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Legal Fragmentation, Extraterritoriality and Uncertainty in Global Financial Regulation

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Abstract—This article explores the reasons for legal fragmentation and extraterritoriality in the global regulation of finance. It shows that duplicative and overreaching rules are not necessarily the result of regulatory competition in which egoistic states undercut the rules of others in order to improve their position. An equally pivotal problem that global financial regulation has to cope with is uncertainty. Such uncertainty exists with regard to the right measures for achieving financial stability and with regard to the willingness and ability of other states to adopt them. The article analyses approaches to overcoming legal fragmentation while maintaining global financial stability. It suggests that there is no alternative to a collaborative approach, using intensified regulatory dialogue, a broadening of the information base and deference to other states' rules. In order to improve the current mechanism, it proposes the introduction of multinational panels to assess whether regulatory and supervisory set-ups of two or more states lead to comparable outcomes, in which case they must be recognised as being 'equivalent' or 'substituted compliant'.

Keywords: financial law, legal harmonisation, regulatory competition, regulatory dialogue, equivalence, substituted compliance

1. *Introduction*

A lack of sufficient regulation has been blamed for being at the root of the 2008 global financial crisis (financial crisis).[1] Today, it seems that this problem has

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[1] Financial Crisis Inquiry Commission, *The Financial Crisis Inquiry Report, Authorized Edition: Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States* (PublicAffairs 2011)

been overcome, but that another has taken its place: too much regulation. In the regulatory wave of the last years, states have created a plethora of new rules. Often these rules are applied extraterritorially and therefore overlap; this poses a challenge for transnational market actors, who must comply with two or more regimes. The duplicity is worsened where these measures have contradicting content, which makes it impossible for a transnationally active firm to comply with all of them simultaneously. As a result, market access is effectively denied and markets become segregated.

Legal fragmentation and extraterritoriality are frequently bemoaned. The Financial Stability Board (FSB), for instance, reports that in three meetings, held in Hong Kong, London and Washington, DC in April 2014, industry representatives complained about national regulators promulgating 'duplicative, inconsistent and conflicting requirements which lead to significant compliance burdens and unnecessary barriers to cross-border trading and investment'.[2] Similarly, the Atlantic Council has issued a strong warning about the 'dangers of divergence', in particular duplicative regulatory requirements for clearing houses and in technical rule making in the derivatives sector.[3] Three Asian regulators criticise in a letter to the US Commodity Futures Trading Commission (CFTC) the 'increasing market fragmentation and, potentially, systemic risk' and the 'compliance burden on industry and regulators' that may result from its planned cross-border application of certain swap rules.[4] The UK Financial Markets Law Committee highlights that divergent national approaches and differences 'present a serious challenge to effective cross-border regulation'.[5] The International Swap and Derivatives Association (ISDA) has loathed the negative impact of conflicting extraterritorial legislation.[6] Even the G20 was forced to acknowledge the problem when the heads of state gathered in Saint Petersburg in 2013 noted the presence of 'conflicts, inconsistencies, gaps and duplicative requirements' in the regulation of derivatives.[7]

52–3 (citing deregulation, in particular the repeal of the Glass-Steagall Act, as one of the causes of the financial crisis).

[2] IOSCO Task Force on Cross-Border Regulation, 'Consultation Report' CR09/2014 (2014) 43.

[3] C Brummer, 'The Danger of Divergence: Transatlantic Financial Reform & the G20 Agenda' (Atlantic Council 2013) 30, 43.

[4] B Gibson and others, 'CFTC Proposed Guidance on Cross-Border Application of Certain Swap Provisions of Commodity Exchange Act ("Proposed Guidance")' 2 <http://comments.cftc.gov/PublicComments/CommentList.aspx?id=1234> accessed 8 October 2015.

[5] UK Financial Markets Law Committee, 'Coordination in the Reform of International Financial Regulation—Addressing the Causes of Legal Uncertainty' 9 <www.fmlc.org/uploads/2/6/5/8/26584807/fmlc_g20_discussion_paper.pdf> accessed 25 March 2015.

[6] ISDA, 'Public Comment on the IOSCO Task Force on Cross-Border Regulation Consultation Report' (2015) 4 <www.iosco.org/publications/?subsection=public_comment_letters>.

[7] G20 Heads of State, 'Leaders Declaration Saint Petersburg Summit' 2013 17–18, para 71 <https://www.bundesregierung.de/Content/DE/_Anlagen/G7_G20/G20-erklaerung-petersburg-en.pdf?__blob=publicationFile&v=3> accessed 12 March 2015.

Most of these statements concern the derivatives market, where the difficulties are currently most acutely felt because of this market's high level of interconnections. Yet, given the prospects of increasing globalisation in more markets, it may foreshadow things to come in other areas of finance, such as financial technology. Legal fragmentation is a cause for concern. Besides the obvious costs and obstacles for transnational financial firms, it may also endanger general interests. In particular, it may cause a 'renationalisation' of finance, with the result that economies of scale and scope will be lost, market liquidity reduced and the flow of information subdued. This might lead to a situation where the opportunities for a firm to obtain finance will once again depend on its location rather than on the merits of its business model. In short, all the benefits of global financial market integration over the past decades are in danger of being reversed.

This article will analyse the causes of legal fragmentation and suggest some remedies. In section 1, it will make the case for a coherent regulation of financial markets. Section 2 will show that one reason why this goal is particularly difficult to reach is uncertainty. Against this background, section 3 will discuss three proposals made in the literature that may overcome legal fragmentation: adopting 'hard' international rules; introducing more flexibility at the national level; or increasing harmonisation through the extraterritorial application of domestic law. Since all of these proposals have shortcomings, section 4 will make alternative suggestions of how regulators may align their actions in order to reach more harmonious results.

2. *Coherence in Global Financial Regulation*

A. *The Concept of 'Global' Financial Regulation*

When one talks about 'global financial regulation', it is first necessary to clarify what the adjective 'global' means. There is a risk that the term might be confused with 'international', in its literal meaning 'between states'. This would be a misunderstanding. Global regulation is not limited to legal sources of international law, such as treaties or soft law adopted by states or acts and resolutions by international organisations, but can also spring from national law or non-governmental bodies. Nor is it concerned, at least not primarily, with inter-state financial issues, such as balance of payment or foreign debt.

What, then, is 'global' financial regulation? The term 'global' should be reserved for laws that use a specific global approach to tackle a problem that affects all of humankind. In this sense, the peculiarity of global law is that it deals with questions from a worldwide vantage point. In the case of financial regulation, this particular perspective is macroeconomics seen from its most general level. Global financial regulation is not about individual institutions or national markets as such; rather, it deals only with those factors that pertain to the functioning of the global market. More specifically, its aim is to guarantee worldwide financial stability and prevent systemic risk.[8]

An early forerunner to global financial regulation is the Basel I regime on capital measurement and capital standards, which was adopted as early as 1988.[9] However, global financial regulation really started off with the financial crisis.[10] Instrumental in its rise were the various G20 summits held as a reaction to the crisis. In 2008, in Washington, DC, the heads of state of the leading industrial nations recognised that while 'Regulation is first and foremost the responsibility of national regulators… our financial markets are global in scope'.[11] They set out a specific policy agenda, including issues such as improved disclosure standards for off-balance-sheet vehicles and more stringent regulation of rating agencies.

This was indeed a paradigm shift at the highest level. For the first time, financial markets were not viewed as being primarily national or international, but as a single integrated phenomenon. A macroeconomic perspective encompassing the world economy as a whole was adopted. The change in perspective is comparable to that of the emergence of global environmental law or of the human rights debate.[12] As in these fields, it was realised that there is a global interest which exceeds the interests of each individual state, and that this interest calls for specific rules.

B. *The Need for a Systematic Approach to Global Regulation*

The concept of global financial regulation as has been set out here implies that this regulation takes a certain form. It does not suffice for each state to adopt rules for safeguarding its own financial stability. Instead, national and international legislators and law enforcers must work hand in hand towards the common goal of achieving global financial stability. They must interact with one another, and their actions must be aligned and correspond to each other, similar to body parts whose movements are controlled and co-ordinated by the mind. This is what some authors mean when they call for 'global governance'

[8] O De Bandt and P Hartmann, 'Systemic Risk: A Survey' (2000) European Central Bank Working Paper Series, Working Paper No. 35 <https://ideas.repec.org/p/ecb/ecbwps/20000035.html> accessed 2 March 2015.

[9] Basel Committee on Banking Supervision, 'International Convergence of Capital Measurement and Capital Standards ("Basel I"), July 1988' <www.bis.org/publ/bcbs04a.pdf> accessed 30 March 2015.

[10] A certain indication of its rise is the time that it entered book titles. Most of them were published after the start of the crisis. See H Davies and D Green, *Global Financial Regulation: The Essential Guide* (Polity 2010); E Avgouleas, *Governance of Global Financial Markets: The Law, the Economics, the Politics* (CUP 2012). For an early treatment of the subject, see K Alexander, *Global Governance of Financial Systems: The International Regulation of Systemic Risk* (OUP 2006).

[11] G20 Heads of State, 'Declaration of the Washington, DC Summit on Financial Markets and the World Economy' 2 <http://www.un.org/ga/president/63/commission/declarationG20.pdf> accessed 2 March 2015.

[12] See eg S Turner, *A Global Environmental Right* (Earthscan, Routledge 2014); T Evans, *Human Rights in the Global Political Economy: Critical Processes* (Lynne Rienner Publishers 2011).

of financial systems.[13] One could also say that we need a systematic approach to global financial regulation.

Such a systematic approach corresponds to the object of regulation. In fact, global finance is itself a system. Its various parts are interconnected and interdependent, making them vulnerable to the risk of contagion and common shocks. In its complexity and interconnectedness, the financial system resembles other global networks, such as communication and information systems, the water supply system or the climate.[14] What is common to all of them is that problems in one part have the potential to affect other parts of the world as well, as epitomised by the notion of 'systemic risk'.[15] This particularity calls for a co-ordinated response. Instead of focusing on each of its parts individually, the global system must be comprehended and treated as a whole. The more integrated a global phenomenon is, the greater the need for a systematic regulatory reaction.

States should therefore not tackle the issue of financial regulation in isolation from each other. Instead, a concerted effort is required. Since risk can come from anywhere in the financial system, regulation must cover all of its parts. The G20 heads of state have realised this from early on. In Washington, DC, in 2008, they promised to ensure that 'all financial markets, products and participants are regulated or subject to oversight'.[16] Such comprehensiveness requires quite a high degree of co-ordination.

C. *Under-regulation, Over-regulation and Legal Fragmentation*

Today's global financial regulation is quite far from the ideal of a systematic approach. Many divergences in national rules exist. They result in under-regulation, over-regulation or in legal fragmentation.

Under-regulation occurs where the regulatory network leaves a gap. A case in point is hedge funds, which the G20 leaders have identified as a potential source of systemic risk.[17] Assuming that this assessment is correct,[18] many blank spaces exist in their global regulation. While the United States and the EU provide for some rules, these are limited to managers established and shares distributed on their territory.[19] They may be easily circumvented by a

[13] Alexander (n 10).

[14] See D Helbing, 'Globally Networked Risks and How to Respond' (2013) 497 Nature 51.

[15] On the notion of systemic risk, see De Bandt and Hartmann (n 8) 11; see also Jean-Pierre Fouque and Joseph A Langsam, *Handbook on Systemic Risk* (CUP 2013) xxi; Helbing (n 14).

[16] G20 Heads of State, (n 11) 3.

[17] G20 Heads of State, 'Official Communique London Summit' <http://eu-un.europa.eu/articles/en/article_8622_en.htm> accessed 3 September 2015 no 15.

[18] There are continuing doubts about the threats posed by hedge funds. See eg D Awrey, 'The Limits of EU Hedge Fund Regulation' (2011) 5 Law and Financial Markets Review 119.

[19] See s 203(m) of the Investment Advisers Act 1940 (15 USC § 80b-21) exempting fund managers with less than $US 150 million of assets under management in the United States from the requirements of the Act. In the EU, the AIFMD applies to managers registered or authorised in a Member State or which have their registered office and/or head office there, see Art 7(1) in conjunction with Art 4(1)(p) of the Directive 2011/61/EU on

hedge fund taking its seat to another jurisdiction and distributing its shares only in countries with a lower regulatory standard. Such a move may create dangers for the financial stability of all states. The breakdown of a fund could leave counterparties high and dry and therefore cause spillovers into other markets.[20] Given that not all countries have proper hedge fund regulations, the systemic risk is not contained.

The second effect of regulatory divergence is over-regulation, which occurs where two or more nations try to regulate the same market, product or participant. The reporting rules concerning derivatives provide a salient example. The EU and the United States oblige participants in the global derivatives market to report trades to their authorities.[21] Many transactions are therefore subject to double reporting requirements. Because of the differing standards, they cannot be submitted in the same format.[22] The situation is compounded by the fact that other jurisdictions, such as Hong Kong, Singapore, Malaysia and Australia, are developing their own standards.[23] Consequently, firms must build discrete reporting systems, with the ensuing increase in costs. Of even greater concern is the fact that supervisors will not get the full picture because each of them is looking at data submitted in a different format.

Finally, there may be a situation in which double regulation leads to complete market fragmentation. This is the case where the regimes of two or more states impose contradictory rules. Take, for example, the regulation of uncleared swaps. The United States and the EU have for long been battling over the rules for calculating required margins.[24] The question is of particular importance because the scopes of their regimes overlap tremendously. Both, for instance, would apply to swaps between American and European firms. This causes significant legal uncertainty as to which standards need to be obeyed.[25]

Alternative Investment Fund Managers [2011] OJ L174/1; under Art 35 of the same Directive, non-EU hedge funds may market their shares in the EU only if they comply with the EU rules.

[20] On spillovers, see F Lupo-Pasini and RP Buckley, 'Global Systemic Risk and International Regulatory Coordination: Squaring Sovereignty and Financial Stability' (2015) 30 American University International Law Review 665, 709–11; R Kulms, 'Lehman's Spill-over Effects: Cooperation v Regulatory Arbitrage?' (2012) 3 Peking UJ Legal Stud 3.

[21] In doing so, they have complied with the demands of the G20 Heads of State at their summit in Pittsburgh 2009. See G20 Heads of State, 'Leaders' Statement: The Pittsburgh Summit' 9 <www.g20.utoronto.ca/2009/2009communique0925.html> accessed 3 May 2015.

[22] ISDA (n 6) 6.

[23] ibid.

[24] See T Cave, 'Decoded: The US–EU Derivatives Stand-Off' *Dow Jones Financial News* (11 May 2015) <www.efinancialnews.com/story/2015-05-11/us-eu-derivatives-standoff-implications> accessed 10 December 2015. The United States has recently offered to accept European standards as substituted compliance, but this concept cannot apply in the absence of any definite EU rules on the matter. See ISDA Quarterly, 'Cross-Border Challenges', <www.isda-iq.org/2016/07/09/cross-border-challenges/> accessed 27 September 2016.

[25] UK Financial Markets Law Committee (n 5) 2.

The practical result of incompatible standards is market segregation: firms that are subject to conflicting standards will avoid being active in two markets.[26] As a result, cross-border activities that are economically beneficial cannot take place and global markets are segregated into national ones.

In sum, under-regulation, over-regulation and legal fragmentation have significant negative effects on global finance. Risk is not eliminated but, on the contrary, exacerbated, supervision is deficient and markets are segregated.

3. *Why It Is So Hard to Achieve Coherent Global Financial Regulation*

The question at the heart of this contribution is how under-regulation, over-regulation and legal fragmentation can be overcome. In particular, it shall be asked why political statements and appeals for more regulatory co-ordination and co-operation, like those frequently issued by the G20 and other global fora, have hitherto been of little or no avail. In order to clearly perceive the reasons for the current disarray, a sober view of the working of global financial regulation is necessary.

A. *Two Familiar Tales: The Financial Dilemma and Regulatory Competition*

The analysis must start with the observation that global financial regulation, despite its worldwide object, is mostly done at the national level. All the efforts by international fora such as the G20, the Basel Committee on Banking Supervision or the FSB cannot divert from the fact that nation states determine the content of financial regulation. There is thus a disconnect between the regulatory goal—stability of the world's financial system—and the actors that are responsible for it—nation states: while the goal is global in nature and can therefore only be reached by a systematic approach on a worldwide level, the actors are individual states with a narrow vision and limited competence restricted to a certain territory.

This mismatch leads to tensions. They have been described by the familiar tale of the 'financial trilemma'.[27] Regulators are presented as being caught between three conflicting policy objectives: maintaining financial stability; fostering cross-border integration; and following national policies. If one considers the first two of these as being global interests, one can say that the options of the regulator boil down to a dilemma: whether it should take

[26] Some Asian firms have therefore already withdrawn from the United States and now trade exclusively in the EU. See M Steinbeck-Reeves, 'Ripples from Western Derivatives Regulation Spreading across Asia' *Nikkei Asian Review* (21 November 2013) <http://asia.nikkei.com/magazine/20131121-Hang-on-Yangon/Markets/Ripples-from-Western-derivatives-regulation-spreading-across-Asia> accessed 10 November 2016.

[27] D Schoenmaker, 'The Financial Trilemma' (2011) 111 Economics Letters 57; see also RJ Herring, S Claessens and D Schoenmaker, 'A Safer World Financial System: Improving the Resolution of Systemic Institutions' [2010] Geneva Reports on the World Economy 12, 32.

measures to enhance global financial stability and foster cross-border financial integration even where this hurts its domestic interests. The latter may be very palpable, such as gaining important tax revenues, getting high-paid jobs for its citizens and maintaining influence over the provision of capital to the economy. This illustrates how hard the choice faced by the regulator is.[28]

The financial dilemma is exacerbated by regulatory competition.[29] According to another familiar narrative, states are competing with each other to become attractive financial centres. As it is relatively easy to move financial activities from one state to another, they must fear that a regulatory clampdown may trigger an exodus of firms and transactions from their territory.[30] A state that does not look to preserve and advance the interests of the industry therefore risks an exodus to other states. This gives a very strong incentive to liberalise its regime. A regulator may even feel morally justified in doing so because if it did not adopt laxer standards, then another state would step in and do so. The negative effects of such behaviour mostly concern other states. In economic terms, this means that the adverse consequences of the regulator's behaviour are externalised.[31] If all states adopt this attitude, a 'race to the bottom' will follow.[32]

B. *A Neglected Variable: Uncertainty*

The stories of the financial dilemma and regulatory competition encapsulate a reality. Yet, like all models, they are simplified. They paint a picture of regulators being driven by the interests of their state and strictly preferring these domestic interests over global ones. The reality, however, is much more complicated. It is possible that a regulator is willing to advance long-term global interests at the cost of short-term domestic benefits, yet will find it hard

[28] One could object that the dilemma is largely illusory since global financial stability is also in the long-term domestic interest. However, state politicians and regulators have strong incentives to pursue short-term goals. See P-H Verdier, 'Transnational Regulatory Networks and Their Limits' (2009) 34 Yale Journal of International Law 113, 125; S Gadinis, 'From Independence to Politics in Financial Regulation' (2013) 101 California Law Review 327, 388 (noting that the long-term benefits of bailouts is in tension with the short-term outlook of political considerations). They often focus on the here and now, turning a blind eye to the future consequences of their actions. Thus global financial stability could be severely discounted in any policy decision. At least in the minds of politicians and regulators, the dilemma between domestic and international goals therefore is real.

[29] On the role of regulatory competition in global finance, see JP Trachtman, 'The International Law of Financial Crisis: Spillovers, Subsidiarity, Fragmentation, and Cooperation' in T Cottier, JH Jackson and RM Lastra (eds), *International Law in Financial Regulation and Monetary Affairs* (OUP 2012) 186–8; W-G Ringe, 'Regulatory Competition in Global Financial Markets—The Case for a Special Resolution Regime' (2016) 1 Annals of Corporate Governance 175, 183–7; LG Baxter, 'Understanding the Global in Global Finance and Regulation' in R Buckley, D Arner and E Avgouleas (eds), *Reconceptualizing Global Finance* (CUP 2016) 18.

[30] Ringe (n 29) 193–5.

[31] L Enriques and M Gatti, 'Is There a Uniform EU Securities Law after the Financial Services Action Plan' (2008) 14 Stanford Journal of Law, Business & Finance 49, 49.

[32] It is true that regulatory competition does not necessarily lead to a race to the bottom, but can also set off a course for the more stringent standard. See eg RK Winter, 'State Law, Shareholder Protection, and the Theory of the Corporation' (1977) 6 Journal of Legal Studies 251; DR Fischel, 'The "Race to the Bottom" Revisited: Reflections on Recent Developments in Delaware's Corporation Law' (1982) 76 Northwestern University Law Review 913; Ringe (n 29) 190–2. Yet such a 'race to the top' is hardly more conducive to global harmony, but also leads to fragmented markets.

to do so because it first needs to answer the crucial question as to what these global interests require. This problem is very complex, and provides an additional reason why legal fragmentation is omnipresent.

For example, as has been noted above, some Western states have endowed themselves with special rules for hedge funds in order to prevent a future systemic crisis, while other states with equally developed financial markets have been less enthusiastic in doing so.[33] One of the latter countries is Japan. It applies the general rules of the Financial Instruments and Exchange Act[34] to hedge funds, but has no dedicated set of rules for them. A representative of the Japanese financial supervisor promised in 2010 that the agency would further improve the regulation,[35] but this has not yet happened. On the contrary, it has even become even easier to set up hedge funds in Japan.[36] There is no indication that this was done in order to attract new hedge funds to the Japanese territory. Rather, it is the result of a conviction that these funds are already sufficiently regulated and do not require any further special rules.[37]

This example serves as a healthy reminder that the financial dilemma and regulatory competition are not the only causes of regulatory divergence. A good part of it is not the effect of states' egoistic furtherance of domestic interests, but is due to real divergences in opinion about what is necessary for the maintenance of global stability. The reason for these differences of opinion is uncertainty. Though uncertainty exists in many fields, it is a particularly pervasive feature of financial markets. While in other areas, such as the protection against climate change or the fight against terrorism, it is relatively easy to determine which measures need to be taken, this is not the case for systemic risk in financial markets. This is because markets depend first and foremost on human behaviour, or free will, which may be rational as well as irrational.[38] Although psychology gives us some clues about the direction that this behaviour may take, it is much less predictable than natural events, which

[33] See the references in section 2.C above.

[34] An English version is available at <www.fsa.go.jp/common/law/fie01.pdf> accessed 13 December 2015.

[35] N Kinoshita, 'Japan's Capital Market Regulation in the Aftermath', speech held in Tokyo at the international conference, 'Regulation Crossing Borders' on 31 March 2010, page 6 <www.fsa.go.jp/sesc/kouen/kouenkai/20100331b.pdf> accessed 13 December 2015.

[36] See R McMeeken, 'Japan Opens Door to Foreign Hedge Funds' *Dow Jones Financial News* (26 September 2013) <www.efinancialnews.com/story/2013-09-26/japan-opens-door-to-foreign-hedge-funds> accessed 13 December 2015.

[37] See the speech by N Mori, Commissioner of the Japanese Financial Services Agency, 'Rethinking Regulatory Reforms' (Thomson Reuters 6th Annual Pan Asian Regulatory Summit, 13 October 2015, Hong Kong) <www.fsa.go.jp/common/conference/danwa/20151013/01.pdf> accessed 13 December 2015. Although he does not mention hedge funds, he effectively conveys the idea that much of the regulation of the last years has been an overreaction from a Japanese point of view. A similar view can be gleaned from K Harada and others, 'Japan's Regulatory Responses to the Global Financial Crisis' (2015) 7 Journal of Financial Economic Policy 51, 61 (stressing that Japan already had a reasonable resolution mechanism banks before the crisis and would therefore not need to overhaul it). Nobuyuki Kinoshita presents the view that 'hedge funds operating in Japan are not necessarily taking excessive risks as to raise systemic concerns at the moment': see Kinoshita (n 35) 6.

[38] On the importance of 'animal spirits' for the course of the economy, see JM Keynes, *The General Theory of Employment, Interest, and Money* (Prometheus Books 1997) 161–2; GA Akerlof and RJ Shiller, *Animal Spirits* (Princeton UP 2009) 2–5.

are the subject of other sciences. The uncertainty in finance is of a different quality than the probability of a change in weather or a certain result of a lottery: 'We simply do not know', as Keynes wryly remarked.[39] This insecurity produces genuine disagreement between states about what needs to be done.

In this debate, no state can claim a monopoly on the truth. It is well known that, because of their varied history, customs and cultures, states handle risks very differently.[40] Some may consider another state's regulation as an overreaction based on a particular experience.[41] They may also be under the impression that such regulation is dictated by political expedience rather than by hard facts. Moreover, they may—reasonably—think that most regulation comes in the wake of a crisis and does not prevent future crises.[42] A state may also be guided by the idea that it is better to avoid overly complex regulation because it is in itself a source of systemic risk.[43] Even where there is agreement on the need for a certain type of regulation, there may still be reasonable disagreement as to the precise shape such regulation should take, as is evidenced by the divergences between the United States and the EU concerning derivatives regulation.[44] Whether any of these opinions is wrong or right cannot be proven. One must therefore not necessarily impute to a state whose regulatory policies diverge from those of others that it would put its interests before those of other states. It may simply take a different attitude in the face of uncertainty.

That uncertainty has so far been ignored as a root cause of legal divergence is not surprising. It is in line with its general neglect in economics. Traditional or neoclassical economics is built on the idea that all market participants are rational actors who know the way to achieve their goals perfectly well. Its political counterpart, public choice theory, uses the same assumption.[45] Both posit that actors have all necessary information available and take their decisions with the full knowledge of this information. This model features a

[39] JM Keynes, 'The General Theory of Employment' (1937) 51 Quarterly Journal of Economics, 209, 213 (distinguishing between probability in sciences and uncertainty in economics).

[40] C Brummer, 'How International Financial Law Works (and How It Doesn't)' (2011) 99 Georgetown Law Journal 257, 269. The different attitudes to risk are illustrated by the varieties of capitalism debate. See eg A Dignam and M Galanis, *The Globalization of Corporate Governance* (Routledge 2009).

[41] See Mori (n 37).

[42] See AM Pacces, 'Consequences of Uncertainty for Regulation: Law and Economics of the Financial Crisis' (2010) 7 European Company and Financial Law Review 479, 481 (noting that states assume fixing the regulatory failures of the past will suffice to avoid the next one).

[43] On the last point, see S Claessens and LE Kodres, 'The Regulatory Responses to the Global Financial Crisis: Some Uncomfortable Questions' IMF Working Paper No 14/46, 14 March 2014, 15 <www.imf.org/external/pubs/cat/longres.aspx?sk=41422.0> accessed 8 October 2015; Pacces (n 42) 484 (noting that increasing the regulatory burden on traditional intermediation may be conducive to the very externalities regulation intends to avoid).

[44] See above n 24.

[45] Because public choice is grounded on the idea of rational actors, it is also called 'rational choice'. For an overview, see DC Mueller, 'Public Choice: An Introduction' in CK Rowley and F Schneider (eds), *The Encyclopedia of Public Choice* (Springer US 2004) 32 et seq.

high level of abstraction. In reality, most human decisions are taken based on probabilities and not on certain knowledge.[46] This is an important aspect of what Herbert Simon has called 'bounded rationality'.[47] This term describes three constraints on rational actions: uncertainty about the consequences that follow from a particular action; incomplete information about the available alternatives; and complexity preventing the computation of all consequences.[48] These constraints also plague regulation. Because regulators need to take decisions on the scarce information that is available to them, they are prone to error. It also follows that they may have different opinions and that these divergences, rather than opposing interests, could be at the root of legal divergence.

The uncertainty paradigm developed here does not deny the existence of the financial dilemma and of regulatory competition, but puts them in a larger context. Both phenomena do indeed exist, yet they make the uncertainty even greater. The insecurity about the most promising route to achieve financial stability is compounded by the insecurity about the true motives of other states that legislate in the financial area. When a country lowers its standards, its motives may be viewed with suspicion by others. They may ask themselves whether the alleviation of a standard is indeed grounded in an honest belief that strict regulation is not necessary or in the egoistic pursuance of a 'beggar thy neighbour' policy at the cost of other countries. As the recipe to attain financial stability is unknown, a country can easily hide self-serving motives behind rational sounding arguments. The resulting ambivalence is intensified by the fact that actions are rarely based on only one reason, but on a bundle of different motives. It is therefore often difficult, if not impossible, for other states to disentangle the true rationale for liberalisation. While doubts may emerge where a measure *prima facie* benefits the domestic position of one state, the others will find themselves unable to prove that another state is acting *purely* out of self-interest.

To the two kinds of uncertainty expounded here—uncertainty about the requirements of financial stability and uncertainty about the motives of other states—another kind can be added: uncertainty about the capability of supervisors. Even where it is clear which measures are necessary in the common interest, and even if all states are willing to adopt them, it remains uncertain whether they are able to apply them effectively. Enforcing financial regulation of the complex kind requires expertise, skill and savviness. It would be naive to assume that this know-how exists in all regulatory authorities.

[46] See JM Keynes, *A Treatise on Probability* (Wildside Press 2010).

[47] The seminal work is HA Simon, *Models of Man: Social and Rational. Mathematical Essays on Rational Human Behavior in a Society Setting* (Wiley 1957). See also HA Simon, 'Theories of Bounded Rationality' in Jacob Marschak and others (eds), *Decision and Organization. A Volume in Honor of Jacob Marschak* (North-Holland Pub Co 1972).

[48] Simon, 'Theories of Bounded Rationality' (n 47) 169. While the complexity issue exists even where all facts are completely known, it may nevertheless be characterised as a form of uncertainty as complexity makes it impossible to calculate the best course of action.

Much more realistic is the assumption that some of them will be incapable of performing the tasks they must fulfil in the global interest.[49] This increases uncertainty even more, as it concerns not only the knowledge and motives of supervisors, but also circumstances that are exogenous and cannot be influenced by them.

C. *Uncertainty and the Rise of Soft Law*

The uncertainty paradigm has a particular explanatory force. It accounts for a number of characteristic features of the current regulatory system. In particular, it may elucidate the pervasiveness of soft law in global financial law. The many international bodies that are charged with the regulation of cross-border finance, such as the G20, the FSB, the International Organization of Securities Commissions (IOSCO) or the Basel Committee, mostly produce recommendations or non-binding standards. Treaties as classic instruments of diplomacy are practically non-existent.

Several reasons have been given for this. One of them is the story of regulatory competition: states would prefer soft law over binding commitments because they want to maintain their ability to undercut global standards adopted by others in order to increase their attractiveness as financial centres.[50] While this may partly be true, it does not explain why firm commitments have been undertaken by states in other areas, such as anti-dumping, intellectual property law or environmental protection, in which diverging interests exist as well. Another explanation that has been advanced is the fact that financial regulation is mostly done by regulatory authorities, who do not have the power to enter into treaties.[51] However, this contrasts with the finding that the regulation of banking and finance is today considered an issue of highest priority, which is handled more and more by politicians and not by regulators.[52] Taking the involvement of politicians of the highest order into account, one is hard pressed to say why they do not use treaties to make their commitments binding.

A more plausible reason for the pervasiveness of soft law in financial regulation is uncertainty.[53] As the way to attain financial stability is subject to

[49] Brummer (n 40) 309 (stating that few countries have the technical expertise and experience in financial regulation present in leading developed countries).

[50] JC Coffee, 'Extraterritorial Financial Regulation: Why ET Can't Come Home' (2014) 99 Cornell Law Review 1259, 1268 (highlighting that because non-binding soft law is unenforceable, it is easier for a nation to defect and ignore its prior commitments); KW Abbott and D Snidal, 'Hard and Soft Law in International Governance' (2000) 54 International Organization 421, 436–9 (noting that soft law imposes few defection costs and therefore enables a 'cheap exist' from commitments).

[51] C Brummer, 'Why Soft Law Dominates International Finance—and Not Trade' (2010) 13 Journal of International Economic Law 623, 634.

[52] On this point, see Gadinis (n 28).

[53] While its ability to cope with uncertainty is a rationale for the adoption of soft law, it is not the only one, see Abbott and Snidal (n 50) 434 et seq (citing lower contracting and sovereignty costs as well as the facilitation of compromise as additional advantages of soft law). This explains why soft law is also on the rise in other areas, such as tax law, labour law and environmental law: see Abbott and Snidal (n 50) 437, 441.

doubt, no state wants to legally commit to a particular method or set of tools. Leaders want to be able to choose the best and most efficient way to overcome a financial crisis and safeguard their national interest. In other words, they want to preserve policy space.[54] They wish to avoid a situation in which they have to decide between serving the interests of their country and violating international law.

Even those states that are most affected by such a crisis (that is, those with developed financial markets) cherish the flexibility that comes with soft law commitments. The informality of soft law allows them to react to new developments and therefore counter uncertainty. This is particularly important in an area that is constantly evolving.[55] Financial markets, with their high level of innovation and volatility, prohibit any solution that is set in stone. They call for a freedom to adapt to changing circumstances which formal treaty obligations would not allow. It is true that soft law commitments are weak, in that it is uncertain whether they will be honoured, yet this uncertainty perfectly matches the uncertainty in finance.

D. *How Uncertainty Leads to Extraterritoriality*

In the following, it will be shown that uncertainty also accounts for the importance of extraterritoriality in financial legislation and regulation. Many legislative rules purport to govern events that lie outside the territory of the enacting state. It is equally frequent that regulatory authorities apply legislation to facts or actors abroad. The most salient examples can be found in US law. That is true even though the Supreme Court established a 'presumption against extraterritoriality' in its seminal judgment *Morrison v National Australia Bank*.[56] In the same week in which the judgment was pronounced, Congress reversed it in part through the Dodd-Frank Act, which explicitly empowers the Securities and Exchange Commission to regulate transactions and conduct outside of the United States[57] and provides for certain swap rules to apply extraterritorially.[58] In this way, the *Morrison* presumption has been largely refuted.

The extraterritorial approach taken by the United States has been frequently criticised for its unilateralism and the frictions it causes with other nations.[59] Yet the United States is no longer alone in applying its laws beyond its territory: the EU also increasingly extends provisions to events that take place

[54] C Tietje and M Lehmann, 'The Role and Prospects of International Law in Financial Regulation and Supervision' (2010) 13 Journal of International Economic Law 663, 668.

[55] Brummer (n 51) 637.

[56] 561 US 247, 130 SCt 2869, 2887 (2010).

[57] Dodd-Frank Wall Street Reform and Consumer Protection Act 2010, s 929p(b).

[58] See s 2(i)(1) of the Commodities Exchange Act (7 USC § 2), as introduced by s 722(d) of the Dodd-Frank Wall Street Reform and Consumer Protection Act 2010.

[59] S Choi and A Guzman, 'The Dangerous Extraterritoriality of American Securities Law' [1996] Northwestern Journal of International Law & Business 207; H Baum, 'Globalizing Capital Markets and Possible Regulatory Responses' in J Basedow and T Kono (eds), *Legal Aspects of Globalisation: Conflicts of Laws, Internet, Capital Markets and Insolvency in a Global Economy* (Kluwer Law International 2010) 90–3.

outside of the Member States.[60] An example is a provision in the European Market Infrastructure Regulation (EMIR), which extends the scope of the derivatives clearing obligation to contracts between entities established in third states if 'the contract has a direct, substantial and foreseeable effect within the Union or where such an obligation is necessary or appropriate to prevent the evasion' of the Regulation.[61]

Uncertainty provides an explanation for the fact that extraterritoriality is not dying out, but is rather on the rise. In the global financial system, every state can be affected by events that occur outside of its borders. Because of divergences regarding the proper regulation and because of the unknown motivation and ability of other regulators, no state can be sure that other states are properly fulfilling their part in the control of systemic risk. Given this uncertainty, it must be able to unilaterally adopt measures that are in its opinion indispensable for preserving its financial stability.

Extraterritoriality can therefore be a necessary means for securing global financial stability. In a way, it counterbalances the legitimate difference of opinion caused by uncertainty. Where a state thinks that other states fail to prevent systemic risk, its national regulator must have the ability to jump in and act in their place. It follows that it is not always correct to equate extraterritoriality with legal imperialism. It can also serve as a safeguard against systemic risk under the conditions of uncertainty.

E. *Uncertainty and Legal Fragmentation*

The uncertainty paradigm also helps in clarifying the root cause of legal fragmentation. At a superficial level, it is quite easy to see that where nations are divided on a particular topic, they will adopt differing rules. But legal fragmentation requires more: it only occurs where the scope of contradictory rules overlaps. Such overlap is not infrequent due to the tendency of states to apply their laws extraterritorially. Because some states are uncertain about global risks and the willingness and ability of other regulators to control them, they are afraid of a regulatory vacuum, or under-regulation. For this reason, they also apply their laws to events that take place in the territory of another state but that have an effect on them. This results in duplicative legislation. Where these rules are contradictory, the effect is legal fragmentation.

[60] J Scott, 'Extraterritoriality and Territorial Extension in EU Law' (2014) 62 American Journal of Comparative Law 87; J Scott, 'The New EU Extraterritoriality' (2014) 51 Common Market Law Review 1343; see also P Athanassiou, M Prokop and A Theodosopoulou, 'Effets extraterritoriaux du droit américain sur les institutions financières non-américaines—une vue d'ensemble' [Sept/Oct 2014] Revue du droit bancaire et financier 11, 12.

[61] Art 4(1)(a)(v) of Regulation (EU) No 648/2012 on OTC derivatives, central counterparties and trade repositories (EMIR) [2012] OJ L201/1.

		State B Accept stability regulation by state A (grant market access to its firms)	Apply own stability regulation to firms of state A (extraterritorial application)
State A	Follow global preferences in stability regulation	co-operation	over-regulation
	Follow own preferences in stability regulation	under-regulation	legal fragmentation (market segregation)

This is illustrated in the following example.

In this example, state A has adopted certain rules to counter systemic risk, such as capital requirements. State B follows its own rules on this subject. Imagine now a firm established in state A that wants to make some transactions with firms in state B. If the rules of state A are conducive to financial stability from state B's point of view, it may allow the firm to enter its markets. The result is co-operation (upper left quadrant). However, due to uncertainty, state B fears that state A's regulation and supervision are insufficient. This could result in serious under-regulation from the point of state B (lower left quadrant). To counter this risk, state B may impose its capital requirements and deny market access where the firm fails to comply with all of its domestic rules. B may do so even though the majority of the activity of the firm is in state A and the transactions with firms in state B are of relatively minor significance. In this case, it is commonly said that state B applies its regulation 'extraterritorially'.[62] As a result, the firm is subject to the rules of both state A and state B, and will therefore incur additional compliance costs. This is the case of over-regulation (upper right quadrant). Where it is impossible to comply with the rules of both states because they are contradictory, legal fragmentation occurs (lower right quadrant). The firm can avoid being subject to two sets of contradictory rules only by refraining from even the slightest contact with customers in the other state. It must thus limit its activities to either state A or state B, shunning the other's market completely. The result is perfect market segregation.

It now becomes clear how extraterritorial regulation and legal fragmentation are intertwined. It is equally plain to see how they potentially disrupt

[62] This term is not entirely correct since state A is seeking market access in state B and therefore to some extent engages with state B's 'territory'. The ambiguity is due to the fact that notions such as 'territory' and 'extraterritoriality' lose their meaning in highly mobile markets with intangible products that cannot be located geographically. See C Brummer, 'Territoriality as a Regulatory Technique: Notes from the Financial Crisis' (2011) 79 University of Cincinnati Law Review 499, 506.

the functioning of global markets. Significantly, states will have a tendency to end up in the situation in the lower right corner of the table, as is evidenced by game theory.[63] Both states here are in a classic prisoner's dilemma[64]: neither of them can be sure about the actions of the other, so each will think that it is better off by applying its own rules. From its view, this has the advantage of enabling it to realise its own vision of financial stability, which in its opinion is superior to that of the other state. In addition, the application of a state's own rules also favours its short-term domestic interests: the exporting industry of state A must not adapt to the standards of state B, while the industry of state B must not fear the intrusion by lighter regulated competitors on its markets. This illustrates that financial regulation can also be abused as a tool for protectionism.

Game theory teaches that the prisoner's dilemma can be overcome and co-operation established through frequent repetition of the game.[65] Yet this does not work where the pay-offs are unclear. Given the uncertainty surrounding financial regulation, the costs of deferring to another state's rules are unknown. Hence there is a real danger that the world might get stuck in a situation of legal fragmentation. As a result, actors will refrain from transnational activities and the global market will break up into national ones.

4. Some Proposals for More Coherence and Why They Do Not Work

A. *Introducing More Hard Law*

The most immediate remedy against legal fragmentation is harmonisation. A more systematic approach could be achieved through binding rules under public international law. This is what scholars mean when they talk about the need for more 'hard law'.[66] It could take the form of new treaties or a transferral of rule-making power to existing or novel institutions.

Calls for more public international financial law have now been heard for over a decade,[67] yet they have fallen on deaf ears. The practical background is

[63] On game theory, see eg R Axelrod, *The Evolution of Co-Operation* (Penguin 1990). Game theory has been repeatedly used to analyse strategic co-ordination between countries. See DW Drezner, *All Politics Is Global: Explaining International Regulatory Regimes* (revised edition, Princeton UP 2008) 51–9; Brummer (n 40); Verdier (n 28) 125. The focus of these studies was the alignment of standards. In contrast, here the more frequent question of recognition of the other's standards is analysed.

[64] On this, see W Poundstone, *Prisoner's Dilemma* (Anchor 1993).

[65] R Axelrod, *The Evolution of Co-Operation* (Penguin 1990) 10–11.

[66] Trachtman (n 29) 201; Bin Gu and Tong Liu, 'Enforcing International Financial Regulatory Reforms' (2014) 17 Journal of International Economic Law 139, 155–61 (proposing to harden soft law along four dimensions: obligation, stringency, delegation and enforcement); Verdier (n 28) 168 (suggesting that the results of informal networks and agreements do no necessarily constitute an optimal regulatory outcome from a collective standpoint).

[67] Alexander (n 10) 162, 165 (calling for a World Financial Organisation); EJ Pan, 'Challenge of International Cooperation and Institutional Design in Financial Supervision: Beyond Transgovernmental Networks' (2010) 11

that states want to preserve policy space to react to unforeseen developments.[68] Yet even if states were willing to curtail this power by a treaty or to transfer it to an international institution, there is a reason why one should not—at least for the time being—wish for a globally uniform financial law or a 'global financial regulator'. That reason (again) is uncertainty. There is as yet no known panacea to financial instability.[69] To counter this uncertainty, it is advisable to let states test different models and use regulatory competition as a discovery process.[70] Through trial and error, one may find out which model works better.

In addition, a uniform approach would not relieve all uncertainty. Uniform texts themselves give rise to different interpretations. This is well known from other contexts, such as the United Nations Convention on Contracts for the International Sale of Goods (CISG).[71] In the absence of an international tribunal or body called to interpret it, a uniform construction seems impossible to achieve.[72] Similar creative interpretations have been noted with regard to the Basel capital requirements.[73] This empirical finding is theoretically supported by the idea of legal theory and philosophical hermeneutics, which account for the possibility of different understandings of one and the same text.[74]

Uncertainty does not completely exclude public international law from the realm of financial regulation. It merely posits the conditions under which 'hard law' may be useful.[75] If, in the future, it can be convincingly shown that a certain type of regulation is necessary to uphold financial stability, then there is no reason why these standards should not be laid down in an international agreement. It may also be advisable to have one or more global financial regulators that are called upon to apply these texts in a uniform manner when

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Chicago Journal of International Law 243, 273–7 (recommending the establishment of a new independent agency); AF Cooper, 'Consolidated Institutional Cooperation and/or Competitive Fragmentation in the Aftermath of the Financial Crisis' (2011) 12 Whitehead Journal of Diplomacy and International Relations 12, 24 (suggesting the enhancement of the role of the G20 from a crisis committee to a comprehensive steering committee).

[68] See n 54.

[69] See R Romano, 'For Diversity in the International Regulation of Financial Institutions?: Critiquing and Recalibrating the Basel Architecture' (2014) 31 Yale Journal on Regulation 1, 5.

[70] To some extent, this testing of different regulations by states is reminiscent of the evaluations and comparisons that have been described by Herbert Simon as leading to the construction of complex designs: see Simon, 'Theories of Bounded Rationality' (n 48) 172.

[71] Vienna, 11 April 1980. Despite the relative clearness of its rules, the Convention is notorious for the different interpretations adopted by national courts. See eg HM Flechtner, 'The Several Texts of the CISG in a Decentralized System—Observations on Translations, Reservations and other Challenges to the Uniformity Principle in Article 7(1)' (1998) 17 Journal of Law and Commerce 187; JO Honnold, 'The Sales Convention in Action—Uniform International Words: Uniform Application?' (1988) 8 Journal of Law and Commerce 207.

[72] See Flechtner (n 71).

[73] Romano (n 69) 49.

[74] On Ronald Dworkin's theory of law as a concept that is open to different interpretations, see N Stavropoulos, 'Legal Interpretivism', *The Stanford Encyclopedia of Philosophy* (2014). In philosphy, the impossibility to construct an objective meaning of a text has been underscored by H-G Gadamer, *Truth and Method* (J Weinsheimer and DG Marshall tr, 2nd edn, 1st English edn, Crossroad 1975) 164–9.

[75] For other situations in which public international law may already be helpful, see section 5.A and D below.

one can be sure that these regulators have better or at least the same level of knowledge and expertise as national agencies. One must not forget that we are currently witnessing global financial regulation in its infancy. With the passage of time, the situation may look very different from now. The calls for more hard law and a global financial regulator are thus not wrong, but premature.

B. *A Flexible International Regime*

A diametrically opposite concept is to allow discretionary departures by some states from the strictly harmonised rules. Roberta Romano has suggested that the Basel Capital Accords be reformed in this way.[76] She envisions a procedural mechanism under which states could apply for exceptions from the rules of the Basel regime. Such an application would be subject to peer review by a specialised committee, which would analyse its impact on financial stability.[77] The burden of proving that the proposal would have a substantial likelihood of increasing global systemic risk would lie with the review committee.[78] Any rejection of the application for departure would require a reasoned decision in writing.[79] If a nation receives permission to depart from the Basel rules, it would be subject to ongoing oversight and periodic reassessments.[80] If no risk materialises, Romano suggests the country should be permitted to keep the deviating rules. In addition, she recommends combining the deviation mechanism with a sunset review of the Basel rules.[81] Where a deviation has been proven as not harmful to financial stability, the rule deviated from would eventually be abandoned.

The mechanism elaborated by Roberta Romano is designed to introduce experimentalism and flexibility into the Basel regime. It would thus be an ideal tool to counter uncertainty. Yet the biggest obstacle to its implementation is uncertainty itself. The review committee that Romano suggests would have to be nothing less than omniscient. Not only would it have to know the risks for stability emanating from the Basel rules and from the alternative set-up, but it would also need a method to compare those risks with each other. Moreover, the committee would also have to know how both rules interact with one another, in particular how stability will be affected if one country adopts one set of rules while the others stick to the conventional ones. Given that the Basel Committee has been unable even to foresee the risks of its existing rules, it seems unlikely that it could manage this gargantuan task.

[76] Romano (n 69).
[77] Romano (n 69) 27.
[78] Romano (n 69) 34.
[79] Romano (n 69) 36.
[80] Romano (n 69) 38–9.
[81] Romano (n 69) 43–4.

Another obstacle to the proposal is regulatory competition. It is not unlikely that states might apply for a deviation in order to improve their economic situation. This would necessarily cause envy in those states that have not applied for a deviation. Sooner or later, they too would try the same. Over time, a rat race for deviations could develop. For the review committee, it would be impossible to judge whether such proposals are motivated by egoistic interests or a genuine desire to improve the worldwide regime. Due to the burden of proof that the committee bears under Romano's proposal, it would have to allow those applications in case of doubt. This would erode the global standard from the inside.

Finally, the proposal would also diminish accountability. By rubber-stamping the application of a country for a deviation, the review committee would effectively certify that the new method does not lead to an undue increase in systemic risk. Should the experiment go wrong, it could hardly avoid bearing some responsibility for the failure in the eyes of the public. It is not unlikely that the applying state itself would accuse the review committee of having misjudged the consequences of the deviation, and vice versa. Such 'blame games' are well known in political science.[82] They are particularly widespread in financial regulation due to the uncertainty and complexity of the issues concerned.[83] A deviation mechanism would effectively increase this tendency since such a mechanism does not allow one to neatly separate the spheres of responsibility of national governments and international institutions. Instead, it mixes the two spheres together, with the result that failures cannot be clearly attributed to one or the other.

In sum, the proposal is not convincing. It sacrifices the benefits of international harmonisation on the altar of regulatory competition. In doing so, it leads to unforeseeable risks, a run for deviations and a blame game between national and international regulators.

C. *Harmonisation through Power Politics*

Another way of achieving more coherent regulation may be by the use of market power. Such an approach has been advocated by John C Coffee, who suggests that the United States and the EU should proactively seek to forge a consensus on common regulatory standards and then compel other nations to adhere to them.[84] As a means of such compulsion, he proposes that the United States and the EU should prohibit their firms from trading derivatives in any jurisdiction that has different rules.[85] This form of extraterritoriality is thought

[82] C Hood, *The Blame Game: Spin, Bureaucracy, and Self-Preservation in Government* (Princeton UP 2010).

[83] See MJ Dubnick, 'Toward a "Responsible" Future: Refraiming and Reforming the Governance of Financial Markets' in IG MacNeil and J O'Brien (eds), *The Future of Financial Regulation* (Bloomsbury Publishing 2010) 396–7.

[84] Coffee (n 50) 1267–8.

[85] Coffee (n 50) 1300.

to be the only way of preventing other countries from 'free-riding' on global financial stability by turning themselves into 'financial casinos'.[86]

The main counterargument against this suggestion is that no one can claim to know the best rules for obtaining financial stability. It is by no means certain that the United States and the EU are in possession of the correct recipe for achieving financial stability. In fact, the uncertainty paradigm suggests otherwise. The fact that a state has market power and stronger 'incentives' does not mean that its regulatory policies are more correct than those of others. This was strikingly evident during the pre-crisis years, when the United States and the EU tirelessly demanded that other countries deregulate their financial markets. That they have now become the preachers of increased regulation is no small irony. Moreover, the considerable uncertainty that still exists regarding systemic risk is strikingly illustrated by the fact that the United States and the EU themselves were unable to agree on the precise measures to counter it. One can therefore hardly chide other countries for taking a different regulatory perspective.

The suggestion of unilaterally imposing one's regulation also violates the principles of democracy and sovereignty. Consider the hypothetical case wherein the rest of the world agree upon certain rules and then try to force them upon the United States and the EU. How would the latter respond? Conversely, one could imagine a scenario in which stability rules imposed on the world by the Western countries fail and trigger the next crisis. Would the transatlantic governments and regulators want to take responsibility for forcing reforms upon others that could potentially create havoc in these countries' economies?

All of this shows that power is not the right means for overcoming uncertainty. Extraterritorial legislation is not the way to prove that one is right. Resorting to extraterritorial rules can only be justified where it serves to protect a state from spillovers that might possibly affect its markets. This is even a legal requirement. Extraterritorial rules typically require a substantive effect on the territory of the state that adopts them. For instance, the application of the Dodd-Frank Act's provisions on the clearing of swaps is conditioned on the existence of a 'direct and significant connection with activities in, or effect on, the United States'.[87] This is a description of the 'effects doctrine', which sets out a mandatory limit to every state's jurisdiction under public international law.[88] In other words, extraterritoriality is legally conceptualised to be a means of securing oneself against adverse effects, not as a weapon for forcing agreement on other states.

[86] Coffee (n 50) 1268–9.

[87] See s 2(i)(1) of the Commodities Exchange Act (7 USC § 2), as introduced by s 722(d) of the Dodd-Frank Wall Street Reform and Consumer Protection Act 2010. On the similar requirement under EU law, see n 61.

[88] On the effects doctrine, see J Crawford and I Brownlie, *Brownlie's Principles of Public International Law* (8th edn, OUP 2012) 462–4; J Coppel, 'A Hard Look at the Effects Doctrine of Jurisdiction in Public International Law' (1993) 6 Leiden Journal of International Law 73.

5. *A Plea for More Collaboration*

The different suggestions on how to reach more coherent global financial regulation leaves one with a certain sense of pessimism. Outright harmonisation, a flexible regime and power politics do no work. This is why another route for a systematic approach to financial regulation is suggested below. It encompasses classic instruments, such as discourse and information sharing. These instruments have long been known,[89] yet in the face of legal fragmentation, they acquire a new and more important role.

A. *Discourse*

The best way to overcome differences between national regulations is to try to convince other states of the reasonableness of a certain kind of regulation. Such an approach has distinct advantages. First, consensus ensures legitimacy. Rules that have been forced on a state will hardly be seen in conformity with the requirements of democracy.[90] Secondly, the quality of rule making can be improved by healthy debate. The more arguments brought to the table, the better the chances of a more comprehensive regulation. Thirdly, the effectiveness of harmonisation increases where the regulator is convinced of the benefits of a rule and is not extorted to implement it. It will also know much better when and how to apply a certain rule.

There is no better way to overcome uncertainty than by rational debate. The exchange of rationales between regulators is therefore indispensable. They need to shown how, when and why systemic risk could endanger global financial stability. Global fora like the Basel Committee or IOSCO offer the opportunity to discuss the need for legislative reform.[91] They may serve as springboards for an even wider debate.

Any dialogue requires openness to the possibility that the other side might be right and oneself might be wrong. This is a central insight of philosophical hermeneutics.[92] If communication is to make sense, it must not be a one-way street. Each discussant must be ready to learn from the other. This is valid even for Western countries: the fact that they have experienced a financial crisis does not give them a monopoly on truth. Especially when one is facing a different culture, a readiness to accept the other's viewpoint as potentially being correct is indispensable. Those who want to persuade must be open to persuasion themselves.[93]

[89] See, in particular, Baum (n 59).

[90] Writers have often debated the democratic deficit in international rule-making due to the significant role of regulatory authorities. See Brummer (n 40) 307. A similar argument can be made where nations are not even allowed to give voice to their own regulatory views.

[91] IOSCO has been praised as being 'uniquely placed to facilitate resolution of disputes between jurisdictions': ISDA (n 6) 2.

[92] On Gadamer's model of dialogue, see I Scheibler, *Gadamer* (Rowman & Littlefield 2000) 50.

[93] ibid.

It could be objected that the ultimate aim of discourse is to achieve harmonised regulation, which seems to be precisely the wrong strategy in the face of uncertainty. It would create a type of herding behaviour that would broaden the impact of any regulatory error. Yet uniformity is not necessarily bad. Harmonisation offers distinct advantages. Specifically, it avoids legal fragmentation. When the uniform solution adopted is the right one, it is the optimal solution. It is true that one cannot know whether a solution is right or wrong. However, a reasoned debate guarantees to the utmost extent possible that the harmonised rule is correct. If a common conviction were not enough, then uniform rules could never be adopted.

It is, of course, difficult to reach consensus on a subject as complex and politically fraught as financial regulation, yet one should not assume that states are impervious to argument. The fact that they may have different short-term preferences or interests does not stop them from finding global solutions where a common danger can be convincingly shown, as is evidenced, for instance, by the accords on climate change concluded in 2015 in Paris. In the area of finance, the Basel rules provide a striking example of states voluntarily agreeing on certain standards. There is no reason why similar detailed standards should not be achieved on other issues.

A possible pathway to arrive at harmonised rules is minilateralism.[94] Minilateralism means that some states enter into small, bilateral or regional agreements, which can then form the basis for more general agreements between a large number of or all states. Although this method has proven successful in the past, it has often been criticised for its supposed lack of democratic legitimacy. Critics highlight that many countries will not be able to make their voice heard, but instead must just accept what is agreed upon by others.[95] Yet such concerns cannot truly convince as long as all states have the option to decide on the package submitted by the minilateralist group.

One form of minilateralism is regulatory dialogue. Regulatory dialogue means that regulators meet on a regular basis, inform each other about new developments and explain the reasons behind their standards. Its aims are to improve mutual understanding, exchange information and make sure that both sides are striving for the same basic goals and adopt converging approaches.[96] This is more than a 'talk shop'. It currently provides the most important basis for mutual adjustment of rules. A prominent example is the regulatory dialogue between the United States and the EU.[97] It should be deepened into the

[94] The idea goes back to journalism: see M Naim, 'Minilateralism' *Foreign Policy* (21 June 2009) <https://foreignpolicy.com/2009/06/21/minilateralism/> accessed 17 December 2015. It has been greatly expanded by C Brummer, *Minilateralism: How Trade Alliances, Soft Law and Financial Engineering Are Redefining Economic Statecraft* (CUP 2014).

[95] See Brummer (n 94) 181.

[96] See European Commission, 'The EU–US Financial Markets Regulatory Dialogue: Experiences and Expectations' 1–2 <http://ec.europa.eu/internal_market/finances/docs/general/20050914_fsc_eu_us_paper_en.pdf> accessed 17 April 2015.

negotiation of common standards, which could then be suggested to other countries. In addition, similar dialogues should be held with other countries. Their effectiveness depends on the level of expertise and sophistication of both sides. Where the conditions for a fruitful exchange of views are not present, then dialogue could take the form of training and workshops.

B. *Information*

Rational discourse requires reliable information. It is therefore necessary to improve the empirical basis. The root causes of systemic risk and the emergence of financial crises need to be investigated and better understood. To this end, more studies need to be undertaken. In order to secure the quality and independence of research, analysts need to be chosen and supervised by international bodies such as the FSB or IOSCO. This is preferable to each state conducting its own research for several reasons. First, national studies may be of varying quality and for this reason can lead to diverging results. Secondly, not all states have the means to conduct extensive analyses. Thirdly, information is a non-rivalrous good: its usefulness remains undiminished by sharing with others. The costs of finding the information goes down when it is gathered centrally. The pooling of resources is therefore helpful. The results should be disseminated amongst the public and discussed with representatives of all states.

More information is also needed about the quality of supervision and regulation in different countries. This is necessary to overcome uncertainty about their willingness and ability to prevent financial crises. Again it is helpful to have the official backing of an international body. The Financial Sector Assessment Program reports published by the IMF and the World Bank could provide such a basis.[98] Yet in order to relieve the information deficit, they need to be much more detailed. International organisations so far lack adequate manpower to conduct comprehensive studies. Besides a general lack of staff, another reason is that assessing the quality of supervision and regulation is not their main task. Supervising the supervisors should become a priority for them.

So long as there are no detailed international reports available, a low-cost alternative is for states to engage in supervisory colleges.[99] While the efficacy of such colleges in reaching their goals is questionable, they provide an excellent opportunity for regulators to learn about the particularities of other countries'

[97] K Alexander and others, 'A Report on the Transatlantic Financial Services Regulatory Dialogue' (2007) Harvard Law and Economics Discussion Paper No 576 <http://papers.ssrn.com/abstract=961269> accessed 17 April 2015.

[98] On their function in banking supervision, see K Chan, 'Financial Sector Assessment Program: A "Report Card" for Bank Supervision in Asia' <www.frbsf.org/banking/programs/asia-program/pacific-exchange-blog/financial-sector-assessment-program-bank-supervision-in-asia/> accessed 6 January 2016.

[99] On supervisory colleges, see eg OECD, *International Regulatory Co-Operation: Case Studies, Vol 2. Canada–US Co-Operation, EU Energy Regulation, Risk Assessment and Banking Supervision* (OECD Publishing 2013) 80.

financial markets. At the same time, they provide states with the chance to get a glimpse of the expertise (or lack of it) of their foreign counterparts.

Another obvious means to ease uncertainty is the bilateral or multilateral exchange of information. This can be complemented by other methods of co-operation to raise awareness about systemic risk, such as the training of staff. Through such assistance, a learning curve can be started. It is in the best interests of developed nations that foreign regulators climb this curve as quickly as possible and have the requisite knowledge and information to adequately address systemic risk. They should therefore be prepared to spend resources on this.

C. *Deference*

As long as regulations are not harmonised, the most important tool to overcome legal fragmentation is deference. Deference means that a regulator refrains from imposing its own rules where the rules of another regulator govern. The basis of deference is the idea that the foreign rules are comparable to its own because they fulfil the same function—to guarantee financial stability. This is a relativistic attitude: the regulator effectively acknowledges that there may be different means that serve the same end. At the same time, it is also a realistic attitude: given the continuing uncertainty about the appropriate response to systemic risk, differences between national regulations are inevitable.

Deference has many advantages. It avoids duplication of laws and the tremendous costs that come with legally fragmented financial markets. There is no doubt it is for this reason that the G20 heads of state favour it.[100] IOSCO holds the same opinion. Its Task Force on Cross-border Regulation has even developed a toolkit for regulators to allow for more deference.[101]

Deference comes in varying forms. First, it is possible that a state waives the application of its own rules to foreign firms. It may, for instance, grant an exemption from its national regime where the activities on its soil are minor.[102] It is also possible that firms are allowed to use the same manners and formats as in their home country for complying with the host country's rules.[103] Another type of deference is recognition. Recognition means that a state accepts that a foreign regime fulfils the same function as its own. It may be applied unilaterally, whereby each state determines which laws are comparable, or it may be mutual, whereby two or more states consider their regimes as fulfilling the same

[100] See G20 Heads of State (n 7) 17: 'We agree that jurisdictions and regulators should be able to defer to each other when it is justified by the quality of their respective regulatory and enforcement regimes, based on similar outcomes, in a non-discriminatory way, paying due respect to home country regulation regimes.' This is cautious diplomatic language. The point is not that regulators should be able to defer to each other, which they are under most legal systems; what is really meant is that they should use this authority.

[101] IOSCO Task Force on Cross-Border Regulation, 'Final Report', FR23/2015 <www.iosco.org/library/pubdocs/pdf/IOSCOPD507.pdf> accessed 19 December 2015.

[102] An example of such an approach is Regulation S adopted by the SEC, see Baum (n 59) 94–5.

[103] An example is US law allowing foreign issuers to prepare their financial statements in accordance with IFRS instead of US GAAP: see IOSCO Task Force on Cross-Border Regulation (n 101) 9.

function. Where each state can certify firms so as to enable them to enter the market of the other, a so-called passport system is established.[104]

The most widespread method of deference at the international level today is unilateral recognition. The United States speaks of 'substituted compliance', the EU about 'equivalence'. The different names reflect certain differences in approach.[105] More important than these technicalities is the spirit with which deference is applied. The recognition of foreign regimes is of little or no avail if the conditions precedent are so stringent that the regulator only accepts rules that are identical to its own. It is important to have a cosmopolitan perspective: the very possibility of considering a foreign regulation as 'equivalent' or 'substituted compliant' implies that one's own law is not the ultimate truth, but that different ways exist to attain the same goal. In short, one must accept uncertainty in financial regulation as a fact and therefore give room to some regulatory diversity. An agency should therefore not interpret any variance of a foreign regime as a sly attempt by the other state to undercut strict standards in order to improve its position in global regulatory competition. It may just as well be that the divergence is based on a different tradition, experience or knowledge of the particular country.

Recognition as a concept entails that a regulator must accept a foreign regulation even though it may not be optimal from its point of view and might not even achieve the same goal. This is what is meant when the G20 says that deference shall be based on 'similar outcomes'.[106] The wording is important: the outcomes need not be identical; instead, it is sufficient for them to be 'similar'. Thus, a state must even accept a foreign regulation that it believes creates an additional risk to global financial stability. This increase in risk, which will often be theoretical, must be carefully balanced against the very palpable disadvantages that a fragmented financial system would have. Global harmony cannot be achieved where a state insists that only its own vision of financial stability is ensured.

On the other hand, a regulator should not be naive. One lesson of this contribution is that there is uncertainty about the quality of other states' enforcement.[107] A regulator must therefore not limit itself to an analysis of the legislative texts and implementing rules and guidelines when assessing the equivalence or substitutive compliance of a foreign regime. It also needs to look at the practice, the experience and the capacity of the agency. A cut-and-paste approach to foreign regulation is not enough to ensure that systemic risk is

[104] For a taxonomy of the different instruments of deference, including their advantages and disadvantages, see IOSCO Task Force on Cross-Border Regulation (n 101).

[105] See J Lindenfeld, 'The CFTC's Substituted Compliance Approach: An Attempt to Bring about Global Harmony and Stability in the Derivatives Market' (2015) 14 Journal of International Business & Law 125; HE Jackson, 'Substituted Compliance: The Emergence, Challenges, and Evolution of a New Regulatory Paradigm' (2015) 1 Journal of Financial Regulation 169; A Artamonov, 'Cross-Border Application of OTC Derivatives Rules: Revisiting the Substituted Compliance Approach' (2015) 1 Journal of Financial Regulation 206.

[106] G20 Heads of State (n 7) 17.

[107] See the end of section 3.B above.

adequately controlled. Consequently, it must be possible to deny recognising rules even though they are *identically formulated* to those of the recognising jurisdiction. This may be perceived as a humiliation and even discrimination by the other regulator. Yet it is nothing of the sort: the other state needs to understand that the uncertainty with regard to the quality of its regime cannot by relieved by simple assurances or promises.

An argument against generous deference is regulatory competition. In some areas, for instance in the derivatives market, this competition is so strong that even a very small divergence of rules may lead to an exodus of the industry to the most favourable jurisdiction. Recognition may therefore cause a double blow to the recognising jurisdiction: in addition to being exposed to more systemic risk from its point of view, there is also the chance that jobs and transactions will migrate to another jurisdiction.[108] Yet these effects are to be accepted in the interest of having globally open markets. If a jurisdiction can achieve similar outcomes to another with a lighter regime, then it has found an economically better way to regulate. This advantage should be rewarded and not be subdued through a denial of market access or extraterritorial legislation. States who regulate systemic risk must not be immune to competition. They should be forced to look for a regime that is conducive both to financial stability and to financial development. Deference can exert some useful pressure on the recognising jurisdiction to improve its own regulation.

D. *Multinational Recognition Panels*

Though deference is an important tool for avoiding legal fragmentation, the way it is practised today suffers from severe weaknesses. Unilateral recognition, which is the prevalent mode of deference, implies that each regulator assesses whether the other's rules fulfil the requirements of 'substituted compliance' or 'equivalence'. This has serious drawbacks. First, it results in a waste of supervisory effort. Staff and resources that would be better utilised on direct supervision are tied up in controlling foreign regimes. Because regulators verify each other's quality, this waste is exacerbated. Secondly, the control is time-consuming.[109] Market access by foreign firms may be blocked for years. Thirdly, unilateral recognition is opaque. Comparability may be denied without giving reasons, which will inevitably nurture suspicions of protectionism. Finally, the mechanism may result in an uneven playing field. Since the standards for assessing the comparability are not aligned, it is entirely possible that a regulator considers another's regime as comparable, while the other

[108] Coffee (n 50) 71.

[109] The FSB notes that the timeline for the assessment of another regulator's regime could take at least several months and that most jurisdictions are not able to provide specific timelines: FSB, 'Jurisdictions' Ability to Defer to Each Other's OTC Derivatives Market Regulatory Regimes, Report to G20 Finance Ministers and Central Bank Governors' 3 <www.fsb.org/2014/09/r_140918/>.

refuses to do so. The fear of such lack of reciprocity may motivate a regulator to deny recognition in advance, further reinforcing the prisoner's dilemma.

A simple way to overcome these deficiencies would be to install neutral panels to assess the comparability of regulations. These panels could be composed of experts from all over the world. Ideally, they would also comprise representatives from the states whose regimes are to be compared in order to give them a chance to explain the merits of their country's laws to their peers. The task of such panels would be to assess two or more regimes of different states and determine whether they are likely to achieve 'similar goals'. They could be organised under the auspices of an international organisation, such as IOSCO.[110]

There are several advantages of such neutral, international recognition panels. First, the effort required to control the quality of foreign supervision and regulation is reduced. For instance, if an international panel, rather than the two national agencies, compares two countries' regimes, the cost is reduced by half. Secondly, the process should ideally be quicker than if it was undertaken by two or more national agencies working in isolation. Thirdly, the procedure is more transparent as the two regimes are now examined by the same panel. Finally, any inequalities are reduced since the decision rendered can only be uniform: if the regime of country A leads to comparable outcomes to that of state B, then both are equivalent or in 'substituted compliance'. If they are not, then neither of the two will be granted recognition.

A possible counter-argument against such panels is uncertainty. Specifically, one could criticise that such a panel would sit as a sort of arbiter about the best type of regulation, while there can be no guarantee that it is capable of surmising all possible consequences and effects. Yet such a critique would miss a crucial element: the panel suggested here would not be called upon to decide about the best way to achieve financial stability. Specifically, its task would not be to devise or assess new ways as to how such stability could be obtained. Instead, its power would be limited to comparing the rules of one regulator with those of another and deciding whether, in light of their common goal, they are likely to achieve similar outcomes. That is a much more restricted and manageable task then finding the most appropriate type of regulation.

One could also object that it would be irreconcilable with national sovereignty to transfer issues of such a far-reaching nature to an international panel. In particular, it could be argued that each state must maintain exclusive power to protect itself against financial risks, and that concerns about open markets and global trade in financial services could not justify the deciding of these issues anywhere else than in the state itself. Yet this argument would be specious. It is not infrequent that international tribunals or panels decide over

[110] ISDA (n 6) 8 has suggested that IOSCO should 'provide a forum for discussion of disputes and consider the institution of an arbitration or college type process for resolution of matters of international importance'. This proposal is very much in line with what is suggested here.

issues that are inherently uncertain and in which states have tremendous interest. The World Trade Organization dispute settlement mechanism provides a salient example. Its panels have rendered decisions on a number of crucial health issues, ranging from the effects of tobacco to those of hormones.[111] It is hard to argue that these decisions were less important to states and their citizens than those on financial issues. There is no apparent reason why international panels can decide about the necessity of health regulations but not about the comparability of financial regulation. Perhaps the day will come when global markets have been hampered so much that states accept panels to decide on this issue as well.

6. *Conclusion*

This article has come full circle. It started with the need for a systematic approach to fighting regulatory divergence in all of its three variants: under-regulation, over-regulation and legal fragmentation. It then posited that such regulatory divergence is not necessarily due to states following their domestic interests and seeking to undercut each other's standards to improve their position in regulatory competition. Alternatively, it may be caused by uncertainty about how to achieve global financial stability.

A first important finding of this article therefore is what can be called the 'relativity' of regulation: it is the acceptance of the fact that no state holds the golden key to the proper regulation of global markets. There are legitimate divergences of viewpoints about how to obtain more financial stability. For this reason, one should be wary of accusing another state holding a different opinion of wanting to improve its position in regulatory competition. Instead, one must accept that the divergent opinion can be rational.

A second important—and perhaps surprising—finding is that extraterritorial legislation and application of law is not necessarily reprehensible. To the contrary, it has been shown that extraterritoriality may be a proper response to the uncertainty about the right way to achieve financial stability and about the motives and capability of other regulators. Where a regulator is uncertain how other states act and why, it is legitimate for it to protect its own interests and do what is necessary in its view to secure global financial stability. Those states that take the problem of systemic risk seriously will fear the backlash on their own markets and therefore protect their financial system by extraterritorial legislation. This is not legal imperialism, but a necessary response to the interconnectedness of finance and the existence of systemic risk.

[111] Art XX(b) GATT provides an exception from the agreement's obligations where a state measure is necessary to protect human, animal or plant life or health. On the extensive case law on this issue, see B McGrady, 'Trade and Public Health: The WTO, Tobacco, Alcohol and Diet' (2013) 4 European Journal of Risk Regulation 589.

The third finding is that extraterritoriality comes at a cost. It will often lead to over-regulation and—where the rules are contradictory—to legal fragmentation. Transnationally active firms will therefore be subject to duplicative and sometimes irreconcilable standards that they cannot comply with simultaneously. As a result, global markets will be broken up and renationalised. It was shown that states are bound to end up in a situation of legal fragmentation because they are confined in a version of the prisoner's dilemma. Since they are uncertain about the motives and ability of other regulators, they will tend to turn towards regulation that both secures financial stability and protects their domestic industry from unwelcome competition. In other words, they will adopt a protective and non-co-operative attitude and seal off their markets to foreign firms. From a macroeconomic perspective, the net result for all states combined will be less favourable than a scenario in which states co-operate towards financial stability and open their national markets.

The conclusion to be drawn is that one must not let regulatory divergence get in the way of functioning global markets. Though the regulatory quest for financial stability is important, it can lead to legal fragmentation, the cost of which may well exceed that which would be produced by a country having a slightly insufficient systemic risk regime. Therefore, a trade-off between financial stability and open markets is required. Alignment and co-ordination are necessary as they make the differences between national regulations bearable for transnationally active firms, even if they come at a small cost of financial stability. As has been shown, such alignment and co-ordination cannot be achieved through more 'hard' international law, or by internationally allowed deviations or through power politics. It can only be achieved by informed dialogue.

Realistically, differences between national regimes will remain. Deference is the tool to reduce the externalities resulting from them and to help prevent them from turning into regulatory barriers for global markets. It is suggested that regulators should mutually recognise each other's regimes as long as they achieve similar outcomes, and that minor differences between their rules should not be an obstacle. Regulators should carefully weigh the benefits of enforcing their individual vision of systemic stability against the drawbacks of fragmented markets.

Currently, each state decides unilaterally whether another country's regulation and supervision is 'equivalent' or 'substituted compliant' to its own. This produces additional uncertainty, high costs and an uneven playing field. Moreover, deference may be withheld for protectionist reasons. Therefore, from a macroeconomic viewpoint, it would be better if the comparison of different regimes were put in the hands of a neutral body, for instance a panel of regulators chosen from different countries.