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The Danger of Divergence: Transatlantic Financial Reform & the G20 Agenda

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The views expressed in this report are inspired by conversations with the rapporteur and do not constitute a consensus view from the Co-chairs or task force and advisory board members. Nor do the views expressed here necessarily represent the views of the Atlantic Council, Thomson Reuters, or TheCityUK.

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Foreword

As the United States and Europe continue to work to secure their financial markets after the crises of 2008-10, they also face new and growing challenges in a rapidly evolving global economy. Countries such as China, India, Brazil and other emerging markets are outpacing growth rates in the transatlantic economies, and new investment opportunities are arising around the world. Our first *Danger of Divergence* report, released in 2010 as leaders in Washington and Brussels designed their initial policy responses to the crisis, examined the risks and costs of divergence in US and EU financial regulations. Today, this new report explores the many challenges still faced by both the United States and the European Union as they implement those sweeping changes. In particular, this report tracks the areas of continuing differences, especially in key areas including banking oversight, derivatives, and privacy protection. It also calls on leaders to work collaboratively to ensure the future stability and vitality of the global financial system.

We have come together to highlight a set of crucial ongoing issues with transatlantic financial regulatory reform, and offer an approach to addressing these. At the heart of the report is a call for enhanced and more effective cooperation on this key international challenge. We believe this is not only an economic and financial imperative for our countries, but also of great international strategic importance. Our two economies must continue to set the global standard for financial regulation and recognize the significant value in doing so.

While many key issues are covered in this robust report, several common themes emerge. First, without a re-energized commitment from the European Union and the United States to focus the Group of 20 (G20) agenda on international regulatory reform, the future of coherent global financial regulation is unclear. Second, a new generation of cooperative regulatory agreements between the United States and the European Union is essential to bolster bilateral cooperation. This includes ensuring that we deploy all appropriate diplomatic tools, both informal and legal, to contribute toward resolving divergent approaches in a consistent, prudent manner. Third, the United States and European Union must act expeditiously and collaboratively if they are to continue as leaders of financial reform on the global stage.

This publication is the result of a significant partnership between the Atlantic Council, Thomson Reuters, and a new partner, TheCityUK. We are deeply appreciative of Dr. Chris Brummer, the C. Boyden Gray Fellow on Global Finance and Growth at the Atlantic Council, for his work in producing this report. We would also like to thank our co-chairs for helping organize the report launch, our Advisory Board for their valued perspective and guidance, and our task force for their extremely helpful technical support and input.

We believe this report provides new analysis and key insights into the issues associated with financial regulatory divergence, and that it demonstrates the vital importance of transatlantic financial cooperation. Without this essential US-EU dialogue, which needs to be characterized by robust, effective, and forward-looking exchanges, the risk of repeating the mistakes of the past with potentially grave consequences for the global economy is all too apparent. Leadership is about seizing the moment. We believe this moment is here and we hope that our report provides vision and guidance on how the transatlantic economies can move ahead with conviction and secure our shared future.

Sincerely,

Frederick Kempe	Chris Cummings	David Craig
President and CEO	*Chief Executive*	*President, Financial and Risk*
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Executive Summary

Transatlantic cooperation has never been more important for the regulation and oversight of the global financial system. The need for US-EU cooperation has also grown stronger as it has become clear that the transatlantic regulatory alliance is no longer the only game in what has become a truly global town. Today, three of the fifteen largest banks in the world are Chinese, equity markets for the BRIC countries (Brazil, Russia, India, China) are already half the size of those in the United States, and 60 percent of global initial public offerings (IPOs) are held in China or other emerging markets. As transactions have moved to ever more diverse parts of the world, so has regulatory influence. Thus, closer coordination among the transatlantic economies—still the world's two largest—is vital to ensure that regulators send consistent messages to market participants and rising powers, including regulators in Asia and the global south, to build a coherent regulatory framework for the international financial system.

Since the our last report on this topic—*The Danger of Divergence: Transatlantic Cooperation on Financial Reform*—the United States and European countries have worked to translate an ever-growing body of international financial regulations into legally binding rules at home. Although this process has been largely harmonious and remarkably consistent, American and European regulatory practices have diverged in several crucial areas, which could come to seriously affect the efficiency and growth of the transatlantic financial marketplace. This report is not intended to judge one approach as better or worse than the other. Nor is this report about the costs of regulation. Rather, this report strives to highlight the forms, risks and costs of *divergence*, and identify productive paths forward for transatlantic cooperation in regulatory policymaking.

This examination of the current state of US-EU cooperation on financial regulation brings to light several key themes:

- Regulatory divergence carries a variety of costs. Divergent practices help enable regulatory arbitrage that can undermine the effectiveness and stability of the global financial system, as well as undermine the ability of transatlantic financial authorities to export their regulatory approaches and best practices to the rest of the world. Furthermore, divergence can introduce duplicative or inefficient practices for both providers and users of capital, thereby undermining global economic growth and, by extension, job creation on both sides of the Atlantic.
- Process matters: the European Union and United States have vastly different administrative and political rule-making processes, which can impede or hinder effective transatlantic cooperation.
- Although the United States and Europe have mostly focused on the quality and amount of capital banks must hold, sharp differences over bank structure and geographic requirements for capital still exist, thus rendering transatlantic bank resolution increasingly improbable.

- The European Union and United States have adopted similar approaches toward derivatives regulation, but technical inconsistencies relating to issues including trade reporting and business conduct still create considerable uncertainties for many businesses that likely create deadweight costs for the economy.
- Divergent approaches to data protection, accounting principles, and trade reporting continue to undermine the two economies' ability to efficiently exchange information and assess risks and evaluate firms.
- Increasingly, differences will also arise between Asian regulatory approaches and those adopted by the European Union and United States, especially where the two jurisdictions do not agree on policy, which will create new challenges for global coordination.

The time is clearly ripe for a major push to address global financial regulation. The United States and European Union should reenergize their own bilateral efforts at regulatory coordination and focus their efforts on achieving deep policy consensus with one another. Increasingly, only when the transatlantic partners act in unison will they be able to export their policy preferences. In particular, they should focus on the following areas where the danger of divergence is most significant.

- **The implementation of Basel III**
  - Although both the European Union and United States appear poised to undertake largely consistent reforms aimed at increasing the amount and quality of capital that financial institutions must hold, the speed of implementation has diverged, in part due to the eurozone's need to restructure the banking system internally among members in a more challenging economic environment. In addition, the United States appears poised to go beyond Basel III with regards to some liquidity and leverage metrics, while the European Union has proposed more stringent rules on banker compensation and a financial transaction tax.
- **Reform of banking structure and resolution**
  - While the US approach to banking structure and resolution is embodied around the Volcker Rule, which is meant to prevent banks from engaging in proprietary trading in securities, the European Union's still-evolving system of banking structure and resolution reform places more emphasis on enhanced capital for core deposit-taking functions. Also, both jurisdictions appear to be adopting different standards and approaches with regard to the regulation of foreign banking organizations (FBOs), which has lead to an erosion of goodwill and risks undermining transatlantic cooperation. Transatlantic bank resolution remains far from operable and thus a distant goal.
- **Reform of the OTC derivatives market**
  - EU and US reforms do showcase a high level of commonality in their approach toward derivatives regulation post-crisis. But despite shared regulatory objectives, significant areas of divergence are emerging in the implementation process, especially with regards to trade reporting and swap execution facilities. Although implementation of derivatives regulations in both jurisdictions largely mirrors G20 mandates, a slew of technical inconsistencies between the two regimes threatens transatlantic regulatory coordination, even as supervisors have drafted a framework laying out a path forward.
- **Data privacy**
  - Regulatory divergence in data privacy rules could affect transatlantic commerce, as well as the substantive content of transatlantic financial regulation. These differences could be exacerbated if the EU's Data Protection Directive is implemented in its current form, including the controversial "right to be forgotten." EU initiatives have largely focused on individuals' rights to confidentiality and emphasized a single framework across countries to protect personal data, while the US approach has focused on the rights

of free speech and varying national and state responsibilities, thus resulting in a multilayered framework that emphasizes enforceable codes of conducts, disclosures, and opt-out rights in certain sectors, including financial services.

Re-energizing the EU-US commitment to coordinated financial reform is crucial for the future health and vitality of the global economy. But the United States and European Union cannot reform global financial rules on their own. The growth of financial markets in Asia and elsewhere suggests that any efforts to regulate the global financial system must move quickly beyond the traditional money centers in Europe and the United States. Recent reforms in Asia indicate that this kind of engagement is most effective, however, when done not just via cross-regional dialogues (like EU-ASEAN or US-ASEAN), but through forums like the G20 and Financial Stability Board (FSB). Thus, we recommend that:

- **The United States and European Union should lead an effort to reenergize the G20 as the pre-eminent global forum on financial reform and call for a reaffirmation of this commitment at the next leaders' summit.**

  Since the 2009 G20 summit in Pittsburgh, the leaders' summits have focused more on macroeconomic policy rather than market regulation and supervision, much of which has been left to the FSB. But with the risk of significant divergence growing, it is now time for the leaders to re-engage and tackle the hard political questions. In particular:

  - Global cross-border regulatory bodies like the International Organization of Securities Commissions (IOSCO) and the Basel Committee should be explicitly encouraged by the transatlantic partners to increase their levels of cooperation in finalizing and enforcing standards and regulations.
  - High-level political engagement should be focused on the thorny issue of cross-border resolution. When big firms are distressed and seem poised to become insolvent, there are great incentives for national officials to grab assets and protect local creditors. To reduce the urgency and concern driving such measures, leaders should refocus their attention on the issue of resolution, and commit to the establishment of a credible and operational resolution regime in the next decade.
  - The G20 should improve the interoperability between regulatory bodies like the FSB, IOSCO, and Basel Committee by delineating their roles more explicitly and charging the FSB with rulemaking authority when other bodies fail to act swiftly or where the interdisciplinary nature of a regulatory challenge makes its participation useful for enhancing both sectoral and national consistency.

- **The United States and the European Union should launch a comprehensive program aimed at bilaterally coordinating implementation of their reforms across regulatory agencies.**

  Transatlantic coordination should not only intensify as regulators implement global standards, but should also be operationalized in parallel with the G20 process. The US-EU Financial Markets Regulatory Dialogue, in particular, should find new life alongside G20 meetings of treasury officials and central bankers. EU and US regulators should be encouraged to present their joint solutions to the FSB as joint proposals for wider international adoption.

- **A new generation of cooperative regulatory agreements is needed to bolster bilateral cooperation.**

  The United States and the European Union should develop a new "toolset" to help countries cooperate not just in reaching existing standards but in improving standards together in an environment of quickly moving markets. Whether through treaties or informal arrangements, a framework should be developed for synchronizing decision-making processes in ways that allow regulators and legislators to mutually identify priorities and proceed simultaneously in addressing them in a coherent way.

The Way Forward for the Transatlantic Regulatory Community

To meet these challenges, the United States and Europe should launch a comprehensive program designed to coordinate implementation of their reforms across and between their independent regulatory agencies. Traditionally, international regulators have relied on mutual recognition and substituted compliance agreements to promote cooperation, and these remain indispensable today. However, in a world where *all* countries are tasked with upgrading their financial systems, mutual recognition and substituted compliance programs should become more robust, and provide procedural mechanisms for coordinating rule-making and administrative processes in an ongoing, collaborative process. They should be the start, not the end, of regulatory coordination. At the same time, such coordinating mechanisms should be—to the extent possible—objectives-based processes measured against international commitments and benchmarks as well as the needs of domestic financial systems, rather than check-the-box metrics that can become quickly outdated in a fast-paced financial marketplace. To this end, metrics should be continuously assessed and updated.

In any case, operationalizing enhanced regulatory cooperation can be resource-intensive. In order to recognize another jurisdiction as essentially equivalent, for example, regulatory agencies must familiarize themselves with practices of other jurisdictions, and then relate these practices to their own domestic financial systems. The challenge to this way forward, problematically, is the lack of manpower to oversee these kinds of mutual agreements. The Securities and Exchange Commission's (SEC) office of international affairs, for example, has approximately two dozen attorneys to examine, understand, and coordinate with the rest of the world's securities agencies. The Commodities Future Exchange Commission's (CFTC) office of international affairs fares even more poorly, with about half the professional staff. Thanks in part to the current political climate in the United States, travel budgets of trade and treasury officials have been curtailed, and key officials have been furloughed, while ongoing budget battles present considerable challenges to transatlantic diplomacy. Still, with the health of the global economy at stake, resources should be directed toward these vital functions.

The Stakes are Too High to Ignore This Opportunity for Global Leadership

International financial reforms are moving ahead, though not always with the full weight of EU and US consensus, and not infrequently reforms are bypassing the G20 process altogether. As a result, gaps continue to arise that can undermine both efficiency and stability, as well as undercut the projection of transatlantic policy preferences abroad. Therefore, a call to cooperative action is needed. Minimizing the dangers of such divergence is critical, and involves not only promoting flexibility where possible, but also rethinking the very institutional structure through which the European Union and the United States promote economic relations through leadership. The urgency for smart and robust transatlantic regulatory cooperation thus remains stronger now than ever before.

Acronyms

AIG	American International Group
APA	Administrative Procedure Act
ASEAN	The Association of South East Asian Nations
BaFin	German Federal Financial Supervisory Authority
BCBS	Basel Committee on Banking Supervision
BRIC	Brazil, Russia, India, China
CFTC	Commodity Futures Trading Commission
CCP	Central Counterparty
CFTC	Commodities Future Exchange Commission
CRD	Capital Requirements Directive
DCO	Derivatives Clearing Organization
DFA	Dodd-Frank Wall Street Reform and Consumer Protection Act
DGS	Harmonized deposit guarantee schemes
EBA	European Banking Authority
ECB	European Central Bank
EIOPA	European Insurance and Occupational Pensions Authority
EMIR	European Market Infrastructure Regulation
ESMA	European Securities and Markets Authority
FASB	Financial Accounting Standards Board
FBO	Foreign Banking Organization
FDIC	Federal Deposit Insurance Corporation
FIO	Federal Insurance Office
FMRD	Financial Market Regulatory Dialogue
FSB	Financial Stability Board
FTC	Federal Trade Commission
FX	Foreign Exchange
G20	Group of Twenty
GAAP	Generally Accepted Accounting Principles
GDP	Gross Domestic Product
G-SIBs	Global Systemically Important Banks
HQLA	High-quality Liquid Assets
IAIS	International Association of Insurance Supervisors
IASB	International Accounting Standards Board
IFRS	International Financial Reporting Standards
IHC	Intermediate Holding Company
IOSCO	International Organization of Securities Commissions
IPO	Initial Public Offering
MAD	Market Abuse Directive
MiFID	Markets in Financial Instruments Directive
MiFIR	Markets in Financial Instruments Regulation
MSP	Major Swap Participants
MTF	Multilateral Trading Facility
NAIC	National Association of Insurance Commissioners
NFE	Nonfinancial Entities
OIA	Office of International Affairs
OTC	Over the counter
OTF	Organized Trading Facility
RMB	Renminbi
SD	Swap Dealer
SEF	Swap Execution Facility
SDR	Swap Data Repository
SEC	Securities Exchange Commission
SRM	Single Resolution Mechanism
SSM	Single Supervisory Mechanism
TBTF	Too Big to Fail

The Danger of Divergence: Transatlantic Financial Reform and the G20 Agenda

Transatlantic cooperation has never been more important for the regulation and oversight of the global financial system. As both the European Union and United States have pursued reform plans in the wake of the 2008 and euro-area financial crises, it has become clear that their domestic efforts must be coupled with cooperation from the other side of the Atlantic if they are to be effective. Because firms in the two jurisdictions regularly rely on one another for capital and investment opportunities, gaps and divergences in policy create scope for arbitrage that can undermine the soundness of national reforms as well as the safety of the global financial system. Divergent practices also create drags on the economy to the extent that they create inconsistent practices or requirements not only for the financial providers of capital, but for the businesses that use capital as well.

The call for cooperation has also grown stronger as it has become increasingly obvious that the transatlantic regulatory alliance is no longer the only game in what has become a truly global town. The crisis has significantly eroded both jurisdictions' share of global markets and activity. Moreover, the rest of the world is quickly catching up with the transatlantic authorities as sources of regulatory power and influence. Indeed, the facts speak for themselves:

- Today in 2013, three of the fifteen largest banks in the world are Chinese;
- Sixty percent of the world's IPOs are taking place in China and other emerging markets;
- The equity markets for the BRIC countries are already half the size of US equity markets;
- HSBC has estimated that by 2050, the seven largest emerging markets could be twice as large as the G7;
- And even with a slowdown, growth in emerging markets is still expected to remain at 5 percent, double that of the fastest-growing industrialized country, the United States. In China, the second-largest economy, growth will average well over 7 percent for the foreseeable future.

As transactions have moved to ever-more diverse parts of the world, so has regulatory influence. And in a world of more diffuse power and economic growth, closer coordination is necessary to send more consistent messages relating to best practices and the shared expectations of rising powers, as well as to coordinate engagement with increasingly important and active regulators in Asia and the global south.

Since the Atlantic Council's last report on this topic—*The Danger of Divergence*[1]—appeared in 2010, historic changes have occurred in the regulation of the global financial system. That report was written at a time when the G20 had only begun to articulate an agenda for better regulating global financial markets, and national

1 Douglas Elliott (rapporteur), *The Danger of Divergence: Transatlantic Cooperation on Financial Reform* (Atlantic Council and Thomson Reuters, 2010), http://www.atlanticcouncil.org/images/files/publication_pdfs/403/ACUS_TR_Danger_Divergence_Report.pdf.

regulators themselves had just started to initiate their own rulemaking and implementation processes. Since then, not only have international agenda- and standard-setters crafted a new and growing body of international financial regulations, standards, and principles, but national authorities have embarked on the often difficult task of translating these expectations into legally binding domestic rules.

In this process, the approaches taken by both the European Union and United States have, for the most part, been largely harmonious and remarkably consistent given the vastly different regulatory systems and infrastructures undergirding both market systems. In this report, however, we focus on some of the most important differences between EU and US authorities in key regulatory domains. This report is **not** intended to judge one approach as better or worse than the other. Nor is this report about the costs of regulation. Instead, we have sought to provide, in one unique and accessible report, an examination of the salient differences in EU and US regulatory approaches, and to highlight the costs of ***divergence*** from the standpoints of efficiency and financial stability. We also seek to identify productive paths forward for transatlantic economic cooperation and diplomacy.

The report's examination of the current state of US-EU cooperation on a range of financial regulatory issues brings to the fore a series of observations and conclusions, including:

- Regulatory divergence carries a variety of costs. Divergent practices create opportunities for regulatory arbitrage that can undermine the stability of the global financial system. Furthermore, where the European Union and United States diverge on regulatory approaches, they have been less successful in exporting regulatory approaches to emerging markets. Divergence can also create costs for firms, including end-users of financial services in the real economy, and thus slow the transatlantic economy.
- Process matters. The European Union and United States have vastly different administrative and political rule-making processes, which can have an impact on the timing and priorities involved in implementing international regulatory agendas. These differences can create dynamics that impede or undermine effective transatlantic cooperation.
- Although both the European Union and United States have mostly sought to undertake reforms aimed at increasing the amount and quality of capital that financial institutions must hold, the sharpest differences concern how banks should be structured and what kind of geographically based requirements on capital should exist. Transatlantic bank resolution remains far from operable and thus a distant goal.
- Both the European Union and the United States have adopted largely similar approaches and views toward derivatives regulation, as acknowledged in their July 2013 communique, the *Path Forward on Derivatives*. However, technical inconsistencies in the scope of the two regulatory regimes pose serious challenges, as do rules relating to trade reporting and business conduct. End-users of financial services, including industrial firms that rely on derivatives transactions to hedge against risk, face considerable uncertainties in today's evolving regulatory environment. Indeed, only the largest companies will have access to global markets, while smaller end-users will be limited to local providers.
- Despite nearly a decade's push to harmonize US generally accepted accounting principles (GAAP) with International Financial Reporting Standards (IFRS), and to internationalize IFRS through its adoption by the United States, supervisors of both regimes will likely remain unable to bridge differences in approaches in the near future. Although this divergence will complicate efforts to compare firms with key metrics, like the Basel III leverage ratio, it does present opportunities for much-needed consolidation among current IFRS jurisdictions, which are at the moment unevenly implementing accounting standards.
- Data protection, and the divergence in US and EU regulatory philosophy on this issue, is a

rapidly expanding concern in the transatlantic relationship. To the extent that variations in policy remain unresolved, key areas of transatlantic financial regulation, like trade reporting, could become more difficult to coordinate.

- Diversity defines not only the state of transatlantic regulatory coordination, but also global regulatory cooperation. Differences will arise in Asia, particularly with regards to those approaches adopted by the European Union and United States that depart from G20 norms. Given the increasing role Asian markets will play in the global financial system, this could create new challenges in global coordination.

In light of these circumstances, the time is clearly ripe for a major push to address global financial regulation. The United States and the European Union should reenergize their own bilateral efforts at regulatory coordination, focusing on synching rules and standards. Within the broader global context, the most important relationship remains the EU-US regulatory axis, and both jurisdictions should focus efforts on achieving deep consensus with one another. Though their global market share is diminishing (and with it their share of global regulatory influence), they still account for half of global gross domestic product (GDP), and their financial markets continue to provide the lion's share of liquidity for the global financial system. Furthermore, both jurisdictions are widely acknowledged to be the highest-quality markets for regulation, with the most experience and deepest expertise. Whatever their divergence around the edges, both are largely moving in step toward their implementation of G20 commitments. Going forward, however, it is increasingly likely that only when the United States and the European Union are able to act in unison will they be well-positioned to export their policy preferences.

At the same time, the growth of financial markets in Asia and elsewhere suggests that any efforts to regulate the global financial system must be poised to move quickly beyond the traditional money centers in Europe and the United States and engage a wider number of stakeholders in far-flung locales. Recent reforms in Asia indicate that this kind of engagement is most effective when attempted not only through cross-regional EU-ASEAN (The Association of South East Asian Nations) or US-ASEAN engagement but through established international forums like the G20 and FSB, where standards tend to have special weight and persuasiveness. Thus, we suggest that:

1) It is time for the G20 to re-engage in financial regulation at the top level. Since the Pittsburgh Summit, relatively little emphasis has been placed on market regulation and supervision. Instead, leaders have focused their energy on coordinating macroeconomic policy. In the current environment, however, heightened political involvement, especially on the issue of cross-border bank resolution, would be invaluable. Because of the focus on other issues, most of the work on agenda setting and implementation of international financial regulation has been left to the FSB, which was created by the G20 in 2009 to bring together major "international standard setting, regulatory, supervisory, and central bank bodies." From a technocratic standpoint, this is entirely understandable given the expertise and supervisory responsibilities of its membership. However, the FSB is at times ill-suited to coordinate policies where national interests diverge significantly or where agencies have vastly different policy preferences or starting points. Such work requires the high-level political mandate that only exists in the G20. More engagement by political leaders to "finish what they started" will be essential in pushing cooperation along as the difficult implementation process reaches its conclusion.

2) The United States and European Union must develop an expanded toolset for economic statecraft, not only to strengthen their bilateral cooperation but also—and crucially—to ensure that they can reach out effectively through the G20 as the global economy evolves. Those tools should be adapted to a new international context in which countries are no longer just encouraging others to reach existing standards, but are collectively committing to improving their regulatory standards together. These

new tools should include procedural and policy benchmarks for coordinating issue areas in a synchronized fashion while recognizing that equivalence must constitute the beginning, not the end, of a dynamic, reiterative coordination regime as new risks and challenges arise. Provisions should also be made for enhanced information sharing at critical points in administrative rulemaking processes. Together, these tools can provide the infrastructure for an "Economic NATO" worthy of the transatlantic alliance.

Synchronizing International and National Processes

If the United States and European Union are to work together to reaffirm and reinvigorate the G20 as "the premier forum for international cooperation on the most important issues of the global economic and financial agenda,"[2] there must also be a clear understanding of how this global process relates to the creation of national policy and rules. Working at the level of finance ministers and central bankers, the G20 crafts an overall agenda and works periodically with heads-of-state to articulate the global regulatory agenda. The more technical FSB then works to coordinate the agenda between its members, which includes all G20 and other "systemically important" countries, and sets priorities for international legal rulemaking.[3] It also has limited rulemaking authority to develop standards alongside standard-setting bodies.[4]

Once the G20 and FSB have established the international agenda, the focus moves to setting standards, and the many international bodies where national regulators from G20 countries (and others) meet with their counterparts to generate rules. Among the most important are: the Basel Committee on Banking Supervision, where authorities such as the Federal Reserve/ Federal Deposit Insurance Corporation (FDIC) and the European Central Bank (ECB) meet to discuss standards for deposit-taking institutions; the IOSCO, where securities regulators (including the SEC and the European Securities and Markets Authority (ESMA) hammer out rules for capital market participants; and the International Association of Insurance Supervisors (IAIS), where representatives from all fifty US states, the Federal Insurance Office (FIO), European Insurance and

2 *What Is the G20?*, http://www.g20.org/docs/about/about_G20.html (last visited on Aug. 28, 2013) (The main objectives of the G20 include coordinating between participating states "in order to achieve economic stability [and] sustainable growth;" "promoting financial regulations that reduce risks and prevent future financial crises;" and "modernizing international financial architecture."). See generally James R. Barth, Chris Brummer, Tong Li & Daniel E. Nolle, *Systemically Important Banks (SIBs) in the Post-crisis Era: "The" Global Response and Responses Around the Globe for 135 Countries*, Draft Working Paper (July 2013), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2294641.

3 See Financial Stability Board, *Mandate*, www.financialstabilityboard.org/about/mandate.htm (last visited on Aug. 28, 2013) (emphasis added).

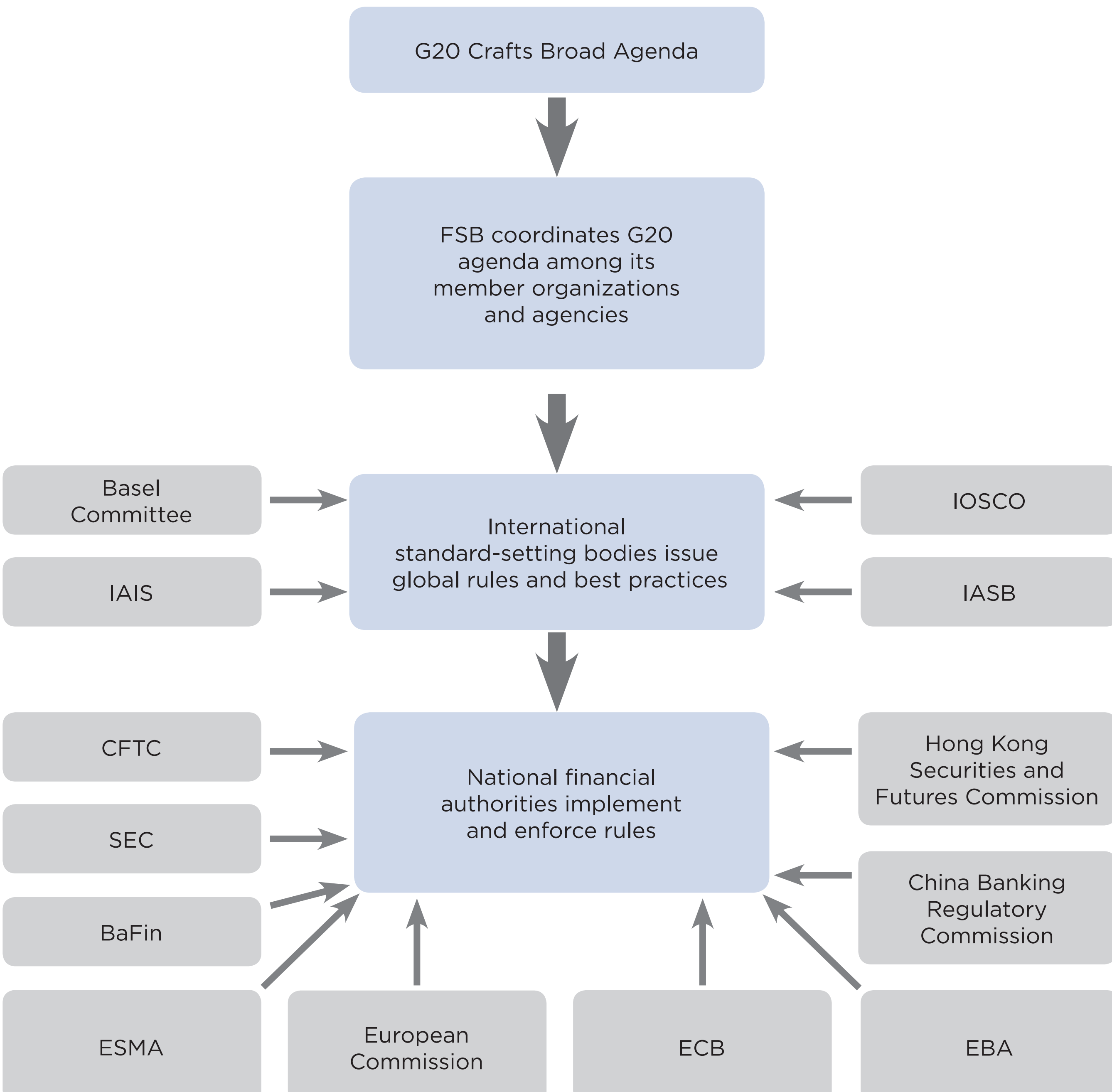
4 Financial Stability Board Charter, art. 2(3), http://www.financialstabilityboard.org/publications/r_090925d.pdf (last visited on Aug. 28, 2013). The FSB is also responsible for the production of *Key Standards for Sound Financial Systems*, a compendium of selected core principles and codes of good practices. See Fin. Stability Bd., *Key Standards for Sound Financial Systems*, www.financialstabilityboard.org/cos/key_standards.htm (last visited Aug. 28, 2013). The FSB is explicit about its authority in this area: "The list of key standards will be periodically reviewed and updated by the FSB." See ibid. See generally Barth et al., supra note 2.

Occupational Pensions Authority (EIOPA), and others develop standards for the insurance sector. Alongside these sectoral standard setters are other organizations with more focused mandates, such as accounting and payment systems.

After agendas and standards have been set, national representatives on the standard-setting bodies are expected to implement the standards. The degree to which they do so is then subject to limited forms of monitoring and surveillance by the World Bank, International Monetary Fund, and, increasingly, to peer-review processes that are themselves conducted "in-house" by the standard-setting bodies.

Importantly, the international standards produced by this regulatory process do not constitute "formal" international legal obligations and are by

The G20 Process



definition nonbinding.[5] International best practices and standards are generally considered to be very serious commitments, however. In some instances, noncompliance by a jurisdiction will negatively affect market participants who fail to comply, and also catalyze action by international regulators to sanction or publicly shame jurisdictions guilty of egregious acts of noncompliance. Thus, once international rules and best practices are promulgated, there are often strong incentives for national regulatory authorities to implement them. Still, because some key stakeholders—including legislators—do not participate in international negotiations, national parliaments do not always feel bound by the conclusions, and it is not unusual for divergence to appear in the process of national implementation.

Although the United States and European Union are often seen as the two leading regulatory superpowers, and—when compared to some other members of the G20—share similarly open market economies, their rule-making processes differ considerably. These differences can lead both the timetable and content of rules to diverge dramatically across the Atlantic, resulting in at times uncoordinated regulatory action, with consequences for transatlantic cooperation, both bilaterally as well as within organizations such as the G20. In the United States, once legislation is approved by Congress and the president, administrative agencies take on an important role as discrete entities charged with implementing the rules through adjudication, rulemaking, or other forms of administrative decision.[6] Federal courts routinely review the conduct and actions of agencies to ensure conformity with their statutory authority, national laws regarding the transparency of agency process and, where necessary, constitutional law more generally.

Historically, independent agencies in the United States have enjoyed considerable flexibility with regards to pursuing their mandates. Born of the New Deal, agencies like the SEC (and later the CFTC) were given the authority to act where necessary and with a wide range of tools—from licensing, to quasi-adjudicatory proceedings, to levying fines—to directly oversee markets and market participants in the service of the public interest. Although their powers are in theory confined to their mandates, these mandates have themselves often been quite vague, granting agencies considerable flexibility and discretion. Thus, the primary restraints have been procedural. To this end, the Administrative Procedure Act (APA) lays out a series of requirements that direct agency decision-making as well as establish the scope and availability of judicial review. Specifically, the APA outlines “notice and comment” requirements, whereby stakeholders and members of the public can comment on draft proposals circulated by agency officials, and administrative hearings. Together with the Freedom of Information Act (FOIA), these mechanisms are intended to enhance transparency and accountability by allowing stakeholder participation in a defined and transparent process, against which agency rulemaking can be evaluated and subject to judicial review.[7]

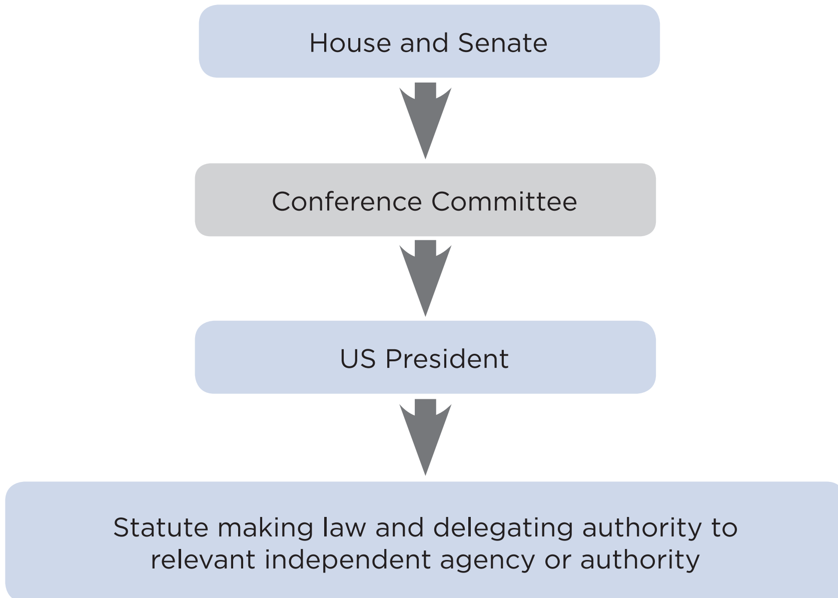
Because of the decentralized nature of this regulatory governance, there can be considerable variation between US agencies on substantive issues. For example, US regulatory agencies such as the CFTC and SEC have occasionally differed as to the extraterritorial effect of various provisions of the Dodd-Frank Act (DFA), even where their rules govern similar or economically identical transactions. Furthermore, independent agencies can and do break with executive agencies like the US Trade Representative—and even the US Treasury Department—on international

5 For a comprehensive study of this system, see Chris Brummer, *Soft Law and the Global Financial System* (Cambridge University Press, 2012). The current system additionally provides no basis for any formalized bilateral transatlantic relationship approximating other areas of transatlantic concern like security. *See* C. Boyden Gray, An Economic Nato: A New Alliance for a New Global Order, *available at* http://www.atlanticcouncil.org/images/files/publication_pdfs/403/tar130221economicnato.pdf

6 See generally Thomas O. McGarity, *Administrative Law as Bloodsport: Policy Erosion in a Highly Partisan Era*, 61 Duke L.J. 1671, 1673-75 (2012).

7 See ibid. at 1734-35 (citing Richard J. Pierce et al, Administrative Law and Practice §§ 7.2, 7.3.3, at 382-84, 390-92 (5th ed. 2009)).

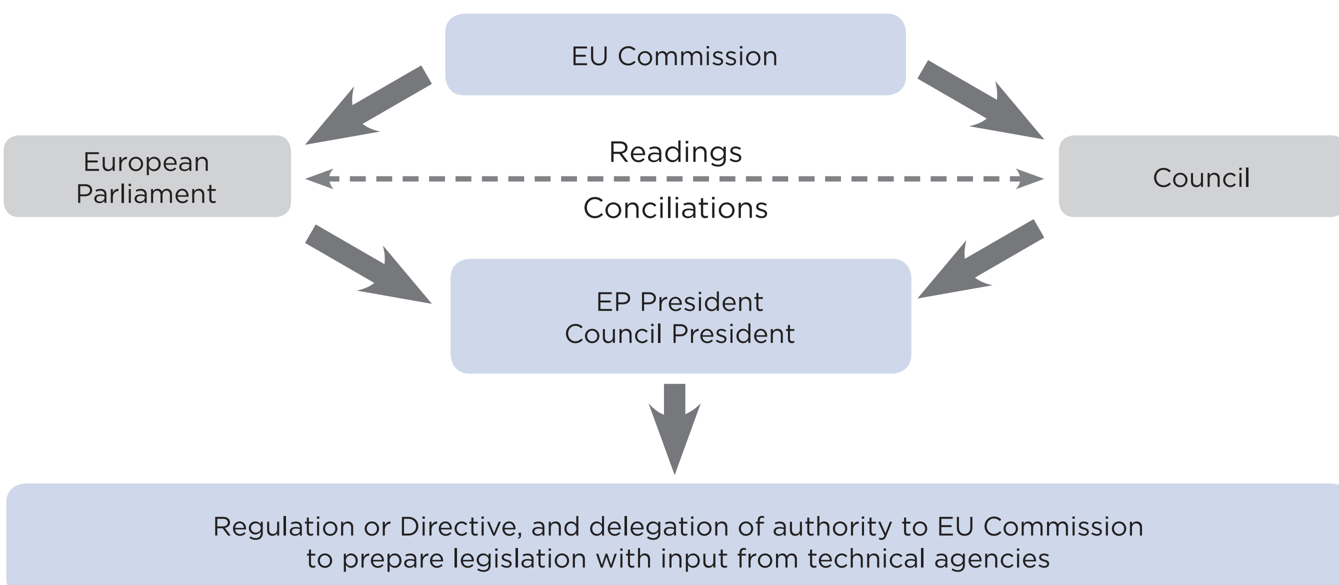
US Rulemaking Process



regulatory policy. This domestic "divergence" can, in turn, create challenges with regards to promoting a unified "US position" across a variety of different sectors.

Within the European Union, the legislative procedure requires consensus among three major institutions: The European Commission (representing the common interests of the European Union), the European Parliament (representing the citizens), and the Council of Ministers (representing the member states). In contrast to the United States, where the rulemaking process is structured so as to balance the interests of states and the federal government, EU rulemaking is designed to balance three sets

EU Rulemaking Process



of interests—the national interests of the member states, the federal or executive interests of the European Union, and the direct interests and priorities of the EU citizenry. Compared to most congressional action, the EU process is often much more prescriptive than the general process of "legislation + delegation" practiced in the United States. As a result, independent agencies, including the European Banking Authority (EBA) and ESMA, play comparatively more limited roles. They are not generally responsible for implementing the rules—which remains the province of national supervisors. This may in part be explained by the structure of the European Union, but also by the relative 'youth' of such agencies.[8] Either way, in the European Union it is clear that the Commission retains a major role in terms of regulatory policy, while agencies play a supporting role, providing technical expertise with little direct authority or, for that matter, any authority or power to offer exemptive relief from EU rules and regulations.

The Impact of Varying Implementation Processes

Given these different administrative practices and the varying roles of particular actors, significant divergence can develop. Widespread dissatisfaction with the credit rating agencies (CRAs) and banker compensation can—at times—drive the agenda of the European Parliament (and spur greater rulemaking in that domain), whereas in the United States, technocratic administrative agencies may be more concerned with preventing the collapse of large financial institutions, which leads them to focus their efforts on the recapitalization of banks. When one jurisdiction introduces regulation in a particular area while the other has not, it can create suspicion—and even expose a country to accusations of being less devoted or "softer" in the relevant area of financial regulation. Moreover, even when suspicion is low, time-lags and divergent practices can still frustrate bilateral cooperation.

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For example, authorities with high-quality regulatory regimes, such as the United States and the European Union, frequently rely on substituted compliance arrangements with one another, which allows market participants from one jurisdiction to operate in another as long as they comply with their (essentially equivalent) home country rules. Yet it is impossible for one jurisdiction to recognize another's regulatory regime as equivalent if the latter has not yet taken any commensurate action. If the United States and European Union are to cooperate more closely, the consequences of their divergent administrative practices should be recognized and acknowledged and, where possible, strategies should be put in place to overcome those differences.

Differences in US and EU administrative processes can also complicate information sharing, not only between each other's market participants and local regulators, but also between the regulators themselves. While administrative agencies and transatlantic decision-makers might be in constant contact with one another informally, opportunities for public assessments and input may be limited. For example, the European Union has an Impact Assessment Board that is supposed to ensure that stakeholder input, including that of foreign regulators, is properly considered.[9] However,

8 Yet in some instances, such as the regulation of credit rating agencies, ESMA gained authority as a direct regulator and supervisor. In the banking field, on account of the economic and financial crisis, direct supervision is also being lifted to the European level, where the ECB is becoming the direct supervisor and regulator of the larger banks in the European Union.

9 See European Commissions, *Commission Impact Assessment Guidelines*, SEC (2009) 92 final (Jan. 15, 2009), http://ec.europa.eu/governance/impact/commission_guidelines/commission_guidelines_en.htm.

there is no European APA to specify formal requirements and guidance on how regulators must address the comments they do receive. As a result, opportunities for stakeholders, interested parties, and foreign regulatory agencies to deliver their opinions on proposed rule changes are confusing and at times inconsistent. Moreover, even when opportunities for stakeholder engagement do arise, they occur at the front end of the regulatory process, and could be easily ignored as the Parliament and Council make changes based on nontransparent political considerations. This differs considerably from US practice, where notice-and-comment opportunities can arise not only at the proposal stage but also during the drafting of various regulatory reforms and proposals.

Transatlantic differences have arisen not only as a matter of administrative process, but also as a result of substantive policy choices—even where jurisdictions agree in principle on broad strategic objectives. Since the beginning of the financial crisis, the United States and the European Union have taken the lead in the G20—and bilaterally—to agree on the need for stronger banking regulation, more transparency on derivatives, and the harmonization of accounting practices. But they have disagreed in some important areas, especially as they begin to implement many new regulations. The most important outstanding issues include: implementation of Basel III; reform of banking structure and resolution; reform of the over-the-counter (OTC) derivatives market and such reform's impact on end-users; and data privacy.

Basel III

During the financial crisis, many of the world's largest banks teetered from poor investments, and in the process ushered in a decade of low economic growth. In order to prevent future crises, G20 leaders committed in 2009 and 2010 not only to increase the amount of capital a bank would have to hold when making loans to cover credit risks (e.g., default), but also to improve the quality of the capital they hold. The focal point of EU and US financial reform has been the implementation of the Basel III Accord, a set of rules promulgated by banking authorities at the Basel Committee on Banking Supervision (Basel Committee), which updated earlier international banking agreements (commonly referred to as the Basel I and Basel II Accords).[10] For the most part, both jurisdictions have adhered closely to the pact, although some differences have arisen with regards to capital, and important decisions are still to be made in the European Union with regards to leverage.

The New Capital Regime

Bank capital is the first (and at times last) line of defense against bank defaults. To the extent to which a bank (or any financial institution) can draw on its own capital reserves in the face of bad loans, or withdrawals of deposits from depositors, it is able to position itself as a sturdier financial institution. To that end, banking regulators have worked consistently since 1988 to create and update a framework for enhancing bank capital.

Banking regulators have consistently relied on a ratio-based system, under which lenders are required to hold a certain amount of total capital (often cash or equity) relative to their assets (e.g., loans) in order to demonstrate that they are adequately capitalized. The difference between this ratio and the standard solvency ratio used in industry is that the Basel Accord weighs both the quality of cash and the risk of the assets, and requires that the amount of the former divided by the latter must meet a basic 8 percent threshold.[11] The General Risk-Based Capital Requirement, as such, can be understood as follows:

$$\frac{\text{Total Capital}}{\text{Risk Weighted Assets}} > 8\%$$

Total capital is divided into two broad categories, "Tier I capital" and "Tier II capital" *(Basel III, Part I)*:

- Broadly speaking, Tier I capital is capital that is available to absorb losses on a "going-concern" basis, or, as commentators have described

10 See Basel Committee on Banking Supervision, Basel III: A Global Regulatory Framework for More Resilient Banks and Banking Systems (Dec. 2010), http://www.bis.org/publ/bcbs189_dec2010.pdf.

11 Ibid.

elsewhere, capital that can be depleted without placing the bank into insolvency, administration, or liquidation.

- Tier II capital is capital that can absorb losses on a "gone-concern" basis, or capital that absorbs losses in insolvency prior to depositors losing any money. It is thus of lower quality than Tier I capital.[12]

Meanwhile, the risk weighting of assets can be done via ratings or internal risk weightings that are subject to varying degrees of oversight by local supervisors.

In addition to the capital ratio, which in its basic form has been in existence since 1988, Basel III requires the amount of common equity (a subset of Tier 1 capital) relative to risk weighted assets to increase from what was 2 percent under Basel I and Basel II to 4.5 percent *(Basel III, Part I)*. To meet this standard, banks might have to issue more stock and use the proceeds to build up their equity cushions. In addition, the minimum amount of total Tier I capital that must be held by banks will increase gradually over a two-year period starting January 2013 from 4 percent under the old Basel Accords to 6 percent[13] *(Basel III, Part I)*.

As a further innovation, Basel III has introduced a "capital conservation buffer," which requires an additional 2.5 percent of Tier I capital to be held over and above the absolute minimum requirements *(Basel III, Part III)*. The idea is that the funds must be available in times of stress; thus, if the buffer is breached, a bank would be constrained in its ability to pay dividends or, potentially, to allocate bonuses.

Finally, another distinct "counter-cyclical" buffer has been introduced to help provide macroprudential oversight to the sector *(Basel III, Part IV)*. The intention here is that where growth in lending among banks in a particular jurisdiction outstrips GDP growth such that it may be contributing to an asset bubble or systemic risk, an additional buffer or set of restrictions can be imposed. The size of the additional charge can range from between 0 to 2.5 percent of a bank's risk-weighted assets, and will be determined by national banking authorities after examining the size and extent of credit growth and potential financial instability. This buffer, along with a capital conservation buffer, is to be phased in from 2016 to 2019.

New Leverage and Liquidity Regimes

Along with improving the amount and quality of capital held by banks, the Basel Committee has moved to limit the amount of leverage, or debt, that banks would be permitted to hold. The logic behind the limits is that risk weightings are not always accurate. As a result, a more blunt limitation must be imposed on banks in order to curb the amount of risk that their activities may engender. Toward this end, the Basel Committee has introduced a new non-risk-weighted leverage ratio of 3 percent to prevent banks from accumulating excessive on- and off-balance sheet leverage. Thus, under this provision, banks would be prevented from being more than 33 times leveraged *(Basel III, Part V)*.

The Basel Committee has also introduced global liquidity standards for the capital held by banks. These standards were conceived to help ensure that banks have sufficiently liquid assets on their books such that they could survive market disruptions that generate extreme or acute risk-aversion. The original proposal required little more than central bank reserves and government bonds to be counted as liquid assets. The new rule expands the range of eligible assets by creating new categories of

12 Clayton Utz, *Overview of Basel III – Minimum Capital Requirements and Global Liquidity Standards* (Jan. 17, 2011), http://www.claytonutz.com/publications/news/201101/17/overview_of_basel_iii-minimum_capital_requirements_and_global_liquidity_standards.page.

13 Ibid.

assets.[14] Concerns about the ability of banks to attain sufficiently liquid assets resulted in reforms of the reform, and Basel III enumerates a larger range of eligible assets that can be used as buffers, including equities and securitized mortgage debt.

US Implementation of Basel III

At the time of our first report, the extent to which national jurisdictions would implement Basel III remained to be seen. In the United States, implementation of earlier generation reforms had been slow. Most US banking institutions operated under the old Basel I capital system, and had delayed implementing Basel II and later agreements, which focused on credit and market risk. However, after issuing three initial proposals in 2012, US banking authorities laid out finalized Basel III rules in July 2013 that will require US banks to increase the amount and quality of capital used to finance their operations. Under the new rules, US banks will have to maintain common equity equal to at least 7 percent of risk-adjusted assets (as well as meet a new 4.5 percent capital ratio for Tier 1 common equity plus a 2.5 percent capital conservation buffer). Meanwhile, an additional common equity surcharge will apply on top of these rules for the eight US bank holding companies that have been identified by the FSB as being global systemically important banks (G-SIBs). US rules have also imposed countercyclical buffers (along the lines of Basel III) that range from 0 percent to 2.5 percent of risk-weighted assets.

Importantly, under new leverage ratio rules, banks will also have to hold capital relative to their Tier 1 assets, with the biggest banks certain to be subject to rules stricter than even the Basel III approach. Under proposals introduced by the Federal Reserve, all banking organizations will be subject to a leverage ratio of 4 percent; in 2018, larger banking organizations will be subject to a minimum supplementary leverage ratio of 3 percent. US officials have additionally suggested that other measures might be introduced, including requirements geared toward compelling banks to hold a minimum amount of equity and long-term debt to help authorities dismantle failing lenders. In that way, stronger leverage requirements would help prevent the downfall of organizations like Lehman Brothers and Bear Stearns, which had assets to equity ratios of more than 30 to 1.

The US approach to liquidity also mirrors Basel III. Under proposals that are as of this writing still subject to comment from the public, on every day of operation large banks will have to calculate their projected liquidity inflows and outflows for the following 30 days, and then determine therefrom the extent to which projected outflows exceed projected inflows. Based on these calculations, banks will have to cover the projected net outflow, subject to a minimum amount of 25 percent of total outflows, by maintaining statutorily defined liquid securities, or "high-quality liquid assets" (HQLA). Importantly, the Fed proposals would require banks to hold enough HQLA to meet the most severe conditions that could arise within 30 days, whereas Basel III only requires sufficiently liquid assets by the 30th day of a stress event. Furthermore, the proposals call for full compliance by 2017, two full years ahead of the 2019 deadline called for in Basel III.

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14 Bank of International Settlements, *Basel III: The Liquidity Coverage Ratio and Liquidity Risk Monitoring Tools* (Jan. 2013), http://www.bis.org/publ/bcbs238.htm; see also David Rowe, *LCR Changes Result from Regulatory High-wire Act*, Risk.net (Jan. 29, 2013), http://www.risk.net/risk-magazine/opinion/2237935/lcr-changes-result-from-regulatory-highwire-act. It defines three categories of assets: level 1, level 2A and level 2B. Level 1 assets are essentially cash and official obligations assigned a zero risk weight in the Basel II standardized approach. Level 2A and 2B assets may include lower-grade official obligations, corporate bonds rated as low as BBB– subject to different haircuts depending on their credit ratings, simple residential mortgage-backed securities rated AA or better (excluding structured products), and even certain equities subject to a 50 percent haircut. Other provisions deal with the added risk of exchange rate fluctuations for liquid assets that are not denominated in the bank's home currency. The terms for calculating the potential net cash outflow were also eased. For so-called stable deposits, specific jurisdictions can lower the 30-day run-off assumption from 5 percent to 3 percent, provided that the national deposit insurance program meets certain requirements and historical evidence can demonstrate a 30-day run-off of less than 3 percent under past periods consistent with the conditions specified in the LCR. Less stable deposits are subject to 30-day run-off assumptions of 10 percent or higher as determined by national supervisors. Finally, implementation is to be phased in, starting with 60 percent of the full requirement in 2015, and rising to 100 percent in 2019.

Finally, in a set of rules unfinished as of October 2013, the Federal Reserve has envisioned regulations that would apply US capital-, liquidity-, and other Dodd-Frank-enhanced prudential standards to the US operations of foreign banking organizations (FBOs) with total global consolidated assets of $50 billion or more and $10 billion or more in total US assets. Under the proposal introduced by Governor Daniel Tarullo in November 2012, FBOs would have to create a US-based intermediate holding company (IHC) for all US bank and nonbank subsidiaries (excluding US branches). IHCs would be subject to enhanced US capital-, liquidity-, and other prudential requirements for all US operations. Smaller organizations with assets of less than $10 billion would be exempt. Branches not part of the IHC would still be subject to liquidity requirements, single counterparty credit limits and, in certain circumstances, asset maintenance requirements.[15]

The argument for IHCs is straightforward. With capital and liquidity regulated at the global level, there is always the possibility that the resources available at the parent level might not be enough to support local entities. Plus, in the absence of mature cross-border resolution mechanisms, the failure of a bank's affiliates abroad can undermine the stability and balance sheet of local firms. This was the case with the insurer AIG, where credit default swaps (CDSs) written in London brought down the United States-based conglomerate. By creating national-level subsidiaries, it is hoped that institutions will be less likely to fail, since material US operations would be better capitalized. Furthermore, the failure of an overseas financial institution would make it less likely that the fallout would ultimately affect US financial markets. FBO rules thus offer not only an extra layer of prudential protection, but also a means of insulating US financial markets from turbulence abroad.

15 For a full report, see Davis Polk, *Dodd-Frank Enhanced Prudential Standards for Foreign Banking Organizations* (Dec. 17, 2012), http://www.davispolk.com/sites/default/files/files/Publication/c891fe48-d955-4c0f-af87-bf845002fa4b/Presentation/PublicationAttachment/7cacd6fa-f6e6-4c4b-8a2c-38b13fd7eabf/121712_Prudential.pdf.

EU Implementation of Basel III

Europe, too, has moved forward considerably since our last report on implementing Basel III. At that time, the European capital framework was directed by Capital Requirements Directive (CRD) I, which implemented Basel II, and two additional directives that focused on, among other things, credit and market risk (though they did not change or add additional capital ratios).

On April 16, 2013, the European Parliament approved the package of legislation—a new Capital Requirements Regulation and a Capital Requirements Directive—which together are commonly referred to as CRD IV. Unlike the previous legislative framework, CRD IV will have a more immediate effect on member states insofar as the Capital Requirements Regulation will be directly applicable to member states and will not require implementation by national authorities. Furthermore, the EBA will be empowered to develop and publish technical standards elaborating the capital charges included in CRD IV.

CRD IV adheres for the most part to Basel III, though there are some differences. Its scope is broader than that contemplated under Basel III (or US regulations) and applies to banks as well as EU "investment firms"—including some broker dealers. But unlike Basel III, which defines common equity Tier 1 capital rather strictly as either retained earnings or common shares, the European Union has adopted a broader—and more flexible—principles-based approach. In practice, some commentators have argued that some European banks will be able to count so-called "silent participations," a form of debt with some characteristics of equity, as the highest quality of capital. Furthermore, Basel III requires banks to deduct significant investments in unconsolidated financial entities, including insurance entities, from common equity Tier 1 capital. CRD IV, however, provides for an alternative treatment, allowing consolidation of banking and insurance entities in a group. At the same time, however, the European Union goes much further than the United States and specifically addresses the issue of banker compensation, fixing bankers' bonuses as a ratio to their salary of 1:1, or, with shareholder approval, to 2:1.

Although the capital charges are to be gradually phased in between now and 2019, many EU banks have already published "fully loaded" Basel III capital ratios alongside their first-quarter results, reflecting the market pressure on lenders to comply early with the new regulations.[16] However, the overall recapitalization of banks in Europe has been slower than in the United States because of stronger US economic growth and earlier intervention by the Federal Reserve to bolster the balance sheet of fragile banks. As a result, Europe has lagged the United States with regards to the operationalization of the Basel III capital ratios. That said, the ECB is actively formulating plans for reviewing the asset quality of regional banks as well as recapitalizing them as part of Europe's transition to a banking union (discussed below).[17]

The European Union moved faster than the United States in first mandating a Basel-based liquidity regime through its Capital Requirements Regulation, though there are as of yet no harmonized EU requirements regarding liquidity for EU banks. Instead, member states are free to implement measures as they deem appropriate until the EBA, in conjunction with the Commission, promulgates EU-wide rules. As of yet, there is no indication yet as to whether or not new EU rules will exceed the Basel minimums in the ways in which the Federal Reserve has recently proposed, though harmonization is mandated by 2015.

The European Union has also not specified what kind of leverage regime it will ultimately adopt, though harmonization is expected under the Capital Requirements Regulation by 2018. Until then, member states are free to implement measures they deem appropriate. There are, however, several reasons why the process may be slow. Leverage ratios may penalize EU banks insofar as they use IFRS and not US GAAP, which may make them appear more highly leveraged than they actually are (discussed below). Furthermore, there has been considerable concern that leverage ratios can be gamed, and they arguably penalize low risk and economically productive activities such as AAA mortgage lending and trade finance. Consequently, the European Union has preferred other routes to impact leverage-related behavior, such as comparatively tougher stances than the United States on banker bonuses, credit rating agencies, and a financial transaction tax.

Finally, the European Union has also refrained, for the moment, from introducing regulations for FBOs. The reasons are both prudential and economic. First, leaders at both the EU- and the member state level have noted that an FBO model could increase systemic risk by interfering with the ability of a bank to allocate capital and liquidity in the manner it determines most efficient or, more importantly, to respond to crisis or financial turbulence. In short, liquidity and capital needs may not be necessary in Europe (or any other single jurisdiction, including the United States) when a firm encounters financial stress. Locking down capital at a regional level could consequently prevent a bank from responding to far-flung economic turbulence and deploying its capital to shore up the position of a subsidiary. This could in turn damage its own balance sheet and financial health, and possibly exacerbate the fallout from a stress-event.

Meanwhile, from an economic perspective, skeptics in both the European Union and the United States argue that an IHC requirement might impose compliance costs that could hamper growth. FBO rules are not "extraterritorial" in the sense that they apply largely national rules to foreign banks. But they would almost certainly require banks to restructure their operations to meet not only higher Basel III requirements at the consolidated (international) level but also likely stiffer capital charges at the (local/regional) entity level. These costs could potentially lead foreign financial institutions, especially mid-sized firms with modest balance sheets, to reduce their

16 On April 30, Deutsche Bank's share price jumped 6 percent the day it unveiled its cash call, *despite the 10 percent dilution for shareholders*. See James Wilson & Daniel Schäfer, "Cash Call Helps Shore up Deutsche Bank's Balance Sheet," *Financial Times* (Apr. 30, 2013), http://www.ft.com/intl/cms/s/0/83be1a82-b1a4-11e2-b324-00144feabdc0.html#axzz2dInujB56.

17 Ibid.

international operations or scrap international expansion plans. And this in turn might negatively influence the availability of credit. Fewer loans would likely be extended, and there would be less competition among banks for customers, thus pushing up interest rates.

At this point, the biggest risk of divergence in capital supervision is not so much arbitrage as it is a potential unraveling in international cooperation.

Consequences of Divergent Banking Approaches

Differences in banking regulation can generate opportunities for regulatory arbitrage, in which financial services providers routinely reroute operations to jurisdictions with fewer restrictions in order to save costs, thereby potentially concentrating risky activities. In the United States, such risks are minimized, at least to the extent that geographically based requirements like FBO regulations are implemented. Yet differences in policy at the margins could incentivize providers to restructure operations in ways yet to be anticipated. To the extent that future policies in Europe adopt lighter leverage and liquidity standards, EU banks could end up being more competitive from the standpoint of regulatory cost, although heightened regulations on banker compensation and a financial transaction tax could provide disincentives for such arbitrage.

At this point, however, the biggest risk of divergence in capital supervision is not so much arbitrage as it is a potential unraveling in international cooperation. The FBO proposal has the laudable objective of preventing a disorderly collapse of a foreign institution in the United States. Indeed, if the Fed gets its rules "right," the risk of a foreign bank failure undermining the US economy could be significantly reduced (just as "wrong" policy choices could impose undue costs and unduly hamper the provision of credit and economic growth). But by taking aim at foreign banks in particular, even while applying national treatment and treating them like US institutions, the proposal would likely prompt international policymakers to introduce similar requirements for US banks that operate in their jurisdictions. Indeed, the European Commission has already warned that acts of US unilateralism could be met with like responses by the European Union. In addition, other jurisdictions in Asia are considering whether to introduce similar measures, which would raise the costs of doing business for foreign competitors. This proposal could spur "domino" ring-fencing throughout foreign jurisdictions, a move motivated by a mixture of prudential concerns and political retaliation.

Some commentators like Margaret Tahyar have also noted that an FBO regulatory regime could complicate the emergence of a cross-border resolution regime, a topic we return to below. By design, an FBO regime increases the number of independent, geographically based subsidiaries operating within a global banking group. The idea is to provide a capital buffer for local operations of banks. However, such an approach would mean that failure of a substantial portion of entities within a banking group would implicate a likely larger number of insolvency regimes managing any restructuring than is now already the case. With more subsidiaries, resolution would necessarily become subject to even more insolvency laws and local decisions, and risk greater fragmentation. Such a world of multiplying decision-makers is in sharp contrast to the international goal of a single global resolution mechanism administered by a parent company's home country resolution authority.

Banking Structure and Resolution

For many financial authorities, price-based regulations alone do not go far enough to address problems like the too-big-to-fail (TBTF) challenge. As a result, in the United States, the European Union, and the United Kingdom, experts have proposed a variety of structural measures aimed either at reducing the size or restructuring the operations of financial institutions in ways that minimize systemic risk. Many of these proposals are intended to enhance or promote the capital-, liquidity-, and leverage–based approaches highlighted in the previous section.

US Regulation of Banking Structure

The US approach is embodied in the Volcker Rule, which prevents banks from engaging in proprietary trading in securities, including short-term derivative instruments *(DFA, section 619)*. Accordingly, banking institutions have to "push out" their swaps activity to a separately capitalized entity *(DFA, section 716)*. Related to this, the DFA limits federal assistance in the form of emergency liquidity to institutions that act as swaps counterparties.

Under the Volcker Rule, large and complex financial institutions would effectively be restructured and broken up in ways intended to limit risk-taking that is considered to be at odds with such activities as deposit taking and wholesale banking. Specifically, it prevents banks from engaging in proprietary trading in securities, including short-term derivative instruments, and mandates that proprietary trading and private equity fund investments be separated from traditional banking *(DFA, section 619)*. These activities would be spun off into separate legal entities, and would not be permitted to operate under the same structure as the core deposit-taking institution *(DFA, section 716)*.

Through these prohibitions, the Volcker Rule has been described as a modern-day version of the Glass-Steagall Act, which separated deposit-taking from investment banking from 1933 to 1999. It is also seen as one potentially effective means of addressing the TBTF problem that arises where banks become so large they must be rescued using taxpayer money. Its implementation, however, has been fraught with difficulty, particularly regarding the distinguishing of proprietary trading and hedging, a topic examined below.

Along with the Volcker Rule, banking officials have attempted to institute resolution plans to facilitate the orderly unwinding of banks in ways that do not require taxpayer money. Specifically, the DFA operationalizes commitments made at the G20—later elaborated at the FSB—to require financial institutions to set out recovery- and resolution planning in advance. It tasks firms with articulating prospectively how they would be unwound after a collapse, and gives the FDIC authority to resolve complex financial institutions. The FDIC is also increasing its efforts to establish cross-border agreements with jurisdictions that host big banks, such as the United Kingdom, Switzerland, and Japan, thereby specifying procedures as to how failing multinational banks could be closed down quickly if needed. As a key part of those efforts, officials are stressing the need for sufficiently high amounts of bail-in capital to support the recapitalization of a bank and avoid the need for a bailout with public funds. Regulators are also considering ways to structure banks that will facilitate the resolution and continuation of critical banking services for customers and counterparties.

The "First Generation" of EU Proposals

Meanwhile in Europe, efforts have centered on approaches that, though less intrusive from a structural standpoint, stop short of the prohibitions envisioned under US reforms. For the most part, efforts have focused on the so-called "ring fencing" of risky activities by banks. In 2012, the Governor of the Bank of Finland, Erkki Liikanen, proposed a series of reforms for the European Union that, while not separating investment from retail banking, would restructure banks and charge them for their trading activities.[18] Specifically, proprietary trading and other significant trading activities would be hived off into separate legal entities. Any such new entity would be part of the same overall banking group, thus preserving the European model of universal banking, though it would be required to hold its own capital.

As a fully independent legal entity, a proprietary trading subsidiary would not be able to rely on the capitalization of its parent or the insurance policies available to traditional deposit-taking commercial banks. It would rise or fall on the strength of its own balance sheet and trading book. As a result, governments would not have to step in to safeguard bank deposits if a bank's asset managers made disastrous trades. Its failure would be buffered, or at least insulated, in terms of capital. Ring fencing would not, however, be absolute. As under the Volcker rule, hedging activities undertaken for clients would receive special treatment, and remain part of the retail bank. Still, as with the Volcker Rule, defining the difference between hedging and trading on the bank's own account will likely prove extraordinarily difficult.

The Liikanen proposal also suggested that banks be required to determine in advance how they could fail without undermining the rest of the European financial architecture. As part of this effort, banks should explicitly designate a category of debt subject to "bail-in," thereby bolstering the cushion of capital while giving bondholders more certainty about their exposure in the event of bank failure. Top management, similarly, would carry clear responsibility in the event of a bank failure, in theory to incentivize them to serve the long-term interests of the business instead of focusing on their bonus.

Transatlantic approaches to banking structure and resolution are still developing. While the US approach is embodied around the Volcker Rule, which is envisioned to prevent banks from engaging in proprietary trading in securities, the European Union's evolving system of banking structure and resolution reform is less prohibitive than the United States' in addressing TBTF institutions in the way the US reforms have. Also, both jurisdictions appear to be adopting different standards and approaches with regard to the regulation of FBOs, which will likely complicate transatlantic cooperation.

A similar, albeit less concrete, approach was embraced in the Vickers Report, which advocated that UK retail banks should also be subject to ring-fencing. Ring-fenced entities would be subject to an additional 3 percent of equity on top of the 7 percent minimum mandated by Basel III. The UK's largest banks would be required to sustain a 17 percent level of primary loss absorbency capacity.[19] The following chart summarizes some of the additional differences between the three regimes:

18 "Final Report of the High-Level Expert Group on Reforming the Structure of the EU Banking Sector" (Oct. 2, 2012), http://ec.europa.eu/internal_market/bank/docs/high-level_expert_group/report_en.pdf.

19 José Viñals et al., "Creating a Safer Financial System: Will the Volcker, Vickers, and Liikanen Structural Measures Help?" at 15 (2013), http://www.imf.org/external/pubs/ft/sdn/2013/sdn1304.pdf.

Comparing the Structural Reform Proposals *(Source: IMF[20])*

	Liikanen group report	United Kingdom	United States
Holding company with banking and trading subsidiaries	Permitted	Permitted	Not permitted
Deposit-taking institution dealing as principal in securities and derivatives (i.e., proprietary trading)	Not permitted (but other group companies may do so)	Not permitted (but other group companies may do so)	Not permitted (see Note)
Deposit-taking institution investing in hedge funds and private equity	Not permitted (but other group companies may do so)	Not permitted (but other group companies may do so)	Not permitted
Deposit-taking institution providing market-making services	Not permitted (but other group companies may do so)	Not permitted (but other group companies may do so)	Permitted
Higher-loss absorbency rule	Yes, via leverage ratio for trading business that exceeds size threshold	Yes, as add-ons to the conservation buffer for UK ring-fenced bank	Yes, via higher leverage ratio and IHCs
Size threshold for application	Yes; applies to all banks with trading books larger than €100 billion, or trading assets more than 15-25 percent of balance-sheet	Yes; applies to all banks and building societies with deposits greater than £25 billion	No
Enacted into law	No	Scheduled for completion by 2015	Yes
Implementing regulations finalized	No	No	No

Note: US federal government and agency securities, debt and securities issued by US state and municipal governments and government-sponsored enterprises, and derivatives on these securities are exempt from proprietary trading restrictions of the Volcker Rule.

The EU's "Second Generation" Reform Platform under the Banking Union

In Europe, the reform-writing process did not end with either Liikanen or Vickers. The euro-area crisis has spurred an additional round of deep structural reforms aimed at addressing the too-big-to-fail problem, as well as the challenges of maintaining a monetary union in the absence of a centrally regulated financial system. As in the United States, low interest rates and weak supervision helped fuel an excessive build-up of credit in the banking system of some smaller euro-area countries, which also had persistent fiscal deficits and historic levels of sovereign debt. And as in the United States, bailouts were required—of sovereign governments as well as of banks. In the wake of the crisis, EU leaders decided that a European-wide banking regulator was needed to prevent future crises, and, if necessary, provide the necessary funding for teetering banks so as to break the negative feedback loop between bank failures and sovereign debt crises.

Under a set of proposals that are still very much under consideration, plans have been launched to centralize key activities of bank resolution and supervision for euro-area countries. The current plan consists of three pillars:

1) Single Supervisory Mechanism (SSM)
2) Single Resolution Mechanism (SRM)
3) Harmonized Deposit Guarantee Schemes (DGS)

The first step toward a banking union is the SSM, an institutional framework for addressing market dynamics and frailties that can contribute to systemic risk across the euro-area and undermine

20 Ibid.

the continent's financial systems. The SSM, which will be operational by the end of 2014 and housed at the ECB, will promote a common set of rules for large euro-area financial institutions, and take primary supervisory authority over the roughly 100 banks within its jurisdiction. While the UK's financial system would not immediately be subject to the SSM (though it would continue to be subject to any EU legislation), certain non-UK banks operating in the UK would be affected by it. Moreover, the banking union is at least technically open to member states outside of the euro-area seeking deeper financial integration.

The second important pillar is the SRM, aimed at achieving the orderly unwinding of nonviable banks such that this process does not require taxpayer money or, at the very least, minimizes that need. Proposals have been made for a broad "framework" for harmonizing the powers of national regulators to step in when a bank is in trouble, create a special insolvency regime for banks, and impose "bail-in" debt to avoid or reduce the need to use taxpayers' money to bail out banks. Meanwhile, the Commission has proposed an SRM for the banking union, which would apply more prescriptive rules and establish a 300-person resolution agency for the member banks. That proposal must still be approved by member states and the European Parliament before it can become effective, and is expected to be met with opposition, particularly from Germany.

The third pillar would provide a common deposit scheme for all euro-area banks, or at least for those banks subject to supervision within the new banking union. In this way, the new EU entity would presumably resemble the FDIC in the United States.

What effect these changes in oversight will have on individual national regulatory approaches still remains unclear. In theory, the SSM's activities will be undergirded by a "single rulebook" administered by the EBA. Regulators in the euro-area will have harmonized prudential standards and practices, including Basel III capital charges. These harmonized practices could spur further regulatory consolidation throughout the European Union. For this to happen, a range of important decisions and assumptions may have to be revisited. For example, ring-fencing proposals generated under Liikanen might have to be revisited, since a bank that previously constituted 100 percent (or more) of a country's GDP would—under a pan-European scheme—perhaps constitute only 10-20 percent of the entire EU's GDP. Moreover, EU member states themselves will have to decide how the necessary financial backstop for cross-border resolution and deposit regimes will operate and be funded—and how the banking union would operate with the national and bilateral ringfencing regimes under consideration in Germany and France.

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The Next Frontier in Capital Standards? A (Brief) Look at Reinsurance

Capital is not only a question confronting banking regulators: it has also been an issue in insurance and reinsurance (the providers of insurance products for insurance firms). Insurance companies play an important role as shock absorbers when extremely adverse events strike their policyholders. Thus, they must be adequately capitalized in order to provide countercyclical assistance in times of crisis.

The regulatory infrastructure for insurance varies considerably between the European Union and the United States. Both insurance and reinsurance firms are supervised at the member state level in the European Union, principally on the basis of legally binding EU insurance and reinsurance directives. In the United States, however, neither insurance nor reinsurance is regulated at the federal level. The Federal Insurance Office, established by the DFA, is tasked with certain specific duties, such as representing the United States at IAIS, but it has no direct regulatory authority. Instead, insurance is regulated by each of the 50 states and the District of Columbia. Specifically, state insurance regulators set standards via the National Association of Insurance Commissioners (NAIC), including drafting model laws and regulations, developing guidance for regulators, and establishing reporting requirements, all of which are aimed at creating uniformity. Importantly, the NAIC's model laws and regulations have no effect until they are enacted or implemented at the state level. States that implement the NAIC's model laws and regulations are NAIC-accredited. However, states may deviate from the NAIC's standards and remain accredited provided that the deviation is considered a more conservative standard.

In recent years, there has been a fundamental overhaul of EU insurance and reinsurance rules via the adoption of the Solvency II Framework Directive. This directive covers all aspects of supervision, including quantitative, qualitative, and reporting requirements with which EU insurers and reinsurers will have to comply. EU regulators are currently discussing what further changes need to be made to the proposed regime to ensure the appropriate treatment of long-term insurance products. Once the nature of these changes have been agreed upon, detailed implementing measures will be needed, measures that have not yet been formally proposed by the European Commission. The Solvency II regime is currently expected to come into force in 2016, though it could be delayed.

A far-reaching review of insurance and reinsurance supervisory rules is also being undertaken in the United States by the NAIC via its Solvency Modernization Initiative (initiated in 2008). Aimed at updating the US insurance solvency regulatory framework, it has principally focused on capital requirements, governance and risk management, group supervision, statutory and financial accounting, and reinsurance.

At this point in time, EU-US cooperation remains in its infancy. In January 2012, the EU-US Insurance Dialogue Project was launched between EU and US regulators "with the objective of enhancing understanding and co-operation for the benefit of insurance consumers, business opportunity and effective supervision." This project has subsequently identified several areas in which US and EU regulatory approaches diverge on capital requirements. More recently, however, the FSB has taken steps to identify some insurance companies as systemically important, so the prospect of a more unified approach to capital and leverage requirements for these firms has become more likely.

The two sectors differ considerably in their treatment of foreign reinsurers. Until the NAIC's model regulations were revised in 2011, insurers were required to post collateral supporting 100 percent of the liabilities assumed if reinsurance was purchased from abroad. In 2011, this policy was changed to depend on a variety of rating factors. The regime, however, remains challenging insofar as a US insurer will only receive 50 percent financial credit for reinsurance purchased from a non-US reinsurer with an A- financial strength rating.

On the other hand, the position in all but two EU member states is that insurers are able to take credit in their financial statements for the cover they purchase from reinsurers, regardless of the reinsurers' location, provided the insurers' regulators are satisfied by he quality of the reinsurance purchased. The insurer will need to satisfy the requirement that its reinsurer is properly capitalized, but there is no artificial differentiation made by reference to the reinsurers' domicile. In contrast, although the US scheme does not prevent market access per se—as non-US reinsurers can participate in the market for insurance—they do so under unequal trading conditions. The purpose of such restrictions is to ensure that an insurance company is able to enters into contracts with reinsurers that have been vetted by local regulatory authorities.

Derivatives

OTC derivatives have faced an enormous amount of criticism from financial regulators since the beginning of the financial crisis. Following the near collapse of American International Group (AIG), OTC derivatives are seen as a major potential source of systemic risk for international markets. With an outstanding notional value of more than $630 trillion,[21] the market for OTC derivatives is global, and dominated by cross-border trades between the United States and the European Union.[22] These global markets have generated global vulnerabilities. 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.[23]

The basic pillars underpinning the G20's reform agenda for OTC derivatives are well established. Reform proposals target three key risks: (i) systemic risks liable to be generated in a large, interconnected market; (ii) information deficits created by opacity in trading practices; and (iii) the potential for market abuse.[24] 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.

21 Bank of International Settlements, Semiannual OTC Derivatives Statistics at End-December 2012 , at A141 (May 8, 2013), http://www.bis.org/statistics/dt1920a.pdf. As evidenced by BIS statistics, interest rate derivatives and currency derivatives comprise the largest segments of the OTC derivatives market, with almost 90 percent of overall market share. Though a comparatively smaller market by outstanding notional value, CDS have garnered considerable attention owing to their role in the AIG collapse as well as JPMorgan's "London Whale" trades.

22 For example, the Committee on Capital Markets Regulation reports that 80 percent of all CDS trades are undertaken on a cross-border basis. See Hal Scott, *"Land Mines in the Derivatives Path Forward," Wall Street Journal* (Jul. 16, 2013), http://online.wsj.com/article/SB10001424127887323848804578606262062299912.html.

23 For example, US-regulated AIG's losses stemmed from trades conducted by its UK subsidiary, AIG Financial Products (AIG FP). Similarly, JPMorgan's losses in the "London Whale" trades arose from portfolios managed by its London Chief Investment Office. See generally Interpretive Guidance and Policy Statement Regarding Compliance with Certain Swap Regulations, 17 C.F.R. ch.I, http://www.cftc.gov/LawRegulation/FederalRegister/FinalRules/2013-17958.

24 The G20 Pittsburgh Summitt, Leader's Statement 9 (Sept. 25, 2009), http://www.g20.org/load/780988012.

In the United States, these goals have been enacted into law by Title VII of DFA.[25] Implementation of Title VII is well underway, led by the CFTC and the SEC. Under DFA, the CFTC is charged with overseeing the swaps and futures market, with the SEC tasked with supervision of security-based swaps.[26] In the European Union, policymakers have taken a more piecemeal approach, with various pieces of legislation tackling different goals and objectives. The thrust of the G20 agenda is contained in the European Market Infrastructure Regulation (EMIR)[27] and ESMA technical standards, which concern clearing and reporting.[28] Business conduct and the regulation of electronic trading platforms have to date been governed by the Market in Financial Instruments Directive (MiFID).[29] However, updates to MiFID ("MiFID II") concerning the trading of derivatives on exchanges, along with proposals for a Market in Financial Instruments Regulation (MiFIR), are currently under negotiation and moving through the legislative process. Neither is likely to come into force before 2014. Other relevant legislation includes the Capital Requirements Directive IV (CRD IV) and the Market Abuse Directive (MAD).[30]

25 Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, Pub. L. No. 111-203, Title VII (codified in scattered sections of 7 USC. and 15 USC.).

26 For example, as of July 2013, the CFTC had passed sixty-nine actions relating to Title VII. See Commodity Futures Trading Commission, Exemptive Order Regarding Compliance with Certain Swap Regulations (Jul. 2013), http://www.cftc.gov/ucm/groups/public/@lrfederalregister/documents/file/2013-17467a.pdf.

27 Council & Parliament Regulation 648/2012, OTC Derivatives, Central Counterparties and Trade Repositories, 2012 O.J. (L 201) 17, http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2012:201:0001:0059:EN:PDF.

28 See European Securities and Markets Authority,"Final Report: Draft Technical Standards Under the Regulation (EU) No 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC Derivatives, CCPs, and Trade Repositories" (2012), at 15-20, http://www.esma.europa.eu/system/files/2012-600_0.pdf.

29 Note that MiFID I will be repealed and replaced by MiFID II. Areas covered by MiFID I will be covered by MiFID II.

30 CRD IV will also be complemented by the Capital Requirement Regulation (CRR). Note that MAD will be repealed and replaced by MAD II and the Market Abuse Regulation (MAR).

The European Union and the United States do showcase a high level of commonality in their approach toward derivatives regulation post-crisis. However, despite 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. While the European Union and the CFTC have signaled their intent to overcome areas of divergence through a "Path Forward" on derivatives, serious differences in technical rulemaking continue to pose a risk to agreement and cooperation.[31] As a result, variations in legal regimes can generate duplicative compliance burdens for market participants, offer opportunities for regulatory arbitrage, and increase the burden on regulators to monitor and provision for risks assumed by the financial institutions they oversee.

Derivatives regulation is an extremely complex area of the law, so we will focus on the various constituent elements relating to how transactions are supervised. First, we will look at the scope of the EU and US rules, then turn to a substantive analysis of how the European Union and the United States approach trade reporting, what obligations market participants have to clear derivatives, how clearinghouses should be regulated, and business conduct requirements.

The Scope of the Dodd-Frank Act

Title VII of the DFA covers a wide range of derivative instruments, underlying reference assets, and business entities. These entities are required to register, after which they become subject to new prudential and business conduct

31 For the public announcement of the path forward, see Press Release, Commodity Futures Trading Commission, The European Commission and the CFTC Reach a Common Path Forward on Derivatives (July 11, 2013), http://www.cftc.gov/PressRoom/PressReleases/pr6640-13. For details, see Commodity Futures Trading Commission, "Cross-Border Regulation of Swaps/Derivatives Discussions Between the Commodity Futures Trading Commission and the European Union – A Path Forward," (July 11, 2013), http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/jointdiscussionscftc_europeanu.pdf.

requirements. The prudential requirements are designed to ensure that registered firms keep sufficient capital buffers to support their swaps activities. Business conduct requirements require firms to develop internal institutional checks and balances to control risk-taking (e.g., appointing a risk compliance officer) as well as external processes to provide proper disclosure and documentation to counterparties and end-users.[32]

The DFA's focus is on instruments classified as "swaps." These are broadly construed to include swaps, security-based swaps, options, and contingent forwards. The DFA does not apply to options on securities, physically settled foreign exchange (FX) swaps, or physically settled commodity- and security forwards. Business conduct and reporting obligations can nevertheless apply in cases of forwards or foreign exchange swaps (even though they are not targeted by Title VII).

The Dodd Frank Act covers...

Swaps	Swaps are financial contracts in which two counterparties agree to exchange or "swap" payments with each other as a result of such things as changes in a stock price, interest rate, or commodity price
Security-based swaps	Swaps based on a single security or loan or a narrow-based group or index of securities
Options on commodities	Contracts giving the purchaser the right to buy or sell a commodity at a fixed price within a specific period of time
Contingent forwards	A contract to sell a pre-determined number of shares each trading day over a defined period of time

....But not

Options on securities	Contracts giving the purchaser the right to buy or sell a security, such as stocks, at a fixed price within a specific period of time
Physically settled foreign exchange swaps	Swaps that are settled by wiring negotiated and agreed-upon currencies.
Security forwards	An agreement in which a seller promises to deliver a predetermined quantity of stocks at a certain date and price to a buyer

Title VII's obligations fall most heavily on Swap Dealers (SDs) and Major Swap Participants (MSPs). Swap dealers make a market in swaps. Where their activities exceed a *de minimis* threshold, SDs must register with the CFTC. Similarly, MSPs hold positions in the swap markets that exceed a *de minimis* threshold and must also register *(DFA, section 731)*. Importantly, non-financial entities enjoy an exemption from Title VII, where such entities use derivatives for purely hedging purposes *(DFA, section 723(a))*. Nonfinancial entities that engage in speculative activity in swaps can become subject to Title VII clearing and other requirements.

The Scope of EU Rules under EMIR and MiFID

The EU approach focuses on regulating instruments classified as "OTC derivatives." As such, EMIR hones in on two categories of market participants. The first involves "Financial Counterparties," which include investment firms as identified by MiFID, credit institutions, and a range of funds. The second box captures "Nonfinancial Counterparties." EMIR applies to a wide variety of derivative instruments that are not traded on regulated exchanges. As in the United States, physically settled foreign exchange derivatives and certain commodity

32 Confirmation, Portfolio Reconciliation, Portfolio Compression, and Swap Trading Relationship Documentation Requirements for Swap Dealers and Major Swap Participants, 17 C.F.R. § 23 (2012); Business Conduct Standards for Swap Dealers and Major Swap Participants, 17 C.F.R. §§ 4, 23 (2012).

derivatives are excluded. ESMA has, however, yet to articulate a final position with respect to foreign exchange swaps and forwards.

MiFID requires most firms that deal in derivatives activities to seek authorization from an EU state regulator. MiFID also stipulates a range of business conduct and organizational requirements for regulated firms. It does, however, offer certain exemptions from the authorization requirement, notably for firms that use derivatives for hedging purposes. Still, the scope of these exemptions is under review and likely to be revised under MiFID II to bring a larger segment of the market under regulation.

Why Varying Approaches to Scope Matter

EU and US regimes do not coincide neatly in terms of the instruments covered by new legislation. For example, the 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, particularly where margin requirements differ between the European Union and the United States. Different margin requirements are likely in view of the exemption granted to FX swaps under the DFA and statements from the European Union suggesting that ESMA will apply margin rules to FX swaps trading.[33]

More fundamentally, 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. The CFTC's categories as to what level of regulation applies are comparatively more complex than EMIR's. Furthermore, the DFA regulates the swaps market, while the focus of the EU regime is on OTC derivatives. While the vast majority of OTC instruments will be regulated by both regimes, differing definitions can encourage gaps and—accordingly—regulatory arbitrage by firms seeking to bring products into categories that fall outside the scope of one or the other regime. Inconsistent scope and terminology may encourage market participants to rename or restructure trades to evade the ambit of new laws or to take advantage of differences in regulatory environments to lower their compliance burden.[34]

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EMIR applies to financial- as well as nonfinancial entities (NFE). However, with respect to NFEs, EMIR applies where swaps activities exceed a set

33 Joel Clark, *Greatest Risk of Regulatory Arbitrage Is for Non-Cleared FX, Says Esma's Chair*, FX Week (Feb. 8, 2012), http://www.fxweek.com/fx-week/news/2144825/risk-regulatory-arbitrage-cleared-esma.

34 See generally Gabriel Rosenberg & Jai Massari, "Regulation Through Substitution as Policy Tool: Swap Futurization Under Dodd-Frank, Working Paper" (Apr. 21, 2013), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2256047. Indeed, commentators are noting a pronounced trend in market participants restructuring their swaps trades into futures contracts in order to benefit from an alternative regulatory regime. Whether a transaction is a swap or a futures contract has numerous regulatory implications under Title VII, from counting toward a classification of a firm as an SD or MSP to mandatory reporting requirements and capital charges. Differences in the EU and US regime as to the regulation of "swaps" versus "OTC derivatives" raise the prospect of firms optimizing these differences by changing how they categorize the financial products they trade. This may prove especially problematic where firms offer hybrid products (e.g., swaptions) or innovate around differences in regulatory regimes to save compliance costs.

threshold *(EMIR, Article 10)*.[35] Currently, NFEs that enter into less than one billion euros in credit or equity derivative contracts, and less than three billion euros in foreign exchange, interest rate, commodity, and other derivatives are exempt from EMIR's clearing obligation. Hedging activities to mitigate commercial or treasury risks (i.e., hedging in its more conventional sense) do not count towards this threshold, which the European Union is currently working to establish. Determining whether an actor uses swaps for "hedging" is, as in the United States, a difficult inquiry.[36] As detailed in the draft ESMA Technical Standards, the definition of hedging is complex and requires policymakers to capture numerous permutations, for example, to account for macro and portfolio hedging, risk mitigation for general commercial and treasury transactions, and hedging under employee stock options. Definitions of hedging also involve analysis to ensure alignment with IFRS accounting standards.[37] These challenges, along with differing interpretations of hedging between the United States and the European Union, invariably create uncertainty for end-users that use cross-border derivatives, a point we pick up below.

US Approaches to Trade Reporting

Trade reporting is a central pillar of the G20 reform agenda. Effective systems for collecting and publishing data help regulators detect accumulations of risk and identify counterparties that may be behaving in a risky manner. Better reporting mechanisms can also discipline market participants, who may be nudged into assuming lower levels of risk knowing that their activities are subject to robust disclosure- and transparency requirements.

Title VII of the DFA requires market participants to report cleared as well as uncleared trades to US-registered swap data repositories (SDRs) *(DFA, section 727)*.[38]

- Swap execution facilities and clearinghouses are generally responsible for reporting exchange-traded swaps.
- Meanwhile, for uncleared swaps, SDs and MSPs (or another financial entity) must report trades to an SDR or a regulator.

Usually only one counterparty must report the trade. Where parties are both SDs and MSPs, or both are financial counterparties, they can agree between themselves which of them must report the trade to the SDR. Otherwise, Title VII sets out a system for determining which counterparty reports a trade depending on whether an SD, MSP, or a financial counterparty is involved, as well as the identity of the other counterparty.

The CFTC requires parties to report the key economic details of the swaps trade, including any post-execution changes to the contract. Broadly, trades must be reported as soon as possible and no later than 15 minutes after execution. SDRs must make this data publicly available as soon as technologically possible (unless the data is subject to a time delay). This can happen when the SDR is dealing with a large or block trade. SDRs report swaps transaction-level data, rather than just reporting data on an aggregate basis. Provisions as to confidentiality of data and data privacy, sharing, and access remain unclear and subject to further elaboration.

EU Approaches to Trade Reporting

The European Union mandates that all counterparties as well as clearinghouses provide details of all derivatives transactions to EU-registered trade repositories *(EMIR, Articles 9 and 81)*. In the case of the European Union, reporting obligations fall on firms on both sides of the transaction. Repositories can then reconcile the data to avoid duplication using the unique identifier attached to the party and transaction.

Parties must report key details of the trade, as well as any post-trade changes to the agreement, to include information such as price, notional value, and maturity terms. EMIR requires information on the economic circumstances undergirding the trade, such as whether the trade is for a commercial- or a hedging purpose and who holds

35 See European Securities and Markets Authority., supra note 28.

36 Ibid., pp. 15-16.

37 Ibid.

38 Real-time Public Reporting of Swap Transaction Data, 17 C.F.R. § 43 (2012).

the beneficial interest in the swap. Uniquely under EMIR, parties must also identify the portfolio of collateral against which the swap is executed.[39] Parties must report to a trade repository within a day of the transaction (or "T+1"), and trade repositories must publicize aggregate transaction data. Currently, it seems that such data is required to be updated at least weekly and made publicly accessible online.[40]

EU law imposes restrictions on data access and data sharing with third countries. Moreover, EMIR requires counterparties to abide by confidentiality undertakings in their trade contracts while also reporting data to trade repositories and regulators.

The Costs of Varying Trade Reporting Approaches

Despite considerable convergence on objectives, and a broad commitment to resolving areas of difference through the *Path Forward*, reporting regimes in the European Union and the United States differ in important respects. Broadly, these relate 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. For cross-border firms, dual reporting regimes create uncertainty as to where trades must be reported, and how quickly and what information must be provided in each case. As reporting is likely to occur on a transaction-to-transaction basis, reporting requirements may change accordingly, especially if counterparties transact using a variety of electronic trading platforms and clearing organizations. Uncertainty in reporting obligations may skew counterparty incentives in favor of trading financial products for which the reporting lines are clear and well-established. Divergence also 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.

EU regulators require firms to report to SDRs registered in the European Union. Similarly, the United States requires firms to report to SDRs registered in the United States. Without accord as to mutual recognition or substituted compliance, firms may find themselves subject to duplicative reporting regimes. Even where EU and US regulators recognize each other's SDRs, regulators must reconcile differing data fields. The European Union imposes fairly detailed data requirements, including information on the collateral that parties provide. The European Union can also require data to differentiate between common transaction data and more sensitive information as to the counterparty involved. When US firms report to EU SDRs, data fields must be adapted to reflect this requirement for additional information. Given this disparity in reporting regimes and potential for duplication, firms may well opt to use the "stricter" standard when making their logistical arrangements for sourcing data and operationalizing data collection and input to SDRs.

However, while the European Union demands deeper information on swaps trades, the United States is more demanding about timing. In general, trades must be reported in real-time. Trades are also subject to public dissemination at a more granular level. As noted, Title VII requires SDRs to publish swaps data as soon as possible after receipt. Meanwhile, the European Union merely requires aggregate data to be published on a weekly basis– though the EU may apply stricter rules on trade publication by trading venues once MIFIR comes into force. Thus there is at least currently the interesting possibility of parties accommodating the strictness of the two regimes by making more data available (per the EU regime) and making such data available for immediate dissemination where parties are subject to US reporting rules.

Divergent practices once again raise the issue of regulatory arbitrage. Given the sensitivity of some OTC derivative trades, 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, where at least for the moment, data is reported by T+1, and thus they benefit from delays

39 See European Securities and Markets Authority, supra note 28, at 56-60.

40 Ibid, pp. 63-65.

in dissemination of the information. Alternatively, firms may seek out ways to break up trades and to report them through different SDRs in different jurisdictions in order to increase the costs to market participants and regulators of collecting and internalizing the information.

Gaps and differences in trade reporting regulation sharpen the significance and importance of information-sharing mechanisms between regulators. However, sharing trade data on a cross-border basis poses a challenge to data privacy laws in the European Union as well as to the policy preferences of regulators seeking to preserve home-state advantages in acquiring access to data before others. Unsurprisingly, regulators are continuing to negotiate terms on which to establish such information-sharing and access mechanisms.

Gaps and differences in trade reporting regulation sharpen the significance and importance of information-sharing mechanisms between regulators.

The information-sharing and analysis mechanisms that regulators use must also accommodate the variations in trade-reporting rules between the United States and the European Union. In other words, EU regulators must interpret data that includes non-EMIR information fields owing to the application of Title VII requirements—and vice versa. This is significant as the different demands made by EU and US regulators impact the ways in which these regulators see the market. 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.[41]

US Approaches to Central Clearing

The DFA shifts swaps from a largely unregulated trading environment toward greater oversight. In line with G20 aims, Title VII mandates that standardized swaps be traded on regulated electronic platforms known as swap execution facilities (SEFs) and be subject to central clearing *(DFA, sections 723 and 735)*. This reform has three basic aims. First, trading in open markets brings greater transparency to swaps trading and facilitates better pricing and liquidity. Second, standardization in swaps contracts works to simplify the risks of trading these instruments. Third, central clearing helps to reduce the counterparty risks that are intrinsic to a bilateral OTC market. It also ensures that the market is supported by adequate capital buffers and regular valuation of assets, preventing runs on collateral where assets drop in value. Clearinghouses or Derivatives Clearing Organizations (DCOs) are key to this design and intended to act as strong buffers against systemic risk.

Before swaps can be centrally cleared, they must first be approved for clearing by either the SEC or the CFTC, and a DCO must offer to clear them. If approved for central clearing, the obligation to clear an eligible swap falls on SDs, MSPs, financial institutions, and end-users that engage in speculative trading. Title VII provides an exemption from the clearing mandate for end-users that engage in hedging as well as for central banks that engage in swaps trading.

Where swaps can be centrally traded, they must also be made available for trading on an SEF or on an exchange. Notably, any platform that allows more than one participant to trade swaps with more than one other participant is required to register as an SEF, regardless of whether it trades products subject to the DFA's SEF-trading mandate. CFTC proposals envisage that SEFs will provide pre-trade transparency for buy-side market

41 See Andrew Green, "Trade Reporting Requirements: EMIR vs. Dodd-Frank and Making Sense of Your Global Obligations," DerivSource (Mar. 15, 2013), http://www.derivsource.com/articles/trade-reporting-requirements-emir-vs-dodd-frank-and-making-sense-your-global-obligations.

participants.[42] Pre-trade transparency works through transactions being made available to trade through an order book or a request-for-quote system that requires a firm looking to buy or sell a swap to submit a request for a quote to at least five participants. Greater pre-trade transparency through a SEF is designed to encourage better price discovery and improve overall market efficiency.

The EU's Path Toward Central Clearing

Like the US, EMIR also requires central clearing of OTC derivatives *(EMIR, Article 4)*. ESMA must determine which contracts are suitable for central clearing, taking into account such criteria as the standardization of contract terms, the volume and liquidity of trading, and the availability of fair pricing information *(EMIR, Article 5(4))*. The European Union obliges financial firms as well as NFEs to clear trades. NFEs can seek an exemption where their trades fall under the set threshold *(EMIR, Article 10)*.

Where contracts can be centrally cleared, ESMA must also determine whether they should be traded on an exchange or other regulated market such as a multilateral trading facility (MTF) or Organized Trading Facility (OTF) *(EMIR, Article 8)*. Under MiFID II, in making this determination, ESMA can take into account criteria such as the frequency of trades as well as their size and volume.

The European Union is developing proposals to encourage pre-trade transparency for OTC derivatives in MiFIR and MiFID (II). At present, it appears as if pre-trade transparency is likely to favor an order book system, rather than a request for quotes. Proposals for pre-trade transparency and the development of MTFs and OTFs for swaps trading (in addition to exchanges) are progressing through legislative review under MiFID II and MiFIR. Full details may not be in place until 2016.

42 These are also known as a Designated Contracts Market (DCM). For details on the basic principles underlying their operation, see Core Principles and Other Requirements for Designated Contract Markets, 17 C.F.R. §§ 1, 16, 38 (2012).

Potential Sources of Divergence in Clearance Procedures

Despite the similarities in approach, 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. As discussed above, under DFA, any platform that allows more than one participant to trade swaps with more than one other participant is required to register as an SEF, regardless of whether it trades products subject to the DFA's mandate to trade on a SEF. This jurisdictional trigger gives US rules extraterritorial reach, thereby forcing EU platforms to register if they allow US market-makers to trade on their facilities. In the absence of a streamlined or joint approach, EU platforms have turned down pleas by US firms to operate on their platforms, just as EU regulators have asked for relief from US rules for EU platforms. As a consequence, markets may see fragmented liquidity and essentially concentrate risk along jurisdictional lines.

Importantly, the trading mandate is itself only triggered after ESMA or the CFTC/SEC determines which contracts are eligible to be cleared using central counterparties (CCPs) or DCOs. This clearance procedure creates the potential for ESMA or the CFTC/SEC to take divergent views as to which products can be traded and cleared. Although regulators have committed to cooperative strategies for achieving consistency in this area, where authorities differ in their determinations, firms can be incentivized to seek out opportunities for regulatory arbitrage. For example, divergence might encourage firms to book trades in those jurisdictions where such trades are categorized as ineligible for mandatory clearing and therefore can still be traded OTC.

Both MiFIR/MiFID (II) and Title VII require regulators to make determinations based on criteria that examine market liquidity, trading volume, size, and depth. However, markets can often vary in quality between jurisdictions. It is possible that derivatives markets in the European Union and the United States might find themselves at different stages of development in particular product categories. For example, one jurisdiction may possess sufficient depth and liquidity in certain swaps to justify exchange trading and mandatory clearing, while the other jurisdiction might not. Such differences in market quality between the European Union and the United States might lead to different judgments as to which contracts are eligible for mandatory clearing and trading. Inevitably, such determinations also give rise to path dependencies, encouraging markets to concentrate in those jurisdictions that see greater liquidity and volume while leaving other jurisdictions without sufficient market participation to justify mandatory clearing and exchange trading.

The need for correspondence as to which products are suitable for clearing and trading extends to ensuring that products that can be traded on exchanges in one jurisdiction are also able to be cleared in that same jurisdiction. There have already been concerns raised in the European Union that MiFIR/MiFID II rules regarding trading eligibility and EMIR rules regarding clearing eligibility do not neatly align.

This raises the issue of whether regulators should also work to ensure that products eligible to be exchange traded in one jurisdiction are also eligible to be cleared in the other jurisdiction. Simply put, can a contract be traded on an exchange in the European Union and be cleared in the United States or vice versa? The policy goal in recent years has been to encourage competition between trading venues both domestically and across international borders. Similarly, clearinghouses compete for business across borders. With the growth of electronic trading platforms and MTFs, traders may seek out the best price for a contract on a market and use a clearinghouse located in another jurisdiction. Without alignment in the categories of product that may be exchange traded or cleared across jurisdictions, firms may have limited choice as to which venues they can use to exchange as well as clear contracts. For regulators, this may be an undesirable outcome if it encourages a concentration of risk in a single jurisdiction or trading venue. And for end-users the result may be restriction of competition between suppliers.

How the United States Regulates Clearinghouses

Standardized OTC derivatives must now be cleared through clearinghouses *(DFA, section 723)*, with the aim of reducing systemic risks in the derivatives market. Financial institutions must become members of clearinghouses, and when members transact with one another, the clearinghouse steps in between to act as a counterparty for both members.[43] As such, clearinghouses reduce the risk of default that parties would otherwise assume in the OTC market. Clearinghouses use a variety of risk-mitigation mechanisms—such as margin, default funds, and high-quality membership criteria—to ensure that the parties that use the clearinghouse are in good institutional standing and do not take on more risk than they can handle.

The CFTC mandates that an eligible swap, including any swaps that are entered into between a US and a non-US person *(DFA, section 722)*, be cleared through a clearinghouse recognized by the CFTC. For the CFTC to recognize a clearinghouse, it must meet certain eligibility criteria. These are contained in the CFTC's Final Rule on DCO Core Principles (Final Rule).[44] Broadly speaking, these criteria relate to a variety of factors, including: (i) the amount of margin that clearinghouses must collect for the swaps they clear; (ii) the conditions that clearinghouse members must fulfill to qualify for membership; and (iii) the amount of capital that a clearinghouse itself must keep as a buffer in case it goes into default. Moreover, when a DCO clears a speculative swap, it can collect more than 100 percent of a customer's initial margin.[45] In addition, a clearinghouse cannot impose initial capital contribution requirements of over $50 million on its members.[46] A clearinghouse must also keep sufficient capital buffers to withstand

43 In the United States, clearinghouses are referred to as Derivatives Clearing Organizations (DCOs), whereas in the European Union they are referred to as Central Clearing Counterparties (CCPs). See generally Yesha Yadav, *The Problematic Case of Clearinghouses in Complex Markets*, 101 Geo. L. J. 387 (2013).

44 Derivatives Clearing Organization General Provisions and Core Principles, 17 C.F.R. §§ 1, 21, 39, 140 (2012).

45 Ibid. § 39.13.

46 Ibid. § 39.12.

the default of the one member to which it has the largest exposure.[47]

Under Title VIII of the DFA, regulators are empowered to designate certain entities as systemically important. This designation allows regulators to impose additional regulations on such entities to assure the stability of the financial markets *(DFA, sections 804-805)*. A number of larger clearinghouses in the United States have been designated as systemically important by the Financial Stability Oversight Council, implying that the Federal Reserve can impose additional regulations on these clearinghouses. It also allows these designated clearinghouses to access the Federal Reserve's discount window for short-term emergency financing *(DFA, sections 804-805)*.

The EU Approach to Clearinghouse Regulation

The European Union mandates that all eligible swaps be cleared through a clearinghouse that is recognized by the European Union, including swaps that are entered into between an EU entity and a non-EU counterparty *(EMIR, Article 4)*. Similar to the United States, EMIR stipulates that clearinghouses must satisfy a number of conditions in order to be recognized. These include provisions as to how much margin EU clearinghouses must collect from members, rules as to member contributions, and mandatory capital buffers that clearinghouses must keep to ensure systemic safety.

There are several differences between US and EU regulation of clearinghouses, however. In one important example, EMIR calculations on margin are based on different confidence intervals and holding periods than in the United States. EMIR also imposes look-back periods, and requires clearinghouses to prevent pro-cyclicality by keeping higher levels of margin in times of stronger market activity *(EMIR, Article 41)*.[48] EMIR requires clearinghouses to keep enough capital to survive the default of either (i) the clearing member to which it has the largest exposure, or (ii) its second- and third-largest clearing members, whichever of (i) or (ii) is larger *(EMIR, Article 42)*.[49] In addition, EMIR contains numerous other differences from Title VII, including different rules for segregating client assets, the quality of assets that clearinghouses and their members can invest in, and concentration limits.[50]

EMIR recognizes the systemic importance of clearinghouses by giving EU member states the discretion to impose further rules on clearinghouses established in their jurisdiction. This implies that 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. At present, there does not appear to be further guidance on whether gold-plating is likely, nor on what kinds of additional rules may be imposed by individual member states in that context.

Why Varying Approaches to Clearinghouse Regulation Matter

Differences in the recognition and regulation of clearinghouses present considerable challenges to implementing reform of cross-border derivatives markets. First, the United States and the European Union both impose strict jurisdictional requirements. A US person that concludes a swap with a foreign person must clear that swap through a clearinghouse that is recognized by the CFTC. Similarly, an EU person that enters into a swap with a non-EU counterparty must clear this swap through a clearinghouse that is recognized by the EU. EMIR and Title VII currently impose different conditions for clearinghouses to gain recognition in their respective jurisdictions. The *Path Forward* promises efforts to ensure greater mutual recognition of clearinghouses. However, in the absence of a mutual recognition or substituted compliance regime for clearinghouses, those that offer cross-border clearing services must obtain

47 Ibid. § 39.11.

48 See also Eur. Sec. & Mkts. Auth., supra note 28, at 37-40.

49 See generally Commission on Capital Markets Regulation, "Letter on Resolution of Differences Between EU and US Clearinghouse Requirements 1-3" (Jan. 28, 2013), http://capmktsreg.org/pdfs/2013.01.28_EU-US_clearinghouse_comparison_letter.pdf.

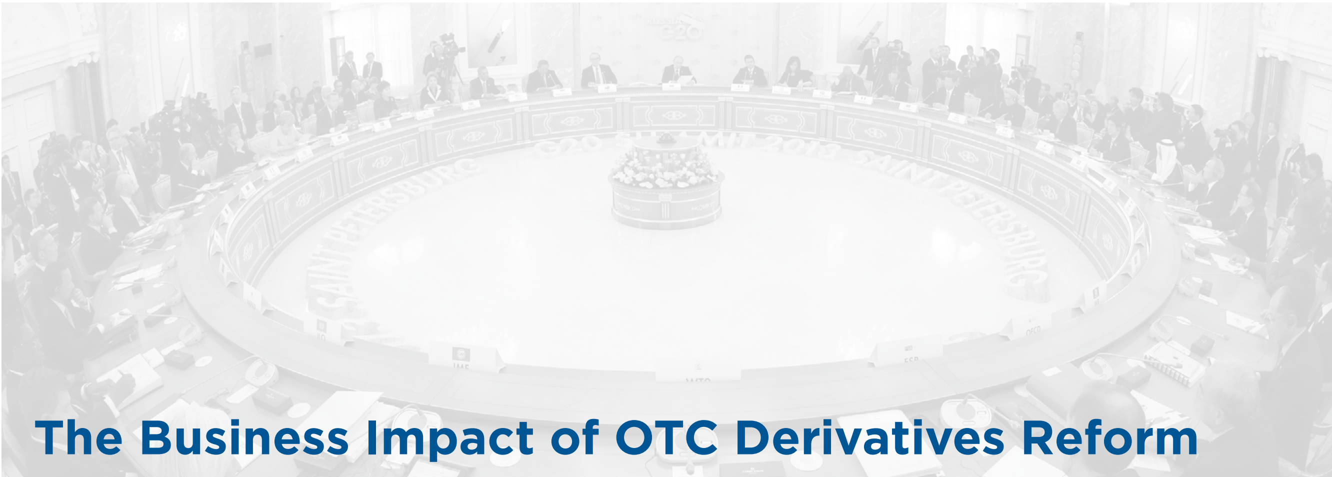
50 Ibid.

recognition from both the European Union and the United States. In such a case, clearinghouses may be faced with duplicative regulatory regimes. At this point, it is unclear whether this would significantly improve the risk resistance of clearinghouses through higher margin and member obligations or, by making it more difficult for clearinghouses to enter the market to provide clearing services, result in a smaller pool of clearing service providers—and more concentration of risk.

In any event, both EMIR and DFA leave room for regulators to impose additional conditions on the clearinghouses that they regulate. In the case of the DFA, Title VIII allows the Federal Reserve to make special rules for systemically important clearinghouses. In contrast, EMIR allows EU home state regulators to set rules above and beyond those set out in EMIR. Clearinghouses that undertake international business are, by their nature, likely to face additional rule-making, especially given the more complex risks that they assume. Duplication may provide a higher level of overall protection; but without a recognition mechanism, or some system of cooperation between EU and US regulators, clearinghouses may end up facing changing and duplicative regulatory regimes that ultimately discourage some firms from using some clearing services. Furthermore, market participants might be incentivized to develop financial products that evade the clearing requirement.

Both EMIR and DFA leave room for regulators to impose additional conditions on the clearinghouses that they regulate. In the case of the DFA, Title VIII allows the Federal Reserve to make special rules for systemically important clearinghouses. In contrast, EMIR allows EU home state regulators to set rules above and beyond those set out in EMIR.

Regulatory arbitrage can also be a concern where clearinghouses are subject to varying prudential and business conduct standards. In particular, clearinghouses that have a presence in different jurisdictions could theoretically seek out ways to clear products through affiliates established in jurisdictions where the costs of clearing those products are lower. For example, since the CFTC imposes comparably higher margin requirements for clearinghouses that clear speculative swaps than does the European Union, a clearinghouse with a presence in both jurisdictions could seek ways to clear products through its EU arm to reduce margin costs. Though this kind of arbitrage would allow clearinghouses to compete more aggressively for business, it would also result in greater concentrations of risk in one or more jurisdictions; regulators would likewise end up with a less than complete understanding of the risks that international clearinghouses assume. Again, regulators have expressly recognized that competing prudential rules present a cause for concern that must be jointly addressed. However, for the present, the differences between the European Union and the United States create significant challenges—not only for international clearinghouses and their members but also for end-users looking for affordable hedging opportunities in the derivatives market. How they will respond to these costs remains to be seen.



The Business Impact of OTC Derivatives Reform

Corporate end-users of derivative instruments are likely to be directly impacted by OTC derivatives reforms. Main Street companies depend on derivatives to control commercial risks, predict funding costs, and improve capital allocation within the firm. Derivatives such as interest rate swaps and currency swaps allow firms to reduce the risks created by multi-currency financing arrangements, including funding demands for global supply chains or cross-border borrowing.[51] Such end-users may include any firm that is not a dealer in derivatives. They may also include financial institutions, such as banks and pension funds, as well as non-financial companies such as airlines, car manufacturers, or pharmaceuticals.[52] Multinational businesses manage a variety of risks across networks of global branches, subsidiaries, and affiliates, and historically have enjoyed access to an international derivatives market, allowing businesses in one jurisdiction to find counterparties in another. 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.

Reform of OTC derivatives markets is likely to affect these end-user companies in important ways. They may be required to: (i) continuously monitor their operations to determine whether or not they must clear their derivatives contracts through clearinghouses; (ii) report transactions to SDRs and to regulators; (iii) use new documentation and standard form contracts in derivatives trades; and (iv) develop internal risk management processes and corporate organizational mechanisms in support of derivatives trading.

Broadly speaking, both the European Union and the United States have sought to lighten the compliance burden on certain categories of corporate end-users by granting an exemption from clearing for nonfinancial companies that use derivatives to hedge commercial risks. However, despite this shared objective, EU and US rule-making exhibits several areas of divergence in the treatment of end-users. Invariably, these discrepancies can create uncertainty for corporations, particularly those managing cross-border businesses subject to a multiplicity of legal regimes. A lack of clarity and consistency can also create concerns for risk-management, as variations in reporting regimes undermine transparency and lead to worries about systemic risk building within the derivatives market.

51 For statistics on the key users of various types of derivatives, see Bank of International Settlements, "Statistical Release: OTC Derivatives Statistics at End-December 2012 (May 2013), http://www.bis.org/publ/otc_hy1305.pdf.

52 Ibid; see also Bank of Int'l Settlements, "OTC Derivatives Market Activity in the First of 2011" (Nov. 2011), www.bis.org/publ/otc_hy1111.pdf (reporting that NFEs comprise a very small fraction of the overall OTC market, approximately 7.6 percent).

US Clearing Exemptions for Corporate End-users

In implementing the DFA, regulators have provided an exemption from clearing for non-financial end-users that use derivatives to hedge or mitigate commercial risk *(section 2(a) (7), Commodity Exchange Act (CEA))*. Financial end-users include a variety of entities, notably commodity pools, private funds, and institutions engaged in activities that are predominantly financial in nature *(section 2(a) (7) (c), CEA)*.[53] The exemption is only available to end-users that are not financial end-users[54] under the definition set out above.[55] Thus, corporate end-users must pay special attention to the activities undertaken by their entire corporate group, particularly since some group members may be financial entities (as defined above) even where the group's overall activities are nonfinancial in nature.

An essential condition of the exemption is that the swap be used to hedge or mitigate commercial risk (i.e., the swap must reduce commercial risks in the management of a company's operations). In determining whether or not a trade counts as a hedge, end-users may take into account risk-reduction for the group as a whole, not just for the particular company that has elected to rely on the exemption. Swaps that are speculative in nature and that cannot be construed as hedging commercial risk must be centrally cleared. In determining whether a contract qualifies as a hedge, the firm may rely on certain international accounting standards.[56]

One qualification to this basic taxonomy relates to cases where a financial entity acts as an agent for a nonfinancial group member. Although a financial end-user ordinarily falls within the scope of the clearing mandate, it may rely on the exemption where it can show that it acted as an agent for a non-financial group member *(section, 2(h)(7)(D), CEA)*. Similarly, certain treasury affiliates that enter into hedges for the group as a whole, and thereby perform duties considered financial in nature, may rely on this exemption where they are hedging commercial risks for one or more group members.[57]

EU Clearing Exemptions for End-users

Similar to the United States, the European Union provides an exemption from clearing for non-financial firms that use derivatives for hedging purposes. In this case, a financial firm is defined as an investment firm, credit institution, insurance or re-insurance company, an Undertakings for Collective Investment in Transferable Securities and its managers, pension scheme, or alternative investment fund *(Article 2(8), EMIR)*.

Under EU regulations, NFE can only enjoy the exemption where their derivatives trading activities fall below a set threshold *(Article 10(4) (b), EMIR)*.[58] In calculating this threshold, a firm's hedging activities are not taken into account. Where an NFE exceeds the set threshold, it is treated much like a regular financial firm, thus forgoing the leniency that EMIR provides for corporate end-users.

53 [Federal Reserve] Definitions of "Predominantly Engaged in Financial Activities" and "Significant" Nonbank Financial Company and Bank Holding Company, 12 C.F.R. § 242 (2013). The CFTC has stated that it will defer to the Fed in determining how to define activities that are predominantly financial in nature. Broadly, a company is a financial end-user where the company and its subsidiaries generate at least 85 percent of their annual gross revenues from activities that are financial in nature, or where the company and its subsidiaries have consolidated assets of which at least 85 percent are related to financial activities.

54 Small financial institutions, defined as financial firms with assets of $10 billion or less, are not deemed financial end-users.

55 See also Clearing Requirement Determination Under Section 2(h) of the CEA, 17 C.F.R. §§ 39, 50 (2013).

56 A swap may also be interpreted as hedging where it is defined as such under the Financial Accounting Standards Board's definitions of hedging.

57 This relief applies to firms that fall within the definition of financial entity solely under section 2(h)(7)(C)(i)(VIII) of the CEA. See No-Action Relief from the Clearing Requirement for Swaps Entered into by Eligible Treasury Affiliates, CFTC No-Action Letter (June 4, 2013), http://www.cftc.gov/ucm/groups/public/@lrlettergeneral/documents/letter/13-22.pdf.

58 Commission Delegated Regulation 149/2013, art. 11, 2013 O.J. (L 52) 11, 12, http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2013:052:0011:0024:EN:PDF.

Interestingly, the threshold of activity is set at a fairly low level. For common derivatives, the thresholds are:

OTC Derivative	Gross Notional Value (Expressed in EUR)
Foreign Exchange	3 billion
Interest Rate Derivatives	3 billion
Credit Derivatives	1 billion
Equity Derivatives	1 billion
Commodity and other Derivatives	3 billion

Three factors are worth noting in the methodology used to calculate this threshold value. First, EMIR uses the gross notional value of a particular derivative contract, as determined over any 30 working day rolling average position. The gross notional value of a derivatives contract represents the total value of the contract, without taking any offsetting positions into account. Secondly, the threshold calculation counts all nonhedging OTC derivatives activities of an NFE's group members, irrespective of whether these group members are located in the European Economic Area or not *(Article 2(16), EMIR)*.[59] Thirdly, it is not clear whether foreign exchange forwards are included in the calculation. As set out above, there remains on-going debate regarding their inclusion within the scope of EMIR.[60]

The definition of hedging encompasses activities that reduce the commercial or treasury financing risk of a firm or its group members. EMIR is more explicit about including treasury financing risks within the scope of risks that may be hedged within the exemption. Finally, EMIR allows a firm to look to international accounting standards in determining whether or not a contract qualifies as a hedging transaction.[61]

59 A "group" may be construed fairly broadly to include the group of undertakings consisting of a parent undertaking and its subsidiaries within the meaning of Articles 1 and 2 of Directive 83/349/EEC or the group of undertakings referred to in Article 3(1) and Article 80(7) and (8) of Directive 2006/48/EC.

60 As noted above, the United States excludes FX forwards from the DFA clearing obligation.

61 For a definition of "hedging" see Commission Delegated Regulation 149/2013, art. 10, 2013 O.J. (L 52) 11, 12, http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2013:052:0011:0024:EN:PDF.

Impact of Differences on Corporate End-users

Differences in applying the end-user exemption in the European Union and the United States raise a number of questions for multinational corporate end-users. To start with, the scope of who is covered by the exemption varies between the two regimes. Under the CEA, the emphasis is on whether a firm is an NFE and whether the firm undertakes a hedging transaction for commercial risks. Under EMIR, a firm must show that: (i) it is an NFE; (ii) the OTC derivatives activities of its worldwide corporate group fall under the threshold; and (iii) the proposed trade is for hedging commercial/treasury financing risks. If all corporate end-users only ever enter into hedging transactions, then there should be little to differentiate the two regimes. However, under EMIR, where an NFE's corporate group includes entities that undertake speculative derivatives trades over and above the threshold value, a key question is whether the NFE's subsequent hedging activity falls outside of the exemption, thus becoming subject to mandatory clearing. In other words, even though an NFE's hedging transactions do not count toward the threshold, once the threshold is crossed for whatever reason, must the NFE clear all OTC trades irrespective of whether they hedge the company's commercial risks? NFEs that cross the threshold under EMIR are generally subject to the mandate—just like all financial firms. The United States, by contrast, allows NFEs to escape the mandate where they undertake hedging transactions.

It is arguable that the EU regime makes it difficult for end-users to rely on the prohibition, especially large multinational end-users. Take the case of a car-manufacturing company based in the European Union. If this company includes group members carrying out speculative derivatives trades in excess of the threshold anywhere in the world, the car company may have to clear all of its derivatives trades under EMIR. Even where this threshold is not exceeded, the car company must continually monitor the activities of its group members to be sure that their activities remain under the threshold at all times.

The impact here is twofold. As the European Union's threshold is set at a comparably low value, EU end-users may end up electing to clear all OTC derivatives trades to avoid instances of noncompliance, particularly if end-users are part of large multinational groups. Additionally, where it becomes more costly for companies to hedge trades in the European Union, corporate groups may seek to book derivatives trades outside of the European Union. When 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. Alternatively, end-users may reduce their derivatives activities altogether to avoid falling within EMIR. By analyzing the corporate group on a global scale to determine whether the threshold is crossed, EMIR can encourage entire groups to curtail their derivatives activities across the board. With reduced participation in derivatives markets, end-users may face a variety of financial risks as well as higher capital costs to fully provision for uncertainties in the market.

A further question relates to the ability of financial firms to escape clearing under EMIR where they act as agent for an NFE within their corporate group. Presumably, any exemption is likely to apply to the extent that both the financial and nonfinancial entity can remain under the threshold. However, greater clarity in this regard may be helpful, particularly where large corporate groups centralize treasury functions for the group into one or two entities.

US Reporting Requirements for End-users

The DFA establishes an extensive reporting regime for all swaps transactions *(section 727, DFA)*. As detailed above, the reporting obligation mandates the following: (i) in general, all swaps transactions entered into after July 21, 2010, must be reported to an SDR or to the CFTC; (ii) this reporting obligation encompasses "creation" data documenting the key economic terms of the swaps trade as well as "continuation" data that details changes to these terms as they happen through the lifecycle of the swap;[62] (iii) parties must also provide information on historical swaps that were in effect as of July 21, 2010, even if these have expired;[63] and (iv) importantly, in each swap where an end-user relies on the clearing exemption, reporting data must include information on whether the exception is being used and by which counterparty.

On its face, this obligation applies to all counterparties, including end-users. However, for all practical purposes, in the case of trade reporting end-users are unlikely to face reporting requirements. These will most likely be satisfied by their counterparty. Where an end-user transacts with a SD or a MSP, reporting obligations must be fulfilled by the SD or the MSP. Similarly, where a non-financial end-user transacts with a financial institution, the financial institution must satisfy reporting requirements. Where two nonfinancial end-users are parties to a transaction, they can agree by contract which one of them will report the trades. Where a US end-user transacts with a non-US counterparty, only then must the US end-user take responsibility for reporting swaps trades.

Importantly, nonfiling end-users must provide an annual filing to the CFTC or the SDR detailing how they meet their financial commitments supporting their swaps activities. Where an end-user does not make such a filing, it must make such information available to its counterparty for every transaction where the end-user elects to rely on the exemption.

62 Real-time Public Reporting of Swap Transaction Data, 17 C.F.R. § 43 (2012); Swap Data Recordkeeping and Reporting Requirements, 17 C.F.R. § 45 (2012).

63 Swap Data Recordkeeping and Reporting Requirements: Pre-enactment and Transition Swaps; Final Rule, 17 C.F.R. § 46 (2012).

EU Reporting Requirements for End-users

Similar to the United States, EMIR establishes robust reporting requirements for derivatives trades *(EMIR, Articles 9 and 81)*. The reporting obligation applies to all derivatives entered into after August 16, 2012, as well as all derivatives that were outstanding on that date. 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. This implies that end-users must establish internal monitoring- and information-processing systems that are sufficiently sophisticated to capture trade data on an ongoing basis, information on collateral, position limits, and so on. The prescriptive nature of trade reporting—and the inability of nonfinancial end-users to limit the scope of their obligations—indicate significant compliance costs in this context.

How EU and US Reporting Requirements Vary

US and EU differences regarding reporting obligations can generate uncertainties for end-users as well as differences in compliance costs between these jurisdictions. Such cost differentials may encourage regulatory arbitrage, or at least prompt end-users to direct trading through subsidiaries located in a single jurisdiction. A few observations merit further analysis.

Nonfinancial end-users in the United States and the European Union are subject to reporting requirements on their swaps trades, irrespective of whether they fall within the clearing exemption. However, nonfinancial end-users in the United States appear to face a less onerous compliance burden, both legally and logistically. These end-users can, with very few (and probably avoidable) exceptions, rely on their counterparties to report trades on their behalf. The United States requires only one party to report swaps trades. In most cases, such reporting is likely to be undertaken by an SD or MSP, or a financial end-user—in other words, institutions with historical experience in reporting complex trades and with processing systems to capture and compute trading data. Moreover, SDs and MSPs are likely to invest in developing reporting systems to comply with their own obligations under the DFA and to service clients across the whole market. This should reduce the need for end-users to invest in and replicate such data-mapping and processing systems. Of course, end-users are expected to develop systems that track their derivatives trading activity.[64] However, the ability to delegate reporting and to be able to rely on this delegation can help save costs, as well as allocate them to actors (notably, SDs and MSPs) that may be better placed to bear them.

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.

The European Union and United States also stipulate different requirements for the kinds of data that must be collected and reported. For example, as detailed earlier, the European Union requires information on the collateral arrangements in place for trades. This divergence is likely to be problematic for end-users and their corporate groups that transact in derivatives on a cross-border basis and thus come under EU as well as US jurisdictions and regulatory regimes. Where end-users are unsure as to which regime applies to their derivatives trades, or where reporting regimes are duplicated, end-users face different compliance costs. On the one hand, faced with the potential for dual regimes to apply, end-users might consider establishing processing systems that collect, collate, and organize data in accordance

64 For example, nonfinancial end-users must obtain unique legal entity identifiers to help regulators track the activity of end-users. For more detail on obtaining such identifiers, see *CICIUTILITY, CFTC Interim Complaint Identifier (CICI) Utility* (2013), https://www.ciciutility.org.

> *The costs of dual reporting as well as varying data demands suggest that end-users may face higher compliance costs than had been envisioned by regulators on either side of the Atlantic.*

with two separate reporting regimes. Alternatively, where end-users regularly transact under both EU and US regimes, prudence could dictate that they adapt their processing systems to comply with the "stricter" standard. Still, stricter standards may not necessarily cover the specific information demands of EU and US regulators, which may require data to be presented in different formats, with different timing, and with a differing depth of detail.

Thus, the United States and European Union should recognize and clarify the application of dual reporting regimes to large multinational corporate groups. The costs of dual reporting as well as varying data demands suggest that end-users may face higher compliance costs than had been envisioned by regulators on either side of the Atlantic. In the absence of mutual recognition, substituted compliance, or clarity as to which regimes corporate groups become subject to and when, divergences may generate frequent breaches by end-users, data loss, duplicative compliance systems, and high levels of redundancies in reporting.

US Approaches to Business Conduct

The DFA also introduced a new governance regime for business conduct in derivatives trading, most significantly by establishing a new framework for the documentation that must be put in place before dealers and their clients are able to enter into derivatives trades.[65] Broadly speaking, the purpose of business conduct rules is threefold:
(i) to ensure that users of derivatives are aware of the risks and obligations that arise in the course of trading; (ii) to check that users are institutionally capable of entering into trades and absorbing the risks that trading entails; and (iii) to formalize an understanding between client and dealer with respect to items such as risk-management, notifications, disclosure, and reporting obligations.

Unless an end-user qualifies as an MSP, it is not likely to face compliance with business conduct rules directly. Nevertheless, in complying with their obligations under DFA, SDs and MSPs can impose a host of requirements on their end-user clients. Clients must provide dealers with detailed information about their institution, including the names of legal and beneficial owners, corporate affiliates, guarantors, and creditors. In addition, dealers must ensure that clients have the necessary corporate authority to transact in derivatives, including risk management and credit risk policies that minimize the chances of the end-user defaulting. These requirements ensure that SDs and MSPs undertake due diligence on their client, implying that end-users face potentially high data demands to cover a wide range of internal institutional procedures and practices. As part of business conduct regulations, SDs and MSPs must provide various disclosures to their clients, including information on the platforms that end-users can elect to use for clearing, the material risks of swap transactions, potential conflicts of interest that SDs and MSPs face.

SDs and MSPs must also ensure that their clients establish a contractual framework for derivatives trading. This provides the client with set terms to govern the life of the swaps-trading agreement. Key terms obligate clients to agree to a valuation process for swaps (only applicable to financial end-users, though nonfinancial end-users can ask for this), arrangements as to annual or quarterly portfolio reconciliation, post-trade swap

65 See Business Conduct Standards for Swap Dealers and Major Swap Participants with Counterparties, 17 C.F.R. §§ 4, 23 (2012).

confirmation, and portfolio compression. Such terms are important for risk-mitigation for SDs and MSPs as well as end-users. But they also require end-users to invest in internal procedures and controls that meet the requirements stipulated by new business conduct rules. In addition, they require end-users and their dealers to execute new contracts that reflect the changes brought in by DFA.[66]

EU Approaches to Business Conduct

Business conduct regulation is also central to the new EU framework for derivatives regulation, as EMIR requires counterparties to establish risk-mitigation protocols to cover areas such as valuation, portfolio reconciliation,[67] compression,[68] and confirmations.[69] Furthermore, EMIR's obligations apply directly to financial counterparties as well as to nonfinancial counterparties, though nonfinancial counterparties below the threshold have fewer obligations to comply with, notably with respect to valuation and collateral segregation.[70] EMIR and its Technical Standard set out fairly detailed provisions to govern arrangements for risk-mitigation techniques, including portfolio reconciliation, compression, and timings for confirmations.

There is considerable US-EU convergence on the importance of business conduct and risk-mitigation. However, EMIR and DFA appear to diverge with respect to the documentation and risk-mitigation protocols stipulated for dealers and end-users.

For example, the DFA imposes business conduct rules on SDs and MSPs, but *not* end-users. Instead, end-users are affected through their contract and trading relationship with dealers and MSPs. By contrast, EMIR makes end-users, including nonfinancial end-users, responsible for complying with risk mitigation rules and protocols—just like financial institutions. While this emphasis forces end-users to take responsibility for monitoring and establishing proper processes for risk mitigation, it can result in imposing a differential cost burden between end-users transacting under EMIR and those transacting under the DFA. Furthermore, there appear to be divergences in risk mitigation protocols for portfolio compression, reconciliation, and confirmation practices, complicating further the cost calculus of firms. That said, authorities are working on operationalizing a framework whereby a swap/OTC derivative subject to joint jurisdiction under US/EU risk mitigation rules would be deemed compliant with both if it complied with either.

Adding it all Up: Why Divergence Matters for End-users

These varying requirements and approaches create a challenging terrain for companies seeking to participate in the world's vast derivatives markets. Multinational firms, whether financial or industrial, confront a complex lattice of regulations when they enter into common derivatives transactions in international markets.

To start with, virtually all firms, including those that clearly qualify as swap dealers or major swap participants, must determine how the new rules apply to them. Are they required to clear trades? What are their reporting obligations? What kinds of changes must they make to internal risk management processes, information systems, and governance practices to account for their participation in derivatives markets? Deceptively simple, these questions require careful analysis and can be challenging questions to answer, even for sophisticated market participants.

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

66 In this context, parties can enter into new ISDA Master Agreements, or otherwise into side agreements that reflect the new obligations of the business conduct rules. ISDA has introduced two standard Dodd-Frank Protocols that include amendments reflecting the DFA, for example, to provide for portfolio reconciliation, compression, and post-trade confirmations.

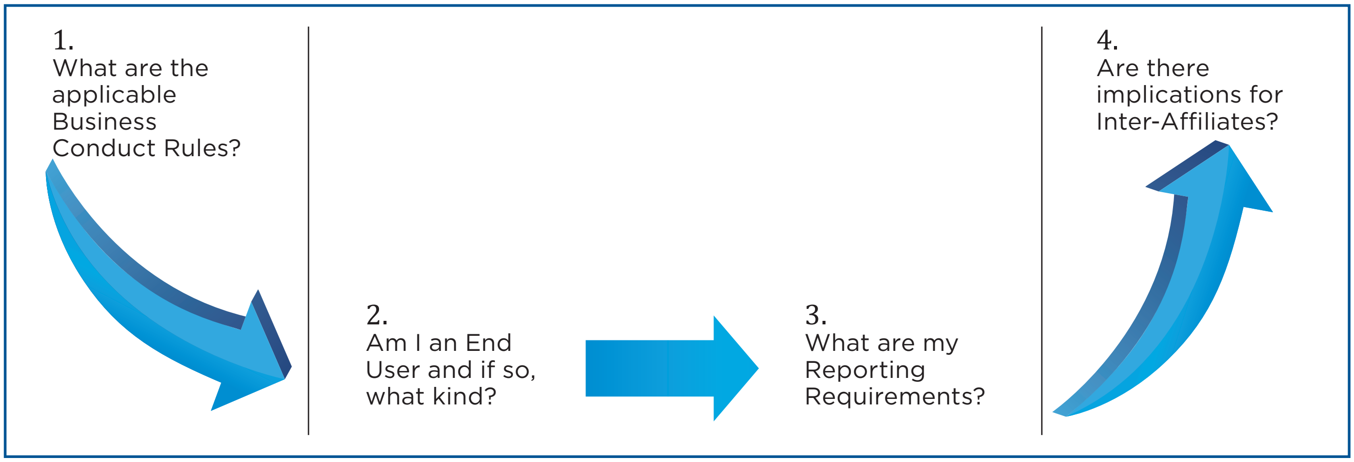
67 Commission Delegated Regulation 149/2013, art. 13, 2013 O.J. (L 52) 11, 12, http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2013:052:0011:0024:EN:PDF.

68 Ibid., art. 14.

69 Ibid., art. 12.

70 Ibid., art. 13.

The Increasingly Complex Decision-making of Hedging



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. With divergences at play, getting this answer right is critical. For example, nonfinancial end-users in the European Union become subject to EMIR when their derivatives activities cross a certain value threshold (without hedging, but taking into account the activities of their entire global group). The threshold value is low, and one might imagine that a large multinational company, such as a major oil concern with diverse derivatives activities across the globe, would cross this threshold fairly easily. In such cases, under EMIR the end-user can become subject to mandatory clearing of hedging derivatives trades and tougher monitoring- and risk management practices. By contrast, under DFA the law looks to whether this company is trading for hedging purposes, and whether it is a financial company. Thus, in the United States it might benefit from greater leniency in derivatives trading. Still, an oil conglomerate that operates through some EU subsidiaries and other US subsidiaries, trading a variety of derivatives with dealers across the globe, faces a complex trade-off. Should it comply with the stricter EU standard and subject all trades to mandatory clearing, even though certain of its hedging trades may benefit from the exemption under the DFA? Bearing in mind that large companies may centralize oversight of global derivatives activities, prudence may dictate complying with higher standards of regulation across the board to avoid inadvertent breaches and inconsistencies in trading practices between affiliates.

This story becomes more complicated when mandatory reporting rules are taken into account. End-users face considerable legal and logistical questions in deciding how to structure derivatives reporting, especially when they conduct derivatives trading through a number of subsidiaries across jurisdictions. Under EMIR, end-users can delegate reporting, but they must take full responsibility for reporting derivatives trades. This would suggest that end-users must ensure that their internal trade monitoring, mapping, and processing systems are sufficiently sophisticated to capture trade data and report it, if necessary, to relevant trade repositories and regulators. Moreover, EMIR sets detailed data requirements to include arrangements for reporting collateral alongside information on the economic characteristics throughout the life-cycle of the contract. The DFA, however, imposes different reporting requirements, ranging from who must report (usually, this is not the end-user) to what data must be collected (for example, no reporting requirement for collateral arrangements) and how quickly this data must be transmitted to the SDR or the CFTC (in real time, rather than by T+1). The large multinational end-user then faces yet another difficult choice: What data must its subsidiaries collect and with what level of granularity? Information-processing systems must adapt to variations in reporting regimes, data fields, and different transmission channels for reporting the data. Where end-users face varying reporting requirements, data capture- and processing systems may be fragmented—and the results may be difficult to centralize in the corporate office that manages derivatives trading. Also, in reporting, there does not appear to be a "stricter" standard between EMIR and DFA, just different standards—with variations in data type, timetables, and the actors responsible for fulfilling the obligations stipulated under new laws. Such uncertainties can create high costs across a corporate group. They can also create risks where complexity leads to mistakes, inaccuracies, or over-reporting of data, thereby generating redundancies and reduced transparency for the system as a whole.

Similar challenges play out in the new business conduct rules with which dealers and other major market participants must comply to ensure transparency and good risk management. Dealers and MSPs are required to put into place new documentation, due diligence, and client investigation practices, as well as risk mitigation protocols to assure a safe and client-conscious environment for derivatives trading. EMIR and DFA vary with respect to these important rules and standards, raising the likelihood that dealers and end-users will confront further uncertainties in determining the format of contracts they must use in trading and the risk mitigation tools they must use to protect themselves against counterparty risks.

The implications of such instances of divergence could be considerable. For instance, a large multinational oil company could see its various subsidiaries and affiliates transacting under a multiplicity of standard form master agreements and subject to changing contractual demands as a result of these differences. These variations might impact not only the quality of compliance that the end-user and dealer provide, but also the structure and design of the markets in which they operate. For example, dealers that do not wish to internalize the costs of multiple business conduct- and risk-mitigation regimes may focus their businesses in jurisdictions where they are already well-established. Similarly, clients may also limit their international search for competitive deals, if by doing so they can avoid adapting their internal systems to deal with new contracts and new business conduct demands from dealers. 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.

Because regulators on both sides of the Atlantic are currently devising and developing each of these three key compliance areas, and in different ways and at different points in time, market participants—both financial and industrial—are operating in an environment with a large degree of uncertainty. In one sense, this creates some opportunities for arbitrage insofar as nimble asset managers and hedge funds are capable of moving to jurisdictions where the regulatory costs are lower, thus padding profits. At the same time, however, large multinational corporations—and in particular end-users with a global footprint—often struggle to keep up with the new rules while complying with whatever rules are in place. Thus, for end-users in particular, the absence of harmonized or coherent approaches across jurisdictions—whether regarding reporting requirements, clearing, or business conduct—can take a toll on firms in the real economy. Only once rules have been firmly established, and the operational and compliance costs have been fully assessed, can we expect to see arbitrage from corporates.

At the same time, there is a sound argument that the winners from divergence may be the largest firms, especially the "too big to fail" institutions operating across borders. Interviews with treasurers at several large multinational end-user corporations suggest that the cost of divergence can be upwards of tens of millions of dollars. As a result, middle-tier companies may retreat to national or regional borders to avoid heightened business conduct obligations or overlapping or multiple compliance costs. A commensurate move from global providers of liquidity to more regional players could additionally raise the costs of hedging for end-users, and could even encourage less hedging by less well-resourced firms.

Accounting

Accounting has turned out to be one of the most intractable areas of international financial regulation. In principle, two regimes dominate international financial transactions. On the one hand is US GAAP, which is promoted by the Financial Accounting Standards Board (FASB), a US standard setter, and on the other is IFRS, which was devised by the International Accounting Standards Board (IASB) and has been adopted by the European Union.
Over the last decade, a push has been made to coalesce around a single set of international accounting standards. As multinational firms and institutions have increasingly sought capital across borders, and as investors themselves have become more interested in international investment opportunities, interest in a common rulebook for understanding and reading financial statements has grown. A single set of standards would allow companies seeking capital to be better assessed and analyzed, leading to better investment decisions and improved allocation of economic resources in the interests of jobs and growth. Furthermore, firms would no longer be burdened with the cost of preparing multiple sets of financial statements where they sought to operate or raise capital in multiple jurisdictions.

Over the last decade, the IASB has been working closely with the FASB to reconcile and eventually adopt IFRS for US firms. A convergence project was inaugurated in 2002 by international memorandum of understanding between the two standard setters, and today the standards are even more closely aligned than in the past. IOSCO, too, has effectively blessed IFRS as a fully fledged alternative to US GAAP. However, the United States has consistently declined to adopt IFRS as its own standard, and has limited reconciliation of IFRS for foreign issuers of securities. Indeed, a decision regarding the adoption of IFRS was expected in 2011, and then in 2012, but no formal determination has been made as of this writing.

The reluctance on the US side has left the two systems divergent in both approach and effect. The two regimes treat financial instruments, for example, very differently, and also present divergent models for how losses can and should be accounted for in financial statements. This has important implications for several issues, ranging from the determination of capital for Basel III purposes to calculating just how leverage should be measured under new bank leverage guidelines. For example, the more generous netting of derivatives allowed under US GAAP but not allowed under IFRS has a significant impact on the perceived leverage of US banks relative to their EU counterparts. Thus, a firm that appears under-leveraged under Basel III using GAAP would likely appear less under-leveraged under IFRS.

Some experts, however, suggest that while divergence makes regulatory (and market) supervision more difficult, the implications of such divergence may not always be bad. IFRS is a much newer standard than US GAAP, and has a much broader array of potential stakeholders. As the accounting organization IAECW has noted, not only does the European Union use IFRS, but so do Brazil, Canada, South Korea, and Mexico, as well as many others. Still, their adoption of the rules can vary significantly in practice. For instance, some countries have announced that they are adopting IFRS, but in the implementation process those countries might tailor the rules to local interests, thereby creating a menu of options with regard to how they account for important balance sheet items. As a result, concerns persist as to the consistency of the standards and their viability as an alternative to US GAAP. It is thus possible that a period of consolidation, during which the two systems operate independently, may provide sufficient time for IFRS to consolidate and evolve as an organization before tackling difficult negotiations with the United States.

The Transatlantic Challenge of Data Privacy

A growing part of the world economy is based on the free flow of data, which fosters job growth and innovation. Sharing data among affiliates or third-party businesses can, for example, save customers from costs associated with fraud, improve customer service, and make production more efficient. Even trends such as the use of the “cloud” have contributed to the obsolescence of certain rules intended to focus on data-transfer. In fact, current data privacy issues have impacts across a far wider spectrum than just finance: they affect a steadily expanding field of transatlantic business in both goods and services. In this analysis we focus on the implications of current developments for transatlantic financial reform.

Financial service companies commonly rely on the free flow of information across national borders to conduct activities that are widely considered commonplace, for example, processing credit card purchases, assessing risks, offering online banking and other interactive or customized web-based services, or even simple tasks like sending and receiving emails. Less positively, however, individuals may become susceptible to data breaches, unsolicited outreach, and harassment. These concerns can be amplified by financial service companies’ increasing tendency to process and store data in countries other than the original source.

The European Union and the United States have each moved to address the issue of personal data protection, including in finance-specific contexts, but they have taken significantly different approaches—usually for deep-seated reasons. For the most part, 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 services. This divergence has the potential to materially affect international commerce, as well as the substantive content of transatlantic financial regulations.

EU Data Privacy Measures

The European Union’s approach to data protection is based on the 1995 EU Data Protection Directive, which was implemented over the following years by each EU member state. The Directive—and the resulting country-by-country legislation—have set forth a regime that promulgates clear rules against the unrestricted sharing of EU-resident individuals’ personal information, both within EU countries and globally. In brief, these measures require (among other things) that a company or other person (i) process data fairly, (ii) store and use it only for purposes that the user has specified, (iii) restrict data to relevant information that is not excessive in light of its purpose, (iv) ensure accuracy and updating, and (v) destroy personal data when no longer needed. Under the directive, personal information is broadly defined and includes virtually all information that may identify particular persons or their accounts.

Cross-border communications containing personal data of EU residents has become a particularly sensitive topic. Because the directive applies throughout the European Union, the directive does not impose special restrictions (beyond those embedded in the directive) on the transfer of personal data into other EU countries. However, since each member state is tasked with developing its own implementation measures, compliance methods and enforcement of the directive can vary widely.

The European Union has identified several other countries (including Canada) that, in its view, have taken adequate steps to safeguard personal information, so data is permitted to be sent into those countries. The United States is not among these countries, so—absent an exemption—a company's US offices could be subject to an EU prohibition on the receipt of personal data sent from the European Union. In order to transfer data out of the European Union, firms in the United States have had to rely on the US-EU Safe Harbor programs (limited to those businesses subject to Federal Trade Commission oversight, which precludes almost all financial service companies, including banks and insurers; these are generally not available to financial institutions such as banks), binding contractual provisions that typically consist of well-established model contract clauses (generally not available to unincorporated branches of banks), or binding corporate rules, which are generally internal policies that may not be breached. These alternatives are not necessarily self-executing and may require approval from an EU body. Most of the larger financial institutions based in the United States are currently able to transfer data via one of the latter two options. However, the proposed General Data Protection Regulation now under consideration in the European Union leaves much uncertainty as to the ease by which this practice can continue. To give a sense of the breadth of these measures, it is worth considering the example of a US company that has no exemption from the measures. The US arm of the company may be prohibited from receiving data about the company's own European employees as well as its customers, marketing targets, and the like. More sophisticated uses of personal data that are becoming an increasingly large part of the world economy would also be forbidden. The EU requirements are, in most cases, broader than the corresponding US federal and state requirements summarized below. A violator of these EU member state laws may be subject to severe sanctions.

The proposed General Data Protection Regulation would modify the scope of the existing Directive and provide for a single set of unified rules that would apply across the European Union, rather than today's system of member state laws that allow for some variance in how they implement the directive. Among other things, the new regulation could apply outside of the European Union with respect to personal data of EU residents, generally without regard for whether another "nexus" or connection exists between the EU and the non-EU party holding the personal data. Many companies around the world might be required to adopt formal internal controls, make their policies and procedures available on request, add periodic public disclosures, and appoint a data protection officer. The regulation could impose significant penalties of up to 2 percent of annual global revenues for noncompliance. The form of the regulation is not final and its effect on any existing exemptions is not yet clear.

US Data Privacy Measures

US data privacy regulations have developed from various sources, each covering specific, limited topics. For example, the US Gramm-Leach-Bliley Act of 1999 and the US Fair Credit Reporting Act as amended in 2003 each mandated several banking, investment, and other federal regulators to adopt privacy-related regulations applicable to financial institutions under their jurisdiction. While there is no binding national framework that applies to all personal data, the patchwork approach arguably provides the same level of privacy protection as the current EU directive. On the upside, the US approach provides more flexibility for different types of businesses, but it is also confusing. Compliance with these regulations is based primarily on providing disclosures, opt-out rights, and responsibility for safekeeping, rather than the imposition of a blanket prohibition on particular kinds of data sharing. More recently, Title VII of the DFA and related rules have imposed on SDRs the duty to maintain policies and procedures reasonably designed to protect the privacy and confidentiality of much of the information that they receive, but do not prohibit certain acts of information sharing.

The laws of particular states throughout the United States vary, and may add obligations (such as public notice requirements of data breaches), but generally do not impose the kinds of restrictions found under the EU directive or the proposed EU regulation. With some exceptions, US regulations protect a financial institution's customers rather than its employees (as compared with the EU measures, which cover employees along with all other EU-resident individuals, generally speaking). In lieu of governmental rules, many US businesses and trade groups have sought voluntarily to adopt best practices, employ self-regulation, or provide more detailed notices than required by law. Some other federal and state laws expand privacy responsibility beyond financial institutions, such as with respect to medical records.

Why Divergent Data Protection Policies Matter

While data protection is not generally viewed as a matter of financial regulatory concern, the ability to transfer data across borders is inseparable from the normal operations of financial institutions. Divergent approaches toward personal data could have a number of implications for transatlantic financial regulation. At a minimum, a company may be tempted to purposely confine its customer base to residents of a particular jurisdiction.

Certain business models, such as banking services that make a product available to specific customers based on their personal preferences, may be available in one jurisdiction but not the other, restricting user choice between financial services providers. Similarly, in order to meet jurisdictional requirements, an organization may find it necessary to form special affiliates within a particular jurisdiction, thereby adding to operational complexity.

> *EU data protection rules in particular could impact trade reporting in both the European Union and the United States.*

Restrictions on data flows could also lead to decreasing access to credit as lenders find it more difficult to examine financial histories, which often include transactions outside of one jurisdiction. Insurers may also become reluctant to offer diverse and comprehensive policies as risk assessment becomes increasingly difficult.

EU data protection rules in particular could impact trade reporting in both the European Union and the United States. As described in the derivatives section, SEFs, clearinghouses, SDs, and MSPs are generally under an obligation to report derivatives trades. Data protection rules could affect the management of that data and the responsibilities of a diverse set of market participants. Indeed, where rules are made on a territorial basis, they could add an extra layer of variation to reporting or even documentation practices mandated by new business conduct regulations. These internationally layered requirements could also weaken the ability of law enforcement officials to proactively detect possible fraud or other illegal activities.

Transatlantic Engagement with the Rest of the World

From banking regulations to derivatives, and accounting to data protection, the European Union and United States are far from being the only actors in financial regulation, nor do they act in a vacuum. Rather, they operate in a larger international regulatory community. For at least a half century, the importance of this community seemed to have little relevance to transatlantic regulatory practice. Such a perspective has for some time, however, been woefully anachronistic, given global market developments. Already, other countries have assumed greater importance in the global financial system, and their influence is only set to increase as growth in nontraditional and emerging markets continues to outpace comparable metrics for growth in the West.

Emerging market governments will demand a greater role in international decision-making bodies.

As noted earlier, the largest banking system in the world now resides in China, not in the United States or Europe. Growth in emerging markets still stands to outpace that of the European Union and United States—particularly Europe—even despite current slowdowns. Over the next decade, emerging economy equity markets will begin to rival those of the West, and they will further deepen in sophistication as China internationalizes its renminbi (RMB) currency and as these emerging markets develop new products and increasingly sophisticated trading instruments.

Comparably stronger economic growth in emerging markets over the medium-term is important on two accounts. First, it implies that the demand for capital is bound to increase as the need to finance growth in Asia and the "global south" continues. Second, the rise in the demand for capital over the next decade and beyond will likely be accompanied by a decline in the transatlantic community's regulatory power, at least relatively speaking. With growth elsewhere, fewer deals will be consummated in the United States and European Union relative to the rest of the world; as a result, financial authorities will have less regulatory power since the markets subject to their jurisdiction will be (relatively) smaller.

This confluence of events will create unprecedented changes in the regulation of global financial markets. First, emerging market governments will demand a greater role in international decision-making bodies. Instead of taking a relative backseat on international policy considerations, they will more vocally assert their own interests and policy preferences in global forums like the G20 and FSB. Second, their policy preferences might not align entirely with those of the European Union and the United States, especially given their different histories and stages of development.

Up until now, emerging markets have been largely constructive regulatory actors. While there is no apparent trend toward adopting Volcker/Liikanen/Vickers style regulations—in part because they were never part of the G20 process—ASEAN, ASEAN+3, Executives' Meeting of East Asia Pacific Central Banks, and the regional consultative bodies of international standard setters like IOSCO, Basel Committee on Banking Supervision, and IAIS have been active in supporting implementation of international standards. The Asian Development Bank, in particular, uses international standards widely in its activities supporting financial sector reform, and an increasing number of jurisdictions have participated in IMF and World Bank monitoring exercises that examine the implementation of international best practices like Basel III. Furthermore, under the ASEAN Capital Market Implementation Plan, the adoption of international standards is now an explicit objective, including the development of an increasing number of regional standards derived from international standards.

Asian markets have also been rapid adopters of both Basel II and Basel III, though implementation will be slow in developing Asian markets. Emerging market banks usually exceed (by far) the minimum ratios required by the BCBS and national regulators; however, liquidity ratios continue to generate considerable concern. Unlike many fully developed countries, emerging market governments cannot generally issue their own debt for their domestic banks to use as capital or collateral. Instead, regional banks often have to purchase foreign debt in global markets to hold as collateral or meet regulatory capital requirements. This drives up the demand for high-quality assets, and tends to affect emerging market borrowers disproportionately. The increasingly heated search becomes all the more noteworthy because CCP clearing, along with Basel III, is also raising collateral requirements for market participants, adding to the global demand for high-quality assets.

Yet some of the most vociferous objections to Basel III center on the concern that it does not address the needs of less-developed financial systems, especially regarding trade finance. One common target of criticism is Basel III's assessment of corporate risks, which puts trade finance on par with other products like syndicated loans and bonds. For capital-hungry emerging markets, especially in Asia, this has caused considerable concern—and even frustration—since trade finance has a much lower risk profile.[71] Another criticism is that Basel III's leverage ratio rules disproportionately affect emerging markets, as a sizable chunk of deals relies on letters of credit and off-balance sheet guarantees, and the conversion of both to fully weighted balance sheet risks could limit the use of such instruments to finance growth.

Generally speaking, OTC derivatives markets are much less developed in Asia than in the United States or European Union, although they are developing rapidly. In contrast to US and EU policy preferences, Asian policymakers generally want the size of these markets to grow, in the interests of better risk management. As a result, countries take divergent approaches even among themselves. Clearing is supported in the more developed Asian markets (e.g., Hong Kong and Singapore). At the same time, exchanges across the region are preparing to support derivatives markets and promote a deeper, more sophisticated infrastructure (e.g., the Hong Kong Exchange's acquisition of the London Metal Exchange). This is particularly important for China, which is seeking to internationalize the use of the RMB, which in turn requires domestic interest rate and exchange rate liberalization. To enable the deregulation of monetary policy, however, more risk management tools are needed to cope with the liberalization process. In less-developed markets, by contrast, clearing is a less-urgent policy priority. Instead, issues such as banking regulation are seen as more important (in the case of banking regulation because it directly impacts the financial sector's ability to support economic development). Furthermore, local authorities are concerned that premature regulation could either kill off nascent

71 According to some reports, including a recent study commissioned by the International Chamber of Commerce, trade finance is 30 times less risky than other forms of finance. Because trade finance has exposures to multiple geographies, related deals are generally smaller in size, diverse, and self-liquidating.

derivatives markets or transfer deals off-shore, and possibly out of the region altogether to the European Union and United States.

The question remains as to whether divergent practices in Asia will eventually crystallize into one pan-Asian regulatory approach. Today, this change seems highly doubtful. ASEAN countries are not generally following the European Union, where a passport approach allows financial institutions to branch seamlessly across the region once they register or attain a license as a corporate body or a subsidiary in one member state's jurisdiction. Instead, because of the greater heterogeneity in Asia with regard to financial infrastructure and development, leading jurisdictions like Hong Kong generally require separately capitalized and regulated subsidiaries in order to avoid regulatory arbitrage from developing country markets (and concomitant cross-border risk). Over the longer term, however, greater integration is indeed possible, especially as these developing markets mature. ASEAN countries are, for example, moving toward the creation of a single integrated marketplace for listed securities, and several ASEAN jurisdictions have taken tentative steps toward the mutual recognition of ASEAN funds.

Possible Paths Forward/Recommendations

This report has focused on divergence, but it is worth repeating just how far the international regulatory community has come—with EU-US cooperation at the forefront—in fundamentally reforming the global financial system. Since the global reform agenda was launched, the world has seen new rules that have:

- Bolstered the amount of capital held by banks;
- Improved the quality of capital held by banks;
- Heightened transparency in derivatives markets;
- Established tougher business conduct and clearing obligations; and
- Reduced the exposure of deposit-taking institutions or operations from speculative and proprietary trading.

Unsurprisingly, these reforms have carried significant—and justifiable—costs for financial services providers, which have been required to hold and fund enhanced levels of capital. And in pursuing these reforms—and especially in implementing them—it is clear that the United States and European Union have occasionally adopted different rules and approaches on a range of important sectoral issues. This, too, should not be surprising: the United States and the European Union (as well as the member states comprising the European Union) have very different financial systems, regulatory infrastructures, and philosophies. Furthermore, as we have seen, the two jurisdictions have vastly different political and administrative processes, which can lead to varying implementation timelines and priorities.

Nevertheless, this report has shown that divergence, even on the margins, can have its own big impact on efficiency and financial stability, as well as through increased costs to business end-users of financial services in the "real economy." Divergence is not always bad—and can even provide an opportunity, as in accounting, for the consolidation of efforts to harmonize or improve other efforts at coordination among like-minded countries. In addition, divergence can hedge against the risks of multiple jurisdictions adopting "bad" rules. But divergence does come with costs—not only compliance costs in situations of regulatory uncertainty, but also the costs inherent in distortions in competition and markets. In a world of increasingly robust regulatory regimes, participants in today's global markets, from banks to auto manufacturers to coffee shops, seek consistency and certainty as to the rules that will apply to their various financial transactions. Fragmented rules create an environment that favors large institutions, and disadvantages smaller ones. Meanwhile, as regulators work to enhance the stability of their financial markets, divergence potentially undermines reforms at home to the extent to which still risky transactions move abroad.

Since the G20 Pittsburgh summit, relatively little emphasis has been placed by heads of state on market regulation and supervision. As a result, most of the energy with regards to agenda setting and implementation of any international financial regulation has been left to the FSB. However, for all of its great work, the FSB is at times ill-suited to coordinate policies where national interests diverge significantly or government agencies have vastly different policy preferences for starting points. Furthermore, the FSB's work routinely overlaps with other international standard-setting bodies, creating increasingly numerous—and important—questions of jurisdiction and regulatory authority.

In this context, the US and EU should lead an effort to reenergize the G20 as the preeminent global forum on financial reform.

We believe a number of avenues are available in this regard:

- A reaffirmed commitment to international regulatory cooperation should be embraced by the G20 at the next leaders' summit as part of a general call for enhanced regulatory engagement.
- Global cross-border regulatory bodies like IOSCO and the Basel Committee should be explicitly encouraged to increase their level of cooperation and consistency in drafting, finalizing, and enforcing standards and regulations. Indeed, the FSB, too, should emphasize coordinated action—not only across sectors but also across borders as a soft means of nudging authorities toward consensus.
- The G20 should improve the interoperability between regulatory bodies like the FSB, IOSCO, and Basel Committee by delineating their roles more explicitly and charging the FSB with rulemaking authority, above all, when other bodies fail to act swiftly or where the interdisciplinary nature of a regulatory challenge makes its participation useful for enhancing both sectoral and national consistency.
- Where particular jurisdictions with relevant expertise (such as the European Union and United States) can work together to reach agreement on domestic regulation that also meets requirements for international uniformity, they should be encouraged to present their agreed solutions to the FSB as proposals for potentially wider international adoption.

The United States and the European Union should launch a comprehensive program aimed at bilaterally coordinating implementation of their reforms, across regulatory agencies.

Bilateral 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. Though their regulatory market share is diminishing, they still account for roughly half of global GDP, and their financial markets continue to provide the majority of liquidity for the global financial system. Furthermore, both jurisdictions are widely acknowledged as containing within their territories the best regulated financial markets, markets replete with the most experience and deepest expertise. And whatever their divergences around the edges, both are largely moving in step with regards to their implementation of G20 commitments. As a result, transatlantic coordination should not only intensify as regulators implement global standards, but should also be sustained in parallel with the G20 process. The US-EU Financial Markets Regulatory Dialogues, in particular, should find new life alongside G20 meetings of treasury officials and central bankers.

High-level political engagement should focus on the thorny issue of cross-border resolution. When big firms are distressed and seem poised to become insolvent, there are great incentives for national officials to grab assets and protect local creditors. Thus, there is often little cooperation among foreign authorities when, for instance, a multinational bank fails. This has spurred preemptive, self-protective measures like the geographically based liquidity mechanisms embodied most controversially by IHCs. To reduce the urgency and concern driving such measures, leaders should refocus their attention on the issue of resolution, and commit to the establishment of a credible resolution regime in the next decade.

At the same time, the growth of financial markets in Asia and elsewhere suggests that any efforts to secure the global financial system must be poised to move quickly beyond the traditional money centers in Europe and the United States to engage a wider number of stakeholders in far-flung locales. Recent reforms in Asia indicate that the United States and European Union are unlikely to be persuasive with the rest of the world when they adopt unilateral rules and then try to coordinate them bilaterally through EU-ASEAN or US-ASEAN channels. Instead, it is when both the United States and the European Union are able to act on a united front that the two jurisdictions will be best positioned to export their policy preferences, and even then only where they do so via the G20 process. Bilateral coordination must be coupled with respectful, collective outreach to emerging markets, and then mediated via the global forums like the G20 (and relevant international standard-setting bodies) that carry the most weight and persuasiveness, in order to have the highest likelihood of success. Both the European Union and United States should, to the extent possible, avoid shunning transatlantic and global coordinating mechanisms.

A new generation of cooperative regulatory agreements is needed to bolster bilateral cooperation.

The transatlantic regulatory relationship must evolve. Traditionally, international regulators have relied on mutual recognition and substituted compliance agreements to promote cooperation. These kinds of agreements are useful to the extent to which they allow regulatory agencies to recognize one another's systems as equivalent, and thereby permit market participants from each jurisdiction to operate in their own jurisdiction so long as they have complied with their home regulator's requirements. They can also incentivize regulators to raise their standards, even where they generate higher costs, insofar as their "trade dividend" improves access for local firms to foreign markets.[72]

However, these solutions—and particularly substituted compliance—have historically been the culmination of a long series of interagency negotiations, from which authorities concluded that supervisory frameworks were essentially the same or could be adjusted relatively easily by one partner to ensure mutual conformity. Thus, an existing benchmark standard existed, against which markets were judged. This is no longer always the case. Coordination of the kind required after the 2008 financial crisis has had to take place under circumstances in which regulatory leaders were *all* tasked with concurrently upgrading their domestic financial systems. In a sense, the relative absence of domestic regulation in some fields presents a new opportunity for coordination, especially where no jurisdiction is necessarily invested in a long-standing regulatory model, and where all have to make regulatory adjustments and reforms. However, the very absence of a longstanding or proven regulatory framework can become a source of skepticism for regulators when judging the steps taken by their counterparts—especially where one jurisdiction tackles an area before others. As David Wright, the Secretary General of IOSCO has noted, "given the different timing of the adoption of national or regional laws, institutional rigidities and inflexibilities can set in, with no one willing to change their domestic rules."[73]

The G20 process largely overlooked such considerations. Instead, G20 leaders were charged with instituting change over time horizons ranging

72 For example, in the case of the Multijurisdictional Disclosure System, a mutual recognition program in place between Canadian and US securities authorities, Canadian regulators were required to institute a range of reforms associated with both issuance rules and supervisory activities as a condition for participating in the program. Moreover, the SEC eked out additional concessions from regulators over time, including concessions on Sarbanes Oxley that were adopted by Canadian officials.

73 Tom Osborn, *Substituted Compliance Requires Global Oversight, Warns IOSCO's Wright*, Risk.net (June 24, 2013), http://www.risk.net/risk-magazine/news/2276470/substituted-compliance-requires-global-oversight-warns-iosco-s-wright.

from one year to a decade. Without more precise direction, or even a schedule for tackling specific regulatory issues and concerns, and taking political pressures into account, both the European Union and the United States (as well as a host of other regulators) can and do often stray from any shared ranking of policymaking priorities, thereby eroding trust.

Thus, it follows that recognition programs of all stripes should provide procedural mechanisms for coordinating rule-making and administrative processes in both jurisdictions. The process could begin with both sides identifying areas of particular interest or of regulatory concern in framework agreements laying out a path to mutual recognition or substituted compliance. Higher priority issues or goals could be identified as such in order to provide direction for rulemaking. Furthermore, information sharing and dual deliberation could be enhanced. Provisions in the agreements could require agencies (and, where relevant, legislative bodies) to be consistently apprised of the stage and status of foreign rulemaking deliberations, as well as allow for periodic and predictable opportunities to provide comments on draft proposals.

Second, mutual recognition and substituted compliance agreements should be envisioned to the extent possible as an objectives-based process focusing on the results in practice that need to be achieved. When detailed rules are applied rigidly to coordination, dictating to partners what steps they need to take (and how)—and then enforcing compliance with those rules—two problems arise: first, agreements will often lack the institutional capacity to respond to changes in regulated activity, and thus risk becoming irrelevant as the “footprint” of regulated activity changes; and second, compliance increasingly becomes synonymous with adherence to the black letter of the law, even where compliance is accompanied by actions that violate the spirit or implicit objectives of the same set of guidelines.

For recognition to be an objectives-based process, regulators must feel confident in the financial supervision exercised abroad, even as tactics evolve both domestically and abroad to address new and emerging threats and challenges. In the case of the G20, mutual recognition and substituted compliance should be premised on meeting the benchmarks as laid out by international regulators and best practices, and as appropriate in light of the makeup of a country’s domestic financial system. The eventual recognition of a regime should also be the beginning, not the end, of coordination, and be supported by continuing back-and-forth cooperation that is geared toward making both financial systems as safe and efficient as possible. All the while, priorities established in framework agreements should be used and relied on as guides for evaluating the appropriateness of enhanced or liberalized market access.

Regulators should be empowered under their mandates—and through the use of agreed on criteria—to withhold or withdraw their recognition where they can demonstrate circumstances to warrant such action. As prudential regulators, their authority should remain paramount. However, withdrawal of recognition should not be based on some crude form of “tick-the-box” rationale, where one party’s deviation in less than material ways triggers a wholesale withholding of cooperation—or at least a threat to withhold such cooperation. Furthermore, if partners can convincingly achieve the same policy ends through other means than withdrawal of recognition, flexibility should be afforded.

Because of the difficulties in securing cross-border cooperation, questions persist as to whether more formal institutional arrangements, like legally binding accords and treaties, could assist international financial regulation.

Regulators and market participants are largely in agreement that formal international obligations are not necessary per se for international financial regulation. International financial markets change quickly, and often require swift responses from both national and global regulators. It is, however, still worth considering the full panoply of international tools available to promote cooperation, and whether more formal institutional mechanisms would be useful with regards to the promotion of international coordination and cooperation. Just as intellectual property provisions have been included in international trade agreements to promote higher protections for IP, discrete chapters in trading arrangements like the proposed Transatlantic Trade and Investment Partnership (TTIP) could be included to promote coordination in international financial regulation. Such provisions should not necessarily articulate prudential standards and rules, however, but instead should help frame procedural benchmarks for ongoing and deepening coordination.

In any case, operationalizing enhanced regulatory cooperation can be resource intensive. In order to recognize another jurisdiction as essentially equivalent, for example, regulatory agencies must familiarize themselves with the practices of other jurisdictions, and then relate these practices to their own domestic financial systems. They must, in short, feel confident that recognition will not undermine their own regulatory efforts. Since rules and regulations often cover thousands of pages, however, regulatory agencies may find themselves overwhelmed and understaffed with regards to carrying out the work of international financial diplomacy. The SEC's Office of International Affairs (OIA), for example, has approximately two dozen attorneys to examine, understand, and coordinate with the world's securities agencies. The CFTC's OIA fares even more poorly, and has even fewer staff. Even trade and treasury officials have had their travel budgets slashed, and in some cases eliminated, and ongoing budget battles present considerable challenges to transatlantic diplomacy. As a result, there should be little surprise that evaluating foreign jurisdictions can take months—if not years—to do well. To speed up this process, regulatory agencies and the legislatures should consider devoting more resources to international financial coordination and the personnel charged with promoting it.

Thus, all in all, a call to *cooperative* action is needed. Financial reforms are moving ahead, though not always with the full weight of EU and US consensus. And not infrequently, reforms are bypassing the G20 process altogether. As a result, gaps are arising that can undermine both efficiency and stability, thus undercutting the projection of transatlantic policy preferences abroad. Minimizing the dangers of such divergence is therefore necessary, and involves not only promoting flexibility where possible, but also a rethinking of the very institutional structure through which the European Union and the United States promote economic relations. In the absence of creative policymaking, opportunities for collective action may still be possible, but their impact, especially if cooperation is delayed for the future, will be far less significant in a world with more diverse sources of regulatory power. The urgency of smart, transatlantic regulatory cooperation thus remains stronger now than ever before.

The Atlantic Council is a nonpartisan organization that promotes constructive US leadership and engagement in international affairs based on the central role of the Atlantic community in meeting today's global challenges.

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