FROM THE GROUP OF TWENTY TO THE GROUP OF TWO:

THE NEED FOR HARMONIZING DERIVATIVES REGULATION BETWEEN THE UNITED STATES AND THE EUROPEAN UNION

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I

INTRODUCTION

Following the approval of the Dodd–Frank Wall Street Reform and Consumer Protection Act (Dodd–Frank) in July of 2010, U.S. Commodity Futures Trading Commission (CFTC) Commissioner Bart Chilton wrote, "Now that the U.S. has approved the largest financial regulatory reform ever undertaken, it's time for other nations to join in to ensure more efficient, effective market systems. Here is what we know: free markets without sufficient sideboards led to the global economic collapse."[1] Chilton began his position at the CFTC in 2007, making him a firsthand witness to the financial crisis and the subsequent rulemaking that ultimately resulted in Dodd–Frank.[2]

Throughout his time at the Commission, Chilton consistently championed the need for cooperation among different nations' regulatory agencies.[3] The legislation itself stresses this need for international regulatory cooperation, with § 752 of Dodd–Frank specifically addressing international harmonization of derivatives reform: "In order to promote effective and consistent global regulation of contracts of sale of a commodity for future delivery and options

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This article is also available at http://lcp.law.duke.edu/.

* Duke University School of Law, J.D. & LL.M. in International & Comparative Law, 2015. I am grateful to Professor Lawrence Baxter, Sean Anderson, Michael Marcantonio, Ryan Marcus, Olivia Renensland, Rachel Smithson, and the editors of *Law and Contemporary Problems* for the insightful conversations and comments on this note throughout the writing process. This note is dedicated to my parents and role models, Maria and James White.

1. Bart Chilton, *The Heavy Lift of Harmonization—CFTC's Chilton*, REUTERS (Sept. 24, 2010), http://blogs.reuters.com/financial-regulatory-forum/2010/09/24/opinion-the-heavy-lift-of-harmonization-cftcs-chilton/.

2. Gina Chon, *Financial Reform Effort Disappoints Former CFTC Regulator*, FINANCIAL TIMES (Mar. 23, 2014, 5:24PM), http://www.ft.com/intl/cms/s/0/26913de2-b10a-11e3-bbd4-00144feab7de.html#axzz2xaDN8J8S.

3. *See, e.g.*, Chilton, *supra* note 1 ("Such communication between regulators at the international level is critically important in the brave new world of global electronic markets.").

on such contracts, the Commodity Futures Trading Commission shall consult and coordinate with foreign regulatory authorities on the establishment of consistent international standards."[4] Moreover, the U.S. push for regulatory cooperation in the financial realm did not stop with this legislation. In fact, President Obama issued Executive Order 13,609 in 2012, specifically directing agencies to focus on international regulatory cooperation in order to minimize unnecessary differences in regulatory requirements.[5] This executive order acts as an additional legitimizing authority on the ability of agencies to cooperate with their foreign counterparts and highlights the top priority given to achieving global regulatory harmonization in the financial sector.[6]

This calling for greater cooperation among regulators has become increasingly common in the past twenty years,[7] with the financial crisis of 2008 only escalating the momentum of international regulatory cooperation. In 2002, Professor Kal Raustiala highlighted the growing need for communication between regulators, writing that "[i]nterdependence among states—the linkages between national economies and societies—has never been higher."[8] The crisis, therefore, merely amplified awareness of this financial interconnectedness. In a recent report on international financial reforms, the U.S. Government Accountability Office (GAO) stressed the consequences of a linked global economy:

> Cross-border interconnections in the financial markets and other factors helped spread disruptions in the global financial system during the 2007–2009 financial crisis and increased systemic risk at the national and international levels. For example, the rise in the complexity and globalization of over-the-counter (OTC) derivatives contributed to economic growth but created interconnections that helped spread disruptions quickly across markets and borders during the crisis.[9]

As specifically identified in this GAO report, derivatives played a central role in the financial crisis and were consequently a central focus of national regulatory bodies in the aftermath. Because of their global nature, however, it

4. 15 U.S.C. § 8325(b) (2014).

5. Exec. Order No. 13,609, 77 Fed. Reg. 26413 (May 4, 2012) ("In some cases, the differences between the regulatory approaches of U.S. agencies and those of their foreign counterparts might not be necessary and might impair the ability of American businesses to export and compete internationally.").

6. Reeve T. Bull, *Developing a Domestic Framework for International Regulatory Cooperation*, 78 LAW & CONTEMP. PROBS., no. 4, 2015, at 50 (explaining the significance of President Obama's executive order: "EO 13,609 thus places a high priority upon a cross-border issue that many agencies had largely neglected insofar as it was viewed as outside the ambit of their overall regulatory missions.").

7. Jonathan Wiener & Alberto Alemanno, *The Future of International Regulatory Cooperation: TTIP as a Learning Process toward a Global Regulatory Policy*, 78 LAW & CONTEMP. PROBS., no. 4, 2015, at 107 ("The trend toward international cooperation among regulators has become a significant feature of regulatory policy in recent years.").

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

9. U.S. GOV'T ACCOUNTABILITY OFF., GAO-14-261, INTERNATIONAL FINANCIAL REFORMS: U.S. AND OTHER JURISDICTIONS' EFFORTS TO DEVELOP AND IMPLEMENT REFORMS ii (2014), http://www.gao.gov/products/GAO-14-261?source=ra (hereinafter GAO REPORT).

quickly became clear that successful regulation of these financial products and prevention of future systemic risk required improved, extensive international cooperation. Already existing international organizations, such as the Group of Twenty (G20) and the International Swaps and Derivatives Association (ISDA), took immediate action to respond to the crisis. The most notable response came from the G20, which has as its objective the coordination of policy among its members.[10]

The standards- and principles-based regulations set forth by these organizations, however, require state implementation by specific governmental agencies, and it is in this implementation process that the need for regulatory cooperation is critical for a successful global regulatory regime of derivatives. Despite being a champion of global regulatory cooperation, Chilton's statement above highlights the largely unilateral approach taken by the United States in response to the 2008 financial crisis in passing Dodd–Frank, with U.S. policymakers expecting other nations to follow in its regulatory path. Timothy Geithner, former Secretary of the Treasury, highlighted this point in his remarks at the International Monetary Conference in 2011, stating that "[t]he United States has taken an important leadership role in comprehensive reform of the over-the-counter derivatives market. Alignment with Europe and Asia is essential."[11] Despite the United States' history of success through unilateral action,[12] the regulation of derivatives is not an area in which acting alone will ultimately lead to a desirable result.

This need for increased regulatory cooperation is quickly becoming apparent with the 2012 passage of the European Market Infrastructure Regulation (EMIR). "Europe's contribution to the centralized reporting, clearing, and enhanced transparency requirements demanded post-crash" that "apes the US Dodd–Frank rules in many aspects," yet leaves "some regional differences still obfuscating the long-desired global harmony and opening up the possibility of regulatory arbitrage."[13] Although both Dodd–Frank and EMIR are based upon the same principles set forth by the G20 and both attempt to achieve the same goals, the slight differences in regulation between

10. *Id.* at 6 ("The G20's objectives are to coordinate policy among its members to achieve global economic stability and sustainable growth; promote financial regulations that reduce risks and prevent future financial crises; and modernize the international financial architecture.").

11. Timothy Geithner, Sec'y, Dep't of the Treasury, Remarks to the International Monetary Conference (June 6, 2011), http://www.treasury.gov/press-center/press-releases/Pages/tg1202.aspx.

12. Kalypso Nicolaidis & Gregory Shaffer, *Transnational Mutual Recognition Regimes: Governance without Global Government*, 68 LAW & CONTEMP. PROBS. 263, 267 (2005).

> [The] United States is best known for applying its law "extraterritorially" in a unilateral manner, from the Helms–Burton Act regarding investments in Cuba, to the sanctions applied in response to European assistance for the Soviet oil pipelines, to the application of U.S. securities and antitrust law to conduct abroad, as in the Hartford Fire Insurance case. The United States has typically applied its law without engaging in any collaboration or coordination whatsoever.

13. Dan Barnes, *Feature: EMIR Financial Markets Regulation Unfolds*, BOBSGUIDE (Mar. 3, 2014), http://www.bobsguide.com/guide/news/2014/Mar/3/feature-emir-financial-markets-regulation-unfolds.html.

the United States and the European Union create gaps in regulation that market participants can take advantage of. As Weadon notes, "[t]he unintended consequences of this uneven regulatory playing field include the concentration of derivatives risk in the most hospitable jurisdictions and a competitive disadvantage for U.S. financial firms. These risks are even more pronounced when one considers that OTC derivatives activity is truly global in nature."[14]

Despite the success of the G20 in quickly responding to the 2008 financial crisis, identifying important concerns raised by derivatives, and setting forth a framework for improving the regulation of derivatives, this note argues that the key to regulating derivatives and preventing a similar crisis in the future is the harmonization of derivatives regulation through effective transgovernmental networks, the most significant of which is that between the United States and the European Union. Without such harmonization, governments incentivize regulatory arbitrage that can result in the concentration of risk in jurisdictions with more favorable or weaker legislation.

Part II provides a description of transgovernmentalism and explains the relevance of this theory in regulating derivatives, noting specific attributes of the derivatives market that sets it apart from other areas, such as securities regulation, and makes it a sector requiring agency-to-agency communication and cooperation. Part III provides a background on the global nature of the 2008 financial crisis and the response by the international community to the risks posed by derivatives. Although part III notes the success of certain global efforts, part IV uses the current gaps and inconsistencies between the United States' and the European Union's regulation of derivatives to highlight the critical need for regulatory cooperation and the strengthening of transgovernmental networks. Part V discusses the consequences of a derivatives regulatory regime that is not harmonized between the United States and the European Union, paying particular attention to the risk of regulatory arbitrage and the resulting concentration of risk. Notwithstanding the serious consequences of failing to harmonize derivatives regulation, part VI acknowledges the challenges and impediments to regulatory cooperation and a harmonized regulatory regime; however, part VI concludes by noting the agreement between the United States and the European Union to overcome these impediments, focusing particularly on the current progress of the two regimes in improving cooperation between their regulatory bodies. Finally, part VII discusses common criticisms of harmonization and the merits of these arguments, stressing that critiques of harmonization can be used by regulators to avoid some of its pitfalls.

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14. Benjamin M. Weadon, *International Regulatory Arbitrage Resulting From Dodd–Frank Derivatives Regulation*, 16. N.C. BANK. INST. 249, 259 (2012).

II

BECAUSE DODD–FRANK SAID SO: ACHIEVING INTERNATIONAL HARMONIZATION OF DERIVATIVES REGULATION THROUGH TRANSGOVERNMENTAL NETWORKS

In a 2014 symposium at the New York University School of Law,[15] a group of practitioners and academics came together to present and discuss new approaches to international regulatory cooperation in anticipation of this 2015 issue of *Law and Contemporary Problems*.[16] Ten years prior, many of these same individuals contributed to the journal's issue on the emergence of global administrative law,[17] which was then an emerging field of legal theory and practice. In this earlier symposium, authors discussed the global administrative space, which includes "international institutions and transnational networks involving both governmental and non-governmental actors, as well as domestic administrative bodies that operate within international regimes or cause transboundary regulatory effects."[18] Although Robert Keohane and Joseph Nye set the groundwork of transgovernmentalism in the 1970s,[19] the 2005 symposium laid a solid foundation for the increasing attention to regulatory cooperation across borders, and ten years later, the prevalence and support of global administrative law and transnational regulatory networks has only grown.[20] Raustiala highlights this trend, noting,

> [M]uch contemporary international cooperation is not inter-*national* at all, rather, it is occurring among discrete, specialized agencies of governments. . . . These constituent parts—especially regulatory agencies tasked with elaborating upon and enforcing the laws that manage complex societies—are increasingly networking with their counterparts abroad. In the process they are sharing information, ideas, resources, and policies. Much of this agency-to-agency cooperation addresses domestic laws that, in a globalizing world, have growing international salience.[21]

Although this area of study and practice now plays an increasingly central role in discussions of reform among international organizations and within national regulatory bodies, the various methods of undertaking regulatory

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15. Symposium on New Approaches to International Regulatory Cooperation, New York University School of Law, Feb. 27–28 2014.

16. Richard Stewart, C. Boyden Gray, Jonathan Wiener, Alberto Alemanno, Robert Ahdieh, Jeffrey Dunoff, David Zaring, Reeve Bull, Fernanda Nicola, Mariana Mora Prado, Francesca Bignami, and Neysun Mahboubi.

17. *See generally* Symposium, *The Emergence of Global Administrative Law*, 68 LAW & CONTEMP. PROBS. 1 (2005).

18. Benedict Kingsbury et al., *Foreword: Global Governance as Administration—National and Transnational Approaches to Global Administrative Law*, 68 LAW & CONTEMP. PROBS. 1, 3 (2005).

19. Robert O. Keohane & Joseph S. Nye, *Transgovernmental Relations and International Organizations*, 27 WORLD. POL. 39, 43 (1974) (introducing the theory of transgovernmentalism and defining transgovernmental relations as "sets of direct interactions among sub-units of different governments that are not controlled by the policies of the cabinets or chief executives of those governments").

20. Paul B. Stephan, *Regulatory Cooperation and Competition: The Search for Virtues*, *in* TRANSATLANTIC REGULATORY COOPERATION: LEGAL PROBLEMS AND POLITICAL PROSPECTS 167, 202 (George A. Bermann et al., eds., 2001).

21. Raustiala, *supra* note 8, at 3–4.

cooperation and contexts in which it arises have resulted in some misunderstandings. Reeve Bull and Adam Schlosser note this confusion surrounding regulatory cooperation in the trade and regulatory context, writing, "[d]espite the widespread support for greater regulatory cooperation, however, some confusion exists as to what calling for enhanced cooperation means," specifically highlighting that "regulatory cooperation is not a synonym for 'harmonization.' Harmonization, merely one of many activities that can be classified as regulatory cooperation, involves the creation of an identical regulation or standard across two jurisdictions."[22] Harmonization also encompasses other forms such as mutual recognition of regulations across borders, information exchange, and regulatory convergence.

This distinction between harmonization and regulatory cooperation is significant, especially in regard to the regulation of derivatives. As discussed above, Dodd–Frank § 752, titled International Harmonization, calls for the more attenuated form of regulatory cooperation, "specifically requir[ing] the SEC, the CFTC, and the prudential regulators to consult and coordinate with foreign regulatory authorities on the establishment of consistent international standards"[23] with respect to the regulation of OTC derivatives in order to promote consistent global regulation. Although this harmonization of regulation—in which standards must closely align and achieve consistency between different regulatory bodies—is not a viable, nor preferable, option in many areas,[24] in the regulation of derivatives, harmonization is necessary in order to effectively eliminate the systemic risk that accompanies that market.

The three main reasons for the rise of transgovernmental networks demonstrate the networks' particular relevance to derivatives regulation: (1) technological innovation, (2) the expansion of the regulatory state, and (3) globalization (economic interdependence).[25] The risk posed by derivatives stems from the technological innovation behind the creation of new financial products, which are significantly complex and resultantly make regulation extremely difficult. Moreover, the systemic nature of the risk created by derivatives is the result of an increasingly global economy, which again can be attributed partially to technology; as Chilton stresses, "[o]ne of the reasons our financial markets and our economies are so interconnected—and we need some harmonization—is because of technology."[26]

22. Adam C. Schlosser & Reeve T. Bull, *Regulatory Cooperation in the TTIP*, REGBLOG (Aug. 27, 2013), http://www.regblog.org/2013/08/27/27-schlosser-reeve-ttip/.

23. *Financial Regulatory Reform: The International Context: Hearing Before the H. Comm. on Fin. Servs.*, 112th Cong. 18 (June 16, 2011) (statement of Mary L. Schapiro, Chairman, Sec. Exch. Comm'n) (speaking on the international implications of the Dodd–Frank Act, specifically regarding the regulation of OTC derivatives and foreign investor adviser registration).

24. *See* Schlosser & Bull, *supra* note 22 (noting harmonization "may make sense in select cases and sectors, but is frequently not desirable or even possible in many others").

25. *See* Raustiala, *supra* note 8, at 12–13 (describing the three key factors, saying that "[t]echnological innovation is thus one major factor behind the rise of networks. A second is the rise of the regulatory state itself").

26. Bart Chilton, Comm'r, Commodities Futures Trading Comm'n, *CFTC: Stopping*

Due to the increasing emphasis on the regulatory state, the response to the financial crisis and the threat presented by derivatives was to bring these products under increased regulation and scrutiny, which requires extensive regulatory cooperation globally.[27] The CFTC's approach to the regulation of derivatives must strive for international harmonization and closely align with the actions of regulatory bodies in other jurisdictions, using transgovernmental networks to produce a regulatory regime of derivatives that will not allow for regulatory arbitrage or foster a concentration of risk due to gaps in regulation.

III
THE GLOBAL NATURE OF THE CRISIS, DERIVATIVES, AND REFORM: LIMITS OF THE G20 IN THE REGULATION OF DERIVATIVES AND THE NEED FOR TRANSGOVERNMENTAL NETWORKS

The 2008 financial crisis highlighted both the interconnectedness of the various major economies and the derivatives market in particular, and the consequences of allowing these contracts to go largely unregulated globally.[28] Although scholars and professionals debate whether derivatives played the primary role in the financial crisis, they widely agree that derivatives did cause significant damage and remain a source of risk. The Atlantic Council highlights this risk in its 2013 report on transatlantic reform, noting, "From the AIG crisis to JPMorgan's $6 billion loss in its 'London Whale' trades, OTC derivatives have shown themselves to be quick and active transmitters of risk contagion between jurisdictions."[29]

In addition to demonstrating the systemic risk posed by derivatives, the global nature of the crisis demonstrated the lack of coordination among states to even identify such risk. As Duke University School of Law Professor Steven Schwarcz notes,

> The 2008 financial crisis also involved a failure to see system-wide correlations—*not only* the tight interconnectedness among banks and non-bank financial firms *but also* the tight interconnectedness between financial firms and markets. What made the

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Stammering—Overcoming Obstacles in Financial Regulatory Reform, *in* COMPENDIUM (Mar. 29, 2011), http://commoditymkts.wordpress.com/2011/03/29/cftc-stopping-stammering-overcoming-obstacles-in-financial-regulatory-reform-commissioner-bart-chilton/#more-1393.

27. Former Secretary Geithner stressed the need for a global approach and reiterated Dodd–Frank's mandate of transgovernmentalism, stating,

> The regulators are independent agencies, with independent mandates. Where Congress has given them the room to adopt common approaches, they need to do so, both so that we reduce the change of risk shifting among institutions subject to their different jurisdictions, but also so that we improve the chances of promoting a uniform global approach that does not damage U.S. firms.

Geithner, *supra* note 11.

28. OTC DERIVATIVES REGULATORS GRP., REPORT ON AGREED UNDERSTANDINGS TO RESOLVING CROSS-BORDER CONFLICTS, INCONSISTENCIES, GAPS AND DUPLICATIVE REQUIREMENTS 1, (Mar. 2014), http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/odrgreport.pdf.

29. ATLANTIC COUNCIL, THE DANGER OF DIVERGENCE: TRANSATLANTIC FINANCIAL REFORM & THE G20 AGENDA, 29 (2013).

> financial crisis so devastating was that these failures combined to facilitate the transmission of economic shocks.[30]

Current CFTC Commissioner Scott O'Malia also addressed this inability of the international community to take a bird's-eye view of the OTC derivatives market. In a keynote address on March 25, 2014, O'Malia highlighted that the "urgency for a holistic view of the financial markets, without borders, was underscored by how the financial crisis caught the world by surprise. Data that could have identified systemic risk was fragmented across regulators and nations."[31]

As a result of this clear inability to identify the significant risks presented by derivatives and cooperate in the regulation thereof prior to 2008, international organizations and standard-setting bodies immediately responded to the crisis by discussing the future of derivatives regulation and by coordinating responses. This international response was supported by individual states as it became apparent that domestic regulation alone would no longer sufficiently incubate a state from financial turmoil, especially in the derivatives context. Geithner's remarks to the international financial community highlight this reaction among states: "Just as we have global minimum standards for bank capital—expressed in a tangible international agreement—we need global minimum standards for margins on uncleared derivatives trades. Without international consensus, the broader cause of central clearing will be undermined."[32]

This broad acceptance of international coordination paved the way for the G20's quick response to the financial crisis. Founded in 1999 and considered the "'premier' organization for international economic cooperation, the Group of Twenty Finance Ministers and Central Bank Governors . . . provides a forum for banking and finance ministers from . . . nineteen of the largest or fastest-developing economies to meet,"[33] with the European Union being the twentieth member. In 2008, President Obama and the other G20 leaders met in Washington, D.C. with the purposes of creating a framework to prevent future financial crises and establishing principles to guide financial regulatory reform.[34] This summit and others have been followed by G20 leaders sending these agreed-upon reforms to the appropriate national authority within their state. Moreover, in 2009, the G20 established the Financial Stability Board (FSB) in order "to coordinate and promote implementation of the financial reforms, which typically involves standard-setting bodies developing international standards (for example, principles, policies, or guidance), followed by

30. Steven L. Schwarcz, *Controlling Financial Chaos: The Power and Limits of Law*, 2012 WIS. L. REV. 815, 828 (2012).

31. Scott O'Malia, Comm'r, Commodity Futures Trading Comm'n, Keynote Address at the SWIFT Institute, the SWIFT's Standards Forum, and the London School of Economics and Political Science Conference: The Future of Financial Standards (Mar. 25, 2014) (transcript available at http://www.cftc.gov/PressRoom/SpeechesTestimony/opaomalia-34).

32. Geithner, *supra* note 11.

33. Chris Brummer, *Post-American Securities Regulation*, 98 CAL. L. REV. 327, 357–58 (2010).

34. GAO REPORT, *supra* note 9.

jurisdictions voluntarily adopting rules or policies consistent with such standards, either through legislation or regulations."[35]

At the 2009 G20 summit in Pittsburgh, the reform agenda centered on OTC derivatives, with the leaders agreeing: "[a]ll standardized OTC derivative contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties by end-2012 at the latest." And that "OTC derivative contracts should be reported to trade repositories" and "[n]on-centrally cleared contracts should be subject to higher capital requirements."[36]

The agreement of the G20 leaders on core components of OTC derivatives reform marked a significant milestone. However, this early success has largely been marred by problems with implementation and the consequent discrepancies existing between member states' derivatives regulatory regimes. First, although several jurisdictions, including the United States, have made progress in implementing the G20 reforms to OTC derivatives, according to a GAO report published in April 2014, most reforms have yet to be implemented in member states.[37] This variation is notable; the report highlights that

> according to a September 2013 progress report, only the United States reported having rules at least partly in effect to implement the G20 reforms requiring derivatives to be centrally cleared, traded on organized trading platforms, and reported to trade repositories, while many other jurisdictions reported having rules in effect for only some of these reforms or adopted or proposed legislation to implement the reforms.[38]

The lack of consistency in national OTC derivatives regulation legislation and the continued inability of many member states to fully implement these reforms in a timely manner demonstrate the limits of international organizations in single-handedly motivating states to take action with regard to derivatives reform.

Despite the G20's success in creating an international consensus in general OTC derivatives reform and regulation, several weaknesses highlight the need to shift focus from global policy setting to transgovernmental networks in which regulatory agencies take the reins away from G20 leaders and work together to actually produce the necessary legislation. First, as an international organization, the G20 lacks true enforcement mechanisms. Brummer notes this limitation, writing, "[T]he G-20 communiqués are not enforceable under international law. Instead, disciplinary mechanisms within the G-20 are largely reputational."[39] The same constraint applies to the FSB, which, despite being "tasked with ensuring coordination in regulation among the G20 members, has

35. *Id*.

36. GRP. OF TWENTY, LEADERS' STATEMENT: THE PITTSBURGH SUMMIT, 9 (Sept. 24–25 2009), http://www.treasury.gov/resource-center/international/g7-G20/Documents/pittsburgh_summit_leaders_statement_250909.pdf.

37. GAO REPORT, *supra* note 9.

38. *Id*.

39. Brummer, *supra* note 33, at 359.

no powers to force the United States or other countries to row back on national reforms and relies on peer pressure for persuasion."[40] Second, regardless of the G20's ability to successfully encourage the implementation of the standards agreed upon in the regulation of derivatives, slight deviations between national legislation can lead to devastating consequences, the most prominent of which is regulatory arbitrage. The necessary detail required for the harmonization of derivatives regulation cannot be achieved solely through standards- and principles-setting, even on a truly global level.

In fact, in the most recent G20 communiqué, the G20 leaders themselves noted that communication between regulatory bodies within their states is critical for successful legislation, with a strong push for meaningful peer reviews of OTC derivatives reform.[41] This renewed focus on transgovernmental regulatory cooperation, where the specific agencies communicate directly with each other in order to achieve increased harmonization, finds significant support. Bull discusses this growing emphasis on G20 peer reviews, noting that some academics view these as an important tool because they can be used to "help deepen commitment to the standards by domestic officials by holding member jurisdictions accountable not only to an international body but also to each other."[42] Again, these peer reviews face similar challenges to the international financial standards as they are not binding;[43] however, in certain contexts this transgovernmental communication can lead to more meaningful results in truly harmonizing the regulation of derivatives.

These weaknesses highlight the need for strong transgovernmental networks, with national regulatory bodies communicating with each other directly, rather than indirectly through their leaders. The most notable and crucial transgovernmental network in the derivatives regulation is between the United States and the European Union.

IV

THE GROUP OF TWO: DISCREPANCIES BETWEEN THE DERIVATIVES REGULATORY REGIMES OF THE UNITED STATES AND THE EUROPEAN UNION AND THEIR CONSEQUENCES

Both the United States and the European Union claim to have passed legislation that fulfills the G20's agenda concerning the regulation of derivatives. The United States enacted the goals and policies set forth by the

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40. Huw Jones, Andy Bruce & David Evans, *Update 1-FSB's Carney Says to Crack Too-Big-to-Fail Bank Barriers by Dec*, REUTERS, (Mar. 31, 2014, 3:55 PM), http://www.reuters.com/article/2014/03/31/g20-fsb-carney-idUSL5N0MS4QV20140331.

41. GRP. OF TWENTY, COMMUNIQUÉ: MEETING OF FINANCE MINISTERS AND CENTRAL BANK GOVERNORS IN SYDNEY 2 (Feb. 22–23 2014) ("We commit to cooperate across jurisdictions with a renewed focus on timely and consistent implementation supported by meaningful peer reviews, including OTC derivatives reform.").

42. GAO REPORT, *supra* note 9, at 48.

43. *Id.*

G20 in Title VII of Dodd–Frank.[44] Also known as the Wall Street Transparency and Accountability Act, "Title VII of Dodd–Frank focuses exclusively on remedying a host of problems surrounding the previously unregulated OTC derivatives products that wreaked havoc on major financial and insurance industry companies including Lehman Brothers and American International Group."[45] Title VII adopts a bifurcated regulatory structure, with the CFTC in charge of the regulation of swaps and participants in the swaps market, and with the SEC as the agency responsible for security swaps and market participants.[46]

Two years later, the European Union promulgated the EMIR in order to set forth the policies agreed upon by the G20 leaders, and this legislation, along with European Securities and Markets Authority (ESMA) technical standards, contains "the thrust of the G20 agenda."[47] As Barnes notes, EMIR's "primary function is to deliver Europe's interpretation of the agreed G20 mandate agreed on 25 September 2009, to make over-the-counter . . . derivatives trading less systemically risky."[48] Moreover, in February 2014, the European Union's Permanent Committee of Representatives approved both the Markets in Financial Instruments Directive (MiFID II) and the Markets in Financial Instruments Regulation (MiFIR),[49] legislative proposals that had been debated since 2011.[50] Together, EMIR, MiFID II, and MiFIR set the framework for trading derivatives, and this "package of legislation governing derivatives regulation originated" from the G20 accord.[51]

Although Title VII of Dodd–Frank, EMIR, MiFID II, and MiFIR all in fact comply with the standards agreed upon at the 2009 summit, the respective legislations of the United States and the European Union differ enough to change the behavior of actors in the derivatives market:

> A comparison of Title VII of Dodd–Frank and the relatively similar European Union proposal for OTC derivatives regulation, known as the European Market Infrastructure Regulation . . . , reveals that even slight variations can have a significant effect on the risk for regulatory arbitrage and competitive imbalance for U.S. based financial institutions competing in the global marketplace.[52]

In this part, this article first addresses several explanations for why

44. ATLANTIC COUNCIL, *supra* note 29, at 30.

45. Weadon, *supra* note 14, at 250.

46. *Id*. at 258.

47. ATLANTIC COUNCIL, *supra* note 29, at 30.

48. Barnes, *supra* note 13.

49. Jonathan Herbst & Hannah Meakin, *MiFID II/MiFIR Series–Impact on Commodities and Commodity Derivatives Trading*, Norton Rose Fulbright LLP (Mar. 20, 2014), http://www.lexology.com/library/detail.aspx?g=88e9372d-c1bf-4259-b9f5-44c4c889d765.

50. *Id.* ("[In] 2011 the European Commission published legislative proposals to amend MiFID by recasting it as a new Directive (MiFID II) and a new Regulation (MiFIR). The European Parliament and the Council of the EU (the Council) have been debating the text since then, taking into account the efforts of the financial services and wider industry to influence the direction of certain provisions.").

51. Ben Moshinsky, *EU Searches for Meaning of Derivative as Rules Take Effect*, BLOOMBERG BUSINESSWEEK (Feb. 25, 2014, 7:23 AM), http://www.businessweek.com/news/2014-02-25/eu-searching-for-the-meaning-of-derivative-as-rules-take-effect.

52. Weadon, *supra* note 14, at 259–60.

variations arose in the respective regulatory regimes. It then elaborates on significant discrepancies between the United States' and the European Union's regulation of derivatives. Specifically, it highlights differences arising from the varying scopes of Dodd–Frank and EMIR, as well as ones stemming from each regime's regulation and treatment of data relating to derivatives transactions.

A. Understanding the Unintended Consequences: Divergences in Implementation

In Professor Jonathan Wiener's article on the future of international regulatory cooperation, which builds upon much of his previous work,[53] he dismisses stereotypes dichotomizing the United States' and the European Union's regulatory regimes. Although Wiener acknowledges differences exist, he notes that "characterizations of U.S. and EU regulatory systems as sharply divergent, such as the notion of a precautionary Europe versus a reactive United States, are exaggerated. The reality of U.S. and EU risk regulation over the past four decades is overall average parity punctuated by occasional divergences."[54] This rings especially true in the context of derivatives regulation because the "European Union and the United States do showcase a high level of commonality in their approach toward derivatives regulation post crisis."[55] Thus, the dissimilarities between the United States and the European Union in their regulation of derivatives are not the result of two regimes that came up with different answers to the same problems. Rather, the occasionally conflicting and divergent regulatory regimes resulted from slight variations in implementation. The Atlantic Council report stresses that these discrepancies are largely unintended, stating, "[D]espite shared regulatory objectives, significant areas of divergence are emerging in the implementation process—differences that have the potential to create high costs for policymakers as well as market participants."[56]

Various factors explain the current gaps and conflicts between the United States' and the European Union's regulation of derivatives. First, the United States is a single nation, whereas the European Union must balance the competing interests of its member states. Because the regulatory bodies of the European Union garner their authority from member states, their methods of implementing reform differ significantly because, in some scenarios, these bodies feel specific discretion or implementation is more appropriately left to the national governments. In short, the European Union can regulate member

53. *See, e.g.*, Jonathan B. Wiener & Michael D. Rogers, *Comparing Precaution in the United States and Europe*, 5 J. OF RISK RES. 317, 343 (2002) ("[E]ven as the US and Europe dispute who is more precautionary than the other, from a global viewpoint both the US and Europe are probably at the highly precautionary end of the spectrum compared to the rest of the world. The acrimony over precaution between the US and Europe may be driven less by real differences over regulatory philosophy than by a larger contest for great power leadership . . . .").

54. Wiener & Alemanno, *supra* note 7, at 114.

55. ATLANTIC COUNCIL *supra* note 29, at 30.

56. *Id.*

states through either regulations or directives. Regulations look like federal statutes and trump state law by "establish[ing] directly enforceable standards."[57] They are very detailed and all of the provisions are binding, "immediately becom[ing] part of a national legal system."[58] A directive, however, is binding as to the result, but not on the courts in the member states.[59] This leaves the means of achieving the required outcomes up to the states.

This distinction is evidenced within the European Union's own package of derivatives regulation, with MiFID II, a directive, and MiFIR, a regulation. The discretion granted by directives creates the potential for "gold plating," in which member countries may impose even stricter guidelines than those imposed by the European Union. An area of derivatives regulation in which gold plating is permitted involves the oversight of clearinghouses by member countries, in which "EMIR provides for the regulation of clearinghouses a basic minimum set of standards that may be heightened ('gold plated'), depending on the jurisdiction in the European Union where the clearinghouse is established."[60] This ability of member states to independently guide implementation in certain areas gives rise to conflicts within the European Union, discussed below with regard to the varying definitions of derivatives currently existing within the regime.

Although derivatives are uniformly regulated across the United States, a similar issue arises due to the various agencies involved in the implementation of the G20 agenda. Former SEC Chairperson Mary Schapiro touched upon the need for domestic regulatory agencies to cooperate amongst themselves, stating,

> Domestically, the SEC is working closely with the CFTC, the Federal Reserve Board, and other federal prudential regulators, as required by the Dodd–Frank Act, to develop a coordinated approach to implementing the statutory provisions of Title VII to the extent practicable, while recognizing relevant differences in products, entities, and markets. Working closely domestically also helps our efforts internationally.[61]

Disagreements among bodies or states within the domestic regulatory regime can create gaps in the regulation of derivatives between the European Union and the United States. The challenges faced by both the European Union and the United States in achieving coordination and consistency within

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57. *See* Paul M. Schwartz, *The EU–U.S. Privacy Collision: A Turn to Institutions and Procedures*, 126 HARV. L. REV. 1966, 1971–72 (2013) (noting directives "require member states to enact national legislation that reflect their principles").

58. Christopher Kuner, *The European Commission's Proposed Data Protection Regulation: A Copernican Revolution in European Data Protection Law*, 11 Privacy & Security L. Rep. 215, 217 (2012).

59. *See* Schwartz, *supra* note 57 (noting directives "require member states to enact national legislation that reflect their principles").

60. *Id.* at 38.

61. *Financial Regulatory Reform: The International Context: Hearing Before the H. Comm. on Fin. Servs.,* 112th Cong. 16–17 (June 16, 2011) (statement of Mary L. Schapiro, Chairperson, Sec. Exch. Comm'n) (speaking on the international implications of the Dodd–Frank Act, specifically regarding the regulation of OTC derivatives and foreign investor adviser registration), https://www.sec.gov/news/testimony/2011/ts061611mls.htm.

their own regulatory regimes highlight the need to take a more nuanced approach in implementing derivatives reform that goes beyond the mere mandates set forth by the G20.

Moreover, timing has proven to be a significant issue, with the reforms agreed upon by the G20 often being passed in one regime before the other, which leads to regulatory arbitrage and uncertainty for many parties engaging in cross-border transactions. A recent *Economist* article discusses the struggling reform of derivatives regulation and highlights the significance of delays therein, writing, "Market fragmentation is a worry too. That is mainly because American regulators—notably the Commodities and Futures Trading Commission—have moved faster than their European opposite numbers. Whether and how European firms are to comply with their requirements remains unclear and controversial."[62] Although the United States has taken the lead in most areas of reform, which arguably works to the detriment of U.S. parties to derivatives transactions,[63] there are parts of the G20 agenda that reached enactment in the European Union first. For example, with regard to dark pools,[64] the United States "is still developing its regulations in some areas covered by MiFID, including for high-frequency trading. In others, such as position limits for commodity derivatives, it already has measures in place."[65]

Finally, policymakers in the two regimes seemingly approach derivatives from different angles, as commentators "suggest that US rules appear to favor a more 'snapshot' view of the market and the positions that dealers hold, whereas EU laws prefer to understand the transaction cycle of each swap."[66] Moreover, differences in the number and types of agencies leading the reform of derivatives regulation in the two regimes have also led to varying approaches in passing legislation, with the United States taking a largely bifurcated approach, separating tasks between the CFTC and SEC, whereas policymakers in the European Union "have taken a more piecemeal approach, with various pieces of legislation tackling different goals and objectives."[67] These inconsistencies

62. *Regulating Derivatives: Teething Problems*, THE ECONOMIST (Jan. 22, 2014, 14:50), http://www.economist.com/blogs/schumpeter/2014/01/regulating-derivatives?zid=295&ah=0bca374e65f2354d553956ea65f756e0.

63. *See, e.g.*, Weadon, *supra* note 14, at 259 ("[T]he fact that the United States jumped ahead of other financial regulators in passing Title VII has created an environment in which differential regulatory standards in major international derivatives markets will prevail absent international harmonization of OTC derivatives regulation.").

64. Dark pools are lightly regulated venues for trading, mostly run by broker dealers, in which the order of trade is not disclosed and information regarding transactions is only published after the fact. Scott Patterson, *'Dark Pools' Face Scrutiny*, WALL ST. J., (June 5, 2013, 9:55 PM), http://www.wsj.com/articles/SB10001424127887324069104578527361102049152. These dark pools are an alternative to exchange trading but are coming under increasing scrutiny due to a lack of transparency and regulation. *Id.*

65. Jim Brunsden, *EU Lawmakers Seal Deal on Financial Market Rules Overhaul*, BLOOMBERG (Jan. 15, 2014, 10:09 AM), http://www.bloomberg.com/news/articles/2014-01-15/eu-lawmakers-seal-deal-on-financial-market-rules-overhaul.

66. ATLANTIC COUNCIL, *supra* note 29, at 35.

67. *Id.* at 30.

regarding approach and areas of priority between the two regimes ultimately are reflected in the legislation, despite the fact that both regimes adhere to the standards agreed upon by the G20.

This discrepancy in implementation of the G20 standards between the United States and European Union highlights the limits of the G20, as the Atlantic Council itself notes: "Importantly, these variations undermine a key goal of the G20 agenda, namely, the standardization of derivatives dealings to promote simplicity and a better understanding of the risks of trading these instruments."[68] The following analysis of the current legislation regarding the regulation of derivatives in the two jurisdictions thus demonstrates the need for increased regulatory cooperation and harmonization between the two regimes.

B. Key Divergences in the Regulation of Derivatives between the United States and the European Union

Before identifying the key differences between the legislation governing the regulation of derivatives in the United States and the European Union, a reiteration of the key proposals agreed upon by the G20 leaders will highlight the room for potential discrepancies in the resulting regulation of derivatives after domestic implementation. In a response to the financial crisis and the systemic risk posed by derivatives, the

> G20 policymakers have broadly committed to reducing these risks by: (i) mandating that standardized OTC derivative contracts be traded on electronic platforms and be subject to central clearing; (ii) increasing capital charges for trades that are not centrally cleared; (iii) requiring that all derivatives trades be reported to trade repositories; (iv) obliging market participants to keep adequate capital; and (v) stipulating detailed business conduct rules to protect derivative counterparties and end-users.[69]

Despite the success of the G20 in coming to an agreement on the most effective methods of eliminating and controlling the risks posed by derivatives, the slightest variation in implementing the G20 agenda can lead to conflicting legislation, which in turn creates the opportunity for regulatory arbitrage.[70] The following sections highlight several significant discrepancies between the United States and the European Union in their regulation of derivatives and their respective legislation-setting for the G20 standards.

1. Scope

According to the Atlantic Council report, the most significant variation between the respective directives, regulations, and legislation in the United States and the European Union is scope: "Despite the similarities in approach,

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68. *Id.* at 48.

69. *Id.* at 29.

70. *See* Ben Protess, *Official Warns of 'Regulatory Arbitrage'*, N.Y. TIMES, (Mar. 28, 2011, 6:44 PM), http://dealbook.nytimes.com/2011/03/28/c-f-t-c-official-warns-of-regulatory-arbitrage/ ("If financial regulators in the United States and Europe enact conflicting rules for the derivatives industry, banks and other financial firms will be free to skirt the new rules, Bart Chilton, a commissioner at the Commodity Futures Trading Commission.").

implementation of the clearing and trading mandate has the potential to result in divergences between the EU and the US regimes. By far the most visible difference has been with regards to scope."[71]

This varying scope is most evident in the extraterritorial nature of both regulatory frameworks,[72] because the reach of their legislation is premised on different metrics and circumstances. Under Title VII, the legislation's extraterritorial reach is provided under § 722(d), in which "non-U.S. persons will be regulated if: they have a direct and significant connection with activities in, or effect on, commerce of the U.S.; or they contravene such rules or regulations as may be prescribed under the Act, necessary or appropriate to prevent the evasion of the relevant provisions."[73]

The extraterritoriality of Title VII is extremely extensive[74] and is one of the most striking aspects of the legislation;[75] however, EMIR also includes a similar provision extending its regulatory regime beyond the borders of the European Union. EMIR, per Article 4,[76] regulates OTC derivatives extraterritorially by applying to transactions "between two entities established in one or more third countries that would be subject to the clearing obligation if they were established in the Union, provided that the contract has a direct, substantial and foreseeable effect within the Union."[77]

Additionally, both regimes allow for substituted compliance in certain situations. However, the question of whether a local law is sufficient is determined on a case-by-case basis and left to the discretion of the respective agency. In the United States, the CFTC determines whether a foreign entity may solely abide by its local comparable regulatory requirements in place of adhering to U.S. regulations.[78] In the European Union, ESMA is given the authority to decide "whether a non-EU entity's local rules are compliant or not,

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71. ATLANTIC COUNCIL, *supra* note 29, at 36.

72. *See* Robert Dilwoth et al., *Comparison of the Dodd Frank Act Title VII and the European Market Infrastructure Regulation*, 17 MORRISON FOERSTER, (Jan. 28, 2014), http://media.mofo.com/files/Uploads/Images/140128-Comparison-of-the-Dodd-Frank-Act-Title-VII.pdf ("Both regulatory frameworks exercise an extraterritorial reach, particularly for mandatory clearing of transactions.").

73. Dodd–Frank Wall Street Reform and Consumer Protection Act § 722(d), 111 P.L. 203, 124 Stat. 1376, 1673 (2010).

74. *Id.*

75. *See* Weadon, *supra* note 14, at 267 ("Considering the distinct possibility for disparate substantive standards and implementation timelines for margin requirements, one of the most striking aspects of the prudential regulators' proposed rules on margin requirements for non-cleared swaps is the extraterritorial reach of the requirements. The proposed rules apply to all swaps transactions of all non-U.S. subsidiaries and affiliates of any U.S. entity.").

76. It is worth noting that the European Union enacted Regulation (EU) No 285/2014 on February 13, 2014 in order to supplement Article 4(1)(a)(v) and to provide "regulatory technical standards on direct, substantial and foreseeable effect on contracts within the Union." This text provides a more comprehensive explanation of what constitutes "direct, substantial and foreseeable effect within the Union."

77. Regulation (EU) No. 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives, central counterparties and trade repositories, art. 4(1)(a)(v), 2012 O.J. (L 201) 1, 17.

78. Dilworth, *supra* note 72, at 20.

and if not the non-EU entity must abide by EMIR standards."[79] Thus, the arbitrariness of these determinations by both the CFTC and ESMA opens the door for even more discrepancies in extraterritorial reach of their respective legislations governing the regulation of derivatives.

The extraterritoriality of both Title VII of Dodd–Frank and Article 4 of EMIR has resulted in overlapping regulatory regimes,[80] with varying and inconsistent scopes that consequently create a complex regulatory web for end-users. In addition, this complexity will likely have unintended consequences that undermine the G20 agenda because"[i]f the conflicting requirements of the CFTC proposed guidance and EMIR is left unresolved, separate clearinghouses will necessarily develop for swaps between E.U. counterparties and swaps between U.S. counterparties."[81] This separation would "reduc[e] netting opportunities for each class of swap and result[] in unnecessarily burdensome collateral requirements for market participants."[82]

Moreover, the specific transactions covered and exempted by each provision vary. The Atlantic Council provides an example of the differing extraterritorial scope of the United States' and the European Union's respective regimes, noting:

> [T]he European Union has not yet determined to what extent foreign exchange swaps are to be covered by EMIR. But in the United States, foreign exchange swaps enjoy a specific exemption from mandatory clearing requirements under the DFA and subsequent Treasury election (*DFA, section 722(h))*. Without alignment, these differences in scope can encourage firms to shift their FX derivatives business to the United States as a way to benefit from (potentially) lower compliance costs.[83]

This example demonstrates the discrepancies in scope and the resulting ambiguity, and it highlights the need for increased regulatory cooperation between the respective agencies.

In addition to the extraterritorial reach of each piece of legislation and the ambiguity of both regulatory regimes in extending that reach, the scope of the two regimes also differ in their levels of detail and complexity attributed to the various elements of derivatives regulation.

Policymakers have made note of this fundamental discrepancy between the regulation of derivatives in the United States and the European Union, stating "the terminology used to define the scope of each regime differs in emphasis, and it remains to be seen how this divergence will impact future implementation . . . . While the vast majority of OTC instruments will be regulated by both regimes, differing definitions can encourage gaps."[84] A

79. *Id.*

80. Commission on Capital Markets Regulation, Letter on Resolution of Differences Between EU and US Clearinghouse Requirements, 1–2 (Jan. 28, 2013) ("[T]he CFTC would require a swap between a U.S. and an E.U. bank to be cleared by a CFTC-recognized clearinghouse, while EMIR would simultaneously require such a swap to be cleared by an ESMA-recognized clearinghouse.").

81. *Id.* at 2.

82. *Id.*

83. ATLANTIC COUNCIL, *supra* note 29, at 32.

84. *Id.*

consequence of this inconsistency in terminology is that parties can take advantage of these differences by renaming or restructuring trades in order to fall outside of the regulatory regime.[85]

To understand the consequences of such discrepancy in terminology between the United States' and the European Union's regulatory regimes, one can look to the current experience within the European Union. According to ESMA Chairman Steven Maijoor, as of February 2014, "'There is no single, commonly adopted definition of derivative or derivative contract in the European Union, thus preventing the convergent application' of the reporting rules within the European Market Infrastructure Regulation."[86] As a result, countries within the European Union may use their own definitions until the Commission adopts a definition, leading to inconsistencies that will inevitably result in varying regulation of transactions. After all, a "derivative transaction in one country might be considered a simple spot trade in another."[87]

Another example of the varying scope of derivatives regulation between the United States and the European Union can be seen in an analysis of actors covered by the end-user exemptions of the respective regimes. A 2010 Clifford Chance and ISDA report noted that, despite significant commonalities, this difference in end-user exemptions is significant: the European Union's regime is

> potentially less burdensome for end-users. In the US, the clearing obligation falls on everyone who trades an eligible contract. In the EU, the clearing obligation applies to financial counterparties when dealing with other financial counterparties and nonfinancial counterparties only become subject to the clearing obligation when their positions (excluding certain hedges) exceed a specified clearing threshold.[88]

This divergence is a leading point of contention among corporate hedgers, who are attempting to persuade U.S. regulators to exempt their trades, as the European Union has done.[89]

2. Data Sharing and Reporting

An extremely important area of derivatives regulation requiring harmonization and improved cooperation is that of data sharing and reporting. Both Dodd–Frank[90] and EMIR[91] include international data-sharing provisions;

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85. *Id.*

86. Moshinsky, *supra* note 51.

87. *Id.*

88. CLIFFORD CHANCE & INTERNATIONAL SWAPS AND DERIVATIVES ASSOCIATION, REGULATION OF OTC DERIVATIVES MARKETS: A COMPARISON OF EU AND US INITIATIVES, 3 (2010).

89. Matt Cameron & Tom Newton, *Pressure Grows for US to Copy EU's CVA Exemption*, RISK (Apr. 19, 2013), http://www.investmenteurope.net/other/pressure-grows-for-us-to-copy-eus-cva-exemption/.

90. Dodd–Frank added section 21 to the Commodity Exchange Act, which created an entity tasked with the functions of collecting and maintaining swap transaction data and information, and which is accessible to certain foreign regulators under specified circumstances. Commodity Futures Trading Comm'n, *CFTC Votes to Clarify Indemnification and Confidentiality Provisions in the Dodd–Frank Act*, (May 1, 2012), http://www.cftc.gov/PressRoom/PressReleases/pr6246-12.

91. In Regulation (EU) No. 151/2013 of 19 December 2012, 2013 O.J. (L 52) 33, ESMA adopted

however, the lack of mutual recognition among the respective regulators highlights yet another gap in the G20 agenda. Although G20 leaders agreed upon an international data-sharing arrangement, a report produced for the G20 in March of 2014 by the OTC Derivatives Regulators Group (ODRG) on Cross-Border Implementation Issues highlights the continuing inability of states to reach agreements on data sharing.[92]

This limited effectiveness can be attributed to numerous factors, including varying data quality and accuracy as well as issues surrounding identification of derivatives products.[93] Moreover, "[a]cross borders, some jurisdictions have been unable to share trade-reporting data with each other because of a host of secrecy and privacy laws."[94] In the ODRG report, the group's members state their preference for regulators to have direct access to relevant data held in trade repositories in other states; however, the report notes that direct access is unlikely to be currently available in many circumstances.[95] As a result, ODRG in fact stresses the necessity for transgovernmental networks—direct communication between the relevant regulatory agency of each country—in the effort to improve data sharing.[96]

In addition to issues with sharing data between the United States and the European Union, the Atlantic Council report delineates key points of divergence between the two regimes with regard to data reporting, noting this inconsistency "relate[s] to differences in: (i) the scope of products covered by the reporting requirement; (ii) the data that must be provided; (iii) the timing of disclosure; and (iv) the depth and breadth of data publication by SDRs."[97] An analysis of the current data requirements illustrates that the European Union and the United States prioritize different aspects of disclosure. For example, "while the European Union demands deeper information on swaps trades, the United States is more demanding about timing."[98] The consequences of such a discrepancy are significant and can put significant pressure on parties to cross-border transactions, who may have to comply with both regimes and consequently make *more* data available *immediately* in order to adhere to both

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Article 3, titled "Third country authorities," which provides the following: "In relation to a relevant authority of a third country that has entered into an international agreement with the Union . . . a trade repository shall provide access to the data, taking account of the third country's mandate and responsibilities and in line with the provisions of the relevant international agreement."

92. *See* OTC DERIVATIVES REGULATORS GRP., *supra* note 28, at 1.

93. Neil Roland, *CFTC to Seek Comment Next Week on Improving Derivatives Trade Reporting, O'Malia Says*, MLEX MARKET INSIGHT (Mar. 12, 2014, 21:05), http://www.mlex.com/user/Login.aspx?PubID=513217.

94. *Id.*

95. OTC DERIVATIVES REGULATORS GROUP, REPORT OF THE OTC DERIVATIVES REGULATORS GROUP (ODRG) ON CROSS-BORDER IMPLEMENTATION ISSUES 1 (Mar. 2014), https://www.osc.gov.on.ca/en/NewsEvents_nr_20140331_odrg-rpt-cross-border.htm.

96. *Id.* ("ODRG members are discussing access issues on a bilateral basis and will continue to work to develop practical solutions to trade repository data access issues[,] as authorities in their respective jurisdictions implement arrangements for the sharing of data held in trade repositories.")

97. ATLANTIC COUNCIL, *supra* note 29, at 34.

98. *Id.*

the European Union's and United States' regimes, respectively.[99]

Moreover, the derivatives regulation regimes in the United States and the European Union diverge in their allocation of reporting obligations. In this area of derivatives regulation, the European Union's regime imposes a burden on more of the parties involved in a transaction, and these parties are subject to higher compliance standards than their counterparts in the United States. This difference is significant for end-users because

> EMIR imposes detailed reporting requirements for the life of the contract, including any changes that occur to its essential terms. In contrast to the practice in the United States, the reporting requirement falls on both counterparties, irrespective of whether their activities exceed the threshold. Though end-users can delegate reporting duties to a third party, such as a dealer or a prime broker, responsibility for compliance remains with the end-user and cannot be contracted or limited by the fact of delegation.[100]

By placing the burden of reporting on more parties and not allowing these parties to delegate their responsibilities to third parties, the European Union's reporting obligations are considerably more burdensome, both in terms of potential liability and the cost of compliance.[101]

These discrepancies in data reporting under the United States' and the European Union's derivatives regulatory regimes, and the difficulty faced by their respective regulators to access each other's data, illuminate the significance of transgovernmentalism in the regulation of derivatives. The intricacies of the information held by the trade repositories within each regime and the impediments imposed by domestic law protecting data require direct regulatory cooperation between states. Although the standards set forth by the G20 set goals for member states, such standards are, on their own, incapable of covering the loopholes that allowed for the financial crisis in the first place: the inability to aggregate information across borders in order to better coordinate regulation and monitor the derivatives market for potential systemic risks.

In order to resolve such deficiencies in the current regulation of derivatives globally, "[b]ilateral and regional efforts should supplement international efforts at the G20 and FSB. The most important relationship should be the EU-US regulatory relationship, and both jurisdictions should focus their efforts on achieving deep consensus with one another as they promote policies internationally."[102] These transgovernmental networks, especially those between the United States and the European Union, will further the international harmonization of derivatives regulation. This will consequently reduce the threat these financial transactions present to the global economy by preventing

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99. *Id.*

100. *Id.* at 44.

101. *Id.* (The report notes that these potential costs of compliance are significant: "The EU regime does not allow end-users to escape liability for reporting even when they delegate reporting responsibilities to a third party. Thus, parties remain responsible for their own reporting. This implies that end-users must develop internal systems for monitoring transactions and for checking the veracity and accuracy of the reporting undertaken by third parties.").

102. ATLANTIC COUNCIL, *supra* note 29, at 57.

the fragmentation of information so that regulators can better anticipate systemic risk.

V
CONSEQUENCES OF AN UNHARMONIZED REGULATORY REGIME OF DERIVATIVES: HIGHLIGHTING THE NEED FOR HARMONIZATION

The global nature of derivatives and the financial innovation that accompanies these instruments make the derivatives market highly susceptible to regulatory arbitrage. Moreover, the resulting concentration of risk poses a threat not limited to those financial institutions required to adhere to a stricter regulatory regime. The current lack of international harmonization poses serious risks, especially for the United States, because there exists

> a very real possibility that the exploitation of "regulatory arbitrage" opportunities created by the first-mover position of the United States will: (1) place U.S.-based banks at a competitive disadvantage with their non-U.S. competitors; and (2) increase the global risk posed by OTC derivatives as origination and trading migrates to jurisdictions with less burdensome regulations.[103]

Although the lack of harmonization between the United States and European Union regulatory regimes does immediately affect participants, because "[t]hese varying requirements and approaches create a challenging terrain for companies seeking to participate in the world's vast derivatives markets,"[104] the most significant threat resulting from divergences in regulation is a potential repeat of the 2008 financial crisis. As discussed in part III, multiple factors contributed to the global crisis, but a central cause was the inability of states and international organizations to coordinate the regulation of highly complex financial products internationally, and subsequently, to aggregate data that could help regulatory agencies better analyze the risks to the global economy.

Unfortunately, the deficiencies that led to the financial crisis in 2008 remain largely unaddressed. Current "differences in international rules are leading to a culture that addresses compliance rather than addresses risk, in which international banks spent too much effort on ensuring they were compliant with regulators in different jurisdictions."[105] This emphasis on compliance with the multiple regulatory regimes arising in the aftermath of the crisis is likely to result in increased regulatory arbitrage, and this regulatory arbitrage consequently results in a concentration of risk, which makes the global economy more susceptible to systemic failure. The solution, therefore, is increased international regulatory cooperation and the ultimate harmonization of derivatives regulation.

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103. Weadon, *supra* note 14, at 251.

104. ATLANTIC COUNCIL, *supra* note 29, at 46.

105. David Bannister, *CFTC Calls for International Swaps Data Sharing Deal*, BANKING TECH. (Mar. 26, 2014), http://www.bankingtech.com/211252/cftc-calls-for-international-swaps-data-sharing-deal/.

This part, addresses the most troublesome and prevalent consequences of the current unharmonized state of derivatives regulation. The discrepancies between the United States' and the European Union's regulation of directives have resulted in an increased cost of compliance, duplicative regulations, inconsistent data on derivatives transactions, and uncertainty among users of cross-border derivatives. These effects are largely interrelated, and the majority will be addressed in the context of regulatory arbitrage and the resulting concentration of risk—two consequences that the harmonization of derivatives regulation would specifically eliminate.

A. Regulatory Arbitrage: The Search for the Most Hospitable Regime

Following the financial crisis of 2008, states and international organizations responded in typical fashion: by amplifying regulation. The increase in regulation of the derivatives market, described above, not only reformed the regulation of products already under the supervision of regulatory agencies, but also brought financial products and transactions previously conducted in the dark under the auspices of regulatory agencies. A resulting spike in the cost of compliance for many financial institutions ensued because a significant number of parties must comply with duplicative regimes due to the extraterritorial reach of Title VII and EMIR either due to uncertainty as to which regime's regulation actually applies[106] or because the parties truly fall under the scope of both regulatory regimes. The current uncertainty surrounding compliance significantly burdens parties to cross-border transactions. When "faced with the potential for dual regimes to apply, end-users might consider establishing processing systems that collect, collate, and organize data in accordance with two separate reporting regimes."[107]

Regardless of whether parties abide by multiple regimes as a result of uncertainty or duplicative regulatory regimes, the result for all parties to cross-border transactions is an increased cost of compliance. This consequent rise in the cost of doing business means that parties will seek out jurisdictions with the most friendly compliance regimes in order to attain a competitive edge. This phenomenon, known as regulatory arbitrage, is particularly prevalent in the case of derivatives due to their sensitivity[108] and global nature.[109]

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106. A recent Atlantic Council report highlights how prevalent this uncertainty is among end-users, especially in the cross-border context, by providing the following example:

> Take the case of a large, multinational auto manufacturer or coffee company that uses derivatives to hedge its risks in the foreign exchange, commodities, and interest rate markets. As an end-user, this company must first determine the legal regime that applies to its derivatives trades. This could be surprisingly complicated, especially if the company trades different types of derivatives through subsidiaries located in different jurisdictions as well as with counterparties situated outside of their home jurisdictions.

ATLANTIC COUNCIL, *supra* note 29, at 46–47.

107. *Id.* at 44–45.

108. *See id.* at 34–35. The report explains that, due to the sensitivity of OTC derivatives,

> parties may seek out ways to avoid the full weight of reporting- and data-publishing requirements. In such cases, parties may seek to book trades through the European Union,

CFTC Commissioner Chilton warned of the possibility of regulatory arbitrage resulting from inconsistencies between regulations in the United States and the European Union, stating, "Dodd–Frank loses its authority at the United States border, and if the European rules are weaker than the law, derivatives trading is likely to shift overseas."[110] Chilton's predictions were realized: following the implementation of Dodd–Frank in the United States, parties to derivatives transactions immediately began to participate in regulatory arbitrage at the expense of U.S. corporations.

In a recent article, Tom Osborn surveyed end-users in order to gather their opinions on recent reforms. A telling response that demonstrates the increase in regulatory arbitrage among parties came from a representative at the Scottish investment company Scottish Widows, who stated,

> We have no interest in being CFTC-registered, until we either have to or want to. Fortunately we don't have any bodies in the US. But as the survey shows, who we deal with in Europe has become important—making sure you're dealing with a bank's European entity, not their US entity, for example. It's modestly reduced the number of counterparties we can deal with.[111]

According to Osborn's article, this response to U.S. regulations of derivatives seems increasingly prevalent, with almost fifty percent of non-U.S. respondents admitting to actively avoiding U.S. counterparties and with others reporting that U.S. firms and U.S. affiliates of non-U.S. firms have been denied access to certain non-U.S. platforms.[112] These effects of regulatory arbitrage are quickly felt, as evidenced by ISDA data in a Wall Street Journal article from March 2014, in which Andrew Ackerman noted, "Activity between European and U.S. dealers in euro-denominated interest-rate swaps fell to about 10% from an average of 25% following the implementation of CFTC's swap trading rules in October . . . ."[113]

The significant regulatory arbitrage parties engage in as a result of regulatory divergences demonstrates the need for the harmonization of derivatives regulatory regimes. This need for improved regulatory cooperation to counter regulatory arbitrage is stipulated in Senator Charles Schumer's letter to Chairman Ben Bernanke, in which Senator Schumer urged the Chairman "to work closely with [his] international counterparts to ensure that they adopt as

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> where at least for the moment, data is reported by T+1, and thus they benefit from delays in dissemination of the information.

Id.

109. *See id.* at 40 ("The global nature of OTC derivatives has led some end-users to seek competitive markets and tailored derivatives contracts outside of their home countries and currencies.").

110. Protess, *supra* note 70.

111. Tom Osborn, *Counting the Cost of Reform—ISDA End-User Survey*, RISK (Mar. 26, 2014), http://www.risk.net/risk-magazine/feature/2335033/counting-the-cost-of-reform-isda-end-user-survey.

112. Dilworth, *supra* note 72, at 55.

113. Katy Burne & Andrew Ackerman, *CFTC Close to New Rules for European Swaps Trading*, WALL ST. J., (Mar. 28, 2014), http://www.wsj.com/articles/SB10001424052702304688104579467680559144744.

rigorous a regulatory regime for the over-the-counter swaps markets . . . . Ideally, those rules would perfectly mirror the U.S. rules. This would minimize the opportunity for regulatory arbitrage by non-U.S. customers of U.S. entities."[114]

Senator Schumer's letter focuses on the competitive disadvantage of U.S. corporations due to regulatory arbitrage and how this shift away from the United States poses a real threat to the U.S. economy.[115] The most damaging effect of parties taking their derivatives transactions outside of the United States, however, is the resulting gap in the derivatives regulatory regime. The current lack of harmonization pushes these transactions into the most lenient jurisdictions or outside of the regulatory context entirely, impeding the effectiveness of regulatory bodies to aggregate data. As Professor Schwarcz notes: "Complexity is the main cause of financial information failure. . . . Regulatory arbitrage increases complexity as market participants take advantage of inconsistent regulatory regimes both within and across national borders."[116]

B. The Concentration of Risk

The rising cost of compliance, due to both uncertainty and duplicative regimes, and the resulting regulatory arbitrage as companies seek a competitive advantage, have led to increased concentrations of risk. The pooling of risk is most notable in three specific areas: (1) those jurisdictions lagging behind in the implementation of the G20 agenda; (2) clearinghouses that can afford to comply with both the United States' and the European Union's regulatory regimes; and, (3) most controversially, those areas that evade oversight by regulatory regimes.

As discussed above, derivatives transactions are becoming more concentrated in certain regimes over others. This trend is particularly evident in the United States since Title VII led the charge in the implementation of the G20 agenda. A specific example in the United States is the exemption of non-U.S. swaps operations, which encourages U.S. financial companies to "shift the bulk of their swaps trading activity to more hospitable jurisdictions."[117] This shift is problematic as it may "result in the concentration of financial risk in jurisdictions with the most favorable regulatory regime as companies exploit the regulatory arbitrage opportunity presented by disparate regulations."[118]

114. Letter from Charles Schumer, U.S. Senator, et al., to Ben Bernanke, Chairman, Board of Governors of the Federal Reserve System, et al. (May 17, 2011), http://www.gillibrand.senate.gov/newsroom/press/release/ny-lawmakers-urge-regulators-to-reconsider-derivatives-rule-that-would-hurt-us-competitiveness.

115. *See* Weadon, *supra* note 14, at 272 ("[I]t is clear that removing the attendant risks of regulatory arbitrage will be integral to the success of Title VII and the long-term health of the U.S. financial services industry and the U.S. economy as a whole.").

116. Schwarcz, *supra* note 30, at 818.

117. Weadon, *supra* note 14, at 271.

118. *Id.*

Although the current shift has been largely away from the United States, the European Union is also losing derivatives transactions as a result of regulatory arbitrage. The growing tendency of parties to seek jurisdictions outside of the reach of Title VII and EMIR will ultimately negatively impact both the ability of regulators to effectively regulate these transactions and the markets themselves, because "[w]hen end-users shift hedging activities to a single market, they can generate concentrations of risk in a single jurisdiction. This impacts liquidity and market competition, and it also increases the cost of capital."[119] Although the United States and the European Union still account for the majority of derivatives trades and transactions,[120] this shift to more hospitable jurisdictions will only increase if harmonization between regulatory regimes is not reached, since emerging markets will strive to attract more business, and other players, such as China,[121] will continue to attempt to assert themselves as financial leaders.

In addition to this concentration of risks in certain hospitable jurisdictions, the discrepancies in regulatory regimes are also leading to a concentration in the number of clearinghouses that service cross-border swaps. Duplication raises costs for clearinghouses, which means that only those clearinghouses with the financial ability to comply with multiple regimes will be able to participate in the cross-border market, ultimately concentrating risk and potentially leading to an AIG-type situation in the future. Seen by G20 policymakers as the solution to many of the problems in the OTC derivatives market, clearinghouses are facing a surging volume of transactions.[122] Although clearinghouses were not intended to eliminate all risk,[123] rather, just to concentrate it into fragmented parts in order to prevent systemic risk, Professor Schwarcz notes this "standardization can backfire" because "Dodd–Frank's clearinghouse requirement might inadvertently increase systemic risk by concentrating derivatives exposure at the clearinghouse level."[124] Derivatives specialist Wallace Turbeville also highlights this unintended consequence, noting that "[t]he fear is that we have not eliminated systemic risk, merely concentrated it."[125] As clearinghouses continue to grow in size and cover a growing percentage of transactions, they begin to present a similar concentration risk to AIG in the years leading up to the crisis.

119. ATLANTIC COUNCIL, *supra* note 29, at 43.

120. Burne & Ackerman, *supra* note 113 ("Analysts and data providers have not provided figures showing how much of the $693 trillion global swaps market has migrated to Europe from the U.S., but observers said the swaps market is divided roughly with 40% in the U.S., another 40% in Europe and 20% in Asia.").

121. ATLANTIC COUNCIL, *supra* note 29, at 53 ("[T]he largest banking system in the world now resides in China, not in the United States or Europe.").

122. *The Risk in Clearing-Houses: All Clear?,* THE ECONOMIST (Apr. 7, 2012).

123. Wallace C. Turbeville, *Derivatives Clearinghouses in the Era of Financial Reform*, THE ROOSEVELT INST., 2 (Oct. 24, 2010), http://www.nextnewdeal.net/sites/default/files/wp-content/uploads/2010/12/derivatives_clearinghouses_in_the_era_of_financial_reform.pdf.

124. Schwarcz, *supra* note 30, at 820.

125. Turbeville, *supra* note 123, at 14.

Although clearinghouses that must abide by duplicative regulatory regimes arguably provide a higher level of overall protection—one regime's regulation may be stricter and fill the gaps of the other—this duplication may "ultimately discourage some firms from using some clearing services. Furthermore, market participants might be incentivized to develop financial products that evade the clearing requirement."[126] The cost of compliance may push market participants to create products that evade clearinghouse services, which clearly undermines the original intent of G20 leaders in requiring the clearing of derivatives transactions.

The most concerning consequence of these concentrations of risk in more hospitable jurisdictions, in larger clearinghouses providing cross-border services, and in areas that evade regulatory oversight is that they impede the ability of regulatory bodies to aggregate data and protect against future systemic risk. This divergence "exerts increased pressure on regulators to establish mechanisms to share data and to develop communication channels to alert others of risks accumulating in cross-border derivatives markets."[127]

All of the unintended consequences of the discrepancies between the regulatory regimes of the United States and European Union, such as increased costs of compliance, duplicative regimes, inconsistent data on derivatives transactions, uncertainty among users of cross-border derivatives, the shift of transactions to most hospitable jurisdictions, evasion of regulation, and concentration of risk, are interrelated. Together, they amount to an enormous threat to global financial stability and demonstrate the need for harmonization of derivatives regulation if the United States and the European Union hope to prevent a crisis similar to the one experienced in 2008.

VI

HARMONIZING THE REGULATION OF DERIVATIVES: IMPEDIMENTS TO REGULATORY COOPERATION AND THE PATH FORWARD

Before the harmonization of derivatives regulation between the United States and the European Union can be achieved, their respective regulatory agencies must be aware of the impediments they face. This part makes note of difficulties that arise in coordinating uniform regulations of derivatives in the two regimes. Despite these challenges, it highlights the current progress of international regulators in cooperating with each other, both in the context of the relationship between the United States and the European Union as well as globally. Finally, it addresses arguments against the harmonization of derivatives regulation among jurisdictions, noting that these critiques should act as a caution and provide guidance to regulatory agencies in their bilateral communications.

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126. ATLANTIC COUNCIL, *supra* note 29, at 39.
127. *Id.* at 34.

A. Impediments to Harmonization

The difficulties in coordinating the implementation of the G20 agenda among the member countries and the European Union demonstrate that, despite the extent to which certain regulatory bodies desire international cooperation, achieving this harmonization in practice can be extremely difficult. In their article on international regulatory cooperation (IRC) in this symposium, Professors Alemanno and Wiener highlight several of the factors that impede the ability of regulatory bodies to coordinate, including

> fears by some interest groups that IRC will mean harmonizing down (a race to the bottom), and fears by other interest groups that IRC will mean harmonizing up (a race to the top); restrictions on sharing information across countries or agencies; limited agency staff and resources; and pre-existing statutes, both substantive . . . and procedural (regarding administrative procedures such as transparency, confidentiality, notice and comment, stakeholder input, executive review, and judicial review).[128]

These constraints all damage the current attempt to harmonize the regulation of derivatives between the United States and the European Union. First, politicians and regulators looking to prevent a repeat of the 2008 financial crisis and regulate systemic risk fear that international regulatory cooperation in the areas of derivatives may lead to a race to the bottom. Although "for the most part American regulators, like their counterparts overseas, have stuck to their guns,"[129] it is acknowledged that international cooperation does lean toward less stringent regulations. As the following statement by Treasury Secretary Jack Lew highlights, "We will not let the pursuit of international consistency force us to lower our standards."[130]

Wiener and Alemanno also listed constrained resources as an explanation for difficulties in achieving international regulatory cooperation, and U.S. derivatives regulators undoubtedly agree. In fact, this lack of funding and resources is a current focal point of the CFTC, which argues "that it needs more resources because its responsibilities have grown tremendously. It has written more than 60 rules over the past three years and the agency now oversees the vast swaps market, which was previously unregulated."[131]

Moreover, restrictions on sharing information across countries are a serious impediment in the context of derivatives regulation. This constraint is specifically daunting for regulators on either side of the Atlantic because of the meaningful substantive differences between the two regimes with regard to data:

> EU actions have focused on individuals' rights of confidentiality, and emphasized a single framework across countries to protect personal data. US policy, by contrast, has been influenced by a focus on the rights of free speech and different national and state responsibilities, resulting in a multi-layered framework that emphasizes enforceable codes of conducts, disclosures, and opt-out rights in select sectors, including financial

128. Wiener & Alemanno, *supra* note 7, at 13.

129. *Financial Fragmentation: Too Much of a Good Thing*, THE ECONOMIST (Oct. 12, 2013).

130. *Id.*

131. Chon, *supra* note 2.

services.[132]

Thus, this divergence in the regulation of data and their different priorities regarding the protection of data makes the sharing of information between the United States and the European Union a current focal point in conversations between their respective regulatory agencies. According to Scott O'Malia, removing this impediment to harmonization is a top priority of the CFTC, as evidenced by his recent "call[ing] on counterparts in Brussels to focus on recognizing each other's swaps data warehouses and develop a means to share trade information. He has asked that Europe and the US should harmonise the form and format of data being reported."[133]

Moreover, differences in procedure and the implementation of regulations between the United States and the European Union also pose challenges to harmonization, as discussed above. The bifurcated approach of the United States, separating the derivatives regulatory regime between the CFTC and SEC, influences the approaches of regulators and, consequently, affects the implementation of reform. Additionally, the use of both directives and regulations in the European Union is a significant and unique attribute of its regulatory regime, and the discretion given to member countries through directives leads to both technical and substantive differences in regulations within the European Union.

B. The Common Path Forward for the United States and the European Union

In order to counter these impediments to regulatory cooperation, on July 11, 2013, the European Commission and the CFTC published a memo in which they agreed to reach a "Common Path Forward on Derivatives."[134] In this publication, European Commissioner Michael Barnier and CFTC Chairman Gary Gensler "acknowledged simultaneous application of EMIR/Title VII could lead to conflicts of law, inconsistencies and uncertainty."[135] In this agreement, the two leading regulators noted that a key step in achieving the desired harmonization is to provide deference to each other on a territorial basis,[136] sharing the view that "jurisdictions and regulators should be able to defer to each other when it is justified by the quality of their respective regulation and enforcement regimes."[137]

Although this agreement acknowledges the vital importance of transgovernmental networks in the regulation of derivatives internationally and

132. ATLANTIC COUNCIL, *supra* note 29, at 50.

133. Philip Stafford, *CFTC and Treasury Share Swaps Resources*, FINANCIAL TIMES (Mar. 25, 2014, 8:28 PM), http://www.ft.com/intl/cms/s/0/3387ecc6-b452-11e3-a09a-00144feabdc0.html?siteedition=intl#axzz2xwdZtAbL.

134. Press Release, The European Commission and the CFTC Reach a Common Path Forward on Derivatives (July 11, 2013), http://europa.eu/rapid/press-release_MEMO-13-682_en.htm?locale=en.

135. Dilworth, *supra* note 72, at 20.

136. *Id.* at 29.

137. Press Release, The European Commission and the CFTC Reach a Common Path Forward on Derivatives, (July 11, 2013) (on file with the CFTC).

sets a significant precedent for other regulatory regimes to follow, the challenges discussed throughout this article demonstrate that much work still needs to be done by both the United States and the European Union in order to eliminate the consequences resulting from the current discrepancies in regulation. Unfortunately, substituted compliance and foreign recognition are not sufficient remedies in the derivatives context; instead, the regulatory agencies of the United States and the European Union need to pay extremely close attention to the nuances of their respective regulations and the potential unintended consequences of their implementation methods in order to achieve harmonization.

C. Current Progress Internationally

Although this note stresses that the need for international harmonization is particularly pressing in the U.S.–EU context due to the concentration of derivatives trading in these two regulatory regimes, this focus does not mean to downplay the ultimate call for the harmonization of derivatives regulation globally. Ultimately, effective regulation relies on a global network of regulatory agencies that operate on the same page, as Chilton notes, "Whether trading occurs in Hong Kong, London or New York, to the extent practical, there needs to be global regulatory harmonization. While important to ensure national interests, without appropriate harmonization of rules, a virtual regulatory race to the bottom could occur."[138] Although some argue that the G20 set the foundation for harmonization, true global harmonization can only be achieved through direct communication between regulatory agencies of the various regimes. Evidence of this type of bilateral regulatory cooperation does exist in transgovernmental networks other than that between the United States and the European Union. Patrick Pearson, the head of financial markets infrastructure at the European Commission, highlights the relative success of global derivatives regulation, stating,

> We talk to each other. There's a group set up between regulators including Japan, the US and Europe, and it's doing a good job—its first report is being published soon," he said. "The group meets three or four times a year, and I've had weekly phone calls from them. I'm encouraged; I've never seen this level of cooperation between different global regulators before. We are ensuring rules around the world match up.[139]

Pearson's positive evaluation of current progress is not unfounded. The focus of the G20 and local regulators, however, still needs to shift away from the standards-based approach, which cannot on its own achieve harmonization, and needs to look instead towards improving the transgovernmental networks of different national regulatory agencies in order to iron out the creases in implementation that ultimately lend themselves to regulatory arbitrage and concentrations of risk. Professor Randall Korskzner from the University of Chicago Booth School of Business stresses this necessary shift in approach,

138. Chilton, *supra* note 1.

139. Bannister, *supra* note 105.

noting, "Global standards and approaches to regulation need to focus more on removing risk from the financial system rather than just compliance—but to do so international regulators will need to harmonise their efforts and embrace technology to a much greater degree."[140]

Moreover, G20 leaders and members of the ODRG are becoming increasingly aware of the limitations on their ability to harmonize derivatives regulations as international organizations. Significantly, recent summits in September[141] and November[142] of 2014 addressed the cross-border issues that require changes to domestic legislation and the need for increased bilateral negotiations among member states.[143] This focus on transgovernmental networks is the necessary next phase of derivatives regulation.

VII
A LACK OF HARMONIZATION ON THE NEED FOR HARMONIZATION

Despite the detrimental consequences resulting from discrepancies in derivatives regulation, there are still critics of the harmonization framework. These arguments against harmonization largely stem from three different theories. One belief, held by several academics and regulators, argues that harmonization will result in weaker regulations globally and, consequently, increased risk. Another line of reasoning finds harmonization impossible, and therefore, a wasteful pursuit. The third and least compelling line of reasoning, as evidenced throughout this note, is that the regulation of derivatives does not require uniformity.[144]

Although harmonization is frequently not desirable,[145] the qualities[146] that

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140. *Id.*

141. *See* REPORT OF THE OTC DERIVATIVES REGULATORS GROUP (ODRG) ON CROSS-BORDER IMPLEMENTATION ISSUES *supra* note 96 ("For the September 2014 Finance Ministers and Central Bank Governors meeting, the ODRG will report to the G20 on further progress in resolving cross-border implementation issues, including identification of any cross-border issues that cannot be resolved without legislative change.").

142. *See id.* ("For the November 2014 G20 Leaders Summit, the ODRG will report how it has addressed or intends to address the treatment of branches and affiliates and organised trading platforms and implementation of the trading commitment and a timetable for implementing these approaches.").

143. *See, e.g.*, *id.*

> ODRG members agreed to continue bilateral negotiations of MOUs between regulators to take into account local specificities, while leaving flexibility for ad-hoc arrangements between regulators. It was agreed that the bilateral negotiations should consider appropriate involvement of the local authority, such as notification, regarding direct access to information of foreign registered entities in the supervisory context and on-site examinations.

Id.

144. GAO REPORT, *supra* note 9, at 48 (including the opinion of "an industry association [that] noted . . . international consistency does not require uniformity but an appropriate level of similarity, comparability and predictability of regulatory outcomes across jurisdictions").

145. Schlosser & Bull, *supra* note 22.

146. *See* Raustiala, *supra* note 8, at 7 (listing the three key factors driving transgovernmentalism: "the expansion of domestic regulation, increased economic interdependence, and technological innovation").

have led to transgovernmental networks and increased regulatory cooperation are explicitly evidenced in the derivatives context, making harmonization desirable. Recently, Benoit Coeure, a member of the European Central Bank's governing board, explained why uniformity is in fact desirable in the context of international financial activities, noting "[i]f you have an idiosyncratic local legal environment, then market participants will find it safer just to play on their home turf because of the legal uncertainty that goes with international activities, and we'll lose the benefit of international financial integration."[147] The other two main arguments against harmonization, however, provide insight into the challenges that confront the harmonization of regulation and provide regulatory agencies with important considerations when interacting in transgovernmental networks.

A. Harmonization and the Possibility of Weakened Legislation

The argument that harmonization of regulation internationally will result in weaker legislation and potentially concentrate risk is noteworthy in that it provides a warning for regulators currently working together to remove the inconsistencies in their respective legislation and regulatory regimes. A report by the OTC Derivative Regulators Group highlights this perspective, noting, "Two academics suggest that if jurisdictions face significant limitations in their ability to reach agreement, harmonization efforts might lead to agreement on only weak global standards."[148] Moreover, total harmonization could reduce the flexibility of regulators to respond to local differences that will inevitably arise among jurisdictions.[149] This inability to respond flexibly to differences and the harmonization of the regulatory network also poses a threat in that it "could cause financial institutions to behave in the same way and unintentionally concentrate risk (for example, holding the same types of assets)."[150]

B. Is Harmonization Possible?

Another critique of the harmonization of derivatives regulation is that it simply cannot be done. According to some policymakers, "The global harmonization of all aspects of financial regulation cannot be achieved. Many elements of financial stability and customer-protection policy can be determined locally. Some competitive distortions and opportunities for regulatory arbitrage will remain inevitable."[151]

These critiques of harmonization highlight potential impediments to and consequences of the harmonization of derivatives regulation; however, rather

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147. *Financial Fragmentation: Too Much of a Good Thing*, THE ECONOMIST (Oct. 12, 2013).

148. GAO REPORT, *supra* note 9, at 47–48.

149. *See id.* at 48 (noting that an academic interviewed for the article argued "harmonized regulations across all jurisdictions may provide a level playing field but could be problematic, in part by not providing jurisdictions flexibility to respond to their differences").

150. *Id.* at 48.

151. Stephan, *supra* note 20, at 202.

than serving as discouragement, these perspectives should act as a warning to regulators in their current transgovernmental discussions. Harmonization should not come at the expense of the necessary level of regulation. Moreover, regulators in harmonizing their regulatory regimes need to pay close attention to the potential unintended consequences of standardized regulation in order to prevent potential concentration of risks that could result from financial institutions centering on, for example, certain products or only operating via specific cross-border clearinghouses.

In order to effectively carry out the mandates of the Common Path Forward,[152] regulators in the United States and the European Union should take pains to understand these critiques and the existing impediments to harmonization discussed above. As part IV demonstrates, achieving effective harmonization in the regulation of derivatives requires more than abidance to standards. Regulatory agencies must understand the nuanced differences in their respective regulatory regimes and search for the functional equivalents in procedure that will allow them to uniformly implement regulations that will prevent regulatory arbitrage and, to the best of their ability, the concentration of risk in order to prevent the threat of systemic risk that derivatives are wont to pose.

VIII
CONCLUSION

The dark side of an increasingly global economy exposed itself in 2008 with the financial crisis. Overnight, governments and financial institutions became acutely aware of the repercussions of the same technological innovation that was praised for easing this globalization, and as a result, businessmen and regulators alike admitted the need to increase and improve regulation. This need for increased regulation was particularly noticeable in the derivatives market due to the widespread, global effects and rapid technological innovation of derivatives transactions and products, a deadly combination that makes derivatives particularly threatening to the global economy. The immediate response of the G20 allowed the international organization to successfully reach an international consensus on required reforms and pinpoint the standards that should rule derivatives in the future. However, the key to effective regulation of derivatives lies in the transgovernmental networks between the national regulatory agencies responsible for implementing reform. This shift from a global, standards-based approach to bilateral regulatory cooperation is critical in preventing another similar crisis in the future and for the effective oversight of the global derivatives market. As discussed throughout this note and exemplified in the analysis of the United States and European Union, slight divergences in domestic regulatory regimes lead to fragmented blocks of

152. As discussed above in part IV.B, the Common Path Forward is the publication set forth by the CFTC and the European Commission in which the two regulators noted the need for harmonization.

information regarding derivatives transactions, in addition to regulatory arbitrage and the concentration of risk in hospitable jurisdictions and dark pools.

Today's most significant and influential transgovernmental network in the derivatives context is the one connecting the regulatory agencies of the United States and the European Union, the two regimes that account for the vast majority of derivatives transactions. The recent implementation of G20 standards by the two regimes has highlighted the need for harmonization and increased communication between their respective agencies: slight variations in their regulatory regimes have led to unintended consequences that undermine the G20 standards and fail to eliminate the systemic risk posed by derivatives transactions. Although the Common Path Forward acknowledges this deficiency and demonstrates a commitment for increased regulatory cooperation, regulators in both the United States and the European Union need to understand the impediments to harmonization and the potential unintended consequences of their respective domestic legislation in order to effectively reach uniformity in their regulation of derivatives.

Despite this note's specific focus on achieving harmonization between the United States and the European Union, ultimately, regulatory agencies globally will need to find a uniform approach to the regulation of this market, as other regions, most notably Asia, garner a bigger portion of all derivatives transactions and become financial leaders alongside the United States and Europe. The threats of regulatory arbitrage and the concentration of risk, however, are most notable today as a consequence of the discrepancies between the regulation of derivations in the United States and European Union. Thus, current efforts looking to prevent the systemic risks and financial crises resulting from derivatives transactions must shift from the international, Group of Twenty context and instead focus on the bilateral regulatory cooperation of the Group of Two: the United States and the European Union.