("footnote 88") included within the CFTC's May 2013 rules for SEFs required that any trading platform, including those based overseas, on which US persons were executing swaps was required to register with the CFTC and comply with the US rules, even if the products being traded were not mandated by rule to be traded on these facilities.[66] As a result of this rule, non-US trading platforms were no longer permitted to allow market participants covered by the US rules to transact on their platforms without registering with the CFTC.

[66] CFTC, 2013b

This measure was described as “an extraterritorial land grab by the CFTC”[67] and it immediately attracted the opposition of derivatives market participants and foreign authorities. After negotiations with the European Commission, the CFTC committed in July 2013 to offer transitional relief to different EU regulated multilateral trading facilities and to consult with the European Commission about granting regulatory relief to those foreign trading platforms that were subject to comparable regulatory requirements as SEFs.[68] Following on this commitment, the CFTC announced in February 2014 that US financial firms could trade on “Qualified Multilateral Trading Facilities” (using the European term for an electronic trading venue) that were "appropriately overseen by home regulators and remain subject to regulations that are comparable to, and as comprehensive as, US law".[69]

The implementation of this regime was problematic. In particular, in order to obtain the designation of “Qualified Multilateral Trading Facility”, the CFTC required European platforms to satisfy a number of conditions that were very similar to full registration.[70] European platforms complained that the requirements for them to continue to give access to US firms were too onerous and the timeframe too inadequate to be worthwhile. [71] When the deadline for European platforms to register as a “Qualified Multilateral Trading Facility” with the CFTC passed in 2014, no European platform had opted to do so. In order to avoid having to comply with two distinct sets of rules, European swap trading venues instead notified US counterparties that they were no longer welcome to participate on their platform.

As a result, the failure of the CFTC to relax the requirements imposed upon foreign swap trading platforms contributed towards a bifurcation of the liquidity in the transatlantic swaps market, with European firms only trading with each other on European platforms. A report produced by ISDA in April 2014 demonstrated that

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[67] Stafford, 2014
[68] CFTC & European Commission, 2013
[69] Wetjen, 2014
[70] CFTC, 2014
[71] Parsons, 2014

only 6% of Euro denominated swaps and 3% of sterling denominated swaps that were subject to the US trading mandate were being traded on US trading platforms.[72]

This outcome is a puzzling contrast to the approach the CFTC has taken for derivatives exchanges trading standardized futures. Foreign derivatives exchanges that sought only indirect access to US clients through brokers can be granted full exemption under CFTC Regulation 30.10. This exemption was granted to several non-US derivatives exchanges as well as the entire UK market. A more extraterritorial regime was imposed upon non-US exchanges seeking to allow US market participants to directly enter transactions into the exchange's matching system, i.e., seeking direct access to US clients. In November 2010, the CFTC implemented the Dodd-Frank Act (Section 738) by requiring these foreign exchanges (labeled "foreign boards of trade" or FBOTs) to register with the commission and to comply with different regulatory requirements taking into account "whether the FBOT's home regulatory authority supports and enforces regulatory objectives … that are substantially equivalent to those supported and enforced by the Commission".[73] While the FBOT regime was described as onerous by foreign exchanges,[74] it is important to note that many nonetheless availed themselves of the opportunity to register. This is not the case with the US SEF regime, where no foreign entities applied to the stringent application of SEF rules within the 'qualified MTF' framework.

How do we explain the different extent to which US policymakers have imposed regulatory requirements upon foreign swap trade execution facilities and foreign listed derivatives exchanges? As with the CCP market, there were again commercial interests – particularly US SEFs – with an interest in maintaining the CFTC's extraterritorial approach to foreign swaps platforms to level the regulatory

[72] ISDA, 2014
[73] CFTC, 2010, p. 70977
[74] Scheid, 2010

implications of accessing US persons, and this commonality of interest should not be discounted. However, it should also be noted that the major banks, which can reasonably be assumed to have had more market and structural power and a greater voice in lobbying efforts that smaller trade execution venues, did not get their way on the harmonization of cross-border swaps execution rules.

This puzzle fits the pattern observed in the previous cases where the mandate of regulatory agencies determines the extraterritorial scope of their intervention. In the case of the regulation of futures markets, the CFTC's extension of its oversight over foreign exchanges was influenced by the extent to which these exchanges would have a direct impact on US market activity and the CFTC's delivery of its market oversight mandate, i.e., by allowing or not allowing US market participants to be direct members. This is consistent with the CFTC's approach to foreign CCPs clearing futures, which was, again, more extraterritorial where there was a clear US nexus and an implication for US market integrity (particularly for US listed futures). Conversely, the fact that the US introduced a regulatory regime governing trading venues for swaps (SEFs) that was substantially more extraterritorial in scope than the US regime for traditional derivatives exchanges can be explained, from a prudential policymaking perspective, by the fact that swaps were thought to present greater risks compared to futures. Moreover, the risks of regulatory arbitrage towards foreign jurisdictions is particularly acute in the case of the trading of swaps since European rules prescribing mandatory trading have been substantially delayed relative to the US rules.

6. Conclusion

This chapter has sought to shed light on one of the most contested issues in the post-crisis regulation of derivatives markets: regulators' extraterritorial application of

the rules introduced to implement the G20 agenda. In particular, this chapter has focused on the rules introduced in the two major centres for the trading of derivatives, the US and the European Union, and investigated how these have regulated foreign dealers, CCPs, and trading venues. In each of these three cases, the US and EU post-crisis rules have been shown to exhibit varying degrees of extraterritoriality in both the extent to which they capture firms and transactions beyond the two respective domestic territories, and the extent to which the rules impose requirements on foreign firms as a condition of access to the domestic market. While in principle, both the US and EU regulatory post-crisis legislation have included mutual recognition to allow foreign actors to comply only with foreign rules, the analysis in this chapter has demonstrated how in practice the application of these tools has failed to rein in the extraterritorial application of US and EU rules.

This chapter has argued that the emergence of extraterritoriality in the implementation of the G20 derivatives agenda has been influenced by the challenges that regulatory authorities have faced in fulfilling their new prudential mandate in the face of highly internationalized derivatives markets. While in some instances commercial interests have complemented the prudential reasons for regulators to export their rules on an extraterritorial basis, in most cases there has been a clash between the prudential motivations and subsequent extraterritorial undertakings of regulators, and the preferences of powerful industry voices.

The emergence of a strong prudential imperative has frequently overridden other forces to influence the extent to which authorities have been willing to extend the scope of their regulatory authority over foreign firms, such as the commercial incentive to either protect domestic market actors and/or 'level the playing field', the preferences of transnational market participants to avoid duplicative requirements, and the role of transnational regulatory institutions in promoting greater deference to each others' rules.

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