Global Financial Regulatory Reform and Government Networks: 
Issues of Governance and Capture


Abstract

The institutional arrangement chosen by the leading nations in order to address financial regulatory reform in the wake of the 2007-9 crisis exhibits two key features of global economic governance innovation. First, it employs a minilateral approach, restricting the participants that negotiate new regulatory standards to a few, highly involved stakeholders. Second, it relies heavily on a combination of soft law and government networks. The arrangement circumvents the traditional intergovernmental model that has proven overly rigid and ineffective in addressing the problems that arise from highly interconnected and fast-changing global markets. Current theories of global economic governance predict that this twofold innovation enhances the effectiveness of financial regulatory reform. Yet a study of the evolution in OTC derivatives regulation shows that this is not the case. The paper then exposes three obstacles to cross-border regulatory cooperation between the two dominant players, the European Union and the United States. Authorities on both sides of the Atlantic are concerned about the distributive consequences of regulation, legislators and legislation hinder cross-border harmonization, and government networks are weak and incomplete. The paper concludes with suggestions of how to overcome coordination failure and theoretical implications for the political economy of networked governance.
In the wake of the global financial crisis of 2007-9, leading nations chose the G20 as the main political forum for financial regulatory reform and the Financial Stability Board as the main vehicle for its implementation. This choice incorporates two key features of global economic governance innovation. First, it employs a minilateral approach, restricting the participants that negotiate new regulatory standards to a few, highly involved stakeholders, while extending or imposing the new standards (on) to the rest of the world once the negotiation phase has concluded. Second, the agreements reached rely heavily on a combination of weak legal form, considerable substance of content, and a strong peer review structure that represent the operational foundation of government networks. The arrangement circumvents the traditional model centered around inter-governmental organizations and international law that has proven overly rigid and ineffective in addressing fast-changing globalized markets in general and global finance in particular.

Given the global alignment of incentives in the wake of the crisis and this twofold governance innovation, state of the art theories of global governance predict that financial regulatory reform will be implemented around the world with a relatively high degree of effectiveness. Yet a case study of the regulatory reform of OTC derivatives markets shows that this is not the case. In spite of the most minilateral approach possible and a long history of cooperation in government networks, OTC derivatives reform in the United States and the European Union exhibits a surprisingly severe instance of coordination failure.

This paper identifies three issues that explain the current state of affairs. First, European and especially American authorities are wary of the expected distributional consequences of cross-border harmonization of OTC derivatives regulation. Second, legislators and pre-existent legislation represent obstacles to cross-border cooperation. And third, the government networks that are expected to overcome these obstacles are not only lacking legal authority, but they are incomplete and weak due to
domestic institutional differences. In conclusion, the paper suggests implications for theoretical and practical approaches to networked global governance.

**Global Economic Governance**

The Bretton Woods institutions that were established in the mid-20th century constituted the major nodes of global economic governance for a significant part of the postwar era. They were born out of and fostered an embedded liberalism that combined increasingly liberal external policies with interventionist ones in the domestic realm (Kahler & Lake, 2003). They were able to operate with effectiveness and at the same time provide a relatively high degree of accountability and representation to member states and its peoples. That there is a tradeoff between effectiveness and representation has been recognized by scholars of domestic organizations in the 1960s, if not earlier. Merton (1966) distinguishes between instrumental and group-maintaining functions and points out that the tension between the two is especially high in democratic organizations. A drive towards more efficient practices threatens to erode the processes that make sure all constituents are represented, or internal democracy in Merton’s words. Conversely, group-maintaining functions that are geared at maintaining representativeness may render the organization ineffectual. Merton (1966, p. 1060) states: “We note that some members develop so deep a passion for democratic processes that they often forget the purposes which these processes were meant to serve.”

This dilemma of representation and effectiveness does not only apply to domestic organizations and governments but also to international organizations. The legal structure of the Bretton Woods institutions was designed to achieve a compromise between both goals. It is firmly embedded in international law: like other inter-governmental organizations (IGO), the international financial institutions are established by virtue of an international treaty that enters into effect once a predetermined number of signatory states ratify the treaty. The IGO then provides the institutional
environment in which representatives of member states engage in often onerous and protracted negotiations for rules that again become legally binding after ratification by a certain number of member states (Sands & Klein, 2001; Shaw, 2008).

However, this model of IGO-centered global economic governance has reached its limits, albeit at different times in different areas during the postwar era. Macroeconomic coordination proved most fragile as the period of IMF-centered exchange rate coordination ended already in the early 1970s. Although it continued to provide technical assistance and resurged as an important – and highly controversial – lender of last resort to developing countries facing financial crises, the IMF lost its function as a body of global monetary governance more than thirty years ago (Stiglitz, 2003). Currently, even the reform of IMF governance has stalled because it fails to find parliamentary sanction in the United States. Multilateral coordination of trade policies in turn got off to a slow start when the US Congress exercised its veto powers in 1946, in similar ways as it does now with the IMF, preventing the establishment of an International Trade Organization (Jackson, 1997). After several successful rounds of trade negotiations, the Uruguay Round culminated with the establishment of the latest – and arguably the last – classic inter-governmental organization of global economic governance, the World Trade Organization. In the twenty years that have passed since, however, the WTO has failed to bring about any agreement of significance. The United Nations and adjacent agencies such as UNCTAD were able to exercise a certain degree of influence on development policy and its coordination, especially in the 1970s. But again, there has been no significant multilateral agreement since the Millennium Declaration of 2000.

The lack of virility in IGO-centered global economic governance can be attributed to two factors. First, the rising number of member states has led to an increase in preference heterogeneity and veto points in the decision making structure of these organizations. With the exception of the United Nations, the initial membership of IGOs that take responsibility for global economic governance was constrained
to a few Western countries. Today they include the vast majority of the world’s countries. Second, the lengthy and arduous process of international negotiations that must take into account the chances of domestic ratification, as modeled in Putnam’s (1988) two-level games, is too cumbersome and rigid to address the exigencies of a fast-changing global market. In Merton’s terminology, facing an increasingly difficult tradeoff between representation and effectiveness, IGOs have focused on the former to the detriment of the latter.

In response to the erosion of effectiveness of classic inter-governmental bodies, innovation in global economic governance has moved in two directions: reduce the number of stakeholders and jettison the ballast of international legal procedures. The following paragraphs discuss these changes from a theoretical and practical perspective.

**Minilateralism**

In a short but influential paper, Moises Naim (2009) proposes minilateralism as a solution to the current problems of global governance, in the economic realm and beyond. He advocates for a strategy to “bring to the table the smallest possible number of countries needed to have the largest possible impact on solving a particular problem”. Successful negotiations, the author argues, can occur only in a club-like environment where only a few of the most involved stakeholders are present. Once an agreement is reached, however, it can be extended to all other countries that are willing to subscribe to it.

It is important to note that Naim’s “minilateralism” is not a new phenomenon but rather the modus operandi of global governance in the realm of finance for decades. After the breakdown of IMF-centered exchange rate coordination, macroeconomic policy coordination fell into the hands of the G7 from 1973 onwards. Another area of global financial governance, prudential banking regulation has never taken the route of a broad and inclusive institutional setting. Instead, the Basel Committee on
Banking Supervision (BCBS) was created by and for a long time restricted to financial regulators of only 10 countries (the so-called G10). In other words, for the last four decades, the governance bodies of global finance were designed to maximize efficiency while paying little attention to representation.

In the wake of the global financial crisis, the members of this exclusive club of rich nations decided to widen the institutions of global economic governance in order to provide emerging economies with more participatory space. But the inclusion of new important stakeholders does not imply a departure from minilateralism. This became clear when G20 members rejected a proposal by Secretary General Ban Ki-Moon to convert a December 2008 UN Conference on Financing for Development into a summit to address the financial crisis, and ignored a subsequent call by the Stiglitz Commission for the creation of a Global Economic Coordination Council under UN auspices (Cooper, 2010; Wade, 2011; Kharas & Lombardi, 2012; Knaack & Katada, 2013). Neither did the “marginal majority” of 150 states (Payne, 2010) participate in the negotiations regarding financial regulatory reform. Even though over 120 jurisdictions claim to adhere to earlier Basel standards of prudential banking regulation for example, only 27 member states were involved in the formulation of the new Basel III rules (Alexander, Dhumale, & Eatwell, 2006; BCBS, 2011).

Even within these small, club-like governance bodies, power is unevenly distributed. This understanding is the point of departure for several main theories of global financial governance. In her approach to the politics of financial harmonization, Simmons (2001) distinguishes between the dominant center where market power is concentrated, such as the United States and Great Britain, and the rest. Simmons (2001, p. 591) states: “The decisions of regulators in the dominant centers can drastically change the choices available to other countries; they create a paradigmatic shift, and any negotiations that follow are merely splitting hairs.”. The global governance arrangement in a given issue area is a function of two dimensions: (1) market incentives for emulation and (2) externalities of non-adherence to the center’s standards. If the externalities of non-adherence are low, multilateral
institutions play a marginal role, and market incentives decide whether harmonization occurs or not. The situation is different in areas where negative externalities of non-adherence are high, however. If market incentives for emulation exist, multilateral institutional arrangements are sought but these arrangements limit their operations usually to information exchange and technical assistance. In the absence of incentives for emulation, however, the dominant centers establish formal multilateral institutions to exert political pressure for harmonization.

The global financial crisis represents a fortuitous occasion to revisit the assumptions and conclusions of this theory. The crisis revealed the high degree of cross-border interconnectedness of the contemporary financial system. What started as a problem in a subsector of the American residential mortgage market soon created major headaches for financial firms, central bankers, and state leaders around the world. No subsector of financial markets was exempt from negative cross-border spillovers. It can thus be argued that Simmons’ second dimensions has contracted, turning all sectors of financial activity into areas with significant negative cross-border externalities. This becomes clear when looking at the two sectors where Simmons previously regarded non-adherence as innocuous for financial stability in the dominant center: accounting standards and securities regulation.

Generally not considered one of the most thrilling areas of global finance, accounting standards have gained unprecedented salience in the wake of the crisis. Politicians and economists weigh the virtues of mark-to-market accounting against its contribution to volatility and pro-cyclicality in financial markets (Friedman, 2011; Stiglitz, 2010; Tirole, 2010). Moreover, G20 leaders started paying attention to the problems inherent in the inconsistencies between accounting standards applied in the United States (GAAP) and elsewhere (IFRS). At the April 2009 summit in London, G20 leaders called on the two main accounting standard setting bodies to “make significant progress towards a single set of high quality global accounting standards”, among other initiatives to strengthen the financial system (G20, 2009a, p. 6). Since then, the Financial Stability Board (FSB) has included accounting standards in every progress
report to date (FSB, 2013b). Gadinis (2013, p. 171) notes with surprise: “That accounting inspires this level of detail in a report to government leaders is, on its own, a fascinating development.”. Even though the convergence efforts in accounting have been tepid and incomplete by the end-2013 deadline, the political salience of this issue area shows that the dominant players in global financial governance are wary of the negative externalities that a lack of cross-border harmonization would entail.

The emergence of political pressure for international regulatory coordination is even clearer in securities markets. In 2001, Simmons stated that information sharing among securities regulators is minimal due to concerns about confidentiality and the absence of systemic risk in this market. This was particularly true for a subsector of the derivatives market that was not traded on exchanges but over the counter (OTC). US Congress passed legislation in 2000 that explicitly exempted OTC derivatives from regulation altogether (K. N. Johnson, 2011). Furthermore, there were few market incentives for emulation of dominant regulatory standards, both in exchange-traded securities and derivatives markets. The conditions of OTC derivatives contracts in particular are negotiated bilaterally and even though the main industry association provides a common standard (ISDA Master Agreement), OTC contracts display considerable heterogeneity not only across countries but also across counterparties. However, awareness of negative externalities and subsequent political pressure for harmonization has changed dramatically with the global financial crisis. Most financial experts had not anticipated the degree of cross-border repercussions that interconnectedness in the derivatives market entailed. In fact, in the run-up to the crisis, between 50% and 75% of OTC derivatives contracts of U.S. financial firms involved counterparties in other countries. After the costly bailout of AIG, US policymakers made derivatives regulation a cornerstone of domestic regulatory reform while simultaneously pushing this issue area onto the G20 reform agenda (Greene & Potiha, 2012). The securities standard-setting body IOSCO, previously described as a rather passive transnational government network, was put in charge of coordinating derivatives reform across borders under the supervision of the FSB.
In sum, it can be argued that the 2x2 taxonomy of Simmons’ theory of regulatory harmonization collapsed into a 2x1 roster after the crisis because no area of financial regulation is considered to merely entail negligible cross-border externalities any longer. This implies that independent of the degree of market incentives for emulation, the dominant center will exert political pressure towards global harmonization of regulatory standards and the elimination of free riding.

The idea that great powers remain the primary rule-makers of the global economy is further developed by Daniel Drezner (2007). The author draws a useful distinction between benefits and adjustment costs of policy coordination. Globalization has increased the rewards of international coordination, but adjustment costs for affected domestic actors remain the same. For sizeable economies, the benefit of adjustment to another state’s standards are low in comparison to the adjustment cost. This is because trans-border transactions represent a smaller share of the overall economic activity. Market size matters because domestic actors voice their resistance if their perceived adjustment costs supersede expected benefits, thus impeding policy coordination. In addition, big states have the go-it-alone-power of large internal markets (Gruber, 2000). They can threaten to deny market access and resort to economic coercion if other states refuse to adhere to domestic standards. This conjecture has two implications. First, Drezner predicts that the equilibrium outcome is a convergence to the standard prevalent in the largest country. Second, effective global governance is established only if the great powers agree on the same standard.

To add further detail, Drezner introduces at a two-dimensional typology of global standards that considers the degree of interest divergence among great powers on the one hand, and that between great powers and other international actors on the other hand. The author contends that in the realm of financial regulation, great powers exhibit a low degree of conflict whereas their interests significantly diverge from that of the periphery. In the wake of the string of financial crises of the late 1990s that shook emerging markets in Asia and South America, regulators in North America and Europe recognized
that promoting a more rigorous set of prudential standards promised to reduce the negative spillovers of financial crises. Drezner (2007) states: “For developed countries, the benefits of global financial regulatory coordination at stringent levels of regulation were significant, while the adjustment costs were relatively minimal.” (p. 123). In developing countries in contrast, adherence to stricter regulatory standards would require both a significant increase in resources dedicated to financial regulatory authorities and in compliance costs for the private sector, whereas the benefits of these changes would be much less tangible. Given this array of interests and power, the dominant players are likely to establish what Drezner calls “club standards”, standards that are formulated by a small group of stakeholders but enforced through an international organization that can monitor the compliance of outsiders. Indeed, in the early 2000s the dominant powers devised the Financial Stability Forum, a club-like governance body that originally was restricted to only the G7, Hong Kong, Australia, and the Netherlands to develop and promote what became known as the 12 Key Standards of financial regulation (Griffith-Jones, Helleiner, & Woods, 2010; Blustein, 2012).

The 2007-9 financial crisis has only reinforced this alignment of costs and benefits. Developed countries, especially the United States and Europe, were hardest hit by the crisis and were forced to massively increase the burden on their public finances in order to bail out financial firms both at home and abroad. Developing countries on the other hand survived the crisis relatively unscathed. Consequently, regulatory reform in the wake of the crisis is driven by the dominant powers who are willing to incur the costs of a regulatory reform that is designed to protect themselves from another financial breakdown. Developing countries on the other hand are voicing concerns not only about the burden of higher supervisory requirements but also the negative impact that regulatory reform would have on their access to capital abroad (FSB, 2013a). Again, financial prudential rules are emerging as club standards in that they are formulated by a slightly larger but still small group (the G20) and enforced through an equally exclusive governance body, the Financial Stability Board (FSB).
In sum, both Simmons’ and Drezner’s approaches lead to the prediction that the global financial crisis will lead to the emergence of a harmonized set financial regulatory standards. The standards are expected to be formulated in a minilateral club such as the G20 and the FSB. Subsequently, the dominant powers have a strong incentive to exert political pressure towards global harmonization, making sure that all relevant jurisdictions adhere to the dominant standard and that none resorts to free-riding. Beyond this minilateral approach to financial reform, the response to the financial crisis engenders innovation in the legal form of global governance.

**Soft law**

Although they gained prominence in the wake of the crisis, government networks have emerged in simultaneous fashion with the current wave of globalization. They represent a response to the dilemmas of global governance. In a world fundamentally characterized by interconnectedness across borders, governance authority must reside at the global level. Yet a world government is neither feasible nor desirable. As discussed above, the formal delegation mechanisms of traditional IGOs are too cumbersome for effective governance, yet self-selected public-private arrangements of self-governance lack legitimacy. Government networks that bring together public officials combine cross-border authority and effectiveness with legitimacy derived from domestic election procedures. Slaughter (2004) notes that such networks defy traditional academic categories: “As a number of scholars point out, these ‘organizations’ do not fit the model of an organization held either by international lawyers or political scientists: they are not composed of states and constituted by treaty; they do not have legal standing; they have no headquarters.” (p. 43). Instead, government networks are characterized by enduring and repeated interactions among government officials in a given special policy area. The pioneering work of Keohane and Nye (1977) depicted transgovernmental relations as an essential
addendum to further the power of inter-governmental organizations. Today’s government networks however exist both under the umbrella of and completely independent of IGOs.

While these networks carry the legitimacy of national governments, decision-making procedures are much more informal than in traditional inter-governmental settings. Soft power mechanisms such as persuasion, socialization, and information-based peer pressure are commonplace in government networks (Slaughter, 2004).

A look at the legal instruments of government networks helps illuminate their prevalent modus operandi. As explained above, classic inter-governmental organizations are firmly embedded in international law: they are established by virtue of an international treaty that enters into effect once a pre-determined number of signatory states ratify the treaty. The IGO then provides the institutional environment for the negotiation of rules that become legally binding after ratification by the legislatures of a certain minimum of member states.

In contrast, government networks rely on three main instruments: promotion of standards and best practices, regulatory reports, and information sharing and enforcement cooperation. Rather than treaties, agreements take the form of a Memorandum of Understanding (MoU). These documents are not legally binding and do not require ratification (Brummer, 2010). Because of its peculiar modus operandi Slaughter (2004, p. 33) characterizes government networks as the “political equivalent of the informal economy, alongside formal international institutions”.

The advantages of this kind of cooperation are obvious. Government networks address the demand for intergovernmental cooperation but significantly reduce sovereignty costs: retaliation issues are less salient, and there is no delegation of authority to external agents. Furthermore, the absence of ratification procedures deprives domestic players of veto power, and unexpected coalitions between domestic interest groups and supranational authorities can be ruled out. In addition, negotiation costs are low, too, because the drafting stage is less time-consuming and agreements can be rather easily
amended or changed. As Slaughter (2004, p. 49) puts it, “Widespread use of Memoranda of Understanding (MOUs) and even less formal initiatives has sped the growth of transgovernmental interaction exponentially, in contrast to the lethargic pace at which traditional treaty negotiations proceed.” This quality of government networks is especially valuable when establishing an international regulatory framework for a sector marked by complexity and uncertainty, and with a fast rate of technological change and innovation, such as finance (Brummer, 2010).

However this array of instruments, often dubbed “soft law”, raises certain questions. What if market forces do not favor compliance with global standards? Given the apparently low cost of defection, how can opportunism be discouraged? What prevents stakeholders from choosing alternative regulatory approaches, cherry-picking certain aspects of agreements, or under-enforcing rules?

Kal Raustiala (2005) addresses these questions by differentiating between form, substance, and structure of institutional design. According to the author, “there is no such thing as ‘soft law’.” (p. 586). States may choose a legally binding or not binding form, and domestic actors and governments themselves have traditionally pushed for the former. However, the legality of commitments is a neither necessary nor sufficient for their effectiveness. Often states decide to formulate legally binding but shallow agreements with large “compliance cushions”. While they can thus ensure compliance, safeguard their reputation, and please domestic interest groups, state behavior is unlikely to change.

The structure of international agreements refers to the rules and procedures to monitor the performance of parties, deter and punish non-compliance. Legally binding agreements with weak structure are of questionable effectiveness for example. In contrast, many of the informal agreements in government networks count on a strong monitoring and enforcement structure. Regular peer reviews, sanctions or even conditional membership provide a strong incentive system for state compliance. Thus state behavior can depart from the status quo because of substantive agreements of weak legal form but strong review structure (Raustiala, 2005).
These are exactly the characteristics of international agreements the G20 have embraced in the wake of the global financial crisis (Helleiner, 2010). Both the G20 and the FSB’s predecessor (FSF) have been in existence for a decade, but occupied a rather marginal position in global economic governance. Its salience changed dramatically when it was elevated to a state leaders’ summit in 2008, but the institutional footing of the G20 has not changed. It does not have existence under international law, it has no mandate, no charter, and no headquarters. Largely the same holds true for the organization that the G20 put in charge of implementing and monitoring financial regulatory reform. The FSB is a quintessential government network. Like its predecessor, it unites regulators, central bankers, finance ministers, and officials of international organizations and standard-setting bodies. FSB membership has been extended to all G20 countries, but again only officials of public financial authorities are invited. Just like those of the G20, decisions in FSB are made by consensus but they do not constitute agreements under international law (Pauly, 2010). Each member jurisdiction then proceeds “unilaterally” with domestic implementation, thus circumventing legislative ratification procedures. At the same time, the FSB places much emphasis on regular review process to exert peer pressure on jurisdictions that lag behind in implementation.

The FSB’s standing as a government network has been questioned and scrutinized in recent years. Following an external assessment of the FSB’s governance structure that highlighted the shortcomings of the organization in terms of transparency and accountability (Lombardi, 2011) and given concerns that it lacks the formal powers to ensure compliance in member states, G20 leaders decided at the 2011 Cannes Summit to review the organizational footing of the FSB, its governance structure and relationship to other regulatory bodies. A year later, the FSB Plenary adopted a series of recommendations regarding wider consultation with stakeholders and greater transparency. What did not change, however, was its positioning as a government network that relies on soft law. The document clearly states: “The FSB considers a treaty-based inter-governmental organisation not to be
an appropriate legal form at this juncture." (FSB, 2012, p. 3). Instead, the Board changed its Charter to be incorporated as an association under Swiss law, a formality that bears no legal implications for its status as a global governance body.

Using Raustiala’s (2005) terminology, the institutional design of the FSB combines a weak legal form with strong review structures. FSB decisions in principle are nothing but pledges, and FSB member jurisdictions are expected to lead by example. At the same time, implementation efforts are subject to regular peer review. The failure of a jurisdiction to make progress entails significant reputational costs for the responsible official in a tightly knit regulatory community (Brummer, 2010). In principle, continued membership in the FSB is conditional upon satisfactory implementation of key international standards. However, even though some member jurisdictions have a very bad compliance record, for example in compensation practices, the issue of exclusion from the FSB has not been recorded thus far.

In order to strengthen the review and monitoring mechanisms and prevent duplication of efforts, the FSB has devised a Coordination Framework for Implementation Monitoring (CFIM) in 2011. It assigns monitoring responsibilities among the internal implementation monitoring network, the Standing Committee on Standards Implementation (SCSI), and external standard-setting bodies that are FSB members. The framework establishes a two-tiered information flow: FSB member jurisdictions and standard-setting bodies are responsible to inform the SCSI on implementation and to evaluate peer performance. The Standing Committee then provides its own assessment of implementation progress and delivers it to the Plenary. The information flow is restricted to selected regulators in the FSB only. The Plenary discusses the SCSI assessment and approves a selection of “key messages” that are then incorporated into G20 Implementation Progress Reports. It is at this final stage that information about implementation becomes publicly available (FSB, 2011a). This filtering process combines peer pressures within the government network at the early stages with public pressure at the time of the G20 progress report publication.
In sum, the institutional setup of post-crisis financial regulatory reform embodies significant innovation in global governance. A minilateral approach to the negotiation of standards combined with soft law implementation across borders that is reinforced and monitored by a government network promises to achieve the highest attainable degree of effectiveness without compromising too much on legitimacy.

Yet financial regulatory reform is beset with coordination failures among regulators, and the gap between G20 commitments and the reality of their implementation is considerable. Why is that the case? The following study of OTC derivatives regulation highlights the failures of post-crisis reform and explores the reasons for the multiple problems that emerge in this issue area.

**Coordination failure in OTC derivatives regulation**

Recognizing the need to bring OTC derivatives markets under supervisory control, G20 leaders at the Pittsburgh Summit in September 2009 made the following pledge:

“All standardized OTC derivative contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties by end-2012 at the latest. OTC derivative contracts should be reported to trade repositories. Non-centrally cleared contracts should be subject to higher capital requirements.” (G20, 2009b, p. Annex 1 pt. 13).

Yet almost five years since that statement was made and more than a year after the deadline passed, reform progress is partial at best. The considerable gap between policy goals and implementation is well documented in the series of seven progress reports that the FSB has submitted to the G20 to date. Concerns started surfacing as early as 2010. The progress report to G20 Finance Ministers and Central Bank Governors in October 2010 recognizes, “Much work and considerable coordination lie ahead in this area.” (FSB, 2010, p. 2).
The lack of progress in OTC derivatives reform prompted the FSB to blow the whistle in a progress report one year later. To make sure that no stakeholder oversees the message, the executive summary of the document starts with the following lines:

“As of now, with only just over one year until the end-2012 deadline for implementing the G-20 commitments, few FSB members have the legislation or regulations in place to provide the framework for operationalising the commitments. [...]This report concludes that jurisdictions should aggressively push forward to meet the end-2012 deadline in as many reform areas as possible.” (FSB, 2011b, p. 1).

By the time the deadline passed, not a single G20 member was close to implementing the commitments made at the Pittsburgh Summit. According to the September 2013 progress report, less than half of interest rate and credit derivatives have been cleared by central counterparties. And even though almost all trades in these two asset classes have been reported to trade repositories, commodity, equity, and FX derivatives are neither centrally cleared nor reported with high frequency. Very few jurisdictions expect to have mandatory clearing obligations in effect “in the near future”, and regulation regarding margin requirements for non-centrally cleared trades is not even in the consultation stage outside the European Union and the United States. The report highlights the holes in the global regulatory patchwork of OTC derivatives markets: “Reforms to legislative frameworks and implementing rules are still underway in many jurisdictions, with few having frameworks in place that will support implementation of all of the G20 reform commitments.” (FSB, 2013c, p. 4).

The latest FSB progress report of Feb 2014 notes that currently only 46% of eligible derivatives in terms of notional outstandings are centrally cleared. Significant progress has been made in the area of capital requirements that banks must hold for their derivatives exposure. This is because capital requirements are under the purview of the Basel Committee and will be implemented as part of Basel III. In contrast, rules on margin requirements that apply to derivatives trades themselves independent of who the contracting parties are have only entered the drafting stage in the United States and the
European Union in late 2013, and are still not even being proposed in any other jurisdiction. The report shows that even by the end of 2014, two years after the original deadline, the G20 commitments regarding OTC derivatives regulation will not be implemented.

This paper argues that the main obstacle to progress in this area of financial regulatory reform lies in the tension between the two dominant centers of finance, the United States and Europe. The following paragraphs trace the development of transatlantic coordination failure. Subsequently, the final section shows why state of the art theoretical approaches to global regulation lack explanatory power in this issue area and proposes three alternative explanations.

**A brief history of transatlantic regulatory bickering**

In contrast to their exchange-traded brethren, bilateral derivatives agreements that are concluded “over the counter” (OTC) have not been subject to regulation until the global financial crisis. There was political momentum to bring this asset class under regulatory purview following the turmoil with highly leveraged institutions in the 1990s, and CFTC Chairman Born was proposing concrete measures to do so until the now-famous 13 Bankers and Assistant Treasury Secretary Lawrence Summers spoke out against her advances (S. Johnson & Kwak, 2010; Roig-Franzia, 2009). The industry was successful at lobbying Congress to exempt OTC derivatives from regulatory supervision with the 2000 Commodity Futures Modernization Act. In subsequent years, the OTC derivatives market ballooned from $95.2tr in 2000 to $672.2tr in 2008 and $710tr by end-2013. AIG, a US government-sponsored enterprise alone had issued $500bn worth of credit default swaps (CDS) without having to post any collateral (BIS, 2014; FCIC, 2011; Public Citizen, 2012).

After the collapse of Lehman brothers, the Fed found itself obliged to guarantee AIG’s derivatives obligations to counterparties, a bailout worth $182bn of taxpayer’s money. Coffee (2014) notes that this AIG debacle has largely informed the legislative overhaul of financial regulation in the
United States. Proposed in June 2009 and signed into law by President Obama in 2010, the Dodd-Frank bill significantly increases the perimeter of financial regulation, including the OTC derivatives market in particular. It is important to note, however, that this initiative was driven by the US Congress, not by the G20. Persaud recognized as much in 2010: “The US bill on financial regulation currently before the Senate makes no acknowledgement at all of what the EU, China, India, Brazil and Russia are up to. Across a wide set of issues, from financial regulation, bankers’ pay and bank taxes to competition policy, national regulators are going down different avenues from their G20 colleagues.” (Persaud, 2010, p. 638).

Following the above-mentioned G20 commitment at the Pittsburgh Summit in September 2009, the FSB was put in charge of coordinating the formulation and implementation of OTC derivatives reform. In April 2010, the Board set up the OTC derivatives working group (ODWG), comprised of regulators from nine member jurisdictions, officials of several international financial institutions and representatives the standard-setting bodies for banks (the Basel Committee), financial markets (IOSCO) and settlement systems (CPSS). By bringing together only a handful of the most involved jurisdictions and only financial market regulators and central bankers, the composition of this group reflects all recommendations regarding successful global economic governance. Yet by relying on technocratic consensus among regulators, the group was oblivious of the political obstacles to its functioning.

A US regulator recalls that the absence of high-enough-level representatives encumbered the coordination process from the beginning: “The European Commission was basically out there saying, whatever you guys do, if it doesn’t include us, forget about it. […] Frankly we couldn’t come to an agreement because every arrangement that we came up with, it was basically […] the market regulators at least in the US had the biggest clout and the European Commission again, Brussels has the biggest clout but they’re not a member of Basel or CPSS or IOSCO per se. So we ultimately came up with the kind of a fudge solution which wasn’t particularly appealing.” (US Regulator 1, 2012).
In 2011, when the lack of progress in the ODWG became evident, FSB Chairman Mark Carney decided to establish the so-called OTC Derivatives Coordination Group, a more high-profile group that brought together the chairs of the standard setting bodies and Carney himself in order coordinate “the international work to achieve the progress on the safeguards that is needed by mid-2012” (Carney, 2012, p. 3). But even though this group had more authority in the regulatory world, it ignored the political realities on the ground. A US regulator explains: “They’ve got basically four central bankers or one bank supervisor and three central bankers. And the SEC, the CFTC and the European Commission which are frankly the major players in the OTC Derivatives Regulation are not there. [...] So there still is a question as to who’s going to have the big stick come December 31st.” (US Regulator 1, 2012).

The failure of any jurisdiction to deliver on the G20 commitments regarding OTC derivatives by the 2012 deadline serves as evidence that the stick of Carney’s Coordination Group was not big enough. The group itself never appeared again in subsequent progress reports. In its stead, a new group, the so-called OTC Derivatives Regulator’s Group was formed. It largely overlaps with the ODWG but is comprised solely of officials with direct supervisory authority over the ten major derivatives markets. The Regulator’s Group deals specifically with all the cross-border conflicts, inconsistencies, gaps and duplicative requirements that have arisen in OTC derivatives regulation over the last years.

One point of friction in this issue area arises from different timetables of implementation of the G20 commitments. While US regulators have taken the lead in implementation of Dodd-Frank, the European Union is lagging about a year behind. Moreover, Europe is not only formulating the new rules but contemporaneously creating new regulatory bodies at EU level for banking (EBA) and securities markets (ESMA) (CFTC & SEC, 2012). Other G20 countries are deliberately delaying OTC derivatives reform until finalization of the rules in the two main markets. This in turn generates problems for the United States. In a 2012 testimony to the US Senate Banking Committee, a high-level US regulator stated that: “Given our commitment to convergence with international standards, our primary concern with
the ongoing efforts to reform OTC derivatives markets is one of timing. If the U.S. is unable to implement market reforms in a coordinated and contemporaneous fashion with all significant derivatives market jurisdictions, we face the risk that trades will move to an unregulated market.” (Walsh, 2012, p. 19).

This is indeed a serious concern given the nature of derivatives markets. Unlike the banking sector where regulators attach regulatory requirements to licenses and charters in a given jurisdiction, derivatives markets represent an infrastructure that defies a territorial approach to regulation (K. N. Johnson, 2011). Market participants cannot easily be excluded, and even though the main participants in the OTC derivatives markets are big financial firms, their broker-dealer operations can change location rather easily, at least on paper. Riles (2011) provides the example of a derivatives transaction between a Japanese and a British bank, posted to their subsidiaries in the Cayman Islands and involving a swap between Chinese Yuan and Singaporean dollars. In which jurisdiction does this trade take place, the author asks, and what law should apply?

Lawmakers both in Europe and the United States have found an answer to this question: theirs and only theirs. Title VII of the Dodd-Frank Act and the European Market Infrastructure Regulation (EMIR) stipulate that entity- and transaction-level requirements apply to counterparties irrespective of location when the trade has a ‘direct, substantial and foreseeable effect’ on the jurisdiction (Dodd-Frank Wall Street Reform and Consumer Protection Act, 2010; Coffee, 2014).

This assertion of extraterritorial authority has been the main source of friction between regulators on both sides of the Atlantic for the last two years.

In early 2012, proposed rules that envision the extraterritorial application of the Volcker Rule irritated political leaders in Europe. EU officials had previously voiced their concern that Dodd-Frank did not even grant the European Central Bank exemption from its rules (Shipkevich, 2011). The British Finance Minister George Osborne wrote a letter of concern to Fed Chairman Bernanke in January, and
the EU Commissioner for financial services Michel Barnier argued a month later that it was “not acceptable that U.S. rules have such a wide effect on other nations.” (Onaran, 2012; Standish, 2012). In diplomatic fashion, Treasury Secretary Geithner responded that “because in some areas U.S. reforms are tougher or just different from the rules forthcoming in other markets, we need to figure out a sensible way to apply those rules to the foreign operations of U.S. firms and the U.S. operations of foreign firms” (Jones, 2012).

The biggest move into extraterritoriality however did not concern the Volcker Rule but OTC derivatives regulation. This was not initially the case. A joint paper by the SEC and CFTC in February 2012 that highlighted the need for further cross-border cooperation to identify gaps and inconsistencies in OTC derivatives regulation was welcomed by foreign regulators (CFTC & SEC, 2012; Greene & Potiha, 2012).

In July 2012 however, the CFTC issued a policy statement regarding “Cross-border Application of Swaps Provisions” that extends the reach of US rules to a wide array of transactions and market participants. Rules regarding market participants (“entity-level rules”) apply not only to so-called “U.S. persons”, that is firms incorporated in the United States or their majority-owned and/or guaranteed affiliates abroad. In addition, even non-U.S. entities are subject to the CFTC’s provisions regarding capital adequacy, risk management, and swap data recordkeeping if they engage to a more than minimal degree with counterparties in or related to the United States. Rules that apply to derivatives trades themselves (“transaction-level rules”) exhibit a similar degree of encompassing extraterritoriality. The rules proposed by the CFTC regarding swap clearing and processing, posting of margin (collateral), reporting and others apply to every trade executed in the U.S. (no matter by what kind of firm) and every trade that involves a U.S. counterparty (no matter where it is executed). For example, a London-based affiliate of JPMorgan engaging in a swap with a Norwegian counterparty would be covered by U.S. rules. Even a swap between a French bank and a French pension fund is subject to CFTC authority if the
trade takes place in the bank’s New York affiliate. In fact, only transactions between two firms that have no significant connections to the U.S. market are exempted from the CFTC rules (CFTC, 2012; Coffee, 2014).

The outcry against such a wide extraterritorial application of U.S. rules came from two sides, European regulators and the financial industry. In a comment in August 2012, the European Commission expressed concern that the proposed guidance “will maximize the potential for overlap and duplication of US regulatory requirements with those of other jurisdictions, including the EU. An EU and a US firm that conclude an OTC derivatives contract will be simultaneously subject to EU and US requirements. This will lead to duplication of laws and to potentially irreconcilable conflicts of laws for market operators.” (European Commission, 2012, p. 2).

The CFTC released an update on its proposed guidance in December 2012, insisting on the majority of its extraterritorial provisions. The European response this time was not restricted to a mere comment letter. Instead, European Commissioner Michel Barnier brought this issue to a higher level by drafting a letter to Treasury Secretary Lew. The letter, signed in April 2013 by Barnier and the Finance Ministers of Brazil, France, Germany, Italy, Japan, Russia, South Africa, Switzerland, and the United Kingdom, openly criticized “the lack of progress in developing workable cross-border rules as part of reforms of the OTC derivatives market.” The undersigned clearly took aim at the CFTC’s extraterritorial provisions by stating that “we hold the view that as a principle, local regulations should not be extended beyond national borders.” (Barnier, 2013). The change not only of tone but also of stakeholders deserves attention. While the 2012 comment letter was signed by a European bureaucrat and sent to the CFTC, essentially a bilateral exchange among regulators, the 2013 letter was a highly visible altercation among G20 politicians. The regulatory agencies that were targeted with the comments were “copied”, but so were the legislative commissions that oversee the CFTC’s operation in the United States, the Agriculture Committees in the House and the Senate. In a paragraph below, this paper highlights the
political influence that these Committees exert on the CFTC. Again, what had started as a technocratic exchange of opinions within a government network of regulators had acquired significant political salience. Secretary Lew dismissed both content and form of the letter, calling it “ill-informed” and “not a helpful way to promote conversations with two independent regulatory agencies” (Stephenson & Lynch, 2013).

The CFTC finalized its guidance in July 2013 with provisions that, while less extraterritorial than the initial guidance, would still bring a large portion of European derivatives markets under American regulatory control (CFTC, 2013b). In September 2013, the head of the UK Financial Conduct Authority published a piece of unusually candid criticism in the Financial Times: “Does it make hard-nosed, practical sense for any one national regulator to attempt to regulate all derivatives activity with any link to its jurisdiction? [...] The clear risk is that a patchwork quilt of national and regional rules runs the risk of becoming unworkable. A mess.” (Braithwaite & Mackenzie, 2013).

The hoped-for solution to sort out this patchwork quilt is “substituted compliance”, a legal concept that stipulates deference to the rules of another jurisdiction whenever they are deemed “functionally equivalent”. Substituted compliance is a relatively new concept and one that has not received widespread acceptance among regulators. Coffee (2014) remarks that: “the attitude of U.S. financial regulators towards ‘substituted compliance’ has approached the schizophrenic. Unlike securities and derivatives regulators, banking regulators have largely ignored or disdained substituted compliance, preferring to rely on a more traditional territorial approach.” (p. 13). As argued above, this divergence in attitude among regulators matches the difference between financial markets where gatekeeping instruments such as licenses are available (banking) and where they are not (securities and derivatives market infrastructures).

Nevertheless, both in earlier comment letters and in the April letter, regulators and politicians outside the United States have expressed support for substituted compliance as a solution to cross-
border regulatory duplication problems in OTC derivatives markets. In principle, this is also the approach envisioned by the CFTC. In its proposed guidance, the agency clearly stipulates which transactions are strictly subject to U.S. rules and which ones are eligible for determination of functional equivalence as a prerequisite for substituted compliance. This common ground among regulators on both sides of the Atlantic formed the basis for the so-called “Path Forward” initiative. Made public in July 2013, the agreement between CFTC Chairman Gensler, European Commissioner Michel Barnier, and the European Securities Market Authority (ESMA) envisioned a joint approach in determining equivalence in regulatory regimes in order to pursue substituted compliance and mutual recognition (CFTC, 2013a). The FSB’s OTC Derivatives Regulators’ Group in its commitment to “avoid, to the extent possible, the application of conflicting rules to the same entities and transactions” and to “eliminate the application of inconsistent and duplicative requirements”, have explicitly endorsed the initiative (ODRG, 2013).

But what started as a promising attempt at regulatory coordination ran out of steam only half a year later. Whereas the European authorities support an outcomes-based approach that assesses equivalence in rather broad terms of contribution to systemic risk, the CFTC employs a much more meticulous rule-by-rule approach that is designed to identify loopholes and prevent regulatory arbitrage. As the end-2013 deadline for determination of equivalence passed, the CFTC had only cleared a few rules for substituted compliance. In a statement of dissent, CFTC Commissioner O’Malia expressed his disappointment: “If the Commission’s objective for substituted compliance is to develop a narrow rule-by-rule approach that leaves unanswered major regulatory gaps between our regulatory framework and foreign jurisdictions, then I believe that the Commission has successfully achieved its goal today.” (CFTC, 2013c). The last in a series of setbacks, the CFTC issued new guidance in November 2013 that again asserts extraterritorial authority over cross-border swaps. The European Commission responded with “surprise” regarding the new rules “which seem to us to go against both the letter and spirit of the path forward agreement.” (Brunsden, 2013). The Path Forward initiative continues, but beyond the issuance
of temporary no-action relief orders that push forward the implementation date of over 130 of the CFTC’s rules, the authorities have not made progress towards regulatory coordination regarding the OTC derivatives market.

Even faster than European and other foreign regulators, the financial sector was the first to voice opposition to extraterritoriality. In a letter to Commissioner Barnier and Secretary Geithner from July 2011, eight financial trade associations expressed concern that rules proposed in Europe and the United States would “leave the global derivatives business with ambiguity and problematic extraterritorial challenges and issues of legal uncertainty and misunderstanding which might give rise to material risk.” In the same letter, the lobby firms remind the officials that the “G-20’s goal of addressing key systemic risk issues cannot be met without international coordination on market infrastructure, regulatory transparency, and counterparty credit risk.” (ISDA et al., 2011).

Those with penchant for irony will find the recent actions of the financial lobby even more delectable. In December 2013, three trade associations filed a lawsuit against the CFTC, contending that its proposed guidance on cross-border swaps is unlawful. The plaintiffs challenge not only the agency’s use of guidance and staff advisories instead of a formal rulemaking process, but claim that the CFTC “imposed a series of rules that are contrary to the spirit and the letter of international cooperation and may harm global markets”. In order to substantiate this claim, the lobby organizations make ample reference to the Path Forward initiative and the statements of European regulatory authorities (SIFMA, ISDA, & IIB, 2013; Chon, 2013).

In sum, four years after G20 leaders gathered in Pittsburgh to declare their joint political will to stand up against the interests of the financial sector and bring OTC derivatives markets under coordinated supervisory control, the financial sector itself is able to exploit statements of the G20 and those made by regulators of one jurisdiction to challenge the regulatory authorities of another. It is hard to imagine a more complete instance of coordination failure in implementing global regulatory reform.
Is the financial sector’s expressed preference for regulatory coordination merely hypocrisy? Regulatory arbitrage has been an important element of “financial innovation” in the run-up to the global financial crisis, and regulatory coordination under the aegis of the FSB or under the Path Forward initiative is designed to minimize arbitrage opportunities. However, uniformly strict requirements are considered less of a burden than duplicative requirements or even market fragmentation along jurisdictional lines. A U.S. regulator explains: “From one perspective where they make their money is arbitrage, but in another perspective where they make their money is volume. So yet to trade off volume versus arbitrage and compliance costs add to that. So all things being equal, you’d rather have a bigger pool with less rules.” (US Regulator 1, 2014).

On the other side, civil society organizations have supported the actions of the CFTC. In a response to the above-mentioned letter by Barnier and his colleagues, 25 organizations from around the world defend extraterritoriality. The letter states: “If, as you suggest, the reach of national regulation cannot extend beyond national borders, then national regulators will be helpless when faced with the global reach of financial institutions.” (Action Aid International, 2013, p. 2). The organizations regard coordination around a “shared high level of financial oversight” as a goal and the CFTC’s actions as a step towards this goal. Members of the same coalition have identified loopholes in EU regulation regarding derivatives (WEED, 2013).

That the current state of OTC derivatives market reform manifests such profound coordination failures cannot easily be explained with state-of-the-art theory. Both Drezner’s and Simmons’ approaches would predict a relatively rapid coordination of (club) standards among both dominant centers, that is the United States and Europe. That major struggles emerge in the bilateral relationship between the two undermines the position of proponents of minilateralism, and that government networks of financial regulators fail to achieve consensus calls into question current theories of networked governance based on soft law. The clash between the business lobby and civil society
associations regarding substituted compliance reveals that neither representation nor effectiveness have been achieved in this area of financial regulation. What explanations for this troubling situation are available?

**Coordination failure: Three reasons and a non-solution**

This paper proposes three answers to this question. First, even though the crisis has aligned the incentives of American and European authorities in favor of stricter financial regulation, the two stakeholders are embroiled in a struggle of redistributive cooperation. Second, the operation of government networks is hindered by national laws and legislatures that fail to engage in cross-border cooperation. Third, government networks are weak and incomplete due to domestic political reasons. The following paragraphs present all three arguments and show why a current proposal to overcome transatlantic regulatory coordination failure does not address these issues in satisfactory fashion.

The theory of redistributive cooperation was developed by Oatley and Nabors (1998) to explain the political economy of the first Basel Accord. According to the authors, the purpose of international harmonization is not merely to impose the same regulatory costs on all corporations around the world, ensuring the oft-cited “level playing field”, but to transfer resources away from foreign firms to compensate the domestic ones.

At the time Basel I was implemented, Japanese and French banks had much lower capital buffers than their American counterparts. This was an advantage that these foreign firms used to gain market share in the major financial centers. Under these circumstances, Oatley and Nabors explain, the effect of Basel I was not only to erode the advantage of foreign competitors but to put American banks at an advantage because they had to raise less capital in order to comply with the new prudential standards. The authors contend that this kind of transfer and redistribution in favor of the domestic sector is the rationale behind global financial regulation. The theory highlights the incentives that the
United States authorities had in pushing for the Basel agreement, but why would the government of any other country voluntarily sign an agreement that erodes the competitiveness of its financial sector or even puts it at a disadvantage? Oatley and Nabors argue that the United States and Great Britain relied on combined market power to coerce other nations. A year before the Basel Accord was signed, the two countries reached an agreement to raise capital requirements for all financial institutions that want to operate under its jurisdiction. Faced with the dilemma between exclusion from the major financial centers and succumbing to the conditions of the bilateral treaty, the government of Japan and other reluctant countries had no better option than to engage in negotiations for a global agreement.

It can be argued that concerns about competitiveness play a major role in the current spat between the United States and Europe. But unlike the field of banking regulation, it is not firms but trading infrastructures that compete in the OTC derivatives markets. In particular, London and New York are major competitors as trading hubs of derivatives today. London’s Canary Wharf emerged as the main hub for these trades in the late 1990s because the regulatory environment of the United Kingdom provided a lucrative arbitrage opportunity for American firms. Both U.S. officials like Geithner (cited above) and civil society organizations believe that the overhaul of derivatives regulation in the wake of the crisis presents more loopholes in Europe than in the United States. A hasty, “outcomes-based” assessment of functional equivalence would thus represent a competitive disadvantage for the U.S. In line with this idea, Coffee (2014) draws the conclusion that “for the United States, substituted compliance will mean a loss of market share, revenues, and jobs as trading moves overseas to marginally less regulated markets.” (p. 45).

A closer look at cross-border inconsistencies in OTC derivatives regulation however does not provide a clear picture of such a tilted playing field. For example, Dodd-Frank rules exempt small businesses from certain margin and reporting requirements. EMIR does not provide any such exemptions. Other regulatory differences do not seem to provide any jurisdiction with a competitive
advantage. A U.S. lobbyist explains: “Let’s take reporting, for instance. In the US at CFTC there is one counterparty that’s responsible for reporting to SDR [Swap Data Repositories] and that’s in the regulation. In Europe both parties report. Okay, is it better or worse? I don’t know. It’s different. But what that causes is great confusion.” (US Lobbyist 2, 2014).

Drezner (2007) differentiates between the standard-setting and enforcement phase of regulation. The former can be conceived of as a coordination game such as the Battle of Sexes. Both parties gain from converging at the same standard but none receives a benefit from non-coordination. While enforcement coordination presents characteristics of a prisoners’ dilemma that resonates with Oatley and Nabor’s redistributive cooperation approach, it is hard to make a stringent argument that European derivatives regulation will draw business away from the United States. Many rules, especially in the EU, are not finalized yet. A thorough legal analysis of the finalized regulatory environment will thus provide necessary insight to answer this question in the future. What matters at this point, however, are the authorities’ perceptions of redistributive implications the new rules may have.

A second explanation for coordination failure lies in the existence of legislative and legal barriers to cross-border harmonization. Unlike prudential banking regulation, OTC derivatives regulation is based on new legislation. Government networks like the Basel Committee involve central bankers and officials of the executive branches of government. In most jurisdictions, new rules such as Basel III are implemented without recurrence to legislative approval. In contrast, OTC derivatives markets regulation relies on new legislation: Dodd-Frank in the United States and EMIR/MiFID 2 in the European Union. Persaud’s remarks (quoted above) that the Dodd-Frank bill does not take into consideration regulatory reform in other G20 countries should not come as a surprise. In her seminal book on government networks, Slaughter (2004) highlights the stark differences in cross-border cooperation between the executive, judicial, and legislative branches of government. In a chapter titled: “Legislators – lagging behind”, the author identifies various obstacles to cross-border cooperation. Unlike ministry officials,
parliamentarians place much importance on their chances of re-election. Consequently, the time horizon of legislators tends to be shorter, and decisions are made with constituents in mind, not foreign counterparts. In addition, parliamentarians deal with a wide array of issues and lack specialized knowledge and technical expertise. It is thus harder for them to develop a technocratic consensus with their peers abroad that characterizes epistemic communities (Haas, 1989). Slaughter (2004) points out that “parliamentarians are politicians responsible to constituents. They cannot rely on the professional consensus that so often provides the glue for regulatory and even judicial networks.” (p. 118). Finally, government networks do not serve as a means of enhancing the power of legislatures vis-à-vis other branches of government in the international sphere. Given this lack of incentives, legislators of different jurisdictions cannot be expected to excel at cross-border coordination.

This problem is compounded by the legislature’s vulnerability to regulatory capture. Re-election is on every Congressman’s mind, but election campaigns are expensive affairs. A civil society representative describes the current situation in the United States as follows: “The overriding problem that we faced and that is currently the case is that financial services unfortunately lives in the mud of enormous campaign contributions from the financial sector and complexity, which allows a Senator to view banking as a fundraising opportunity for which bad policy will not generally get him in trouble with his electorate. Nobody in Idaho is going to vote for or against Senator Crapo based on his views on margin requirements for cross-border swaps trading.” (US Civil Society Representative 2, 2014).

In November 2013, the chairs of the two regulatory agencies that oversee the derivatives market (SEC and CFTC) received a letter from 35 members of the House of Representatives urging them to harmonize cross-border regulation. The letter fittingly makes reference to the complaints voiced in the April 2013 letter sent from the nine foreign finance ministry officials. Earlier that year, the House introduced legislation to mandate that current derivatives regulation in all G-20 countries should
automatically qualify for “substituted compliance” (Coffee, 2014). This proposed bill probably represents the clearest attempt by the industry to turn cross-border harmonization into a race to the bottom.

In reaction to the Republican-dominated House, eight liberal Senators sent a letter to the same two regulatory agencies demanding that cross-border loopholes should be closed and that substituted compliance should not be considered. What these initiatives from both sides of the aisle have in common is that they primarily speak to domestic concerns without contemplating a race to the top in regulatory harmonization.

The cross-border inconsistencies in recent lawmaking are compounded by differences in pre-existing laws. This is especially clear in the field of trade reporting. The G20 Pittsburgh statement includes a commitment that all OTC derivatives trades be reported to trade repositories. At first glance, it appears that reform in this area is quite advanced. Trade repositories in all 19 FSB member jurisdictions (that include the G20 and Switzerland, Singapore, Hong Kong) are either newly created or have been in existence since before the global financial crisis. The CFTC has phased in reporting requirements starting in March 2013, and since August reporting swaps in all asset classes is mandatory. On the other side of the Atlantic, the European Market Infrastructure Regulation (EMIR) is in effect since August 2012. By April 2014, 25 trade repositories are operational in 11 jurisdictions across the globe. However, with the temporal exception of Australia (which chairs the G20 process this year) no jurisdiction has recognized the trade repositories of other countries for unconditional information exchange (FSB, 2014). This means that, outside of bilaterally negotiated information sharing agreements, data on OTC derivatives transactions cannot be shared or aggregated, thus impeding any analysis of transaction flows and corresponding risk at a global level.

Privacy laws in several jurisdictions prevent trade repositories from sharing trade information with institutions abroad. The prevalent instrument of government networks, that is memoranda of understanding, are insufficiently authoritative to override national legislation in this issue area. This
might be the reason why the European Commission requires information-sharing agreements among trade repositories to take the form of legally binding international treaties (FSB, 2013c). The United States and the EU have successfully signed an implemented such an information sharing treaty in 2010 in the area of terrorist financing. However, ratification can be expected to be a much more onerous process in the area of derivatives (terrorists have much less lobby power than derivatives brokers). Even if an agreement between Europe and the United States were to be reached, strong privacy laws in several Asian countries undermine trade reporting at the level of the G20.

Even though the global securities standard-setting body (IOSCO) uses a multilateral memorandum of understanding for mutual recognition on a principles basis and information sharing since 1983, the agreement is restricted to cases of market manipulation and does not provide a sufficient foundation for cross-border cooperation for the purpose of prudential supervision. A U.S. regulator provides insight into the challenges his agency is currently facing in this area: “I mean basically it’s the way the laws are written are very specific and we’ve got a whole group within the international office, 20, 30 people that do nothing but figure out how to work their way through the information sharing on enforcement. We haven’t gotten anywhere near as far, don’t have nearly the experience on supervisory information and less far on just aggregate data, you know, big picture data and it’s just not something that the [agency] shares. I mean we just don’t have a history of sharing. We have a history of sharing in the enforcement space but not nearly as much in supervisory cooperation and even less when it comes to things like data.” (US Regulator 1, 2014).

In conclusion, one of the reasons why regulatory coordination in the OTC derivatives market is failing is that government networks are not powerful enough, and that soft law is too soft. In principle, the legal and legislative obstacles described above can be overcome by political initiative, and no political reform statement to date would be of greater authority than an explicit joint commitment by the heads of state of the G-20. However, a U.S. lobbyist calls the power of the G20 to overcome these
obstacles into question: “G20. Okay. And then all these countries go off and figure out how they can meet that and there’s a whole lot that goes on between Pittsburgh and ‘We've got to go and do this.’ In the US, you have 535 members of Congress that are listening to constituency. You’ve got six or seven regulators. In many countries, Asian jurisdictions, and some European, they have a historic reason why they don’t want – for privacy. A G20 commitment doesn't change any of that.” (US Lobbyist 2, 2014).

In other words, legislators and legislation remain deeply domestic affairs that appear to represent formidable obstacles to cross-border harmonization. However, the following paragraphs show that even government networks of the executive branch exhibit crucial weaknesses.

The third and final explanation for coordination failure is that regulatory cross-border networks are frail and incomplete. Specifically, regulatory oversight of the OTC derivatives market in the United States is divided. According to the Dodd-Frank Act, the Commodity Futures Trading Commission (CFTC) is required to regulate swaps, whereas the Securities Exchange Commission (SEC) regulates “derivatives defined as security-based swaps” (CFTC & SEC, 2012). This rather parochial separation of regulatory powers raises eyebrows not only in the United States. Regulators in other G-20 countries struggle to identify their American counterpart when trying to implement the OTC derivatives reform agenda.

Tucked away in a footnote, even the joint CFTC-SEC report acknowledges this problem:

“The regulatory distinctions between the terms “swap” and “security-based swap” as used in Title VII are not co-extensive with terms used in foreign jurisdictions. Accordingly, the term ‘OTC derivatives’, which is used in this Report to refer to Swaps across various jurisdictions, includes products that may, or may not, fall within the DFA’s [Dodd-Frank Act] scope.” (CFTC & SEC, 2012, p. 4, footnote 9).

Why was regulatory authority over this financial market not assigned to a single agency? A historical institutionalist approach to this issue provides an answer to this question. Created in 1934, the SEC was a lesson learned from the 1929 stock crash and the Great Depression. Its mandate is to exercise regulatory control over brokers and companies that trade their securities at the stock exchange. The
CFTC in contrast was established in 1975 to regulate derivatives markets of commodities. Farmers have used futures for decades as an insurance against price volatility of their crops. It was thus an obvious choice to place the CFTC under the oversight of Agriculture (Ag) Committees in the House of Representatives and the Senate.

Over the last 10 years, the overall market for OTC derivatives has grown 665% in notional value. The commodity-based contracts that farmers rely on, however, have hardly increased in that period, and today they represent less than 1% of all OTC derivatives (Engelen et al., 2011, p. 42f.). When the Obama administration considered bringing all OTC derivatives under regulatory control with the Dodd-Frank Act, it would have been a common-sense solution to subsume the activities of the CFTC under the authority of a strengthened SEC. However, the Ag Committees in both chambers of Congress started a fierce turf battle to ensure not only that the CFTC continued to exist, but that it would have wide regulatory authority over the OTC derivatives market. The Obama administration finally recognized that without the goodwill of Ag Committee members the Dodd-Frank Act would never be passed. For the Committee members, propping up the CFTC has significant benefits because it attracts campaign contributions from the financial sector (US Legislature Aid, 2012). In the 2008 and 2010 election cycles, Senate committee members have received $41.6 million from Wall Street, whereas agribusiness only made $17.6 million in campaign contributions. The situation is similar for House committee members (Puzzanghera, 2009). This means that there was a multimillion dollar incentive for certain US legislators to maintain a bifurcated domestic regulatory regime in the derivatives market.

The two agencies differ significantly with respect to their budget and degree of integration into government networks. The SEC has been actively involved in transgovernmental exchanges with securities regulators in Europe, Japan, and elsewhere. It is a founding member of and protagonist in the securities standard-setting body (IOSCO) since 1983. The CFTC in contrast only holds the status of an associate member. Furthermore, the SEC has been the American regulator at the table of the FSF since
its inception in 1999. It also holds one of the seats in the FSB Plenary today, with the other two reserved for the Treasury and the Fed. The CFTC in turn has only occasionally participated in the FSF. The situation changed to some extent with the creation of the FSB. The agency has a seat at both the OTC derivatives working and regulator’s groups, but its chairman Gary Gensler has not been in extensive contact with this crucial government network. A U.S. regulator recalls: “Gensler has been invited from time to time to the steering committee meetings where they’ve been talking about OTC derivatives in particular.” (US Regulator 1, 2014). Arguably, if CFTC regulators had established the long-term professional ties that lubricate transgovernmental interaction, some of today’s coordination failures across borders could have been avoided.

In addition, the CFTC has a much smaller budget ($208 million in 2013 as compared to the SEC’s $1.35 billion), and thus much fewer resources to engage in regulatory cooperation with its counterparts abroad. A U.S. regulator explains: “It’s kind of an interesting state of affair as where, I mean [the CFTC] got 90% of the market, mas o menos, [the SEC got] 10% but [the latter] got nine people to work on things for every one person that [the former] have. So [the SEC] can afford to throw more resources at it.” (US Regulator 1, 2014).

A CFTC Commissioner recently provided a glimpse of how his agency is dealing with the task at hand: “Our staff is on its knees, some reaching for the exit doors and others already having bailed,” Mr. Chilton said (Abrams, 2014). This dire situation threatens the independence of the agency. A civil society representative points out: “The House Republicans have proposed to cut the CFTC budget. They hold them up before Congress, and wag their fingers up, and they write letters, they use various points of leverage to try to get them to dilute their rules.” (US Civil Society Representative 2, 2012). With a scant history of cross-border engagement, facing significant pressure from the legislature and burdened with formulating the rules for the largest share of the derivatives market on a meager budget, CFTC officials have understandably dedicated few resources to coordination with their counterparts abroad.
In sum, three issues complicate cross-border harmonization of OTC derivatives regulation. European and especially American authorities are wary of the expected distributional consequences of substituted compliance. Legislators and pre-existent legislation represent obstacles to cross-border cooperation. And the government networks that are expected to overcome these obstacles are not only lacking legal authority, but they are incomplete and weak due to domestic institutional differences. The following paragraphs assess a European initiative to address these issues and shows why it is an inadequate solution for the current transatlantic problems.

Recognizing the failure of regulatory networks to harmonize OTC derivatives regulation across the Atlantic, European officials have attempted to find new ways towards cross-border coordination by including financial regulation in the Transatlantic Trade and Investment Partnership, a trade deal that is currently under negotiation. At a conference in Washington in June 2014, European Commissioner Barnier stated: “We in Europe would like to see a mutual EU-US assessment of our rules, outcome-based and backed up by specific arrangements to govern EU-US regulatory cooperation. For this we need a solid treaty-based system for regulatory cooperation, one that harnesses the political push that the TTIP brings while leaving the work on regulation to the regulators themselves [...]” (Bailey, 2014)

This initiative takes both the first and the second reason for coordination failure highlighted in this paper as a point of departure. By attempting to make regulation part of a trade deal, it addresses the issue of redistributive cooperation, where in principle, losers from less stringent financial regulation can be compensated in other areas. Furthermore, it represents an implicit recognition that soft law is too soft in this issue area, and that legal obstacles and legislative veto points can only be overcome by politicizing financial regulation.

The latter recognition is not confined to the European side. A U.S. regulator also hints at the option of taking regulation to a political level in order to remove domestic legal barriers: “They’ve given a lot of responsibility to regulators, but the regulators are all shackled by their domestic regulation or
legislation. And so while we can certainly facilitate things within certain parameters, going outside those parameters is really hard, if not impossible, which is the kind of stuff that the Treasuries of the world can do.” (US Regulator 1, 2014).

The redistributive side of such a negotiation however is not well received by U.S authorities at the moment. American regulators and civil society representatives fear that the trade negotiations would lead to a significant weakening of financial regulatory standards (Donnan, 2014). A U.S. regulator highlights the reasons for this resistance: “Basically the financial regulators and that would include Treasury so far, are not inclined to go into any kind of treaty trade agreement negotiation because you wind up negotiating things that you shouldn’t – phytosanitary conditions versus deposit controls. [...] In any event, the problem is that the regulators can’t negotiate because they don’t have the latitude and those that can negotiate don’t have the expertise.” (US Regulator 1, 2014).

The European proposal would undermine the boundary between epistemic communities of regulators that are independent and serve as representatives of the public good of financial stability on one side, and trade negotiators that explicitly represent the interests of their domestic industries on the other. Given its clout and resources on both sides of the Atlantic, it is not surprising that the financial industry enthusiastically supports the European initiative.

In conclusion, regulators of OTC derivatives markets on both sides of the Atlantic cannot be expected to harmonize their rules as long as the three obstacles outlined above are present. However, by departing from a government network-style of regulatory cooperation and turning it into a trade negotiation, regulators are likely to succumb to the interests of the financial industry by engaging in a race to the bottom. Instead, politicians could make a concerted effort to harness the power of regulatory networks. The conditions for transatlantic cooperation are promising in principle, given cultural affinity and a long history of engagement at the ministerial and regulatory level. Furthermore, both regions were hardest hit by the crisis, and politicians can arguably still summon public support for
stringent financial regulatory reform. It is the responsibility of legislators and regulators on both sides to show flexibility in eliminating idiosyncratic differences in regulatory regimes while providing reassurance that harmonization does not imply competitive advantage for either jurisdiction. In addition, many of the legal obstacles to cross-border harmonization and exchange of information are of such technical nature that removing them is unlikely to arouse widespread public opposition.

At the same time, the Prisoner’s Dilemma aspects of cross-border cooperation need to be addressed as much as the power asymmetry between civil society association and special interest groups. Coffee (2014) fittingly remarks: “Protection against systemic risk is a public good, and, for the future, the great danger is that it will be underprovided. In all likelihood, failure will not be caused by forthright opposition to reform, but rather by delay, piecemeal compromise, and low visibility decisions that eviscerate the formal rules. The public has a short memory, but the industry never forgets.” (p. 75). The nature of interaction between American and European financial authorities will determine whether OTC derivatives regulation will represent a race to the bottom or to the top.
References


ISDA, GFMA, EBF, AIMA, FOA, IMA, ... WMBA. (2011, July 5). Letter to Commissioner Barnier and Secretary Geithner on Extra-territoriality. Retrieved from http://www2.isda.org/attachment/MzU4Ng==/05-%20JT_associations_letter_re_extra_territoriality_5_july_FINAL_approved.pdf


