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TLOs and Global Financial Markets: The Case of Derivatives

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*By Hannah L. Buxbaum**

In these remarks, which draw on a recent article of mine,[1] I will examine a particular episode in financial regulation: the effort following the global financial crisis to develop new rules regulating over-the-counter (OTC) trading in derivatives. My intention is not to focus on the technical aspects of those rules,[2] but rather to explore what this episode can tell us about the formation of transnational legal orders (TLOs)[3] in the area of global financial markets.

In the aftermath of the crisis, it became clear that cross-border derivatives trading, particularly in the form of credit default swaps, had contributed significantly to the crisis. They had created not just systemic risk, in the sense that defaults in the derivatives market spilled over into other sectors of the economy, but *cross-border* systemic risk, in the sense that defaults in one domestic economy spilled over into other countries. Unsurprisingly, regulators responded by calling for a "global" response, suggesting that only through the adoption of consistent regulatory standards across national systems could the systemic risks presented by over-the-counter derivatives be contained.

Given the catastrophic nature of the crisis, and the manifestation of political will to address a problem of clearly global dimension, one might expect to see a move toward greater convergence in the laws governing derivatives markets—in other words, one might predict that the financial crisis would catalyze progress toward the formation of an effective TLO. However, despite the involvement of many transnational organizations, progress has been halting.

The G-20 emerged as the locus for coordinating the efforts of individual countries to implement consistent regulations, and consensus at the most general level—as to the fundamental goals of mitigating systemic risk, improving market transparency, and protecting against market abuse—was easy to reach. By the end of 2009, G-20 leaders had agreed to three core regulatory commitments as to derivatives: (1) all 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; (2) OTC derivative contracts should be reported to trade repositories; and (3) noncentrally cleared contracts should be subject to higher capital requirements.[4]

Some countries, including the United States, Europe, and Japan, have adopted (or are in the process of adopting) comprehensive regulatory schemes translating these core commitments into domestic legislation. Many other countries, however, have made little or no

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[1] These remarks are based on Hannah L. Buxbaum, *Transnational Legal Ordering and Regulatory Conflict: Lessons from the Regulation of Cross-Border Derivatives*, 1 UC Irvine J. Int'l Transnat'l & Comp. L. 91 (2016).

[2] There are many excellent and detailed accounts of the role of derivatives in the financial crisis and of the regulatory steps taken in its aftermath. *See, e.g.*, John C. Coffee, Jr., *Extraterritorial Financial Regulation: Why E.T. Can't Come Home*, 99 Cornell L. Rev. 1259 (2014); David P. McCaffrey, *The Transformation of the Over-the-Counter Derivatives Market, 1984–2016* (Nov. 29, 2016) (working paper, available at www.ssrn.com); Eric Helleiner, *Towards Cooperative Decentralization? The Post-Crisis Governance of Global OTC Derivatives*, *in* Transnational Financial Regulation After the Crisis 132 (Tony Porter ed., 2014).

[3] *See* Terence C. Halliday & Gregory Shaffer, *Transnational Legal Orders*, in Transnational Legal Orders 5 (Terence C. Halliday & Gregory Shaffer eds., 2015) (defining a transnational legal order as "a collection of formalized legal norms and associated organizations and actors that authoritatively order the understanding and practice of law across national jurisdictions").

[4] *Implementing OTC Derivatives Market Reforms*, Fin. Stability Bd. 7 (Oct. 25, 2010), *at* http://www.financialstabilityboard.org/2010/10/fsb-report-on-implementing-otc-derivatives-market-reforms/?page_moved=1.

progress. Some are simply on a slower time schedule, but others appear disinterested in adopting comprehensive regulations. A 2015 report by the International Swaps and Derivatives Association summarized the situation and its effect on market participants:

> A number of differences have emerged in the timing and substance of derivatives regulations in individual jurisdictions. Rather than being subject to multiple, potentially inconsistent requirements, derivatives users are increasingly choosing to trade with counterparties in their own jurisdictions. The result is a fragmentation of liquidity pools along geographic lines, which reduces choice, increases costs, and will make it more challenging for end users to enter into or unwind large transactions, particularly in stressed markets.[5]

Although the story of derivatives regulation postcrisis is still being written, I would offer three preliminary observations regarding the challenges of creating an effective TLO in this area. First, the transnational institutional framework within which derivatives reform was addressed was not well aligned with the scope of the problem. The task of coordinating efforts to implement the core regulatory commitments agreed to by the G20 fell primarily to the Financial Stability Board. This organization, which has been described as a "network of networks,"[6] includes representatives from standard setting bodies, central banks, finance ministries, and supervisory and regulatory authorities. The working group it formed to develop recommendations regarding derivatives regulation included additional members, including representatives of the Committee on Payment and Settlement Systems, the International Organization of Securities Commissioners, and the Basel Committee on Banking Supervision. Thus, the task of regulating derivatives in particular was spun up into a very large group of international institutions, many of whose mandates extended to other areas of financial regulation, and the Financial Stability Board was able to play only a very loose coordinating role.

Second, the efforts of states to develop a cooperative and coordinated regulatory response were in certain respects undermined by their continued assertions of authority to regulate unilaterally. Because rulemaking within the G20 framework was being conducted country by country, it was clear from the outset that significant divergence might remain in the scope and content of regulation (if for no other reason, simply because the speed of legislation would differ). In light of this, both the United States and the European Union, while working to implement their own rules complying with the G20 commitments, nevertheless preserved the right to apply domestic law extraterritorially if they felt that doing so was necessary to protect the integrity of their markets. Each threatened to bar foreign dealers from participating in local swaps markets if those dealers were not sufficiently regulated by their home country. For instance, Section 715 of Dodd-Frank provided that entities could be prohibited from participating in the U.S. swaps markets if they were domiciled in nations whose own regulation was deemed inadequate to protect "the stability of the United States financial system."[7] The European Market Infrastructure Regulation adopted a similar approach. Using the threat of extraterritoriality in this way of course generated disputes between the regulators. While

[5] *The Dodd Frank Act: Five Years On*, INT'L SWAPS & DERIVATIVES ASS'N 8 (July 20, 2015), *at* http://www.isda.org (ISDA Focus: Dodd-Frank).

[6] Chris Brummer, *Post-American Securities Regulation*, 98 CAL. L. REV. 327, 359 (2010).

[7] 15 U.S.C. § 8304 (2012). Section 722(d) further provided that U.S. law would apply to foreign swap activities that had "a direct and significant connection" with activities in U.S. commerce, or that were deemed evasive of U.S. law. 7 U.S.C. § 2(i) (2001).

they were eventually resolved,[8] it was through direct negotiation between the United States and the European Union, not through the participation of the networking organizations.

Finally, there is significant divergence in the incentives of different countries to adopt consensus (and more stringent) regulatory norms in this area. While states do have an interest in maintaining safe and stable securities markets, they also have an interest in attracting capital to those markets. This means that the regulatory norms adopted by individual states reflect different preferences regarding the appropriate level of regulation in this area. It also means that some states stand to benefit from regulatory competition, and so have little incentive to converge around a more unified set of regulatory norms. In addition, the initial assumption after the financial crisis was that the shared, global, systemic risk posed by derivatives trading was enough to outweigh the potential gains from regulatory competition. But even market collapses do not threaten all countries equally. The costs of a systemic risk crisis would fall unevenly on different countries, posing a greater risk to the major markets. Thus, it is those markets, and those alone, that have the incentive to invest in tightening their regulations. Lastly, there are local political pressures that vary from state to state. As rulemaking proceeded, the initial and somewhat rough framing of the issue (that unregulated trading in OTC derivatives creates unacceptable levels of systemic risk) gave way to debates over exactly how the risks created by abusive or purely speculative OTC trading could be contained without eliminating the beneficial aspects of that market. These debates inevitably involved a clash between proponents of greater regulatory intervention and market participants who resisted the characterization of OTC derivatives as inherently dangerous. It was to be expected that in countries with strong lobbies from the latter sector, the pace and extent of regulatory reform would be diminished.

The outcome of all this, at least for the time being, is a persistence of the traditional legal paradigm in this area. It is a paradigm in which each securities market is regulated by its "home country" regulators, applying domestic law (a jurisdictional allocation model), and in which cooperation and coordination mechanisms can be used to address whatever challenges arise as a result of transnational market activity and to preserve the effectiveness of domestic regulation in the face of those challenges. It is important to recognize that this, too, is a form of TLO—a conflict of laws type TLO, which is built on its own set of transnational norms relating to the allocation of jurisdictional authority and the negotiation of structured cooperation mechanisms.

It is a temptation in studying transnational legal orders to think of them as evolutionary—as moving from "primitive" stages of isolationism and unilateralism to an end system of unification. They have no such clear teleology. In some areas, it may not be possible to work toward a top-down type of TLO where the norms are generated within transnational networks or supranational institutions and then diffused—or, indeed, where uniform regulatory norms are developed at all. Rather, a system that continues to tolerate regulatory divergence (based on the political economy of the system being regulated) may persist.

[8] Most importantly, EU and U.S. regulators agreed on a functional equivalence (substituted compliance) system in which certain market participants would be deemed in compliance with local requirements if they satisfied applicable requirements in their home jurisdiction. *See, e.g.*, COMMODITY FUTURE TRADING COMM'N, COMMODITY FUTURE L. REP. 33644, THE UNITED STATES COMMODITY FUTURES TRADING COMMISSION AND THE EUROPEAN COMMISSION: COMMON APPROACH FOR TRANSATLANTIC CCPS (Feb. 10, 2016).