

# Extraterritorial Impacts of Recent Financial Regulation Reforms: A Complex World of Global Finance\*

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## **Introduction and Acknowledgements**

It is my great honor to present the first paper in our joint and annual Financial Law Workshop. I am most grateful to Party Secretary Wang Houji, Deans Ji Wedong and David Levi, and the many Shanghai organizations both within and beyond Shanghai Jiao Tong University, Convenors Professors Yang Li and Paul Haagen, and to both the Duke and KoGuan Law Schools for sponsoring and hosting the event. I look forward to many similar events in the future, all designed to enhance the mutual understanding and exchange of ideas between the financial lawyers of our two nations.

Today I will talk about the growth of the extraterritorial impacts of United States financial reform legislation, and its regulation and enforcement. This development is being mirrored elsewhere, in markets such as the European Union and even Asia. It seems to be symptomatic of an increasingly complex and emerging new world order in which the traditional concepts of state sovereignty no longer shape the forms of global finance or the regimes and boundaries of international financial regulation.

## **Examples of Extraterritoriality**

The laws and regulatory systems of individual nations are usually intended to have domestic impact only and not have application to personal or business activities in other countries. Except when exercising sovereign claims, nations usually do not presume to legislate in ways that will interfere with how the laws and regulatory systems of other nations will apply in those other jurisdictions.

Recent financial reforms and regulatory actions in the United States, however, have been far-reaching and well noticed by foreign bankers and governments. This is because many of these reforms have had a direct and immediate impact on the activities and status of foreign banks, well beyond the borders of the United States. I should emphasize that the United States is not alone in developing and implementing financial laws and regulations that are threatening to have extraterritorial impact: Europe, for example, has also imposed financial

regulations that have extensive extraterritorial impact, particularly but not only in the field of derivatives regulation. China, for example, has imposed restrictions or prohibitions on such global developments as Bitcoin, as have many other countries. We will likely see more unilateral actions from many regions in the global financial system because a variety of changes in the nature of the global financial marketplace, driven by technology in particular, make these actions inevitable.

Before describing some examples, let me be more precise about the kinds of rules and regulation that will have extraterritorial effect. There are three primary categories:

1. Where Nation A imposes rules on its own Bank X (headquartered in Nation A) and these rules or regulatory actions constrain the operations of Bank X in other countries even though the laws of those countries would otherwise permit the activities.
2. Where Nation A imposes constraints upon Bank Y. Bank Y is headquartered in Nation B but operates on an integrated basis in Nation A. Nation A's constraints are more restrictive than would otherwise be allowed to Bank Y by Nation B.
3. Where Nation A imposes sanctions on Bank Y even though Bank Y's offending activities really took place outside the borders of Nation A. Nation A is able to enforce these sanctions by penalizing Bank Y directly within its borders—perhaps because Bank Y has no option but to conduct activities through channels governed by Nation A.

In the United States all three types of extraterritoriality have been imposed.

### ***Type One***

#### **Volcker Rule**

First, the Dodd-Frank Act has imposed numerous restrictions on American banks, even in their foreign operations. In the past, US banks were generally permitted by US regulators to undertake whatever activities were allowed by the

host nation when operating on foreign soil. The much debated Volcker Rule provides one of the most well known examples of this new extraterritorial reach because it prohibits US banks, irrespective of their foreign structures, from being affiliated with firms that are engaged in proprietary trading, or holding significant investments in hedge funds and private equity investments. There are numerous exceptions, but the Volcker Rule is having a profound effect on the way US banks and foreign banking organizations (FBOs) that engage with US banks can operate.

#### Derivatives Reform

The reforms in Title VII of the Dodd-Frank Act, which has made a major change to the way in which derivatives swaps transactions must be conducted, provide another set of examples of US legislation and regulation that has a global reach.

#### ***Type Two***

##### Volcker Rule Illustration

The Volcker Rule also provides an illustration of the second type of extraterritoriality to the extent that FBOs must comply with the Volcker Rule within the United States even if they are not subject to such prohibitions in their home countries. Such restrictions on FBOs not only relate to their activities but also to their corporate structures and funding. Major examples of this latter type of extraterritoriality are the capital and leverage requirements developed by US financial regulators in response to the 2008 Crisis, in terms of which foreign banks are required to hold capital ratios in the United States that may, and often do, differ quite substantially from those required of their home countries.

This restriction is particularly impactful on global banks, most of which like to deploy their capital in a seamless fashion across the span of their global operations without having to allocate specific amounts of capital to the US operations. Deutsche Bank and Barclays were two global banking organizations hit particularly hard by these restrictions and both companies have restructured their operations in an effort to minimize this impact. The Chinese bank, Citic, is also

reported to be considering closing its US branches to avoid the impact of the Volcker Rule.<sup>1</sup>

#### Intermediate Holding Companies (IHCs)

Perhaps one of the most clear cut examples of the second type of extraterritorial impact of domestic law is the requirement that foreign banking organizations of a certain size establish IHCs in the United States. This requirement forces a change in the corporate structure of a foreign banking organization that would otherwise prefer to conduct its operations through a single corporate entity, say by using a branch. Banks tend to prefer the single corporate entity structure because it enables them to leverage the entire capital structure of the company wherever they operate, and because this structure tends to conform to the corporate form they use in countries such as the United Kingdom (where the bank itself resides at the top of the conglomerate organization).

The US IHC requirement is a departure from the long-established branch structure for foreign banks operating in the US. The IHC requirement introduces the subsidiarity principle used in many other nations, in terms of which the foreign bank must establish a local corporate organization with separate capital, leverage requirements, management and boards.

#### ***Type Three***

The third form of extraterritoriality has assumed considerable importance in recent months. This is enforcement action against foreign banking organizations for violations of US law, even when the transactions in question have really only had effect abroad. The US, like other nations and regions, is able to enforce its policies on an extraterritorial basis by using financial networks as a means of controlling the flow of global finance.

Major examples are the actions by New York state and federal banking agencies against HSBC, Barclays and BNP Paribas for anti-money laundering

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<sup>1</sup> See Henny Sender, *Citic may give up US bank branches*, FIN. TIMES, Jun. 30, 2014, <http://www.ft.com/intl/cms/s/0/c7d389d8-0062-11e4-8aaf-00144feab7de.html>.

violations, actions by the United States Treasury and Justice Department against Credit Suisse and UBS for violations of US tax laws, and actions by US banking regulators against banking units based in London and other financial centers for rate manipulations, such as those involving LIBOR and currency transactions.

The US authorities are able to impose, and have imposed, extensive sanctions on these foreign operations for various reasons. First, these FBOs generally use the payments and clearing networks in New York, and it is difficult for them to avoid doing so. Second, many of these FBOs are affiliated in some form with banks headquartered in the US, so the regulators have direct or indirect enforcement jurisdiction over the foreign affiliates. Third, FBOs can be cut out of business with US-headquartered banks and this they can ill afford.

Essentially, in this third category of extraterritoriality, the US is exercising its market power, either directly (by forcing US banks to conform) or indirectly (by denying FBOs access to US facilities), and over the vigorous protests of other governments.<sup>2</sup>

## **Changes in the Underlying Global Financial Marketplace**

### ***Extraterritoriality Elsewhere***

Of course these extraterritorial actions have been met with protests, sometimes from US banks fearing retaliation but more often from foreign banks and foreign governments. Yet US extraterritoriality is not unique by any means: such forms of extraterritorial action are being taken by many nations. China, for example and like many other countries, imposes restrictions on FBO entry and activities that differ from those permitted in the United States.<sup>3</sup> The European Union and many of its member nations have imposed extraterritorial requirements on banking operations passing through Europe.<sup>4</sup> Many nations around the world impose some

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<sup>2</sup> See, e.g., Michael Sothard, Hugh Carnegie, & Martin Arnold, *France urges G20 to put issue of US bank fines on agenda*, FIN. TIMES Aug. 3, 2014, at <http://www.ft.com/intl/cms/s/0/da428604-1963-11e4-9745-00144feabdc0.html>.

<sup>3</sup> HE WEI PING, *BANKING REGULATION IN CHINA: THE ROLE OF THE PUBLIC AND PRIVATE SECTORS* ch. 4 (2014).

<sup>4</sup> See, e.g., Alexandria Carr, *The Extraterritorial Effect of the EU Regulation of OTC Derivatives*, HARV. L. SCH. FOR. CORP. GOV. & FIN. REG., Jun. 14, 2014,

form of subsidiarity on FBOs entering their jurisdictions, whether this is a certain percentage of local ownership or mandatory domestic incorporation.<sup>5</sup> So threats of retaliation through unilateral action raise the specter of trade wars in the very heart of international trade, namely the enabling tracks of international finance themselves.

### ***A New Balkanization?***

At the same time, and partly influenced by these developments, concerns of a new “Balkanization” of the global financial system are often raised. To some extent these concerns are also a reaction against the supposedly far-reaching impacts of the Basel III standards and the actions promoted by the G20 and the Financial Stability Board. Unilateral action that diverges from supposed international consensus is evident. While regulators in the US have imposed standards that are perhaps tougher than those contained in Basel III, many legislators who oppose to tough regulation or who have very different views on how banks should be regulated have actually tried to forbid the implementation of Basel III altogether. Bank regulation, even in this day and age, has often turned out to depend much more on domestic politics—and domestic knowledge and expertise<sup>6</sup>—than on global accords, and in this respect the US appears to be no exception.

### ***Whither the Seamless World of Global Finance?***

Do these unilateral actions suggest an end to the possibility of a seamless world of global finance? I believe that such a vision was never realistic in the first place. In my view we will continue to see a much more complex picture emerge, one

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<http://blogs.law.harvard.edu/corpgov/2014/06/14/the-extraterritorial-effect-of-the-eu-regulation-of-otc-derivatives-2/>.

<sup>5</sup> See, e.g., Rob Blackwell, *Three Threats to US Banks from BNP Paribas Fine*, AM. BANKER, Jun. 30, 2014, [http://www.americanbanker.com/issues/179\\_125/three-threats-to-us-banks-from-bnp-paribas-fine-1068374-1.html](http://www.americanbanker.com/issues/179_125/three-threats-to-us-banks-from-bnp-paribas-fine-1068374-1.html).

<sup>6</sup> See, e.g., Editorial, *Does financial regulation have to be global?*, THE BANKER, July 28, 2014 (“The drive for global regulation should not lose sight of the fact that there is no regulatory substitute for detailed local knowledge”) at <http://www.thebanker.com/Comment/Does-financial-regulation-have-to-be-global>.

in which we will see a fluctuating blend of international cooperation and unilateral acts by national regulators. Life for global banks will be difficult!

This view might seem counterintuitive in an age of global universal banks: these institutions provide and rely upon instantaneous digital flows or currency, derivatives transactions and general global transactions services. This is an era declared to be the “end of geography.”<sup>7</sup>

Nevertheless, I doubt that we will see full harmonization of global financial regulation, at least in a form that would eliminate complaints about unilateral, extraterritorial action. The reason is that the traditional models of private banks, public sovereigns, and a line between international and national action, have lost much of their coherence. The lines have become very blurred. Instead, global financial markets have become host to a tangle of governments, business organizations and consumers of global finance in which the parties to financial activity are partners, collaborators and adversaries—all at the same time.

## **Collaboration, Competition and Conflict**

### ***Pre-Crisis Progress***

For the past century and a half, we have assumed that nations would develop their own laws and regulatory frameworks, which they would apply to financial institutions operating within their borders. Various developments made this model more complicated. For example, in the United States the dual banking system allowed states to make their own rules for banks, and many let foreign banks branch directly within their borders. Claims for competitive parity led both to a federal version of the same thing and restrictions to be imposed on FBOs that would more or less equalize the constraints of both foreign and domestic banks operating within the borders of the United States.

With the development of transnational regulatory coordination through the mechanism of the Basel Committee on Financial Supervision, the concepts of mutual

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<sup>7</sup> RICHARD O'BRIEN, *GLOBAL FINANCIAL INTEGRATION: THE END OF GEOGRAPHY* (1991).

recognition and reciprocity began to emerge during the 1980s.<sup>8</sup> The principle of mutual recognition was recognized, at least implicitly, in the US where FBOs actually enjoyed exceptional treatment in some respects. For example, activities of FBOs that were not permitted to domestic banks were grandfathered in for their operations in the US. A little later, they would also not be subjected to direct US supervision if they enjoyed consolidated and comprehensive supervision in their home countries.<sup>9</sup> Banks encouraged this approach because it reduced their regulatory burdens, led to reciprocal treatment for US banks operating abroad, and because the Basel Committee on Banking Supervision strongly encouraged such reciprocity.

An even further reaching example was that of the European Union. There the Union developed the concept of the “single banking passport” that enabled a bank headquartered in one member nation to “export” its full license to operate throughout the Union, irrespective of the restrictions that might otherwise apply in host nations.<sup>10</sup>

As we drifted toward 2008 it looked increasingly likely that these ideas would spread across the globe. Indeed, by 2007 more than a hundred nations had adopted some version of the Basel agreements. The International Monetary Fund and World Bank for Reconstruction and Development launched a peer review program as part of an overall effort to minimum common standards of bank supervision across the globe. This peer review technique has since been adopted by the Financial Stability Board and other committees involved in international financial regulation. While a single, supranational bank regulator or worldwide governing financial treaty were unlikely politically, they were certainly urged as an ideal towards which to strive.

At the same time, large banks steadily took advantage of this great “smoothing” of global financial regulation. The largest financial institutions developed more or less seamless operations across the globe or at least in large

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<sup>8</sup> See generally, e.g., Pierre Hugues-Verdier, *Mutual Recognition in International Finance*, 52 HARV. INT’L L.J. 56 (2011).

<sup>9</sup> Foreign Bank Supervision Enhancement Act of 1991.

<sup>10</sup> European Union provisions.

numbers of countries. Partly this was to provide global services for clients that had global operations. Partly it was in pursuit of the greater profits offered in developing markets and the demand for large scale financial services brought about by a so-called “financial deepening” in developing countries and by the needs sovereign nations had to finance major development projects. The efficiencies of American-style capital markets were welcomed across the globe. US banks that, by reason of the 1933 Glass-Steagall Act and another, less well known piece of legislation called the McCarran-Ferguson Act, had been prohibited from affiliating with securities and insurance companies, were released from these constraints when the Gramm-Leach Bliley Act was passed in 1999 precisely in order to let them compete on a global stage with the universal banks of Europe and Japan. So by 2008 large banks from all over the world were competing directly with each other in many fields of financial services. It is no wonder that these financial institutions welcomed the pursuit of global harmonization even as they complained about the bureaucracy involved.

### ***Post-Crisis***

Then we had the 2008 subprime meltdown leading to what became the Global Financial Crisis. Stunned by the systemic shocks this crisis generated, the G20 declared its resolve to promote an aggressive agenda of global financial harmonization with higher minimum standards than the members had hitherto applied. For a brief moment many believed that a meaningful global coordination in financial regulation was a genuinely attainable goal.

Yet we now seem further from that goal than ever before. The extraterritorial actions described earlier reflect an era of unilateralism, not coordination or harmonization. At the same time, bankers complain about unreasonable regulations and threaten to move their banks in opposite directions. And in the US, at least, government seems more involved in banking than ever

before in history. And even within the European Union deep divisions on bank regulatory policy are very obvious.<sup>11</sup>

What has happened? In a nutshell the activities, interests and objectives of both banks and governments have become more tightly intertwined than ever. As a result, the objectives and consequences of financial activity have come to reflect the reality of modern global relations, in which nations are not simply aligned for or against each other but, like business itself, are engaged in a complex dance involving part collaboration, part competition and part codependence. Within the context of US-China and other global relations, author Noah Feldman has aptly described this state of affairs as “cool war.”<sup>12</sup>

## The Dramatic Impact of Technology

### *Growth of Megabanks*

These developments have been greatly facilitated by the dramatic sweep of technology. Sophisticated technology platforms, communications and applications have enabled the growth of megabanks beyond a scale that was ever possible before the computer revolution. These megabanks compete on a global stage, no longer as cross-border competitors but being actually “co-located” with their foreign competition all over the world.

### *Government/Bank Codependency*

Furthermore, these firms are not only large enough to enlist the support of the governments of their headquarters nations, but they have also evolved in a relationship of codependency with those governments. In the United States, for example, very large financial institutions are literally too big to fail (however much this is officially denied) and they count measurably on the backing of government when in financial danger. They, and other very large foreign banks, are primary dealers in US Treasuries, and as such are the means by which the US government is

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<sup>11</sup> See, e.g., George Parker, *EU banks step up opposition to new EU financial services tsar*, FIN. TIMES Aug. 3, 2014, at <http://www.ft.com/intl/cms/s/0/ee66a6ba-197c-11e4-9745-00144feabdc0.html>.

<sup>12</sup> NOAH FELDMAN, COOL WAR: THE FUTURE OF GLOBAL COMPETITION (2013).

able to finance its \$17 trillion debt. Despite denials, the large banks enjoy substantial implicit and explicit subsidies. Nor are these advantages confined to the US: similar situations obtain in other countries and regions. Furthermore, the partnership between banks and governments is manifested in other areas: for example, these same large institutions are used by government to assist in handling other large financial institutions when those institutions fail and are too large for government to bail out or liquidate.

### *Tools of Government Policy Implementation*

Technology has also opened up another avenue of government-finance codependency: as the financial transmission belts of the global financial system, large banks have become a convenient tool for applying and enforcing government policy. This is evident in the tax evasion and money laundering cases mentioned earlier. Indeed, the US Treasury has adopted a very conscious strategy for using banks and payments systems to go after violators of US law wherever these violators are and irrespective of whether they enjoy the protection of local laws. The European Union appears to be developing a similar strategy. In the words of one author, these developments have ushered in a “new era of financial warfare.”

Cyberwarfare, the direct result of technology networks, has presented yet another frontier of government-finance collaboration. Internet security has now become a critical issue for banks and this has created a delicate relationship between banks and government. The earlier resistance of banks to government protection has given way to an appeal for government assistance.<sup>13</sup> Yet at the same time, government relationships with businesses in this arena are fragile. Banks face a dilemma brought sharply into relief by the Snowden revelations: to the extent that their networks can be accessed by national security agencies, they also run the risk of losing the trust of their customers. This conflict has broken into the open in the case of companies like Google who, out of fear of losing customers, have

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<sup>13</sup> See Carter Dougherty, *Banks Dreading Computer Hacks Call for Cyber War Council*, BLOOMBERG Jul. 8, 2014, <http://www.bloomberg.com/news/2014-07-08/banks-dreading-computer-hacks-call-for-cyber-war-council.html>.

announced publicly their intentions to take active measures to keep government agencies, domestic and foreign, *out* of their networks. Similar unease is sure to be felt by banks as well.

At the same time, the activities of banks across global markets are particularly interesting for governments as they conduct and assess their relationships with other governments. The public is also now more concerned than ever with the activities of their banks. Both developments have inevitably drawn banks into the political arena, where they are finding that the vision of a seamless or at least harmonious set of regulatory rails upon which to run their global businesses remains a distant prospect. Such ambitions lie at the fluctuating mercies of government policy and international strategy.

#### Prospects for the Future

Without some massive event, such as another global financial crisis that might galvanize worldwide public sentiment into coordinated global action toward genuine harmonization, this complex world of competition, conflict and codependency seems likely to become more the norm rather than less. These circumstances are likely to make global finance difficult to undertake.

The result is that our efforts to develop common minimum standards are, in my view, likely to move slowly forward, but at a very unpredictable pace and with numerous setbacks. Here are some examples of the challenges:

- Many nations will impose stricter regulation than banks themselves expect.
- In efforts to compete as major financial centers, governments might sometimes even *deregulate* where international consensus might have suggested the opposite tack.
- Banks will find themselves both willing and unwilling instruments of the state—the conveyor belts of government policy. This is a price they will have to pay for their heavy codependency with their national governments.
- Domestic political demands for the protection of domestic financial stability will likely drive more extraterritorial efforts, not less.

- Finally, to the extent that the interests of such governments do and always will diverge quite substantially, banks will find themselves performing duties that detract from their ability to compete on the “level playing fields” of which they so often dream.

This is perhaps a gloomy note on which to conclude, though I would hope it is realistic. One consolation, however, is that this complex model of international finance, with all its vicissitudes, contradictions and seemingly counterproductive unilateralism, merely reflects what has been evolving in the domestic and global arenas of business themselves, as well as in the realm of international relations. Essentially, such complexity and contradiction is an unexpected consequence of a world both connected and unglued by technology, a world that is at once both much closer together and further apart.