THE LIMITS OF "NAME-AND-SHAME" IN INTERNATIONAL FINANCIAL REGULATION

Edward F. Greene† *& Joshua L. Boehm*††

† Senior Counsel, Cleary Gottlieb Steen & Hamilton LLP, New York; formerly General Counsel and Director of the Division of Corporate Finance at the Securities and Exchange Commission.

†† J.D., Harvard Law School, 2012; formerly a regulatory consultant for Promontory Financial Group, Washington, D.C.

INTRODUCTION

The fiscal crisis of 2008 revealed manifold weaknesses in national financial regulatory frameworks. Many jurisdictions have made legislative efforts to address these flaws, with varying degrees of promise and success.[1] The United States has been through this process before, most recently in the wake of the savings and loan crisis of the 1980s,[2] and before that, in the aftermath of the stock market crash of 1929.[3] Both crises afforded Congress the opportunity to make landmark changes to the U.S. financial regulatory architecture, most of which have strengthened and safeguarded U.S. markets.[4] Although some of the changes had international dimensions, prompting agencies to interact more frequently with their foreign counterparts, the traditional focus of financial regulatory reform efforts has been domestic.[5]

---

1 For a discussion of one of the United States' largest legislative efforts to fix financial regulation, the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), as well as the Act's principal weaknesses, see generally Edward F. Greene, *Dodd-Frank: A Lesson in Decision Avoidance*, 6 CAP. MARKETS L.J. 29 (2011).

2 *See* Barry Meier, *The Bailout Handbook: The Savings and Loan Crisis 19 Years Ago May Be Instructive*, N.Y. TIMES, Sept. 29, 2008, at C1; Jack Willoughby, *The Lessons of the Savings-and-Loan Crisis: An Interview with William Black*, BARRON'S (Apr. 13, 2009), http://online.barrons.com/article/SB123940701204709985.html#articleTabs_panel_article%3D1.

3 *See, e.g.*, Michael Liedtke, *Bank Investment Plan Is More Depression Deja Vu*, USA TODAY (Oct. 14, 2008), http://www.usatoday.com/money/economy/2008-10-14-1490321705_x.htm (discussing the Reconstruction Finance Corporation, a Depression-era agency, and its relation to the current crisis).

4 For example, following the 1929 market crash, Congress enacted the Glass-Steagall Act and created the Federal Deposit Insurance Corporation to prevent such a crisis from repeating itself. *See* Thomas G. Fischer et al., *The Securities Activities of Commercial Banks: A Legal and Economic Analysis*, 51 TENN. L. REV. 467, 472–74 (1984). These changes have been credited for the then-unprecedented stretch of banking stability that lasted until the mid-1980s. *See* RICHARD SCOTT CARNELL ET AL., THE LAW OF BANKING AND FINANCIAL INSTITUTIONS 20 (4th ed. 2009).

5 For instance, the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA), a centerpiece of Congress's response to the 1980s savings and loan crisis, expanded U.S. banking regulations and prudential examinations to branches of foreign banks but was principally focused on reforming the Federal Deposit Insurance Corporation's (FDIC) domestic authorities. Most importantly, it increased the FDIC's ability to borrow from the U.S. Treasury, mandated the FDIC "to set risk-based deposit insurance premiums," and required a prompt-corrective-action and least-cost-resolution approach for failing banks. *See* CARNELL ET AL., *supra* note 4, at 30; L. Todd Gibson, *The Foreign Bank Supervision Enhancement Act of 1991: Short Run Consequences En Route to the Long Term Goal*, 27 CASE W. RES. J. INT'L L. 119, 126, 128 (1995) (explaining that Congress passed the Foreign Bank Supervision Enhancement Act, which expanded U.S. regulatory supervision over U.S. branches of foreign banks, as Title II of the FDICIA).

This domestic approach will no longer suffice. The 2008 crisis revealed that financial activity has now so thoroughly outstripped national borders as to demand an international approach to regulatory reform. A prime example of the need for an international approach is the downfall of Lehman Brothers and AIG. Lehman Brothers' catastrophic failure not only exposed the lack of coordination and resolution planning among national regulators[6] but also the basic inability of national bankruptcy regimes to deal with complex financial organizations of global scope.[7] AIG's descent derived from concern that if AIG could not meet its obligations on the credit-default swaps (CDS) it had issued, financial institutions around the world would have to sell off securities en masse to remain adequately capitalized.[8] This same concern also formed the core rationale for the U.S. government's decision to give billions of dollars of financial support to AIG.[9] Neither regulators nor market participants had any picture of the extent to which CDS liabilities were woven throughout the system because they were almost entirely unregulated and traded over the counter.[10] Further, the crash of 2008 revealed both the systemic importance and the under-regulation of the so-called "shadow banking" system, in which nondepository institutions conduct bank-like activities[11] that expose them to similar run-risks as banks while not being regulated as such.[12]

Lehman and AIG are just the most prominent examples from the 2008 crisis of the need to enhance and deepen coordination among financial regulators and to harmonize policies across borders. This widespread need for greater international regulatory coordination was not lost on policymakers, who quickly began exploring solutions to address the problem. G-20 finance ministers agreed to a communiqué at the Pittsburgh Summit in the fall of 2009 that laid out a comprehensive set of commitments for policy coordination across the

---

6 *See* ANDREW ROSS SORKIN, TOO BIG TO FAIL: THE INSIDE STORY OF HOW WALL STREET AND WASHINGTON FOUGHT TO SAVE THE FINANCIAL SYSTEM—AND THEMSELVES 357–66 (2010).

7 *See, e.g.*, Jamie Altman, Comment, *A Test Case in International Bankruptcy Protocols: The Lehman Brothers Insolvency*, 12 SAN DIEGO INT'L L.J. 463, 465–67 (2011) (discussing the need for international protocols in Lehman's bankruptcy).

8 *See* Carrick Mollenkamp et al., *Behind AIG's Fall, Risk Models Failed to Pass Real-World Test*, WALL ST. J., Nov. 3, 2008, at A1.

9 *See id.*

10 *See* Nathaniel G. Dutt, *Current United States Credit Default Swap Regulatory Initiatives: A New World Standard or Just a Ploy?*, 16 ILSA J. INT'L & COMP. L. 169, 170 (2009).

11 These bank-like activities are generally a form of short-term borrowing to finance long-term assets.

12 Saule T. Omarova, *From Gramm-Leach-Bliley to Dodd-Frank: The Unfulfilled Promise of Section 23A of the Federal Reserve Act*, 89 N.C. L. Rev. 1683, 1717–18 (2011).

financial regulatory spectrum.[13] The Basel Committee on Banking Supervision (Basel Committee) set to work on a number of multilateral initiatives, including a third iteration of capital standards.[14] Additionally, the Financial Stability Forum, given new powers and responsibilities by the G-20 and renamed the Financial Stability Board (FSB), began to take the lead in coordinating regulatory reforms across a range of critical areas.[15]

But this early promise of a political commitment to meaningful international cooperation has not resolved the underlying coordination problems. For example, the G-20 approach relies on national regulators and legislators to implement the agreed common set of standards, and even though the FSB and the Basel Committee have fleshed out the agreed G-20 principles, they still must rely on national implementation.[16] Thus, while these supranational bodies formulate regulatory reforms, they can do nothing more than "name-and-shame" states that fail to implement the agreed regulatory policies.[17]

As this Article will demonstrate, the current informal approach has already yielded substantial and troubling divergences, and will not be sufficient to safeguard the global capital markets from future crises. The widespread reluctance to engage in more formal arrangements to reform the global financial regulatory architecture is attributable to concerns over sovereignty, as independent nations do not wish to cede oversight to international bodies. Such a nonbinding approach, however, is not without consequences. The experience of 2008 illustrated that in a world of free capital flows and too-big-to-fail institutions, the impact of ineffective financial regulation emanates far beyond national borders and is thus legitimately a matter of multilateral concern.

Further, the inadequacy of an entirely soft-law approach does not mean that the only alternative is a global, all-powerful administrative body. A central goal of this Article is to show that a "one-size-fits-all" legal approach to coordinating international regulatory reform will not suffice—in some areas informal measures will work, while others call for formal arrangements among critical markets. Specifically, building a sustainable mutual recognition framework may be an ideal

---

13 G-20, *Leaders' Statement: The Pittsburgh Summit* (Sept. 24–25, 2009), http://online.wsj.com/public/resources/documents/g20-statement-09252009.pdf.

14 Press Release, Bank for Int'l Settlements, Initiatives in Response to the Crisis by the Basel Committee (Mar. 30, 2009), *available at* http://www.bis.org/press/p090330.htm.

15 Press Release, Fin. Stability Bd., Financial Stability Board Reports to G20 Leaders on Progress in Implementing Financial Regulatory Reforms (Nov. 4, 2011) [hereinafter FSB, FSB Reports to G20 Leaders], *available at* http://www.financialstabilityboard.org/press/pr_111104ff.pdf.

16 *Cf.* Brooke Masters, *Countries Fail to Enact Basel Banking Reforms*, FIN. TIMES, Oct. 19, 2011, at 5.

17 *Cf. id.*

way to resolve international coordination problems in a number of regulatory fields, most importantly over-the-counter (OTC) derivatives.[18]

For global systemically important financial institutions (G-SIFIs), where active oversight and prompt enforcement are indispensable, only deeper and binding efforts can ensure effective supervision, recovery, and resolution.[19] The time-sensitive, high-pressure context of recovery and resolution for G-SIFIs magnifies the probability that even small divergences in rules or procedures could hinder international cooperation. Likewise, it is essential to establish a formal structure for prudential supervision of G-SIFIs, with active coordination and the maximum degree of information sharing, to help ensure that countries will timely address undue risks and deficiencies. While there is no need to incorporate binding agreements on capital and liquidity measures due to the fact that major jurisdictions have committed to implementing Basel III into their national law,[20] the financial community must still monitor and remedy corner cutting in the complex methodologies used in those areas of regulation and understand the potential consequences posed by jurisdictions that wish to go beyond Basel III and adopt enhanced standards.

Accordingly, we advocate a treaty-based system, based at the FSB, for the cooperative supervision and resolution of G-SIFIs.[21] Such a system would give formal legal status to firm-specific cooperation agreements negotiated by home and host supervisors of each G-SIFI, create an institutional home at the FSB for colleges of supervisors,[22]

---

18 Although not covered within the scope of this Article, the regulation of credit-rating agencies is another important area in which mutual recognition would likely be the best way to facilitate international coordination.

19 G-SIFIs are global financial institutions "whose distress or disorderly failure, because of their size, complexity and systematic interconnectedness, would cause significant disruption to the wider financial system and economic activity." *See* FIN. STABILITY BD., POLICY MEASURES TO ADDRESS SYSTEMICALLY IMPORTANT FINANCIAL INSTITUTIONS 1 (Nov. 2011), *available at* http://www.financialstabilityboard.org/publications/r_111104bb.pdf.

20 For a list of the most recent status of Basel III adoption, see BASEL COMM. ON BANKING SUPERVISION, Bank for Int'l Settlements, PROGRESS REPORT ON BASEL III IMPLEMENTATION (Oct. 2011) [hereinafter PROGRESS REPORT ON BASEL III IMPLEMENTATION], *available at* http://www.bis.org/publ/bcbs203.pdf.

21 The FSB first identified a list of 29 G-SIFIs in November 2011; it intends to revise and update the list each successive November. *See* Press Release, Fin. Stability Bd., FSB Announces Policy Measures to Address Systemically Important Financial Institutions (SIFIs) and Names Initial Group of Global SIFIs (Nov. 4, 2011), *available at* http://www.financialstabilityboard.org/press/pr_111104cc.pdf.

22 Currently, supervisory colleges are relatively informal in nature, functioning as "multilateral working groups of relevant supervisors that are formed for the collective purpose of enhancing effective consolidated supervision of an international banking group on an ongoing basis." BASEL COMM. ON BANKING SUPERVISION, BANK FOR INT'L SETTLEMENTS, GOOD PRACTICE PRINCIPLES ON SUPERVISORY COLLEGES 1 n.1 (Oct. 2010) [hereinafter BASEL PRINCIPLES ON SUPERVISORY COLLEGES], *available at* http://www.bis.org/publ/bcbs177.pdf.

and set forth procedures for routinely sharing supervisory information and conducting joint analyses. The system would also require cooperation agreements to delineate each national authority's responsibilities in various adverse scenarios, with particular detail on early intervention (i.e., when certain capital or liquidity thresholds are crossed), resolution processes,[23] and associated funding needs. Ideally, these agreements would provide that resolutions—if necessary—be led by the home authority on a group-wide basis.

But there may well be situations where the home and host authorities disagree on when to execute the agreed steps or on whether unforeseen circumstances should necessitate departures from the agreement. Accordingly, to ensure compliance and to instill market confidence in the global regulatory oversight of G-SIFIs, key jurisdictions should also empower the FSB with a dispute resolution mechanism for hearing disagreements among relevant supervisors and issuing legally binding orders for coordinated action, on potentially very short notice. Finally, the FSB treaty framework should include an independent mechanism to validate and report on the processes used by national supervisors and financial institutions to measure capital and liquidity. This mechanism would look beyond institutions' regular audited statements and assess whether underlying methodologies are consistent with the new Basel III accords.

This framework is not a fanciful, impractical idea. In fact, a number of G-SIFIs and banking associations have already called for binding international measures on resolution authority.[24] Further,

---

23 Although delineating the role of a G-SIFI's resolution authority—for instance, by establishing that the home authority shall direct the group-wide resolution of the G-SIFI—in a binding cooperation agreement is an important first step, we also believe that key jurisdictions should consider adopting a model law to ensure harmonization at the national level. This model law would be along the lines of the work of the United Nations Commission on International Trade Law (UNCITRAL) in cross-border corporate insolvency. *See* LEGAL AND MONETARY AND CAPITAL MKTS. DEP'TS, INT'L MONETARY FUND, RESOLUTION OF CROSS-BORDER BANKS—A PROPOSED FRAMEWORK FOR ENHANCED COORDINATION 17 (June 2010) [hereinafter IMF, RESOLUTION OF CROSS-BORDER BANKS], *available at* http://www.imf.org/external/np/pp/eng/2010/061110.pdf. If broadly adopted, this would allow a failed G-SIFI to gain recognition of its "main" proceeding (i.e., in the home jurisdiction) in all other countries where it had branches or subsidiaries. As described further in Part II, *infra*, this model law would help ensure that potentially unforeseen or underestimated conflicts between national resolution regimes would not hinder the execution of cooperation agreements for G-SIFI resolution.

24 *See Comments Received on the FSB Consultative Document on Effective Resolutions of SIFIs*, FSB, http://www.financialstabilityboard.org/press/c_110909.htm (last visited Apr. 16, 2012). Of the eight G-SIFIs that submitted comments to the FSB, BNP Paribas, Deutsche Bank, Santander, UBS, and Unicredit expressly called for some form of legally binding arrangement for resolution authority. *See id.* Bank of China and HSBC did not address the issue, and Credit Suisse noted that international coordination "should be stronger than outlined in the consultation paper." *See* Credit Suisse, *Comments on the Consultative Document: Effective Resolution of Systemically Important Financial Institutions* 6 (Sept. 2011), *available at* http://www.financialstabilityboard.org/press/c_110909p.pdf. Two large but non-G-SIFI

allowing the United States and other major economies to take these steps would not be an unacceptable infringement of sovereignty. The United States has recognized the importance of such commitments in international trade, as evidenced by its support of the World Trade Organization (WTO) and willingness to work out contentious issues within the WTO's framework.[25] International cooperation in financial regulation is no less critical.

This Article will proceed as follows. Part I addresses the supranational mechanisms that have been set up to coordinate global financial regulatory reform and provides an overview of key national efforts in that respect. Part II discusses three primary areas that demand international cooperation: (1) supervision, recovery, and resolution of G-SIFIs; (2) capital and liquidity adequacy; and (3) OTC derivatives, illustrating the approaches taken in major jurisdictions and the tensions that have emerged. Part III highlights legal and policy implications from the preceding discussion, demonstrating the varying extent to which binding legal arrangements are needed to ensure effective international cooperation.

I
Overview of Key Institutions and Jurisdictions in Regulatory Reform

A. Supranational Frameworks

The G-20 group of industrialized and major industrializing countries was created in the aftermath of the Asian financial crisis in the late 1990s and serves as a forum for finance-minister level coordination of economic policy.[26] Since 2009, the G-20 has been the core forum for coordinating international financial policy, supplanting the

banks, Standard Chartered and Intesa Sanpaolo, also commented and both recommended a legally binding approach. *See Comments Received on the FSB Consultative Document on Effective Resolutions of SIFIs*, *supra*.

25 *See, e.g.*, Bruce Wilson, *Compliance by WTO Members with Adverse WTO Dispute Settlement Rulings: The Record to Date*, 10 J. Int'l Econ. L. 397, 400 (2007) (remarking on the United States' compliance record with the WTO). Although the WTO Agreement was not ratified in the United States as a treaty, Congress passed it as a "congressional-executive" agreement and is U.S. federal law. In fact, any binding U.S. international agreement on financial regulation would likely also be adopted through a congressional-executive agreement rather than a treaty, as this is historically how Congress treats economic-related agreements to which the United States is a party, such as the IMF and World Bank. *See* Louis Henkin, Foreign Affairs and the United States Constitution 215–16 (2d ed. 1996); Jeanne J. Grimmett, Cong. Research Serv., 97-896, Why Certain Trade Agreements Are Approved as Congressional-Executive Agreements Rather Than as Treaties 1 (2004).

26 *The Origins and Evolution of the G-20*, G20.org, http://www.g20.org/en/g20/the-origins-and-evolution-of-the-g20 (last visited Apr. 16, 2012). G-20 members include Argentina, Australia, Brazil, Canada, China, France, Germany, India, Indonesia, Italy, Japan, Mexico, Russia, Saudi Arabia, South Africa, South Korea, Turkey, the United Kingdom, the

G-7 in that role.[27] The policy coordination involved in this task requires periodic summits between top leaders such as presidents and prime ministers—not just between finance ministers as before—underscoring the member countries' determination that their top political figures pay attention to key financial issues.[28] At the Pittsburgh summit in 2009, leaders of the G-20 established a framework for strengthening the international financial regulatory system. They determined that finance ministers and central bank governors should agree on common standards in the following critical areas:

- building high quality capital and mitigating procyclicality;
- reforming compensation practices to support financial stability;
- improving the regulation of OTC derivatives markets;
- addressing cross-border resolutions of systemically important financial institutions;
- achieving a single set of high quality, global accounting standards; and
- continuing to combat noncooperative jurisdictions (i.e., with respect to tax havens, money laundering, corruption, and terrorist financing).[29]

While the G-20 formulates such policy decisions, it outsources a great deal of its monitoring and implementation responsibilities to the FSB, which the G-20 created at its summit in London in April 2009.[30] The G-20's express goal in creating the FSB was to "coordinate at the international level the work of national financial authorities and international standard setting bodies [ ] in order to develop and promote the implementation of effective regulatory, supervisory and other financial sector policies."[31] Members of the FSB include central banks and finance ministries from most G-20 countries, several EU institutions, and a number of prominent international organizations and standard-setting bodies.[32] U.S. Treasury Secretary Timothy Geithner, in highlighting the FSB's importance among supranational institutions, dubbed it the "fourth pillar" of the global economic gov-

United States, and the European Union. *Members*, G20.ORG, http://www.g20.org/index.php/en/g20/members (last visited Apr. 16, 2012).

27 Duncan Alford, *Supervisory Colleges: The Global Financial Crisis and Improving International Supervisory Coordination*, 24 EMORY INT'L L. REV. 57, 76 (2010).

28 *See id.* at 75.

29 G-20, *Leaders' Statement: The Pittsburgh Summit*, *supra* note 13, at 8–10. This list is a representative, but not comprehensive, reproduction of all areas the G-20 identified as important.

30 The G-20 did not create the FSB from scratch. Rather, the FSB replaced a previously existing organization known as the Financial Stability Forum, and it was given an expanded mandate in coordinating and monitoring G-20 member states' implementation of commitments made in financial regulatory reform. Alford, *supra* note 27, at 75.

31 FSB Charter art. 1, *available at* http://www.financialstabilityboard.org/publications/r_090925d.pdf. For a list of FSB members, see *id.* at Annex A.

32 *Id.*; *see also* Alford, *supra* note 27, at 75 (discussing the formation of the FSB).

ernance framework—the other three pillars being the International Monetary Fund (IMF), the World Bank, and the WTO.[33] The mandate of the FSB is:

- to assess vulnerabilities affecting the financial system and identify and oversee action needed to address them;
- to promote co-ordination and information exchange among authorities responsible for financial stability;
- to monitor and advise on market developments and their implications for regulatory policy;
- to advise on and monitor best practice in meeting regulatory standards;
- to undertake joint strategic reviews of the policy development work of the international standard setting bodies to ensure their work is timely, coordinated, focused on priorities, and addressing gaps;
- to set guidelines for and support the establishment of supervisory colleges;
- to manage contingency planning for cross-border crisis management, particularly with respect to systemically important firms; and
- to collaborate with the IMF to conduct Early Warning Exercises.[34]

Since its creation, the FSB has been very active in formulating standards and frameworks, coordinating with standard-setting bodies, monitoring member state implementation, and reporting regularly to the G-20 across the full spectrum of financial regulatory issues.[35] However, the only real penalty for noncompliance with FSB efforts is "naming-and-shaming" through FSB-conducted progress reports and peer and sector reviews.[36]

---

33 *Regaining Their Balance: A New Chapter for the World Economy, Maybe*, ECONOMIST (Sept. 26, 2009), http://www.economist.com/node/14530394.

34 *Mandate*, FSB, http://www.financialstabilityboard.org/about/mandate.htm (last visited Apr. 16, 2012).

35 *See, e.g.*, FSB, FSB Reports to G20 Leaders, *supra* note 15. Aside from the FSB and the Basel Committee, which is also discussed at length in this Article, other standard-setting bodies and transnational networks participating in financial regulatory reform include the International Organization of Securities Commissions (securities regulation), the Organization for Economic Co-operation and Development (corporate governance) and the International Monetary Fund (financial stability and other macroeconomic issues).

36 The FSB's ongoing efforts to promote global standards on international cooperation and information exchange illustrate how this works. The FSB began its initiative in March 2010, and in its April 2011 progress report noted that "[a]ll but a few of the jurisdictions" contacted by the FSB "already demonstrate sufficiently strong adherence to the relevant standards or are implementing reforms to strengthen their adherence." Fin. Stability Bd., *Promoting Global Adherence to Regulatory and Supervisory Standards on International Cooperation and Information Exchange: Progress Report* 1 (Apr. 29, 2011), *available at* http://www.financialstabilityboard.org/publications/r_110429.pdf. At the same time, the FSB stated that "[a] very small number of jurisdictions" had not "cooperated satisfactorily," and that it intended to publish a list of those jurisdictions to induce compliance. *See id.* at 3–4.

While the FSB takes the leading role among transnational networks in coordinating most areas of regulatory reform, the Basel Committee continues to have a preeminent position in setting capital and liquidity standards for banks worldwide.[37] Like the FSB, the Basel Committee does not have any formal supervisory or legal power over its members or other states but rather helps formulate guidelines and best practice recommendations "in the expectation that individual authorities will take steps to implement them through detailed arrangements—statutory or otherwise—which are best suited to their own national systems."[38] The Basel Committee reports to central bank governors and heads of supervision of member countries and has four main working groups.[39] It is now working on its third iteration of capital standards, known as Basel III, which substantially increases minimum ratios and places more emphasis on common equity buffers than did its predecessor, Basel II.[40] Basel III's development is partly in response to criticism that Basel II played a substantial role in al-

37 The Basel Committee is also complementing the FSB's work in certain areas beyond capital, using a similar approach of formulating core standards and monitoring the efforts of national authorities to converge to those standards. Notably, the Basel Committee's cross-border bank resolution group has made recommendations on model cross-border resolution frameworks and followed up with a report on how jurisdictions are progressing with respect to those recommendations. *See* BASEL COMM. ON BANKING SUPERVISION, BANK FOR INT'L SETTLEMENTS, RESOLUTION POLICIES AND FRAMEWORKS—PROGRESS SO FAR 31–35 (July 2011), *available at* http://www.bis.org/publ/bcbs200.pdf. It has also made recommendations regarding best practices for supervisory colleges, as will be discussed later in this Article. *See infra* note 83 and accompanying text.

38 Basel Comm. on Banking Supervision, *History of the Basel Committee and Its Membership*, BANK FOR INT'L SETTLEMENTS 1 (Aug. 2009), http://www.bis.org/bcbs/history.pdf.

39 These include an accounting task force, a standards implementation group, a policy development group, and a consultative group (which reaches out to nonmembers on Basel initiatives, among other roles). *About the Basel Committee*, BANK FOR INT'L SETTLEMENTS, http://www.bis.org/bcbs/about.htm (last visited Apr. 16, 2012).

40 *International Regulatory Framework for Banks (Basel III)*, BANK FOR INT'L SETTLEMENTS, http://www.bis.org/bcbs/basel3.htm (last visited Apr. 16, 2012). The Basel Committee issued the first iteration of its Basel Capital Accord in 1988, which called for banks to implement credit risk management frameworks with a minimum capital level of 8%. PROGRESS REPORT ON BASEL III IMPLEMENTATION, *supra* note 20. Essentially all countries—and not just members—with internationally active banks have now adopted this minimum level. Patricia Jackson et al., *Capital Requirements and Bank Behaviour: The Impact of the Basle Accord* 1 (Basle Comm. on Banking Supervision, Working Paper No. 1, 1999), *available at* http://www.bis.org/publ/bcbs_wp1.pdf. The Basel Committee issued the second iteration of Basel standards, known as Basel II, in 1999. *See* PROGRESS REPORT ON BASEL III IMPLEMENTATION, *supra* note 20. Basel II differed from Basel I in its greater reliance on banks' own risk metrics through a mechanism known as "Advanced Approaches," used as a supplement to supervisors' determination of risk-weighted capital requirements. *See id.*; *Basel II—Advanced Approaches*, OFFICE OF THE COMPTROLLER OF THE CURRENCY, http://www.occ.gov/topics/capital-policy/baselii-advanced-approaches/index-basel-ii.html (last visited Apr. 16, 2012).

lowing global financial institutions to become overleveraged during the run-up to the financial crisis.[41]

B. The United States

Over a year and a half after the financial crisis commenced in the fall of 2008, the U.S. Congress passed the Dodd-Frank Act,[42] the most significant legislation on financial regulatory reform since the Great Depression.[43] In Dodd-Frank, Congress delegated a number of key decisions to regulatory agencies for implementation.[44] While it is common for Congress to make such delegations, especially in particularly technical or fast-changing areas that are best handled by agencies (which generally have greater expertise and flexibility than Congress), Dodd-Frank was overly reliant on this practice. From the standpoint of international coordination, this is troublesome for at least three reasons.

First, in many cases Dodd-Frank places key decisions in the hands of the very same regulators whose critical oversights and failures contributed to the crisis. The Act also requires close cooperation among these regulators, despite the fact that many of them have a long-standing record of rivalry and turf battles.[45] Second, Dodd-Frank creates a rushed and inflexible U.S. regulatory reform process that could disrupt efforts to coordinate policy with foreign counterparts. Agencies must go through a lengthy "notice and comment" process before promulgating final rules, governed closely by the United States' Administrative Procedure Act (APA).[46] The simultaneous need to comply with the detailed requirements of the APA and to stay up-to-date with Dodd-Frank's aggressive timelines has created an overwhelming burden on U.S. agencies, and this burden likely hinders their ability to engage in meaningful consultation with foreign regulators during

---

41 *See Financial Regulatory Reform: The International Context: Hearing Before the H. Comm. on Fin. Servs.*, 112th Cong. app. at 70 (2011) [hereinafter *Financial Regulatory Reform Hearing*] (statement of Sheila C. Bair, Chairman, Federal Deposit Insurance Corporation), *available at* http://financialservices.house.gov/UploadedFiles/112-39.pdf.

42 Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), Pub. L. No. 111-230, 124 Stat. 1376 (2010) (codified in scattered sections of 7, 12, 15, 18, 22, 31, and 41 U.S.C. (Supp. IV 2010)).

43 *See generally* Alert Memorandum from Cleary Gottlieb Steen & Hamilton LLP, Dodd Frank: One Year Later—Key Current Issues for Financial Institutions pmbl. (July 27, 2011) [hereinafter Dodd Frank: One Year Later Memo], *available at* http://www.cgsh.com/News/Search.aspx (search "one year later"; then follow title link under "Alert Memoranda") .

44 *Cf. id.* at 1 (discussing the pressure regulators face from Capitol Hill to "address complex issues" and "implement ambiguous statutory provisions").

45 *See* Greene, *supra* note 1, at 1.

46 *See generally* Jill Nylander, *The Administrative Procedure Act: A Public Policy Perspective*, MICH. B.J., Nov. 2006, at 38, 39, *available at* http://www.michbar.org/journal/pdf/pdf4article1078.pdf (discussing the steps involved in the notice and comment process).

the rulemaking process.[47] Third, to the extent that the United States must forge ahead and finalize rules pursuant to this process, it consistently puts the EU and other countries in a "take-it-or-leave-it" position with respect to streamlining their policies with the United States.

Partly as a result of the incredible burdens on U.S. agencies and the time pressures resulting from Dodd-Frank, the U.S. courts' response to such hastily formulated rules is uncertain—they may decide to strike down these rules on the grounds that agencies did not follow either the APA or Dodd-Frank's procedural requirements for a given provision. The U.S. Court of Appeals for the D.C. Circuit has already made several such rulings, most recently in July 2011 when it held that the Securities and Exchange Commission (SEC) had not done a full cost-benefit analysis on a proxy access rule that it promulgated under Dodd-Frank.[48] Judge Douglas Ginsburg lambasted the SEC in that case, finding that the agency "inconsistently and opportunistically framed the costs and benefits of the rule; failed adequately to quantify the certain costs or to explain why those costs could not be quantified; neglected to support its predictive judgments; contradicted itself; and failed to respond to substantial problems raised by commenters."[49] Should additional rules prove vulnerable to judicial challenge, a shifting, unpredictable landscape could emerge for international coordination of regulatory reform.

On an organizational level, Dodd-Frank has not only failed to consolidate the already fragmented U.S. regulatory system, but it has also contributed to its further fragmentation, creating several new major bodies—the Financial Stability Oversight Council (FSOC) and Consumer Financial Protection Bureau (CFPB)—within the Federal Reserve Board (FRB), while eliminating only one—the Office of Thrift Supervision (OTS).[50] These agencies supplement the SEC, the Commodity Futures Trading Commission (CFTC), the Office of the Comptroller of the Currency (OCC), the FRB, and the FDIC as the principal federal financial regulators in the United States. To complicate matters further, Dodd-Frank also limits the power of federal agencies to preempt state agencies and attorneys general in certain

---

47 *See Promoting Economic Recovery and Job Creation: The Road Forward: Hearing Before the H. Comm. on Fin. Servs.*, 112th Cong. 102 app. at 102 (2011) (prepared statement of Hal S. Scott, Nomura Professor of International Financial Systems, Harvard Law School) *available at* http://financialservices.house.gov/UploadedFiles/112-1.pdf (arguing that Dodd-Frank mandates and pressure have resulted in agencies "abandoning their responsible, deliberative rulemaking processes," thus leaving the public and interested parties without sufficient opportunity to comment).

48 *See* Jesse Hamilton & Joshua Gallu, *Dodd-Frank Rules May Be at Legal Risk After SEC Loses U.S. Court Appeal*, BLOOMBERG (July 23, 2011), http://www.bloomberg.com/news/2011-07-22/dodd-frank-act-s-rules-may-be-at-legal-risk-after-sec-appeals-court-defeat.html.

49 Business Roundtable v. SEC, 647 F.3d 1144, 1148–49 (D.C. Cir. 2011).

50 *See* Dodd Frank: One Year Later Memo, *supra* note 43, at 1, 4.

areas of regulation.[51] Taken together, these developments in U.S. financial regulation make for an intriguing inverse of Henry Kissinger's famous statement as U.S. Secretary of State in the 1970s: "If I want to call Europe, who do I call?"[52] Today, European regulators would be forgiven for expressing similar confusion when determining how to coordinate their reforms across America's multitude of agencies.

C. The European Union

Within the European Union, financial regulatory policy at the supranational level has dramatically centralized since the global credit crisis. Traditionally, financial regulation has been handled almost entirely within and by member states of the EU.[53] But now, in terms of EU-level policymaking, the European Commission (EC) has taken the lead role. Pursuant to the Lamfalussy Process, the EC's Directorate for Internal Market and Services (DG Markt) is responsible for promulgating EU directives in the area of financial reform, which, after approval from the European Council and Parliament, must be implemented by EU member states.[54] In March 2009, the EC set forth a comprehensive blueprint for a reform agenda, drawing heavily on the findings of an expert panel—chaired by former IMF Managing Director Jacques de Larosiere—that had investigated financial regulatory

---

51 *See id.* at 69.

52 James Meek, *What Is Europe*, GUARDIAN (London) (Dec. 16, 2004), http://www.guardian.co.uk/world/2004/dec/17/eu.turkey1.

53 *Cf.* MYRIAM VANDER STICHELE, SOMO, FINANCIAL REGULATION IN THE EUROPEAN UNION: MAPPING EU DECISION MAKING STRUCTURES ON FINANCIAL REGULATION AND SUPERVISION 6 (2008), *available at* http://www.eurodad.org/uploadedFiles/Whats_New/Reports/EUMapping_Financial_Regulation_FINAL.pdf ("Major European governments have been promoting a strong liberalisation and deregulation of financial markets at both European and international levels with the belief that this would strengthen European economic and monetary policies. They now recognise the problem of insufficient coordination between European supervisors and between European governments and regulators.").

54 *See Lamfalussy*, FSA, http://www.fsa.gov.uk/pages/About/What/International/european/lamfalussy/index.shtml (last updated Feb. 10, 2012). The EU established the Lamfalussy Process in 2001 to allow for greater convergence and coordination in EU financial regulation. It is a four-step process. In the first step, the EC proposes legislation that must be adopted by codecision with the European Council and Parliament, with the legislation (either directive or regulation) specifying how and whether power should be delegated to the EC for implementing measures. Assuming such delegations are made, the second step consists of the EC drafting and adopting secondary legislation in consultation with the relevant European Supervisory Authority (ESA) bodies. In the third step, the ESAs advise the EC on when and whether it is setting forth more detailed guidance, and undertake consultation with interested market participants as applicable. The fourth step involves monitoring and enforcement by the EC, which is responsible for ensuring that EU legislation is transposed into domestic law and properly applied by member states. *See id.*

shortcomings in the EU.[55] This EC blueprint continues to guide the broader European effort in regulatory reform.

Although the EU is still formally a federation of twenty-seven sovereign states, DG Markt and its Commissioner, Michel Barnier, form a principal point of contact for the EU in coordinating financial regulation with foreign counterparts. This unified approach contrasts with America's array of independent agencies, as described above. To be sure, Barnier has established a channel of communication with the U.S. Treasury Secretary, Timothy Geithner, and the two officials have already exchanged several public missives on their respective concerns over their jurisdictions' interaction in the reform process.[56] But Geithner's ability to influence the rulemaking processes of the various U.S. agencies, which possess a great deal of independence within the U.S. executive branch, is limited, especially when compared to the EC's authority. While European member states generally have some degree of flexibility in determining how to implement an EC directive, they must still achieve substantial compliance with it by a prescribed deadline.[57]

Although not codified in a single piece of legislation, like Dodd-Frank, the EU's current initiatives can generally be classified into a similar set of areas: systemic risk and financial stability, cross-border crisis management, derivatives, executive compensation, credit-rating agencies and securitization, alternative investment fund regulation, and consumer protection.[58] A brief overview of key structural and organizational changes within the EU framework follows. This overview provides context to the later discussion of the substantive provisions within the identified areas of EU initiatives that have transnational implications.

As an initial matter, the pan-European community has a new supervisory framework, which comprises several new institutions, including the European Systemic Risk Board (ESRB), which has a similar macro-prudential role as the United States' FSOC, and a European System of Financial Supervisors, which consists of three sector-focused

---

55 *See* Alford, *supra* note 27, at 66–67 (citing COUNCIL OF THE EUROPEAN UNION, BRUSSELS EUROPEAN COUNCIL: PRESIDENCY CONCLUSIONS (Mar. 2009), *available at* http://register.consilium.europa.eu/pdf/en/09/st07/st07880.en09.pdf).

56 *See* Tom Braithwaite & Peter Spiegel, *US Defends Its Banking Reforms*, FIN. TIMES (London) (June 2, 2011), http://www.ft.com/cms/s/0/d91a5142-8cc3-11e0-beca-00144feab49a.html#axzz1bM3vvlR8.

57 *See Directives—Definitions*, EUR. COMMISSION, http://ec.europa.eu/eu_law/directives/directives_en.htm (last updated Aug. 17, 2011).

58 *See* Alert Memorandum from Cleary Gottlieb Steen & Hamilton LLP, Financial Regulatory Reform in the European Union: State of Play and Prospects 1–3 (July 26, 2011) [hereinafter Financial Regulatory Reform in the European Union Memo], *available at* http://www.cgsh.com/News/Search.aspx (search "financial regulatory reform"; follow title hyperlink under "Alert Memoranda").

European Supervisory Authorities (ESAs).[59] These ESAs include the European Securities and Market Authority (ESMA), the European Banking Authority (EBA), and the European Insurance and Occupational Pensions Authority (EIOPA).[60]

The ESA framework is a very positive development; indeed, the United States should have aimed for a similar structural rearrangement in Dodd-Frank.[61] The ESA institutions will be responsible for micro-prudential supervision in their respective sectors, and they will also be empowered to mediate between national-level officials, to license credit-rating agencies, and to advise the EC on new directives and legislation.[62]

In terms of substantive areas of regulation, both EU and key national agencies have indicated that they recognize the FSB's leading role in coordinating financial reforms of international scope.[63] This suggests that where major EU jurisdictions—principally the UK, France, and Germany—have forged ahead with pilot programs in various areas, there is diminished risk that those regimes will conflict with each other or with final EC directives. Accordingly, the most important elements of EU financial regulatory reform that will emanate beyond European borders—including cross-border resolutions, derivatives reforms, and capital standards—will likely accord closely with FSB standards, as will be discussed in the sections to follow.

Yet ultimately, the slower pace of the FSB and EC relative to the United States, which has already established a statutory regime and imposed firm deadlines and mandates for regulators to follow, creates

---

59 The new ESA, created in January 2011 pursuant to an expert panel's recommendations on regulatory reforms after the financial crisis, is empowered to coordinate and monitor the supervision of European financial institutions with cross-border activity. Although national and lower-level EU regulators maintain primary responsibility for day-to-day oversight, ESA officials have the power to compel certain actions when it determines that those regulators are not performing adequately. *See European Supervisory Authorities (ESAs)*, FSA, http://www.fsa.gov.uk/pages/About/What/International/european/esas/index.shtml (last updated Jan. 21, 2012).

60 *See id.*; *see also Microprudential Supervision*, BaFin, http://www.bafin.de/nn_720492/EN/BaFin/International/europeansupervision/microprudential/mikroprudentielleaufsicht__en__node.html?__nnn=true (last visited Apr. 16, 2012) (discussing the ESAs and their powers and functions).

61 This could have been achieved by consolidating the SEC and CFTC into a securities and market authority and by combining all of the federal banking regulators into a single banking authority.

62 *See* Karel Lannoo, CEPS Policy Brief, No. 241, The EU's Response to the Financial Crisis: A Mid-Term Review 2–3 (2011), *available at* http://www.ceps.eu/ceps/download/5500.

63 *See, e.g.*, Fin. Servs. Auth., The FSA's International Agenda 6, 9 (Oct. 2010), *available at* http://www.fsa.gov.uk/pubs/international/agenda.pdf; Michel Barnier, Member of the European Comm'n, Speech Delivered at the Asian Financial Forum in Hong Kong: Restoring Confidence in the Financial Sector—Acting Regionally and Globally (Jan. 16, 2012), *available at* http://europa.eu/rapid/pressReleasesAction.do?reference=SPEECH/12/6&format=HTML&aged=0&language=EN&guiLanguage=en.

a clear risk of transatlantic divergence. Because most global financial transactions still take place within the United States and the EU,[64] it is critical that these two jurisdictions adopt a unified front in the reform process.

D. Other Jurisdictions

This Article focuses principally on the issue of divergence between the United States and the EU in financial regulatory reform, given that cooperation between the two is absolutely essential to any successful effort to build a strong, coordinated global framework.[65] This focus, however, is not intended to downplay the importance of key emerging jurisdictions participating in the reform process. To that end, the United States and the EU must keep two critical imperatives in mind as they take a leadership role in shaping and implementing G-20 and FSB standards.

First, in order for the FSB to emerge as the "fourth pillar" of the global financial architecture as Secretary Geithner predicts,[66] it must develop a firm foundation of legitimacy among all G-20 members. U.S. and EU leaders, then, must take care to resolve differences on a broader, multilateral basis where possible, as excessive reliance on bilateral talks could weaken the FSB's authority and alienate other G-20 members. Such alienation and dimunition of authority would almost surely fracture the global financial regulatory reform effort. Many G-SIFIs have substantial operations in emerging markets, but as a proportion of each G-SIFI's global footprint, the emerging market activity may be relatively minimal as compared, for instance, to the G-SIFI's U.S.- or EU-based business.[67] Because of this comparative insignificance, regulators may not take sufficient account of emerging market regulatory concerns in deciding on recovery or resolution measures for G-SIFIs.[68] Without correctly taking these concerns into account, officials in such markets may adopt restrictive measures to limit the domestic consequences of a G-SIFI's failure, including ring-fencing of assets and restrictions on cross-border distributions to affiliates.

---

64 *See, e.g.*, Atlantic Council, The Danger of Divergence: Transatlantic Cooperation on Financial Reform 2 (2010), *available at* http://www.acus.org/files/publication_pdfs/403/ACUS_TR_Danger_Divergence_Report.pdf.

65 Of the twenty-nine financial institutions currently designated as G-SIFIs by the FSB, for instance, only four are based outside the United States or the EU: Bank of China, Mitsubishi UFJ FG, Mizuho FG, and Sumitomo Mitsui FG. *See infra* note 71 and accompanying text.

66 *See supra* note 33 and accompanying text.

67 *Cf.* IMF, Resolution of Cross-Border Banks, *supra* note 23, at 8 ("Certain branches or subsidiaries may, in economic terms, be comparatively insignificant to a group yet be of critical importance to their host country's financial system.").

68 *See id.* ("[P]arent banks [may] simply 'walk away' should the subsidiary encounter difficulties, irrespective of the impact on the host country economy.").

Second, the United States and the EU must maintain a firm, common approach in implementing G-20 recommendations, and they must resist the temptation to weaken standards, which would likely promote regulatory arbitrage. To be sure, it is possible that if U.S. and EU policymakers enact tough, relatively uniform, new regulatory standards, multinational financial institutions might pursue higher leverage opportunities and fewer activity restrictions by migrating business to enterprising jurisdictions outside the United States and the EU that are less rigorous in financial regulation. But if major jurisdictions can create a unified regulatory front that market actors perceive as a "gold standard" for rules, supervision, and enforcement, institutions that engage in regulatory arbitrage could face higher costs of capital that would outweigh compliance savings. Indeed, a substantial body of academic literature suggests that the U.S. securities regulation regime accrues a valuation premium to international firms that opt into it, due to investors' belief that those firms must meet the highest standards for disclosure or face steep regulatory or litigation costs.[69] This phenomenon is known as "bonding."[70] Over the medium-term horizon, much will turn on whether international financial reform efforts exert enough bonding influence to forestall arbitrage within noncooperative jurisdictions.

II
Regulatory Issues with Critical International Implications

A. Supervision and Resolution

1. *The Financial Stability Board Framework*

After the November 2011 Cannes Summit, the FSB released a document on policy measures to address "too-big-to-fail" risks posed by G-SIFIs, and for the first time it named a group of twenty-nine G-SIFIs that must meet certain resolution-related requirements by the end of 2012.[71] The policy measures cover four general areas: reform

69 *See, e.g.*, Luzi Hail & Christian Leuz, *Cost of Capital Effects and Changes in Growth Expectations Around U.S. Cross-Listings*, 93 J. Fin. Econ. 428, 428–29 (2009) (noting that firms that cross list on U.S. exchanges decrease their cost of capital).

70 *See id.*; Craig Doidge et al., *Why Do Foreign Firms Leave U.S. Equity Markets?*, 4 J. Fin. 1507, 1508 (2010).

71 *See* Fin. Stability Bd., *Policy Measures to Address Systemically Important Financial Institutions* at 1, 4 (Nov. 4, 2011), http://www.financialstabilityboard.org/publications/r_111104bb.pdf. The currently designated G-SIFIs include: Bank of America, Bank of China, Bank of New York Mellon, Banque Populaire CdE, Barclays, BNP Paribas, Citigroup, Commerzbank, Credit Suisse, Deutsche Bnak, Dexia, Goldman Sachs, Group Crédit Agricole, HSBC, ING Bank, JP Morgan Chase, Lloyds Banking Group, Mitsubishi UFJ FG, Mizuho FG, Morgan Stanley, Nordea, Royal Bank of Scotland, Santander, Société Générale, State Street, Sumitomo Mitsui FG, UBS, Unicredit Group, and Wells Fargo. *Id.* at 4.

of national resolution regimes, requirements for recovery and resolution planning, more intensive supervision, and capital requirements.[72] This subpart deals with the first three of those areas, and subpart II.B covers the matter of capital requirements.

At the Cannes Summit, the G-20 approved the FSB's document *Key Attributes of Effective Resolution Regimes for Financial Institutions*, which they intend to become the blueprint for recovery and resolution frameworks throughout key jurisdictions.[73] Regarding regulatory authority, the FSB observes that regulators must be able to preserve a failing institution's systemically important functions—those that would cause widespread harm if disrupted—and should minimize the cost of resolution while making shareholders and creditors—not taxpayers—bear any such costs.[74] The FSB also recommends that regulators have a "broad range of resolution powers," including the ability to separate, operate, and sell systemically important functions (either through a "good bank, bad bank" or "bridge" institution mechanism) and to restructure or recapitalize institutions, potentially using statutory "bail-in" measures.[75] More generally, the FSB stresses that regulators must have sufficient authority over the institutions' contracts and assets to be able to wind the firm down in an orderly fashion.[76]

The FSB, having stated in a prior release that there is "no immediate prospect" of a treaty-based agreement to govern the resolution of G-SIFIs,[77] recommends only that the "statutory mandate of a resolution authority should empower and strongly encourage the authority

---

72 *See id.* at 1. Recovery plans should set forth an institution's strategy to quickly restore capital and liquidity should it suffer significant, unexpected losses or experience a run on deposits. They should outline management responses to both idiosyncratic (i.e., firm-specific) and systemic (i.e., market-wide) causes of adversity. Resolution plans, by comparison, should provide a blueprint for rapid restructuring of the institution in a manner which minimizes contagion effect, maintains systemically important operations, and enables the orderly sale (in part or whole) of the institution. The core idea of recovery and resolution planning is to craft "responses to a continuum of stresses" and to contingent circumstances. *See* KPMG, THE IMPLICATIONS OF RECOVERY AND RESOLUTION PLANS . . . STRESSED BY THE BREAK UP? 5–6 (May 2011), *available at* http://www.kpmg.com/global/en/issuesandinsights/articlespublications/Documents/recovery-resolution-plansV2.pdf.

73 *See* FIN. STABILITY BD., KEY ATTRIBUTES OF EFFECTIVE RESOLUTION REGIMES FOR FINANCIAL INSTITUTIONS 1 (Oct. 2011) [hereinafter FSB, KEY ATTRIBUTES], *available at* http://www.financialstabilityboard.org/publications/r_111104cc.pdf.

74 *See id.* at 1, 3, 7–8.

75 *See id.* at 7–9. Statutory bail-in would allow the regulators to convert debt to equity without the consent of the holder and to write-down equity. *See* CEYLA PAZARBASIOGLU ET AL., INT'L MONETARY FUND, CONTINGENT CAPITAL: ECONOMIC RATIONALE AND DESIGN FEATURES 18 box 3 (Jan. 2011), *available at* http://www.imf.org/external/pubs/ft/sdn/2011/sdn1101.pdf.

76 FSB, KEY ATTRIBUTES, *supra* note 73, at 17.

77 RBS Group PLC, *FSB Consultative Document: Effective Resolution of Systemically Important Financial Institutions—Recommendations and Timelines: Response* 7 (Sept. 2, 2011), *available at* http://www.financialstabilityboard.org/press/c_110909xx.pdf.

wherever possible to act to achieve a cooperative solution with foreign resolution authorities."[78] Furthermore, the FSB believes that establishing national legal powers for cross-border cooperation (e.g., via memoranda of understanding), crisis management groups within institutions,[79] and institution-specific cross-border cooperation agreements, while "falling short of a binding framework," is nonetheless a "significant step."[80] The FSB further recommends that all G-SIFIs be required to prepare both recovery and resolution plans, which regulators should review annually.[81]

With respect to supervision, in November 2008 the G-20 called for supervisors to "collaborate to establish supervisory colleges for all major cross-border financial institutions, as part of efforts to strengthen the surveillance of cross-border firms."[82] The Basel Committee has set forth a document on "good practice principles" for supervisory colleges, which focuses generally on informal, consultative matters.[83] According to the Basel Committee, "[c]olleges should not be seen as a substitute for effective national supervision nor undermine the legal and prudential responsibilities of respective supervisors. Colleges are not intended to be decision-making bodies but should provide a framework to enhance effective supervision . . . ."[84] Furthermore, the Basel Committee intends its principles to "allow adequate flexibility in the way that they are implemented by different

---

78 FSB, KEY ATTRIBUTES, *supra* note 73, at 13; *see also* FIN. STABILITY BD., CONSULTATIVE DOCUMENT: EFFECTIVE RESOLUTION OF SYSTEMICALLY IMPORTANT FINANCIAL INSTITUTIONS: RECOMMENDATIONS AND TIMELINES 14–15, (July 2011) [hereinafter FSB, CONSULTATIVE DOCUMENT], *available at* http://www.financialstabilityboard.org/publications/r_110719.pdf ("[J]urisdictions should ensure that no legal, regulatory or policy impediments exist that hinder the appropriate exchange of information, including firm-specific information, between supervisory authorities, central banks, resolution authorities, finance ministries and the public authorities responsible for insurance guarantee schemes.").

79 Crisis management groups have the objective of "enhancing preparedness for and facilitating the management and resolution of a cross-border financial crisis." Cooperation Agreement on Cross-Border Financial Stability, Crisis Management and Resolution Between Relevant Ministries, Central Banks and Financial Supervisory Authorities, Den.-Est.-Fin.-Ice.-Lat.-Lith.-Nor.-Swed., ¶ 2(i), Aug. 17, 2010, *available at* http://www.fi.ee/failid/Koostoolepingud/NB-MoU_public_170810.pdf. They are to include supervisory and resolution authorities, central banks, finance ministries, and deposit guarantee officials from jurisdictions that are material to the G-SIFI's resolution. *See* FSB, CONSULTATIVE DOCUMENT, *supra* note 78, at 30.

80 Fin. Stability Bd., *Effective Resolution of Systemically Important Financial Institutions: Overview of Responses to the Public Consultation* 3 (Nov. 4, 2011) [hereinafter FSB, *Overview of Responses*], *available at* http://www.financialstabilityboard.org/publications/r_111104dd.pdf.

81 FSB, CONSULTATIVE DOCUMENT, *supra* note 78, at 17.

82 Press Release, G-20, Declaration: Summit on Financial Markets and the World Economy 4 (Nov. 15, 2008), *available at* http://www.financialstabilityboard.org/press/pr_151108.pdf.

83 BASEL PRINCIPLES ON SUPERVISORY COLLEGES, *supra* note 22, at 1.

84 *Id.*

jurisdictions."[85] And in a crisis situation, the envisioned role of supervisory colleges is to assist "in planning the crisis management meeting, encouraging the banking group to produce appropriate information for crisis management and serving as a conduit for information sharing."[86]

2. *The United States Framework*

Dodd-Frank's supervisory reforms center on heightened prudential standards that the FRB is to promulgate and apply to designated SIFIs.[87] All bank holding companies with total consolidated assets of at least $50 billion, as well as non-bank financial companies that the FSOC designates as SIFIs, will be subject to those heightened standards, which are yet to be finalized.[88] Other important supervisory reforms include Dodd-Frank's annual stress testing requirement for SIFIs, as well as SIFI capital surcharges, which will be discussed in Part II.B, *infra.* Although other national regulators, such as the OCC, retain key supervisory roles within large financial institutions, Dodd-Frank clearly envisions the FRB as having the lead role in ensuring the safety and soundness of SIFIs.[89] Beyond its broad power to designate SIFIs for FRB supervision, the FSOC's role is relatively informal and advisory in nature.[90]

The centerpiece of Dodd-Frank, however, is the new Orderly Liquidation Authority (OLA), over which the FDIC has primary responsibility. Two key factors—a widespread consensus about the unsuitability of bankruptcy for resolving complex financial institutions and the unpopularity of using public money to bail out those firms—shaped much of the U.S. debate and eventual legislation on resolution authority. As set forth in Title II of the Dodd-Frank Act, Congress created OLA with the express goal to facilitate the liquidation of "failing financial companies that pose a significant risk to the financial stability of the United States in a manner that mitigates such risk and minimizes moral hazard."[91] Title II establishes that another purpose of OLA is to ensure that taxpayer money will not be used for bailing out failing financial institutions; instead, creditors and shareholders must bear all losses.[92] Under OLA, the FDIC is responsible for the receivership and liquidation of financial companies, and it is statutorily required to minimize loss, mitigate risk, and maximize the realiza-

---

85 *Id.*
86 *Id.* at 13.
87 Dodd Frank: One Year Later Memo, *supra* note 43, at 6–8.
88 *Id.* at 8.
89 *Id.* at 6–7.
90 *Id.* at 6.
91 Dodd-Frank Act § 204(a), 12 U.S.C. § 5384(a) (Supp. IV 2010).
92 *See id.*

tion value of the failed company's assets while carrying out these responsibilities.[93] Although OLA predates the FSB blueprint, the key features of the two are substantially similar.[94]

OLA functions in the following way. First, specified federal regulators[95] make a recommendation to the Treasury Secretary that OLA is necessary to resolve a particular institution.[96] Among other factors, the Treasury Secretary determines whether resolving the institution under its default insolvency regime, typically bankruptcy, would have profoundly adverse effects on the economy.[97] If the Treasury Secretary finds that it would have such effects, OLA liquidation can commence with the approval of the company's board.[98] However, the Treasury Secretary can override a board's refusal by obtaining a court order from the federal district court in the District of Columbia.[99] Once the FDIC has taken the financial company into receivership under OLA, it can exercise similar powers as it has under its organic statute, the Federal Deposit Insurance Act, to transfer assets and liabilities of the firm to third parties or a bridge bank without shareholder or creditor approval.[100] The FDIC can also repudiate burdensome contracts or enforce contracts that another party could otherwise terminate.[101]

There are also some important limitations on the exercise of OLA power. First, the FDIC cannot put foreign subsidiaries of a financial institution into receivership because to do so would require coor-

---

93 *See id.* § 210(a)(9)(E), 12 U.S.C. § 5390(a)(9)(E).

94 Jamieson L. Hardee, *The Orderly Liquidation Authority: The Creditor's Perspective*, 15 N.C. Banking Inst. 259, 261–67 (2011) (describing the OLA blueprint).

95 Depending on the type of financial institution, different regulatory agencies are responsible for issuing this recommendation. For brokers or dealers (or financial companies in which a broker or dealer is the largest domestic subsidiary), the FRB and the SEC make the recommendation, in consultation with the FDIC. For insurance companies (or financial companies in which an insurance company is the largest domestic subsidiary), the FRB and the Federal Insurance Office make the recommendation, again in consultation with the FDIC. For all other systemically important financial institutions, the FRB and the FDIC make the recommendation jointly. *See The Orderly Liquidation of Lehman Brothers Holdings Inc. Under the Dodd-Frank Act*, 5 FDIC Q., no. 2, 2011 at 31, 36, *available at* http://www.fdic.gov/bank/analytical/quarterly/2011_vol5_2/Article2.pdf.

96 *See* Dodd-Frank Act § 203(a)(2), 12 U.S.C. § 5383(a)(2).

97 *See id.* § 203(b)(2), 12 U.S.C. § 5383(b)(2).

98 *See The Orderly Liquidation of Lehman Brothers Holdings Inc. Under the Dodd-Frank Act*, *supra* note 95, at 35–37.

99 *See* Dodd-Frank Act § 202(a)(1)(A), 12 U.S.C. § 5382(a)(1)(A). This order is likely to be granted, since the Treasury Secretary's determination may only be struck down if it is found "arbitrary and capricious," a threshold that is generally difficult to meet in judicial review of administrative actions. Envtl. Def. Fund, Inc. v. Costle, 657 F.2d 275, 283 (D.C. Cir. 1981) ("This 'arbitrary and capricious' standard of review is a highly deferential one, which presumes the agency's action to be valid." (citation omitted)).

100 *See* Dodd-Frank Act §§ 210(a)(1)(G), 210(h)(1)(B), 12 U.S.C. §§ 5390(a)(1)(G), 5390(h)(1)(B).

101 *Id.* § 210(c), 12 U.S.C. § 5390(c).

dination with the relevant jurisdictions.[102] If OLA had existed at the time of Lehman Brothers' demise, the firm's large UK subsidiary would still have been subject to the UK insolvency laws. Accordingly, OLA would have done little to obviate the lack of regulatory cooperation between U.S. and UK authorities that has so hindered Lehman's resolution.

Second, while the FDIC can borrow from the Treasury to facilitate a firm's liquidation, Dodd-Frank provides that if creditors and shareholders cannot ultimately finance the insolvency themselves, regulators will impose an *ex post* levy on the remaining large financial companies to make up the difference.[103] In this respect OLA diverges sharply from the FDIC's largely successful approach of financing resolutions *ex ante* through the collection of deposit insurance premiums from banks, based on the institutions' balance of deposits and degree of risk posed to the fund.[104]

While Congress set forth a relatively detailed statutory framework for what OLA must and must not do, it also left some room for regulators to make rules and clarify certain resolution-related matters. So far, OLA rules have indicated that OLA does not apply to qualified financial contracts, which ensures that the statutory safe harbor applies.[105] This approach of honoring derivative contracts of troubled financial companies should help minimize the risk of derivative-related contagion in the event of a major financial institution's insolvency, and as such, other jurisdictions should adopt similar provisions. OLA rules, however, have also muddied the waters regarding set-off rights because the rules indicate that the FDIC can transfer assets of a failed firm free from any such rights. This contradicts Dodd-Frank, which indicates that regulators should still respect contractual set-off rights, but not common-law rights.[106]

Likewise, Congress generally has left U.S. regulators with a substantial degree of flexibility in making rules on recovery and resolution planning, while imposing several notable restrictions that could hinder the international alignment of such plans. Most importantly,

---

102 *See id.* § 210(a)(1)(E)(i), 12 U.S.C. § 5390(a)(1)(E)(i) (granting power with respect to a failing subsidiary of a financial company only if the financial company is organized under the U.S. federal or state law).

103 *See id.* § 210(o)(1), 12 U.S.C. § 5390(o)(1).

104 *See* 12 U.S.C. § 1817(b)(2)(B) (describing the FDIC's assessments protocol).

105 Dodd Frank: One Year Later Memo, *supra* note 43, at 15. The safe harbor exempts qualified financial contracts (QFC), which are generally derivative instruments, from several key bankruptcy provisions. They are not subject to the automatic stay on claims, nor the debtor's ability to assume or reject contracts (absent the creditor party's consent). Collateral collected by QFC creditors on the eve of bankruptcy also cannot be attacked as a preference. *See* Stephen J. Lubben, *Derivatives and Bankruptcy: The Flawed Case for Special Treatment*, 12 U. PA. J. BUS. L. 61, 67 (2009).

106 Dodd Frank: One Year Later Memo, *supra* note 43, at 16–17.

Dodd-Frank stipulates that financial companies must structure resolution plans with reference to the U.S. Bankruptcy Code, and they cannot contemplate the use of OLA in their hypothetical resolution planning.[107] Considering that OLA was created precisely because the Bankruptcy Code inadequately handled the resolution of complex financial firms, this requirement may make it difficult for the largest and most complex G-SIFIs to write resolution plans that would be deemed "credible," which could allow regulators to exercise authority under Dodd-Frank to compel the sale or subsidiarization of certain business units.[108] Because Dodd-Frank also requires U.S. regulators to subject foreign banking organizations with over $50 billion in global consolidated assets to the U.S. resolution-planning process,[109] there are serious international implications arising from U.S. agencies' eventual definition of a "credible" plan.

Finally, Dodd-Frank did nothing to remedy the problems that U.S. ring-fencing laws and domestic depositor preference pose to the effective resolution of internationally active firms, insofar as they allow for discrimination against foreign creditors.[110] Ring-fencing laws provide for separate estates for non-U.S. banks' branches and agencies in the event of bankruptcy.[111] If such an institution were to fail, ring-fencing laws could allow a state to first satisfy the claims of state creditors of the branch before returning the surplus funds, if any, to the institution's home office.[112] Furthermore, certain state ring-fencing laws even allow other states to satisfy claims before the remainder of the funds is returned to the home office.[113] Similarly, giving claims of domestic depositors of failed FDIC-insured banks precedence over the claims of foreign depositors and general creditors, as is currently the U.S. approach, could hinder the exercise of OLA power by encourag-

---

107 *See* Dodd-Frank Act § 165(d)(4), 12 U.S.C § 5365(d)(4); Dodd Frank: One Year Later Memo, *supra* note 43, at 21.

108 *See* Dodd-Frank Act § 165(d)(5), 12 U.S.C. § 5365(d)(5); Dodd Frank: One Year Later Memo, *supra* note 43, at 22–23.

109 *See* Dodd-Frank Act §§ 165(a)(1), 165(d)(1), 12 U.S.C. §§ 5365(a)(1), 5365(d)(1); Dodd Frank: One Year Later Memo, *supra* note 43, at 21.

110 *See* Dodd Frank: One Year Later Memo, *supra* note 43, at 24 ("U.S. ring fence laws may impede the development of global resolution plans by tying up assets needed to satisfy creditors of the home office.").

111 *See id.*

112 *See id.* at 24–25.

113 Given the substantial amount of assets that many international banks keep in New York, the ring-fencing laws of New York State could significantly hinder the effective resolution of such institutions. *Id.* It is unclear whether the FRB, as the designated supervisor of non-FDIC insured U.S. branches of foreign institutions, could preempt state ring-fencing laws. To do so, the FRB would likely have to establish that the state law obstructs the orderly resolution of international financial firms and therefore frustrates the purposes and objectives of Congress (as expressed in OLA). But if this position were untenable, Congress would have to preempt state ring-fencing laws through additional legislation.

ing foreign counterparts to enact, maintain, and potentially use similarly discriminatory measures.[114]

In their public statements, U.S. government officials have expressed satisfaction with OLA powers as currently constituted, remarking that an international resolution mechanism would be both unnecessary and politically unfeasible.[115] But with Title II of Dodd-Frank leaving so many key cross-border elements insufficiently addressed, it is difficult to be confident that OLA will facilitate the effective resolution of any U.S.-based systemically important financial institution, given that nearly all such institutions have substantial international operations.

3. *The European Union Framework*

The EC is currently in the process of formulating a cross-border supervisory and crisis management framework. The EC has indicated that it intends to proceed "gradually" toward a comprehensive EU regime for troubled and failing banks and has set forth a multiyear blueprint for doing so.[116] Its first step "will include a common set of resolution tools and reinforcement of cooperation between national authorities in order to improve the effectiveness of the arrangements for dealing with the failure of cross border banks."[117] In its second step, the EC will study the need for harmonization of member states' bank insolvency regimes—with an eye to ensuring no conflicts between substantive and procedural rules—and will legislate as neces-

---

114 In 1993, Congress provided that claims of domestic depositors of failed FDIC-insured banks should take precedence over claims of foreign depositors and general creditors. This is known as national depositor preference. James A. Marino & Rosalind L. Bennett, *The Consequences of National Depositor Preference*, FDIC BANKING REV., Oct. 1999, at 19, *available at* http://www.fdic.gov/bank/analytical/banking/1999oct/2_v12n2.pdf. Such a policy of depositor nondiscrimination is absolutely required before any treaty-based framework on resolution can emerge. *See* Candice A. Wyllie, *A Comparative Analysis of Nondiscrimination in Multilateral Agreements; North American Free Trade Agreement (NAFTA), Energy Charter Treaty (ECT), and General Agreement on Tariffs and Trade (GATT)*, 18 WILLAMETTE J. INT'L L. & DISP. RESOL. 64, 65–67 (2010) (discussing the importance of nondiscrimination clauses in international treaties).

115 *See, e.g.*, *Does the Dodd-Frank Act End "Too Big to Fail?": Hearing Before the Subcomm. on Fin. Insts. and Consumer Credit of the H. Comm. on Fin. Servs.*, 112th Cong. app. at 74–78 (2011) (prepared statement of Michael H. Krimminger, General Counsel, FDIC), *available at* http://www.financialservices.house.gov/UploadedFiles/112-37.pdf (stating that "the regulatory authorities who will administer the OLA are in a far better position to coordinate with foreign regulators [as compared to pre-Dodd-Frank powers] in the failure of an institution with significant international operations" and that "[i]t does not appear that creating [an international resolution] framework is a realistic near-term goal").

116 Internal Market and Servs. Directorate Gen., European Comm., Working Document: Technical Details of a Possible EU Framework for Bank Recovery and Resolution 1–2 (Jan. 6, 2011) [hereinafter DG Internal Market and Servs., Possible EU Framework], *available at* http://ec.europa.eu/internal_market/consultations/docs/2011/crisis_management/consultation_paper_en.pdf.

117 *Id.* at 7.

sary on this issue by the end of 2012.[118] Finally, if the EU has successfully "put in place a single set of substantive rules with respect to resolution and insolvency," the EC's third step will be to create a single European Resolution Authority (ERA), possibly by 2014.[119]

With respect to resolution financing, the EC, like their U.S. counterparts, expects G-SIFI shareholders and creditors to bear the initial burden.[120] In preparing for situations where those resources might be insufficient, the EC is still working through options: it has launched consultations on bank taxes for financial transactions and activities and on a separate *ex post* bank levy (similar to the United States) as possible funding mechanisms for EU resolutions.[121] EC leaders are also considering mechanisms to help finance recoveries of G-SIFIs, most notably contingent capital instruments that would facilitate statutory or contractual "bail-ins," while emphasizing that such measures should only be a "last resort" so as to "underpin market discipline."[122]

As currently envisioned, the EU's cross-border management legislation will apply to all credit institutions, certain investment firms, and their holding companies (covered institutions).[123] It will allow member states' prudential supervisors to retain the power to exercise early intervention, and member states will also be able to choose which authority is responsible for resolution, provided that resolution and supervisory authorities are functionally distinct.[124] Although the EC proposed that early intervention powers be tied to the requirements of the EU's Capital Requirements Directive (CRD), such that a CRD deficiency would trigger intervention, commenters to the EC's proposal argued that this standard would be too indeterminate.[125] Whatever the final EC legislation sets as a trigger, the early intervention powers are likely to include the ability to: (1) compel capital raises or the allocation of net profits to rebuild capital; (2) prohibit distributions to shareholders; (3) restrict or limit certain business activities; (4) impose additional reporting requirements; and (5) order replacement of board members or executives.[126]

The EU will also require all covered institutions to draw up recovery plans that outline the measures they would take in the event of systemic or idiosyncratic adversity, such as raising capital or liquidity

---

118 *See id.*
119 *Id.*
120 *Id.* at 9.
121 *See id.* at 7.
122 *See id.* at 9, 86–87.
123 Financial Regulatory Reform in the European Union Memo, *supra* note 58, at 9.
124 *See id.*
125 *See id.* at 10.
126 *See id.*

problems.[127] In addition to recovery plans, the EU will require institutions to have resolution plans. But in an important contrast to the U.S. process, EU regulators will be in charge of drafting these plans, with input from the covered institution.[128] Although the exact way the resolution plan requirement will apply to various units of the covered institution is currently uncertain, it appears likely that EU officials will impose the requirement at both the holding-company and business-unit levels.[129] Thus, if a covered institution fails to submit a credible recovery plan or refuses to implement additional measures required by regulators after their review of the plan, those regulators could install a "special manager" for a one-year term with the mandate to either restore the institution's stability or to wind it down.[130]

The EC's potential creation of an ERA echoes an approach set forth in a 2010 IMF working paper that the then-managing director and European operations director for the IMF endorsed.[131] If created, the ERA will be an important complement to the existing ESAs. The EC has already discussed the possibility of giving the European Banking Authority (EBA), one of the ESAs, substantial powers in the supervisory aspects of this framework, specifically the power to develop and coordinate recovery and resolution planning and even possibly to resolve national disputes over how to apply preparatory and preventative measures.[132] The ESAs currently have representation in the supervisory colleges of regulators for each major cross-border institution, and they will likely have the power to require those colleges to take certain actions relating to preventive and recovery measures.[133]

Although most of these powers are clear and uncontroversial, the EBA's potential power to order national resolution authorities, through its participation in supervisory colleges, to cooperate or take certain actions in event of a financial institution's insolvency is less clear.[134] As the EC suggests in its consultation paper on the EBA's role regarding resolutions, mixing supervisory and resolution authorities does not seem entirely appropriate, given the risk of forbearance that could arise.[135] Yet this potential conflict of interest need not prevent a well-structured regulatory body from exercising both functions

---

127 *Id.* at 9.

128 *Id.*

129 *Id.*

130 *Id.* at 10.

131 *See* Wim Fonteyne et al., *Crisis Management and Resolution for a European Banking System* 57–60 (Int'l Monetary Fund, Working Paper No. 10/70, 2010), *available at* http://www.imf.org/external/pubs/ft/wp/2010/wp1070.pdf.

132 DG Internal Market and Servs., Possible EU Framework, *supra* note 116, at 14–15.

133 *See* LANNOO, *supra* note 62, at 2–3.

134 *See* DG Internal Market and Servs., Possible EU Framework, *supra* note 116, at 15.

135 *See id.* at 14.

effectively, as the FDIC's long and largely successful track record of bank supervision and resolution indicates.[136] Until the ERA materializes, it is important to have some EU-level authority such as the EBA that will be able to coordinate potentially divergent national resolution approaches in the midst of a crisis.[137]

4. *Key Tensions*

As the foregoing discussion indicates, the United States and the EU could potentially diverge on supervisory and resolution authority in a number of ways, and this divergence could hinder the future handling of a complex financial institution's insolvency. To eliminate this concern, the two jurisdictions need closer cooperation. Such cooperation may be difficult to achieve, however.

The first issue is timing. The United States has already codified its authority in this area with Title II of Dodd-Frank,[138] and Congress is unlikely to devote substantial attention to revising OLA in the short to medium term. As such, the EU will have to model much of its framework on OLA in order to ensure harmony because the ability of U.S. officials to "converge" toward the EU will be limited to U.S. agencies' rulemaking authority under Dodd-Frank—and such rulemaking must arise from a reasonable interpretation of the statute to withstand judicial scrutiny.[139] Fortunately, the FSB's consultative document on

---

136 *See The Orderly Liquidation of Lehman Brothers Holdings Inc. Under the Dodd-Frank Act*, *supra* note 95, at 34–35 (discussing the FDIC's role as receiver to failed banks).

137 To their credit, key EU jurisdictions have been working to set up new orderly resolution mechanisms in the meanwhile. In its Banking Act of 2009, the UK established a Special Resolution Regime (SSR) that allows the UK authorities five options in resolving banks, which is a power that is broadly similar to the FDIC's under OLA. *See Special Resolution Regime*, BANK OF ENG., http://www.bankofengland.co.uk/financialstability/role/risk_reduction/srr/index.htm (last visited Apr. 16, 2012) (stating that the SSR powers include the authority to (1) "transfer all or part of a bank to a private sector purchaser;" (2) "transfer all or part of a bank to a bridge bank . . . pending a future sale;" (3) "place a bank into temporary public ownership;" (4) "apply to put a bank into the Bank Insolvency Procedure;" and (5) "apply for the use of the Bank Administration Procedure to deal with a part of a bank that is not transferred and is instead put into administration"). Germany has also passed legislation setting forth its own framework for the resolution authority of a "systemically important bank." MONTHLY REPORT: FUNDAMENTAL FEATURES OF THE GERMAN BANK RESTRUCTURING ACT, DEUTSCHE BUNDESBANK 59–60, 69 (June 2011), *available at* http://www.bundesbank.de/download/volkswirtschaft/mba/2011/201106mba_en_bank_restructuring_act.pdf. The German Bundesbank, while describing its new framework in terms substantially similar to the FSB's, frankly acknowledges that "[a] purely German approach to solving this problem is likely to be insufficient in the case of internationally active credit institutions" and frequently makes deferential note of the EC's progress toward an EU-wide approach to resolution authority. *Id.* at 75.

138 Dodd-Frank Act §§ 201–217, Pub. L. No. 111-203, 124 Stat. 1376, 1442–1520 (2010).

139 *See* Chevron U.S.A., Inc. v. Natural Res. Def. Council, Inc., 467 U.S. 837, 840–45 (1984) (holding that if a "statute is silent or ambiguous with respect to the specific issue," the reviewing court must defer to the agency's interpretation if it is a reasonable interpretation of the statute).

resolution authority tracks OLA closely, so the EU's eventual legislation should not diverge substantially from the United States' if EU officials continue to orient their efforts to the FSB.[140] However, to the extent that the EU goes beyond what the FSB has proposed in its "third step"—the creation of an ERA—material differences between OLA and the ERA might emerge.[141]

The way in which the United States and the EU will execute the FSB's call for "firm-specific" agreements on resolutions is also unclear.[142] The proposed arrangement within the EU is for the EBA (as an ESA) to have representation within the supervisory colleges and power to order national regulators to cooperate or take certain actions.[143] But where financial institutions have substantial operations outside the EU, necessitating the engagement of non-EU supervisors, this deepening of intra-European authority—without similar integration among other relevant jurisdictions—could create a multilayer system of supervisory cooperation that may prove confusing and ineffective. In the short run, memoranda of understanding could help alleviate this matter, but beyond that, as this Article will argue, a treaty-based framework under the FSB's aegis will be essential to streamlining and formalizing these supervisory mechanisms.

Moreover, the United States' and the EU's approaches to recovery and resolution planning also pose a number of potential tensions. Under its broad definition of "covered institutions," the EU will subject thousands of banks and other financial firms to the recovery and resolution-planning requirement, whereas the United States only requires the largest banks to do so.[144] The fact that the EU provides for regulators to write the plans, albeit with institutional input, as compared to the United States' requirement that the firms themselves write the plans is another area ripe for inconsistency.[145] And the impractical Dodd-Frank provision that U.S. resolution plans cannot refer

---

140 *Compare* Dodd-Frank Act §§ 201–217, 124 Stat. at 1422–1520, *with* FSB, CONSULTATIVE DOCUMENT, *supra* note 78.

141 *See* DG Internal Market and Servs., Possible EU Framework, *supra* note 116, at 7.

142 *See* FSB, CONSULTATIVE DOCUMENT, *supra* note 78, at 15 ("Firm-specific agreements are needed among all members of a firm's Crisis Management Group (CMG), which should include the home and all key host jurisdictions.").

143 *See supra* text accompanying notes 132–33.

144 *See* Edward F. Greene & Seth Grosshandler, Cleary Gottlieb Steen & Hamilton LLP, High-Level Comparison of Dodd-Frank and Emerging EU Regulations 4–5 (July 26, 2011) (unpublished PowerPoint outline) (on file with authors) (comparing the power of U.S. regulatory authorities under the Dodd-Frank Act with European resolution authorities); Gabriele Steinhauser, *EU Proposes Tougher Bank Rules*, ABC NEWS (July 20, 2011), http://abcnews.go.com/Business/wireStory?id=14115296 ("The EU will force all 8,200 banks and investment funds based in the bloc to stick to the new capital requirements. By contrast, the U.S., which has promised to implement the Basel III rules, will only make the 20 biggest lenders apply the rules . . . .").

145 Steinhauser, *supra* note 144.

to OLA may well conflict with EU requirements, to the extent that European regulators allow their institutions to contemplate the use of their orderly liquidation regimes in resolution planning.[146]

Recovery and resolution financing could be a critical transatlantic flash point as well. Dodd-Frank eschews any use of *ex ante* (i.e., before resolution) financing, such as bail-in instruments.[147] European leaders, by contrast, appear more open to such mechanisms to finance recoveries as a "last resort"[148]—a more versatile and pragmatic approach. Dodd-Frank's inflexibility on this point may not only strait jacket U.S. regulators in the event of another financial meltdown but may also limit the ability of foreign counterparts to coordinate with the United States in executing recovery measures for a G-SIFI. By comparison, there is less likelihood for divergence between the United States and the EU in resolution financing, given the baseline expectation in both jurisdictions that G-SIFI creditors and shareholders should bear that burden entirely. But in situations where additional financing is necessary, it could make a difference whether the EU aligns with the United States in imposing an *ex post* tax on the banking industry or instead opts for a separate policy.

B. Capital and Liquidity Standards

1. *The Basel Committee and Financial Stability Board Frameworks*

At its Seoul Summit in November 2010, the G-20 endorsed the Basel Committee's proposed Basel III capital and liquidity framework, with leaders pledging to begin implementation by January 1, 2013 and to finish no later than January 1, 2019.[149] The key difference between Basel III and its Basel II is its vastly greater emphasis on equity capital, which is a positive development. Under Basel III, banks must increase their common equity capital ratio (as a percentage of risk-weighted assets) to 4.5% by 2015—more than double the current requirement of 2%.[150] By 2019, banks must also implement a new "capital conservation buffer" of 2.5%, meaning that the common equity requirement will effectively be 7% once Basel III is fully in place.[151] Basel III also raises the Tier 1 and total capital ratios to 8.5% and 10.5%, respec-

146 *Compare supra* text accompanying note 107, *with supra* text accompanying note 132.

147 *See supra* note 103 and accompanying text.

148 *See* DG Internal Market and Servs., Possible EU Framework, *supra* note 116, at 9.

149 G-20, *The G-20 Seoul Summit Leaders' Declaration* ¶ 29 (Nov. 11–12, 2010), *available at* http://online.wsj.com/public/resources/documents/G20COMMUN1110.pdf.

150 Press Release, Basel Comm. on Banking Supervision, Bank for Int'l Settlements, Group of Governors and Heads of Supervision Announces Higher Global Minimum Capital Standards 1–2 (Sept. 12, 2010) [hereinafter Basel III Announcement], *available at* http://www.bis.org/press/p100912.pdf.

151 *Id.*

tively, including a conservation buffer, and it narrows the definition of Tier 1 capital.[152]

At the urging of U.S. officials, Basel III also now tentatively includes a so-called "leverage ratio."[153] This ratio reflects the measure of Tier 1 capital over total assets, and the accord provisionally sets it at 3%.[154] Because the denominator in the three risk-weighted measures depends heavily on banks' internal risk methodologies, the relatively simpler leverage ratio, in which assets are not risk-weighted, will serve as an important backstop in case the risk of certain assets are systematically underestimated, as mortgage-backed securities were in the last crisis. The Basel Committee will assess the level of the leverage ratio for appropriateness between 2013 and 2017, and the level will not become final until 2018.[155] The intention of the Basel Committee is that the above ratios should be mandatory for all G-20 banks, but as the Basel Accords are not treaties but instead nonbinding agreements between central banks and supervisory authorities, member countries must uniformly implement them to achieve the desired legal effect.[156]

The Accords also provide for a discretionary countercyclical capital buffer, ranging from 0% to 2.5% of risk-weighted assets, which national regulators can choose to impose during positive economic conditions.[157] Just as deleveraging is a long, painful process due to the feedback loop between falling asset prices and capital cushions,[158]

---

152 The Tier 1 ratio will increase from 4% of risk-weighted assets to 6% (and thus 8.5% when added to the capital conservation buffer). The total capital ratio will be raised to 8% (and thus 10.5% when added to the capital conservation buffer). *See id.* at Annex 1. Tier 1, which previously consisted of mortgage servicing rights, minority investments in qualifying financial institutions, certain deferred tax assets, and trust preferred securities to count fully alongside common equity, will—over a 10 year transition period—eventually exclude trust preferred securities entirely and only allow the other noncommon equity factors to be recognized as Tier 1 up to 15% of common equity. The total capital ratio allows Tier 1 plus certain reserves and hybrid instruments. *See* CARNELL ET AL., *supra* note 4, at 263 (describing pre-Basel III capital definitions); Memorandum from Mayer Brown, Legal Update: Basel III Capital Ratios and Transition Periods Set, but Key Questions Remain 3 (Sept. 17, 2010), *available at* http://www.mayerbrown.com/publications/article.asp?id=9659&nid=6 (describing changes to capital ratios as a result of Basel III).

153 *See Financial Regulatory Reform Hearing*, *supra* note 41, app. at 74 (statement of Sheila C. Bair, Chairman, Federal Deposit Insurance Corporation).

154 Basel III Announcement, *supra* note 150, at 2.

155 *Id.*

156 *Id.*; *see also* WALTER W. EUBANKS, CONG. RESEARCH SERV., R41467, THE STATUS OF THE BASEL III CAPITAL ADEQUACY ACCORD 1 (2010), *available at* http://assets.opencrs.com/rpts/R41467_20101028.pdf ("The [Basel] accords are not treaties. Member countries may modify the agreement to suit[ ] their financial regulatory structures.").

157 Basel III Announcement, *supra* note 150, at 2 ("The Basel Committee and the FSB are developing a well integrated approach to systemically important financial institutions which could include combinations of capital surcharges, contingent capital and bail-in debt. . . . Governors and Heads of Supervision endorse the aim to strengthen the loss absorbency of non-common Tier 1 and Tier 2 capital instruments.").

158 Falling asset prices deplete a financial institution's capital cushion, which requires the financial institution to shed assets to eliminate liabilities in order to restore the various

leveraging can naturally and dangerously accelerate during times of rising asset prices. The countercyclical capital requirement is a wise implementation that aims to dampen this whipsaw effect between periods of leveraging and deleveraging.

Also at the Seoul Summit, the G-20 approved the FSB's proposal to subject G-SIFIs to an additional capital requirement.[159] This controversial proposal contemplates the use of instruments such as convertible capital or bail-ins, in addition to common equity, to meet the G-SIFI requirement.[160] In June 2011, however, the Basel Committee agreed that the way to meet the requirement was with a "progressive common equity tier 1 capital requirement ranging from 1 percent to 2.5 percent, depending on a bank's systemic importance."[161] To prevent moral hazard among banks at the 2.5% level, the G-20 has also recently approved a Basel proposal that would allow them to impose an additional 1% on such banks if those banks become more systemically important.[162] The G-20 will implement this measure between January 1, 2016 and the end of 2018.[163]

To sum up the capital picture, G-20 banks will eventually be subject to ratios of 7%, 8.5%, and 10.5% for risk-weighted common equity, Tier 1 capital, and total capital as a baseline matter,[164] and potentially up to 9.5%, 12%, and 13% for these same categories in boom times should national regulators impose countercyclical buffers in full.[165] The banks will also face a separate, non-risk-weighted leverage ratio, which, if not finalized at 3% in 2018, should not be markedly different.[166] Since the G-20 has approved the Basel G-SIFI proposal, G-SIFIs face even higher common equity ratios, including a minimum of 8% to 9.5% depending on the size and systemic importance of the institution and potentially higher still if regulators impose the countercyclical or the "moral-hazard" SIFI surcharges.[167]

---

ratios. When a number of institutions are selling off assets in this fashion, downward price pressure on those assets persists, thus perpetuating the feedback loop.

159 Basel III Announcement, *supra* note 150, at 2; *see also* G-20, *The G20 Seoul Summit Leaders' Declaration*, *supra* note 149, at 2 (announcing "measures to better regulate and effectively resolve systemically important financial institutions").

160 Basel III Announcement, *supra* note 150, at 2.

161 Huw Jones, *Central Bankers Agree on Bank Capital Surcharge Plan*, REUTERS (June 25, 2011), http://www.reuters.com/article/2011/06/25/us-basel-banks-idUSTRE75O0Z1201 10625. Basel's Group of Governors and Heads of Supervision reached this agreement; this group is comprised of representatives from member countries and is Basel's highest decision-making body. *Id.*

162 BASEL COMM. ON BANKING SUPERVISION, BANK FOR INT'L SETTLEMENTS, GLOBAL SYSTEMICALLY IMPORTANT BANKS: ASSESSMENT METHODOLOGY AND THE ADDITIONAL LOSS ABSORBENCY REQUIREMENT 16–16 (Nov. 2011), *available at* http://www.bis.org/publ/bcbs207.pdf.

163 Jones, *supra* note 161.

164 *See supra* notes 151–52 and accompanying text.

165 *See supra* note 157 and accompanying text.

166 *See supra* notes 154–73 and accompanying text.

167 *See supra* notes 158–61 and accompanying text.

Perhaps just as important as its capital enhancements, Basel III also addresses liquidity risk for the first time. It will do so through two ratios: a liquidity coverage ratio (LCR) and a net stable funding ratio (NSFR).[168] The LCR, which will be implemented by 2015,[169] requires banks to hold enough liquid assets to be able to survive a short-term, thirty-day, liquidity crunch.[170] As currently designed, government bonds form the bulk of the LCR rule[171]—a structure that could come into question in light of sovereign troubles in Europe. The NSFR, which will come into effect in 2018,[172] focuses on banks' ability to withstand longer-term market stress. In particular, the NSFR aims to establish a minimum amount of stable funds that banks must use to finance various kinds of lending.[173] Stable funds are those that a bank can expect to maintain for at least a year of adverse systemic conditions.[174]

2. *The United States Framework*

As the G-20 continues to endorse Basel III and FSB proposals on capital, the United States will undertake to implement those proposals. So far, however, U.S. regulators have indicated that they will only subject the twenty largest U.S. banks to Basel III, marking a sharp divergence from their EU counterparts, who will apply it to all banks and certain investment firms for a total of over 8000 institutions.[175]

Unlike resolution authority, where Dodd-Frank sets forth a comprehensive statutory mandate that U.S. agencies use[176]—irrespective of how it may diverge from subsequent developments abroad—capital and liquidity standards give regulators more rulemaking flexibility. The most contentious capital-related issue in the United States relates to the implementation of the SIFI surcharge, in regards to which FRB Governor Daniel Tarullo set off a firestorm of bank protests in early

168 MARC SAIDENBERG, FED. RES. BANK N.Y., BASEL III—THE LIQUIDITY RULES AND REGULATIONS 3 (2011), *available at* http://www.chicagofed.org/digital_assets/others/events/2011/bsc/saidenberg_1020am_0506.pdf.

169 *Id.*

170 *Id.* at 5.

171 *See, e.g.*, Zentraler Kreditausschuss, *Position Paper on the Consultative Document of the Basel Committee: "International Framework for Liquidity Risk Measurement, Standards and Monitoring"* 10 (Apr. 16, 2010), *available at* http://www.bis.org/publ/bcbs165/zkral.pdf (defining the characteristics of "high quality liquid assets" as used in the LCR's numerator).

172 SAIDENBERG, *supra* note 168, at 3.

173 *Id.* at 6.

174 *Id.*

175 Steinhauser, *supra* note 144.

176 *See, e.g.*, Memorandum from Cadwalader, Wickersham & Taft LLP, Orderly Liquidation of Financial Companies, Including Executive Compensation Clawback, Under the Dodd-Frank Wall Street Reform and Consumer Protection Act 1 (July 20, 2010), *available at* http://www.cadwalader.com/assets/client_friend/072010_DF2.pdf (describing the OLA provision).

June when he opined that "[t]he enhanced capital requirement implied by this methodology can range between about 20% to more than 100% over the Basel III requirements," which would entail a potential maximum common equity ratio up to 14%.[177] But the FRB's proposed rule of December 2011 requires designated SIFIs to maintain a Tier 1 common risk-based capital ratio greater than 5% under both normal and stressed conditions; beyond that, the FRB intends to make a later proposal to separately set risk-based capital surcharges based on Basel III.[178] Although this rule has yet to be finalized at the time of this writing, the fact that the FRB does not intend to depart materially from Basel III is encouraging from the standpoint of cross-border alignment.

Several other new U.S. requirements in the capital and liquidity area also have potential international implications. One is the Board of Governors of the Federal Reserve System's (the Fed) proposed rule to require U.S. bank-holding companies (BHCs) with $50 billion in assets, as well as U.S.-domiciled BHC subsidiaries of foreign banks that also meet that criterion, to submit annual capital plans to the Fed for review and approval.[179] These plans must address how the institution would continue operations and keep adequate capital levels during adverse economic conditions.[180] The parameters set forth in the plans will carry formidable legal consequences, including restrictions on capital distributions, dividend payments, and stock repurchases.[181]

Another important requirement is the stress-testing framework that the Fed and OCC will impose on BHCs with more than $10 billion in assets.[182] According to those agencies' guidance document, they envision stress-testing as a "forward-looking" and flexible endeavor.[183] In its proposed rule, the Fed intends to conduct annual stress tests under "baseline, adverse, and severely adverse scenarios" and disclose the results publicly.[184] In practice, agencies will likely draw on the successful experience of stress-testing U.S. banks in 2009, which provided much-needed market transparency to the banking

---

177 Craig Torres & Ben Moshinsky, *Fed Is Said to Back Three-Percentage-Point Capital Surcharge for Big Banks*, BLOOMBERG (June 7, 2011), http://www.bloomberg.com/news/2011-06-07/fed-is-said-to-back-3-percentage-point-capital-surcharge-for-largest-banks.html (quoting Federal Reserve Governor Daniel Tarullo).

178 Enhanced Prudential Standards and Early Remediation Requirements for Covered Companies, 77 Fed. Reg. 594, 602 (proposed Jan. 5, 2012) (to be codified at 12 C.F.R. pt. 252) [hereinafter Enhanced Prudential Standards Proposed Rule].

179 Dodd Frank: One Year Later Memo, *supra* note 43, at 9.

180 *Id.*

181 *Id.*

182 *See id.* (outlining the stress-testing framework).

183 Enhanced Prudential Standards Proposed Rule, *supra* note 178, at 608 ("[A] covered company's liquidity stress scenarios must be forward-looking and incorporate a range of potential changes to a covered company's exposures . . . .").

184 *Id.* at 601.

sector and allowed banks to raise substantial private capital for the first time since the crisis.[185] As U.S. agencies continue to hone their procedures in this area, they should consult with the EU and other foreign counterparts to try to harmonize stress-testing processes to the fullest extent possible.

3. *The European Union Framework*

In the EU, the fourth iteration of the Capital Requirements Directive (CRD IV) will implement Basel III.[186] The EC proposed the draft CRD IV in July 2011, and it must still gain approval of EU member states and European Parliament.[187] While the vast majority of CRD IV draws directly from the Basel Committee's framework, there are some noteworthy, albeit relatively minor, differences and elaborations. First, in imposing CRD IV on EU investment firms, the EC went beyond Basel III's focus on "internationally active banks." The EU has justified this departure by arguing that including investment firms is necessary to forestall regulatory arbitrage and to avoid creating an unfair competitive landscape for banks.[188]

Another difference between the frameworks is that prior CRD iterations took the form of directives, which required transposition into national law, while CRD IV consists of both regulations and directives.[189] In contrast to directives, regulations set forth prescriptive rules (which are effective when the regulation is adopted) that EU member states must follow.[190] The CRD IV regulations cover capital,

---

185 *See* U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-10-861, TROUBLED ASSET RELIEF PROGRAM: BANK STRESS TEST OFFERS LESSONS AS REGULATORS TAKE FURTHER ACTIONS TO STRENGTHEN SUPERVISORY OVERSIGHT 19 (2010), *available at* http://www.gao.gov/assets/320/310225.pdf (finding that the U.S. stress tests helped strengthen market confidence in the banking system).

186 Martina Garcia, Deputy Dir., Banking & Fin. Sector Analysis, HM Treasury, Implementing Basel III for a Healthier EU Banking Sector 3 (Apr. 8, 2011) (unpublished PowerPoint presentation), *available at* http://www.ebrd.com/downloads/research/news/Basel_Garcia.pdf. The original CRD was promulgated in 2006, before the financial crisis, *Basel II and the Capital Requirements Directives*, EURACTIV.COM (July 7, 2009), http://www.euractiv.com/financial-services/basel-ii-capital-requirements-directives/article-141423?display=normal, and has been followed by a CRD II and CRD III. The CRD II contained reforms relating to securitizations, large exposures, and capital definitions, requiring implementation between October 2008 and December 2010. The CRD III covered trading books, bonds, and compensation issues, and required implementation between July 2009 and July 2011. Garcia, *supra*, at 3.

187 Brooke Masters & Nikki Tait, *Brussels Unveils Tough Bank Capital Rules*, FIN. TIMES (London) (July 20, 2011), http://www.ft.com/intl/cms/s/0/8a45955a-b2a6-11e0-bc28-00144feabdc0.html#axzz1Uf07Mna2.

188 PricewaterhouseCoopers, *Flash News: CRD IV—Announcement of 20 July 2011: A Revised Basel III?* 1 (Aug. 1, 2011) [hereinafter PWC, CRD IV], http://www.pwc.com/lu/en/risk-management/docs/pwc-risk-management-0811.pdf.

189 *Id.* at 2.

190 *Id.*

liquidity, leverage, and counterparty credit risk issues,[191] virtually ensuring that EU member states will not diverge in these areas. The prior directives covered a number of other areas that the EC deemed to have an integral relation to national administrative law—and were thus better suited to the transposition process—including prudential supervision, corporate governance, and sanctions.[192]

With respect to liquidity-risk management, the CRD IV maintains substantial fidelity to the Basel III framework, with several minor exceptions. Following Commissioner Michel Barnier's repeated skepticism of rating agencies in determining the liquidity risk of assets, the CRD IV assigns the EBA the role of formulating criteria for how to judge assets under the LCR of Basel III.[193] The EC also reserves the right to amend the LCR requirement through the implementation process should unexpected effects occur.[194] As to the NSFR, the EC did not lay out any specific details, noting that it will avail itself of Basel III's lengthy observation period that lasts until 2018 to write a proposal.[195] The EBA will need to consult with peer authorities in other jurisdictions to ensure that these classifications do not diverge internationally.

4. *Key Tensions*

At present, both U.S. and EU officials seem to agree on the key aspects of Basel III, and they are making progress toward those key aspects' implementation.[196] Accordingly, the risk of divergence appears relatively lower in capital and liquidity than in other key areas of regulation. Nevertheless, it will be critical for policymakers to maintain momentum over Basel III's lengthy implementation periods, especially as financial institutions apply substantial pressure on regulators to not impose overly burdensome requirements.

The most obvious area of potential divergence between the United States and the EU concerns the number of institutions that Basel III will cover. The United States proposes to apply it only to the twenty largest institutions active in its jurisdiction, whereas the EU will subject substantially all European-active banks to Basel III requirements.[197] Commissioner Barnier has repeatedly emphasized that the

---

191 *Id.*
192 *Id.*
193 *Id.* at 7–8.
194 *Id.* at 6.
195 *Id.*
196 *See, e.g.*, *EU, US and Japanese Banks Face Basel Checks on Capital Starting in First Quarter*, AUSTRALIAN (Jan. 9, 2012), http://www.theaustralian.com.au/business/world/eu-us-and-japanese-banks-face-basel-checks-on-capital-starting-in-first-quarter/story-e6frg90o-1226239877298.
197 Steinhauser, *supra* note 144.

United States' position will invariably lead to regulatory arbitrage, arguing at one point that "you cannot apply rules to 8,200 banks as you would to 20 banks."[198] Both sides have valid claims: on the one hand, subjecting very small banks to Basel III as the EU does may well impose a needless compliance burden on those banks, but on the other hand, differentiating among institutions as the United States does may cause potential uniformity and fairness problems. But beyond the merits and drawbacks of either position, the most concerning element is the mere fact of disparity between the United States and the EU and the uneven capital regulation landscape that will consequently emerge. As such, it is critical that these jurisdictions reach some form of compromise.

The implications for competition resulting from higher capital standards will be another probable point of cross-border tension. Truly onerous capital standards would likely hinder growth at precisely the moment when most economies need a jumpstart. But as U.S. Treasury Under Secretary Lael Brainard has pointed out, the average Tier 1 ratio among the fifty largest global banks is already 11.3, which is squarely in the range of the Basel III requirement and the proposed SIFI surcharge.[199] Accordingly, meeting those requirements would not entail any additional deleveraging; it would only prevent those institutions from releveraging.

Furthermore, European regulators bought into the Basel II framework—which relied heavily on banks' own internal modeling to calculate regulatory capital—more thoroughly than did U.S. regulators (with the exception of the SEC).[200] Accordingly, it may be somewhat more difficult for the U.S. to move toward the markedly different Basel III regime—most notably, the leverage ratio and higher common equity requirements.[201] As former FDIC Chairman Sheila Bair pointed out:

> European banks continue to effectively set their own capital requirements using internal risk-estimates, unconstrained by any objective hard limits. . . . [R]epresentatives of some major European governments go out of their way to express public misgivings about following through to implement the internationally agreed leverage

---

198 Huw Jones, *EU Banks Face Fines If They Fall Short on Capital*, REUTERS (July 20, 2011), http://www.reuters.com/article/2011/07/20/eu-banks-idUSL6E7IK0KD20110720.

199 *Financial Regulatory Reform Hearing*, *supra* note 41, app. at 92 (statement of Lael Brainard, Under Secretary for International Affairs, U.S. Dep't of the Treasury).

200 ATLANTIC COUNCIL, *supra* note 64, at 19.

201 The EU is clearly taking a more measured pace in implementing the leverage (i.e. non-risk-weighted) ratio that their American counterparts consider so critical. While agreeing to implement the ratio, the EC will initially make it a nonbinding "Pillar 2" measure under the CRD. Beginning in 2013, EU regulators will begin to assess banks' leverage ratios, and if no unexpected side effects emerge, the liquidity ratio will become part of the binding "Pillar 1" by 2018. PWC, CRD IV, *supra* note 188, at 5.

> ratio. . . . [T]he prospects for further banking problems are unsettlingly high.[202]

For their part, major U.S. banks have strenuously argued that the United States should not necessarily commit to a common SIFI surcharge with foreign counterparts. They often note the difficulty of ensuring that other jurisdictions are enforcing the capital standards uniformly, and they point out that the U.S. regulators may have legitimate, one-off reasons for exempting institutions from the surcharge.[203] One such reason may be the recognition that if foreign governments provide an implicit or explicit "too-big-to-fail" backing to their banks, those banks would enjoy an artificially lower cost of capital than U.S. banks, despite being subject to nominally equal capital requirements (assuming, of course, that market participants believe that OLA will work as intended). U.S. banks have also tried to portray their systemic importance as relatively less than that of foreign banks,[204] given that the assets of the five largest U.S. banks represent 56% of the U.S. GDP, whereas the top three banks hold assets worth 337% of the GDP in the UK, 237% in France, and 84% in Germany.[205] In its proposed rule, the FRB seems to have ignored these concerns,[206] which is likely to invite strong feedback from banks during the comment period. Whether the FRB will hold its ground in the final rule remains to be seen.

Along similar lines, banks have expressed great concern over how regulators will implement the LCR and NSFR requirements, arguing that the permissible types of assets are too limited, that the measurements are too crude, and that retail-deposit-heavy banks, while not necessarily safer than counterparts that finance themselves differently,

---

202 *Financial Regulatory Reform Hearing*, *supra* note 41, app. at 80 (statement of Sheila C. Bair, Chairman, Federal Deposit Insurance Corporation).

203 *See, e.g.*, Tom Braithwaite & Patrick Jenkins, *JPMorgan Chief Says Bank Rules "Anti-US"*, FIN. TIMES (London) (Sept. 12, 2011), http://www.ft.com/intl/cms/s/0/905aeb88-dc50-11e0-8654-00144feabdc0.html#axzz1kElKLGc5 (reporting JPMorgan CEO Jamie Dimon's criticism of Basel III as being against U.S. economic interests); Spencer Jakab, *"The Plot" Against America's Biggest Lenders*, FIN. TIMES (London) (Sept. 16, 2011), http://www.ft.com/intl/cms/s/0/4959ca56-dfcf-11e0-b1db-00144feabdc0.html#axzz1bM3vvlR8 (citing U.S. bank concerns); Joe Nocera, *Banking's Moment of Truth*, N.Y. TIMES, June 20, 2011, at A27, *available at* http://www.nytimes.com/2011/06/21/opinion/21nocera.html (reporting that U.S. House Financial Services Committee members expressed concern that proposed U.S. capital regulations would harm the competitiveness of U.S. banks).

204 *See, e.g.*, Jakab, *supra* note 203 (discussing Jamie Dimon's contentions regarding the relative systemic importance of U.S. and European banks).

205 Tyler Durden, *Presenting Total Bank Assets as a Percentage of Host Countries' GDP*, ZERO HEDGE (Feb. 17, 2010, 2:01 PM), http://www.zerohedge.com/article/presenting-total-bank-assets-percentage-host-countries-gdp.

206 *See* SIMPSON THACHER & BARTLETT LLP, REFLECTIONS ON DODD-FRANK: A LOOK BACK AND A LOOK FORWARD 13–15 (2011), *available at* http://www.stblaw.com/pdf/ReflectionsOnDoddFrank.pdf (summarizing FRB's rationale behind supporting the SIFI surcharge).

will receive unfair advantages.[207] But because both standards will be subject to an observation period to see if adverse, unintended consequences result, and because regulators will be allowed to make adjustments as necessary,[208] these fears seem misplaced.

Whereas there may be legitimate debate as to the details regarding LCR and NSFR, the undeniable role of liquidity shortages during the last crisis should leave no doubt that institutions need robust liquidity standards of some form. Having adequate capital, after all, does not inoculate financial institutions from liquidity struggles: a panic among depositors and other short-term creditors can still render a well-capitalized institution insolvent within a very short period of time. One prominent example is Cleveland's National City Bank, formerly one of the top five largest U.S. banks by assets.[209] National City had raised more than enough capital by late 2008 to withstand the crisis, but regulators nonetheless forced it into a Troubled Asset Relief Program (TARP)-facilitated acquisition by PNC due to crippling liquidity problems.[210]

C. Over-the-Counter Derivatives

1. *The Financial Stability Board Proposal*

At the Pittsburgh Summit, the G-20 agreed that "[a]ll 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."[211] Until this summit, OTC derivatives had been virtually unregulated, but the role of derivatives in AIG's monumental collapse revealed the need for more transparency and oversight of those products.[212] The G-20 also stipulated that "OTC derivative contracts should be reported to trade repositories [and that] [n]on-centrally cleared contracts should be subject to

---

207 *See* Jim Brunsden, *Basel Liquidity Rules May Bite Harder than Capital Thresholds*, BLOOMBERG BUSINESSWEEK (June 22, 2011), http://www.businessweek.com/news/2011-06-22/basel-liquidity-rules-may-bite-harder-than-capital-thresholds.html.

208 Press Release, Bank for Int'l Settlements, Basel III Rules Text and Results of the Quantitative Impact Study Issued by the Basel Committee (Dec. 16, 2010), *available at* http://www.bis.org/press/p101216.htm.

209 *National City Bank*, ENCYCLOPEDIA CLEV. HIST., http://ech.case.edu/ech-cgi/article.pl?id=NCB (last updated Oct. 13, 2009).

210 *See* The PNC Fin. Servs. Grp., Inc., Registration Statement (Form S-4), at 35–36, 41 (Nov. 10, 2008) (noting that after a mid-2008 capital infusion, "National City's regulatory capital ratios were among the highest of large U.S. banks," but that the systemic adversity in September increased "liquidity pressures on National City in particular," leading to its acquisition by PNC via TARP).

211 G-20, *Leader's Statement: The Pittsburgh Summit*, *supra* note 13, at 9.

212 *See* Joanna Slater, *Ignorance of Derivatives Spurred AIG Fall*, GLOBE & MAIL (Ont., Can.) (June 30, 2010), http://www.theglobeandmail.com/report-on-business/ignorance-of-derivatives-spurred-aig-fall/article1624574/.

higher capital requirements."[213] It asked the FSB and relevant FSB members to assess the implementation of these mandates on a regular basis and to determine whether the implemented measures actually improve derivative market transparency, lessen systemic risk, and protect against market abuse.[214]

Unlike in the area of resolution authority, where the FSB has taken a more prescriptive role in setting forth standards for the G-20 to consider and approve at subsequent meetings, in the OTC derivatives area, the G-20 jurisdictions are essentially drawing up their own frameworks based on the high-level principles agreed upon at Pittsburgh.[215] This approach is even more different from the treatment of capital and liquidity standards, where G-20 members are, at least so far, implementing the Basel III standards with only minor variations.[216] The FSB effectively has a monitoring role with respect to OTC derivative reform, publishing periodic progress reports and releasing recommendations on practical issues that authorities may face in implementation. In its reports, it also tracks international workstreams on particular OTC derivative standard products, such as capital charges for noncentrally cleared OTC derivatives at the Basel Committee and coordination of central clearing requirements by the International Organization of Securities Commissions.[217]

In its first progress report, in April 2011, the FSB highlighted a number of divergences among major jurisdictions. Conceding that "ultimately there likely will be a range of jurisdictional approaches taken," the FSB has decided to focus on three areas in future assessments: (1) determining the degree to which jurisdictions meet G-20 commitments; (2) highlighting areas that need future coordination; and (3) flagging areas where differences in approaches may lead to regulatory arbitrage or interjurisdictional conflicts.[218] The FSB, clearly concerned that key implementation efforts have stalled, took a sterner tone in its October 2011 report, stating that "any doubt should be removed over the applicability of the G-20 commitments relating to central clearing and reporting to [trade repositories] for standardised derivatives that are moved onto organised platforms."[219] Whether this kind of admonishment, without any tangible penalties,

---

213 G-20, *Leaders' Statement: The Pittsburgh Summit*, *supra* note 13, at 9.

214 *Id.*

215 *Id.*

216 *See supra* note 149 and accompanying text.

217 *See, e.g.*, FIN. STABILITY BD., OTC DERIVATIVES MARKET REFORMS: PROGRESS REPORT ON IMPLEMENTATION 1–4 (Apr. 2011), *available at* http://www.financialstabilityboard.org/publications/r_110415b.pdf.

218 *See id.* at 7.

219 FIN. STABILITY BD., OTC DERIVATIVES MARKET REFORMS: PROGRESS REPORT ON IMPLEMENTATION 14 (Oct. 2011), *available at* http://www.financialstabilityboard.org/publications/r_111011b.pdf.

will be enough to spur jurisdictions that are lagging remains to be seen. At present, though, the role of supranational institutions in coordinating OTC derivatives reforms is plainly inadequate.

2. *The United States Approach*

Congress addressed OTC derivatives in Title VII of Dodd-Frank, assigning the SEC and the CFTC the task of engaging in numerous rulemakings that have proven very difficult to manage so far.[220] Once fully implemented, though, Dodd-Frank will result in a vastly altered landscape for OTC derivatives markets. They will be regulated by mandatory clearing and electronic trading of a broad range of standardized contracts, limitations on the ability of institutions receiving federal assistance to deal in derivatives, stringent regulatory obligations for major derivative-market participants and dealers, and tighter position limits for both listed and unlisted commodity derivatives.[221]

The U.S. Congress erred in opting not to combine the SEC and the CFTC into a single market regulator in Dodd-Frank; years of innovation in financial markets and products have long since blurred the functional distinction between their traditional mandates.[222] Now, the two agencies straddle an uncertain divide in the field of OTC derivatives regulation: Dodd-Frank assigns jurisdiction for "swaps" to the CFTC, "security-based swaps" to the SEC, and so-called "mixed swaps" to the agencies' joint jurisdiction.[223] The agencies still have not decided on a precise definition of these terms, as Dodd-Frank requires.[224] Moreover, the agencies' proposals on a number of rulemakings have resulted in a number of inconsistencies, despite Congress's explicit direction to the agencies to harmonize their approach.[225]

Accordingly, market participants remain in the dark as to whether, how, and to what extent their derivatives businesses will be regulated. At present, the broad definitions of "swaps" and "security-based swaps" cover the types of OTC derivatives that are most widely traded, including credit-default swaps, commodity swaps, total-rate-of-

---

220 *See* Dodd Frank: One Year Later Memo, *supra* note 43, at 26 ("Although Title VII contemplated a general effective date of July 16, 2011, most of the required rulemakings have not been finalized and, in some cases, remain to be proposed.").

221 *See id.*

222 *See* JOHN C. COFFEE, JR. & HILLARY A. SALE, SECURITIES REGULATION 62 (11th ed. 2009) ("This expansion in the scope of futures trading beyond agricultural products and other commodities produced friction [between the CFTC and] the SEC.").

223 Dodd-Frank Act §§ 712(a)(8), (b)(1), (b)(2), 15 U.S.C. §§ 8302(a)(8), (b)(1), (b)(2) (Supp. IV 2010); Dodd Frank: One Year Later Memo, *supra* note 43, at 27.

224 Dodd-Frank Act § 712(d)(1), 15 U.S.C. § 8302(d)(1); Dodd Frank: One Year Later Memo, *supra* note 43, at 27.

225 *See* Dodd-Frank Act §§ 712(a)(1)–(2), 15 U.S.C. §§ 8302(a)(1)–(2); Dodd Frank: One Year Later Memo, *supra* note 43, at 2.

return swaps, and interest-rate swaps, as well as most foreign exchange instruments.[226] While Dodd-Frank formally excludes a number of other derivatives from its coverage,[227] the SEC and the CFTC may be able to regulate those derivates under antievasion authority.[228]

Definitional challenges also inhere in Dodd-Frank's prescription of regulated entities. Most rules promulgated under Dodd-Frank will apply to "swap dealers" (SDs) and "major swap participants" (MSPs).[229] SDs generally cover swap or security-based swap dealers, market-makers, or any other entity that regularly enters into swaps or security-based swaps "with counterparties as an ordinary course of business for its own account."[230] In other words, most of the entities that have central roles in the swap markets will easily qualify as SDs. The concept of the MSP is more disaggregated, containing several independent bases for regulating entities that do not qualify as SDs but nonetheless have a significant presence in swap markets.[231] Under proposed rules, these bases generally subject non-SDs to regulation as MSPs if they maintain substantial positions in certain types of swaps or security-based swaps or create systemically significant counterparty exposure risk due to swap activity.[232] The agencies' proposals for defining SDs and MSPs contain highly detailed, multifactor tests that may prove cumbersome to apply in practice. Of notable contention is how SD and MSP requirements should apply to interaffiliate transactions and to situations in which a single corporate entity includes multiple SDs or MSPs as subsidiaries or branches—a particular concern when that entity has active cross-border operations.[233]

Beyond the question of which entities and products are subject to OTC derivatives regulation, Dodd-Frank also imposes an array of substantive requirements. While most of these requirements are outside the scope of this Article, a handful have potentially significant international implications. The first such requirement is the so-called "pushout" provision, which will prohibit SDs and MSPs from receiving certain kinds of federal assistance, such as FDIC insurance and access to

226 Dodd Frank: One Year Later Memo, *supra* note 43, at 27.

227 These include puts, calls, and other options on securities; indexed debt securities and depository instruments; futures; spot contracts; and non-financial commodity forwards that are theoretically intended for physical settlement. *Id.*

228 The SEC and CFTC have signaled that future rulemakings will clarify exclusions for a wide range of financial products, including certain forward contracts, insurance contracts, and loan participations. *Id.*

229 *See id.* at 2.

230 Dodd-Frank Act § 721(a)(49), Pub. L. No. 111-203, 124 Stat. 1376, 1670 (2010) (amending Commodity Exchange Act § 1a, 7 U.S.C. § 1a (2006)).

231 *Id.* § 721(a)(33), 124 Stat. at 1663 (amending Commodity Exchange Act § 1a).

232 *Id.*

233 Dodd Frank: One Year Later Memo, *supra* note 43, at 29–30.

the FRB discount window.[234] When this provision comes into effect in July 2013, it could create an uneven competitive and regulatory landscape between U.S. and foreign swaps dealers and participants, given the importance that markets may place on the availability of such emergency support measures.[235] However, several limits on the push-out requirement could partially limit its potential to cause cross-border conflict. Notably, the provision does not actually prohibit swaps activity in institutions that are eligible for federal assistance, meaning that the restrictions would only come into play when institutions actually request federal assistance.[236] Furthermore, the provision contains a number of exemptions for insured depository institutions, including situations where institutions use swaps activity only for hedging purposes or where they restrict swaps activity to certain low-risk securities.[237]

The mandatory clearing requirement in Dodd-Frank is another area with cross-border ramifications. Dodd-Frank allows regulators to require certain swaps or security-based swaps to be cleared, provided that they allow a thirty-day notice and comment period and consider a number of statutorily required factors in justifying their decision.[238] It remains to be seen how regulators will actually exercise this authority and whether they will attempt to coordinate with foreign counterparts so that market participants are subject to a consistent set of clearing requirements across jurisdictions. While the mandatory clearing requirement does allow a limited exception for certain nonfinancial end users (generally, nonfinancial entities that use swaps for hedging only), the scope of this exception remains ambiguous and needs clarification in rulemaking.[239]

If a central clearing party does not clear swaps, Dodd-Frank requires that regulators impose margin requirements on SDs and MSPs.[240] Similar to the push-out and mandatory-clearing areas, lack of international harmonization in margin requirements for non-cleared swaps could allow for regulatory arbitrage or create uneven

---

234 Dodd-Frank Act § 716(a), 15 U.S.C. § 8305(a) (Supp. IV 2010).

235 *See* Dodd Frank: One Year Later Memo, *supra* note 43, at 32–33.

236 Dodd-Frank Act § 716(b)(1), 15 U.S.C. § 8305(b)(1).

237 The "push out" provision also will not prevent an insured depository institution (IDI) from having a swaps entity affiliate provided that (1) the IDI is part of a bank or thrift holding company supervised by the FRB and (2) the swaps entity affiliate complies with several other provisions in the Federal Reserve Act (among other requirements that may be deemed appropriate by the FRB, CFTC, or SEC). Dodd-Frank Act § 716(b)(2)(B), 15 U.S.C. § 8305(b)(2)(B); Dodd Frank: One Year Later Memo, *supra* note 43, at 33.

238 Dodd-Frank Act § 723(a)(3), Pub. L. No. 111-203, 124 Stat. 1376, 1675 (2010) (amending Commodity Exchange Act § 2, 7 U.S.C. § 2 (2006)).

239 Dodd Frank: One Year Later Memo, *supra* note 43, at 34.

240 Dodd-Frank Act § 731, 7 U.S.C. § 6s (amending Commodity Exchange Act, 7 U.S.C. §§ 1–26 by inserting new § 4s(e)(2)); *see also* Dodd Frank: One Year Later Memo, *supra* note 43, at 37.

obligations for market participants. Several key areas of contention relate to margin requirements. First, U.S. agencies have signaled that they will set the initial margin much higher than current market conditions would dictate and will allow only a limited set of instruments to be used as collateral, including cash, Treasury securities, and agency securities.[241] While the AIG experience indicates that the collateral limitations are a sound idea,[242] the wisdom of increasing margin levels substantially only makes sense if it is done in concert with peer jurisdictions, given the ease of circumvention in such a fluid area of financial markets. Furthermore, critics have expressed liquidity-related concerns over the proposed requirement that SDs and MSPs segregate initial margin and over the lack of exemptions for interaffiliate transfers.[243] And crucially, U.S. agencies possibly may apply margin requirements to transactions between foreign subsidiaries of U.S. entities registered as SDs or MSPs, even where the U.S. parent has not guaranteed the obligations of the subsidiary.[244]

3. *The European Union Approach*

Because of the lengthy process involved in formulating and finalizing EU regulations, the European reforms in the area of OTC derivatives are still in a relatively inchoate stage. Although the U.S. rulemaking and implementation process regarding OTC derivatives is quite delayed, as discussed above, Dodd-Frank's statutory framework still remains, and it sets forth the general parameters of the U.S. approach, from which regulators have limited ability to depart.[245] By comparison, the EU bodies are not as constrained in how they may define the substantive scope of OTC derivatives regulation, provided they can reach agreement through the Lamfalussy Process, as discussed above.[246]

Pursuant to the G-20 high-level recommendations, the EC issued a draft resolution on OTC derivatives, trade repositories, and central counterparties in September 2010. This resolution, the European Market Infrastructure Regulation (EMIR), aims at centralizing and adding transparency to derivatives trading and clearing.[247] If approved by the full European Parliament, EMIR will implement: (1) a report-

---

241 Dodd Frank: One Year Later Memo, *supra* note 43, at 37.

242 *See* Henry M. Paulson, Jr., On the Brink: Inside the Race to Stop the Collapse of the Global Financial System 192, 205 (2010) (noting that AIG's credit default swaps would be insufficiently collateralized if AIG was downgraded or if the securities it insured lost value).

243 Dodd Frank: One Year Later Memo, *supra* note 43, at 38.

244 *Id.*

245 *See supra* Part II.C.2.

246 *See supra* note 54 and accompanying text.

247 Financial Regulatory Reform in the European Union Memo, *supra* note 58, at 12–13.

ing obligation for all OTC derivatives; (2) a clearing obligation for certain OTC derivatives; (3) rules to mitigate operational and counterparty credit risk for bilaterally cleared OTC derivatives; (4) a common set of rules for central counterparties and trade repositories; and (5) provisions addressing the establishment of interoperability between central counterparties.[248] EMIR will likely also give the European Securities and Markets Authority (ESMA)—one of the newly formed ESAs, as discussed above—responsibility for overseeing the European derivatives markets, including interfacing with national regulators as appropriate. However, the role that ESMA will play within colleges of supervisors is still unclear.

Since the EC proposed EMIR, the European Parliament and European Council of Ministers have been in negotiations over several areas of contention. Before the Parliament can approve and finalize an EC proposal, the Council must first agree with its terms—this is the standard procedure for EU legislation regarding financial services regulation.[249] In May 2011, a European Parliament committee approved EMIR with a number of important amendments.[250] Perhaps most notably, it proposed that clearing obligations apply only to OTC derivatives while reporting obligations apply to all derivatives.[251] While this position accords with the EC proposal and the G-20 recommendation, it conflicts with a majority of member states on the Council of Ministers that wish to extend the clearing requirement to all derivatives.[252] Importantly, the Council President has been receptive to the Commission's suggestion that EMIR mirror certain U.S. provisions, where possible.[253]

Beyond EMIR, the EC's other derivatives reforms principally result from a new short-selling and CDS regulation and expansions of several existing regulations—namely the Market Abuse Directive (MAD) and the Market in Financial Instruments Directive (MiFID)—that had previously excluded derivatives activity.[254] These reforms share a common high-level goal of targeting manipulation and improving transparency in derivatives markets.[255] In the United States, concerns over short-selling and speculation were last prominent in 2008; first in the early- to mid-2008 stretch of extreme volatility and

---

248 *Id.*

249 *See* Consolidated Version of the Treaty on the Functioning of the European Union arts. 294, 322, Mar. 30, 2010, 2010 O.J. (C 83) 47, *available at* http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:C:2010:083:0047:0200:en:PDF.

250 *See* Financial Regulatory Reform in the European Union Memo, *supra* note 58, at 13.

251 *See id.*

252 *See id.* at 14.

253 *See id.*

254 *See id.* at 14–18.

255 *See id.* at 15–16.

spikes in commodities prices,[256] and then later in the year as troubled banks experienced precipitous declines in their share values.[257] In Europe, however, such concerns have reemerged in the context of the sovereign debt crisis.[258]

With respect to MAD, most respondents to the EC's June 2010 consultation agreed that MAD should be expanded to cover manipulative acts in derivative trading, but they differed somewhat on the details, specifically whether regulators should consider the likelihood of price sensitivity in defining inside information for commodity derivatives.[259] The alternative is to consider the expectations of market users, which is the current criterion.[260] MiFID's expansion entails far more detailed rulemaking than does MAD's; with a general aim of improving transparency and oversight of commodity derivatives, the proposed changes to MiFID set forth a complex and comprehensive set of requirements regarding trade reporting.[261] The proposed short-selling and CDS regulation, meanwhile, would impose a number of new disclosure obligations on holders of short positions, with requirements keyed to the nature of the underlying security—whether it is a public company's stock or a sovereign instrument, for instance—and the size of the position as a percentage of share capital.[262] This regulation also proposes certain limitations on naked shorts and would allow EU or member state authorities, in consultation with ESMA, to impose additional requirements in exigent circumstances.[263]

4. *Key Tensions*

The lack of detailed prescription from either the FSB or the Basel Committee has led to a number of areas where OTC derivatives regulation will likely conflict between the United States and the EU. Put simply, regulators have not heeded the G-20's call for the development of a single, international framework.

First, the scope of derivative products and market participants to be covered will probably be significantly different in these two jurisdic-

---

256 Clifford Krauss, *Commodity Prices Tumble*, N.Y. TIMES, Oct. 14, 2008, at B1.

257 Emergency Order Pursuant to Section 12(K)(2) of the Securities and Exchange Act of 1934 Taking Temporary Action to Respond to Market Developments, 73 Fed. Reg. 54875 (Sept. 17, 2008).

258 Press Release, European Parliament, Parliament Seals Ban on Sovereign Debt Speculation and Short Selling Limitations (Nov. 15, 2011), *available at* http://www.europarl.europa.eu/pdfs/news/expert/infopress/20111115IPR31525/20111115IPR31525_en.pdf.

259 *See* Financial Regulatory Reform in the European Union Memo, *supra* note 58, at 15.

260 *See id.*

261 *Id.* at 16–18.

262 *Id.* at 18–19.

263 *See id.* at 19.

tions, pending final SEC and CFTC rulemaking and EMIR legislation. Much turns on how the U.S. agencies ultimately define "swap" and "security-based swap," and how the EU process resolves the question of whether all derivatives, not just OTC derivatives, are subject to its regulatory regime. At present, though, it appears that both regimes will cover the major categories of OTC swaps, including credit default, interest rate, currency, commodity, and equity.[264]

And while Dodd-Frank defines the covered entities as "swap dealers" and "major swap (or security-based swap) participants," there is no comparable categorization in EMIR or MiFID.[265] MiFID addresses swap dealers but EMIR does not, and neither of these frameworks regulates swap participants.[266] If this gap persists, European market participants may refuse to deal with U.S. counterparties if doing so would bring them under the aegis of Dodd-Frank requirements. Given the global, highly integrated nature of derivatives business, substantial disjunctions between the definitional coverage of U.S. and EU regulations would create immense compliance challenges for businesses, as well as opportunities for arbitrage. Along similar lines, both jurisdictions should ensure that their defined exemptions do not discriminate against foreign entities. A prominent example of such discrimination is the U.S. push-out requirement, under which the depository institution exception currently would not apply to uninsured U.S. branches of foreign banks.[267] To the extent possible, agencies should seek to mitigate the effects of this carve-out in the rulemaking process.

An open question in both the United States and EU concerns which products must be cleared. Here, the legal frameworks seem to provide a flexible means for cooperation between the SEC, the CFTC, and ESMA. In the United States, Dodd-Frank stipulates that the SEC and the CFTC must designate the products to be cleared; likewise, EMIR requires clearing of a list of eligible products.[268] Yet even if the agencies consult and agree to a relatively similar list of products, a potential gap with respect to exemption of nonfinancial end users remains. The U.S. laws allow this kind of exemption in certain cases, whereas the proposed EU system would not, so long as an "eligible

264 *See* Greene & Grosshandler, *supra* note 144, at 2; Memorandum from Shearman & Sterling LLP, Proposed US and EU Derivatives Regulations: How they Compare 4 (Nov. 10, 2010), *available at* http://www.shearman.com/files/Publication/84c83ccc-2a2d-4e20-880c-45c31c6059ea/Presentation/PublicationAttachment/a13fc03b-2189-413c-9ce1-0b066c5d27f1/FIA-111010-Proposed-US-and-EU-Derivatives-Regulations.pdf.

265 Greene & Grosshandler, *supra* note 144, at 2.

266 *See id.*

267 *See* Dodd Frank: One Year Later Memo, *supra* note 43, at 33.

268 *See* Greene & Grosshandler, *supra* note 144, at 2.

product" is at issue.[269] The United States also restricts its clearing requirements to standardized swaps, whereas the EU may go further.[270]

The controversial and important issue of margin requirements adds another dimension to the concerns about products that are not subject to central clearing.[271] The EU has already set up a regime for margin requirements, requiring both financial and eligible nonfinancial counterparties to adopt risk management procedures for margining, with daily marks-to-market and provisions for collateral exchange or equivalent holding of capital.[272] In the United States, Dodd-Frank requires swap dealers and major participants to post an initial and variation margin for uncleared swaps, but regulators have not yet promulgated implementing rules.[273] FRB Governor Tarullo has voiced support for establishing a common minimum margin requirement for noncleared derivatives,[274] and this idea should be pursued.

Central counterparty (CCP) oversight is an additional area where close cooperation may be difficult but necessary. Dodd-Frank did not prescribe specific regulations regarding central counterparties, assigning the CFTC and the SEC to issue rules to that end.[275] So far, the U.S. agencies have proposed rules on ownership limits and independent director roles.[276] In the EU, however, EMIR vests member-state regulators with authority to pass rules on CCP issues.[277] Although ESMA will have oversight powers in this respect,[278] the decentralization of CCP rulemaking in the EU may pose hurdles to transatlantic harmonization. Tensions are already emerging in this area. For instance, the United States puts limits on ownership of central counterparties, whereas EU jurisdictions do not.[279] Furthermore, as CCPs grow in number and complicate the process of multilateral netting, jurisdictions may need to cooperate to devise a mechanism for CCPs to facilitate netting.

---

269 *See id.*

270 *See id.* at 1–2.

271 *See id.* at 2–3.

272 *See id.* at 3.

273 Dodd Frank: One Year Later Memo, *supra* note 43, at 37.

274 *See Financial Regulatory Reform Hearing*, *supra* note 41, app. at 197 (statement of Daniel K. Tarullo, Member, Board of Governors of the Federal Reserve System).

275 *See* Dodd Frank: One Year Later Memo, *supra* note 43, at 34.

276 *See* Greene & Grosshandler, *supra* note 144, at 3.

277 *See id.*

278 *See id.*

279 *See* Directorate Gen. for Internal Policies, European Parliament, Derivatives, Central Counterparties and Trade Repositories: Compilation of Briefing Notes, Parl. Eur. Doc. PE 451.488, at 19 (2011), *available at* http://www.europarl.europa.eu/document/activities/cont/201103/20110324ATT16422/20110324ATT16422EN.pdf; Greene & Grosshandler, *supra* note 144, at 3.

III
Beyond "Name-and-Shame": A Tailored Approach to Formalizing Regulatory Cooperation

A. A Treaty-Based Framework for Coordinating Supervision and Resolution of G-SIFIs

The largest financial institutions have only grown larger since the 2008 crisis, creating systemic risks that are extremely difficult to reliably supervise and resolve through a voluntary or consensus-based system of cooperation. In fact, many of those institutions share this view, as evidenced by the fact that a majority of the G-SIFIs that submitted comments to the FSB on its effective resolution regime blueprint, along with a number of national banking associations, criticized the FSB for not pushing for a treaty arrangement or other legally binding measures between jurisdictions.[280] The FSB rejected these suggestions, however, concluding that the "[d]evelopment of more binding mechanisms will not be feasible without first putting in place the convergent regimes and incentives to cooperation" that its suggested reforms will deliver.[281]

This response misapprehends at least two critical dynamics. First, the political window for agreeing to and implementing legally binding frameworks in this area is likely limited, and that window may well close by the time "convergent regimes" and "incentives to cooperation" are instituted. Second, institutions and investors greatly desire some degree of predictability as to how G-SIFI failures will be handled, and voluntary arrangements simply fall short on that score.

In sum, major jurisdictions must take a more uniform approach to supervision and resolution than they currently do. Although the FSB's guidance on key elements of effective resolution regimes is an important starting point, it will likely be insufficient to ensure the seamless legal coordination that will be necessary in future crises. Furthermore, the current form of the supervisory college system is too weak to have any real impact in enhancing coordination between regulators on a routine basis, much less in a crisis situation. Indeed, to the extent that the Basel Committee's guidance shapes the functioning of supervisory colleges in practice, the lack of any formal requirements or institutional mechanisms makes it unlikely that they will serve a meaningful role in supervising G-SIFIs. If colleges of supervisors are simply in a position to encourage national authorities to share

280 For a list of the G-SIFIs that commented, see *Comments Received on the FSB Consultative Document on Effective Resolutions of SIFIs*, *supra* note 24. The associations calling for legally binding measures include the Institute of International Finance, the European Banking Federation, the British Bankers' Association, the French Banking Federation, the Italian Banking Association, and the Hong Kong Association of Banks. *Id.*

281 FSB, *Overview of Responses*, *supra* note 80, at 3–4.

information, they will have a difficult time maintaining a comprehensive view of the particular institutions at issue.[282]

Instead of relying solely on supervisory colleges and national supervisory agencies, major jurisdictions should create a treaty-based framework to coordinate the efforts of G-SIFI supervisors and resolution authorities. To clarify, we are not advocating the creation of stand-alone international administrative bodies to conduct supervision, as Professor Eric Pan envisions,[283] nor do we support the creation of similar bodies to execute resolutions, as the proposed ERA would do.[284] Rather, we suggest that a treaty create an institutional forum, perhaps at the FSB, where national regulatory authorities can actively cooperate on G-SIFI oversight. To facilitate and formalize those efforts, the treaty would create procedures for the creation and regular revision of detailed, institution-specific supervision and resolution plans that would be negotiated by—and have the force of law between—relevant national authorities for each G-SIFI.[285]

These binding agreements should go beyond the crisis management groups and resolution agreements that the FSB envisions and encompass supervisory colleges as well. If employed correctly, supervisory colleges can help detect and remedy solvency-threatening issues before they become serious. Conversely, the lack of effective cross-border prudential supervision that supervisory colleges could have provided during the U.S. financial crisis, as Pan has observed, rendered the international financial architecture "unable to prevent financial instability in the US from becoming a global financial crisis."[286] Thus, as important as it is to coordinate recovery and reso-

---

282 The 2008 Fortis Bank insolvency illustrates this problem. To deal with the insolvency, the Belgian, Luxembourgian, and Dutch supervisors agreed to a plan to purchase 49% of Fortis's common equity, yet several days after their agreement, the Dutch government unilaterally seized the Dutch subsidiary, abandoning the cooperative effort and breaking up the institution. Alford, *supra* note 27, at 65–66; *see also* Press Release, Fortis, Governments of Belgium, Luxembourg and the Netherlands Invest EUR 11.2 Billion in Fortis (Sept. 29, 2008), *available at* http://www.bnpparibas-ip.co.id/file/ulasan_pers/080929-UK_PR_Fortis.pdf.

283 Eric J. Pan, *Challenge of International Cooperation and Institutional Design in Financial Supervision: Beyond Transgovernmental Networks*, 11 CHI. J. INT'L L. 243, 246–47 (2010).

284 *See supra* note 119 and accompanying text.

285 The jurisdictions to include in the cooperative framework should be determined from several vantage points. On one hand, consideration should obviously be given to which jurisdictions pose firm-wide significance to the G-SIFI; that is, those whose unilateral action would render a resolution or recovery plan ineffective. But from a less appreciated angle, policymakers should also consider a way to include input from emerging jurisdictions where a G-SIFI dominates the national banking sector (even with that activity comprising a small percentage of the G-SIFI's global business) given that those jurisdictions would almost certainly ring-fence assets if that G-SIFI were to fail. This is especially true where the collective effect of ring-fencing by such jurisdictions could pose a material obstacle to a G-SIFI's recovery or resolution.

286 Pan, *supra* note 283, at 246.

lution measures for G-SIFIs, focusing solely on those policies while neglecting divergences in supervisory practices will increase the likelihood that regulators will need to take last-option measures.

In particular, the supervisory aspect of institution-specific agreements should provide for regular interaction, confidentiality protections, and coordinated analysis between national authorities responsible for major subsidiaries. Ideally, it would also allow for collaborative participation in examinations by national supervisors, as suggested by FRB Governor Tarullo, provided that sufficient information sharing guidelines and protections could be put in place.[287] Such transparency and engagement would provide a powerful disincentive to lax supervision. If, for instance, host jurisdictions believed that the home jurisdiction was doing ineffective work in a consolidated supervisory role, they could impose higher capital requirements on the business units they supervised. As the AIG meltdown demonstrated, deficiencies or undue risks in one small unit of a global financial institution, if undetected and unaddressed, can metastasize quickly and threaten the viability of an entire firm.[288]

These agreements also offer U.S. and foreign regulators the opportunity to minimize conflicts in recapitalization and other recovery measures for each institution. As noted earlier, there is an ongoing debate among major jurisdictions as to whether recapitalization instruments should be implemented, and if so, whether they should be statutory or contractual in nature.[289] As Paul Tucker of the Bank of England has pointed out, these instruments can take different forms—featuring "high" or "low" triggers—and can be used in a variety of combinations.[290] If harmonization is not possible on this matter, regulators from home and key host jurisdictions should at least

---

287 *Financial Regulatory Reform Hearing*, *supra* note 41, app. at 201 (statement of Daniel K. Tarullo, Member, Board of Governors of the Federal Reserve System).

288 At the time of its collapse in September 2008, the core insurance operations of AIG, then the world's largest insurance company, were well regulated and solvent; a small unit based out of London, AIG Financial Products, had gotten the parent company in trouble by writing massive CDS contracts on mortgage backed securities. Due to collateral calls on those CDS and AIG's imminent downgrade as the credit crisis intensified after Lehman Brothers' failure, the company faced a massive liquidity shortage that would have quickly bankrupted the company without government intervention. PAULSON, *supra* note 242, at 194–221 (2010).

289 Generally, contingent capital bonds convert to equity when they cross a preset threshold of firm-specific or industry-wide losses. Bail-in capital, by contrast, would convert to equity upon a regulatory determination (as guided by statute). *See* Ramya Jaidev, *CoCos Offer Banks More Hope than Bail-In: CentralBanking.com Panel*, CENTRALBANKING.COM (Dec. 7, 2010), http://www.centralbanking.com/central-banking/news/1930621/cocos-offer-banks-hope-bail-centralbankingcom-panel.

290 *See* Paul Tucker, Deputy Governor, Fin. Stability, Discussion of Lord Turner's Lecture, "Reforming Finance: Are We Being Radical Enough?", Remarks at Clare Distinguished Lecture in Economics, Cambridge (Feb. 18, 2011), *in* BANK OF ENGLAND, http://www.bankofengland.co.uk/publications/speeches/2011/speech477.pdf.

have a global view of whether, when, and how recapitalization measures will likely be used or triggered within a given institution.

But even with the most carefully crafted institution-specific agreements, national authorities still may diverge in executing them, especially as a G-SIFI nears insolvency and recovery and resolution matters are on the table. Accordingly, the treaty framework should also establish a dispute-resolution mechanism—again, likely based at the FSB—with some form of meaningful penalty, so as to ensure that regulators are not gridlocked in the midst of a crisis. How to best structure this mechanism is a difficult and sensitive question, as the decision maker would likely need to be able to resolve a dispute within an extremely short period of time—a matter of days or even hours. Despite the institutional design difficulties, a dispute-resolution mechanism is a necessary feature and should be the subject of further debate and inquiry.[291]

B. A Model Law for Recognition of Resolution Authority Action

Further, policymakers should consider going beyond the FSB's *Key Attributes of Effective Resolution Regimes for Financial Institutions*[292] and craft a model law for the international recognition of resolution authority action, drawing on the UNCITRAL work on cross-border corporate insolvencies.[293] The IMF General Counsel proposed such an approach in a 2010 memorandum, noting that while certain aspects of the corporate model may not apply, others would be very relevant.[294] These include the concepts of center of main interest, powers for different insolvency representatives to collaborate, nondiscrimination against foreign creditors, specific cooperation protocols for individual cases that specify leadership roles and modalities of interaction,

---

291 The established international dispute resolution bodies, such as those of the WTO, do not operate under critical time constraints, thus limiting their relevance as a model for the FSB-based mechanism proposed here. In January 2012, however, a new arbitral forum called the Panel of Recognized International Market Experts in Finance (PRIME) was formed in The Hague as a place to resolve complex and time-sensitive financial disputes. Its rules are based primarily on the UNCITRAL Arbitral Rules, but they allow parties to agree to short timelines and to request certain urgent provisional measures (such as the appointment of an "Emergency Arbitrator," selected from a pre-approved list of experts). Although PRIME's envisioned "fast track" process, which is projected to take a minimum of thirty days, would not be as short as a G-SIFI resolution would require, it could still develop into a rough template for the kind of expedited dispute resolution process suggested above. *See PRIME Finance: A New Dispute Resolution Option for the Financial Sector*, HERBERT SMITH (Feb. 14, 2012), http://www.herbertsmith.com/NR/rdonlyres/B5284DAC-9923-4F98-9688-9A78F6BA8115/0/PRIMEFinance.html; *About P.R.I.M.E. Finance Arbitration Rules*, P.R.I.M.E. FIN., http://www.primefinancedisputes.org/index.php/arbitration (last visited Apr. 16, 2012).

292 FSB, KEY ATTRIBUTES, *supra* note 73.

293 IMF, RESOLUTION OF CROSS-BORDER BANKS, *supra* note 23, at 16–17.

294 *Id.* at 15–16.

and the ability to grant relief to foreign representatives on a discretionary basis (with limitations).[295]

While the U.S. and the EU resolution models will presumably converge with the FSB proposal in broad terms, the risk remains that residual statutory gaps could hinder cooperation in a time of crisis. The above comparison of the United States' OLA with the EU's developing framework suggests that at least some material differences will persist.[296]

As numerous banks have argued in comments to the FSB, it would be most effective for home resolution authorities—if possible—to lead the resolution process on a global, group-wide basis.[297] Even if this kind of resolution arrangement were stipulated to in institution-specific cooperation agreements, a UNCITRAL model law system would nonetheless be of great value in addressing any national statutory barriers that may otherwise emerge in the execution of group-wide resolutions.

Specifically, under a UNCITRAL-like system for financial institution insolvency, the home resolution authority could petition the resolution authorities in host jurisdictions to be recognized as the foreign main proceeding, provided it could demonstrate that it was the "center of main interest" for the insolvent institution.[298] If this status were established, the home resolution authority could ensure nondiscrimination among the institution's creditors and gain legal authority to collaborate and coordinate with foreign insolvency representatives, among other powers. In particular, the UNCITRAL-like system would guarantee that home resolution authorities could transfer assets and liabilities, wherever located in a G-SIFI's worldwide operations, to a bridge-holding company without violating local law in host jurisdictions.

Because of the time pressures involved with financial resolutions, the "center of main interest" determination process must be administrative rather than judicial (as distinguished from the UNCITRAL process for cross-border corporate insolvencies, where a judicial determination is required). Along similar lines, should a prospective FSB-based dispute-resolution mechanism issue a ruling in the midst of a crisis—for instance, to compel a recalcitrant home jurisdiction to commence the cooperative recovery or resolution of a G-SIFI, as stipulated in the institution-specific agreement—it is essential that national administrative authorities in all relevant jurisdictions in which the G-

---

295 *Id.* at 17.

296 *See supra* notes 138–41 and accompanying text.

297 *See* FSB, CONSULTATIVE DOCUMENT, *supra* note 78, at 13–16.

298 IMF, RESOLUTION OF CROSS-BORDER BANKS, *supra* note 23, at 17.

SIFI does business already have full legal power to execute those measures in a coordinated and seamless manner.[299]

C. A Validation Body for Capital and Liquidity Methodologies

As matters currently stand, major jurisdictions have signaled their intention to implement Basel III—or some form thereof—into national law and regulation.[300] But given the political and industry pressures against Basel III, as discussed above, complete and consistent implementation of the new standards should not be taken for granted. The most likely scenario of divergence would unfold as a "race to the bottom," with one jurisdiction believing that the other had cut corners in implementing an aspect of Basel III and, in defense of its home institutions' competitive position, lessening its own standards in response.[301]

Accordingly, the viability of the new capital and liquidity measures will depend on rigorous monitoring, detecting, and remedying of noncompliance with the agreed-to standards. This is a difficult task for several reasons. Beginning with Basel II, as noted above, capital standards have begun to rely more heavily on banks' internal modeling of market and credit risk, which frequently lack transparency and can differ substantially between institutions and jurisdictions.[302] Moreover, the opacity of banks' balance sheets, driven in part by the proliferation of complex financial instruments in recent years, compounds the regulatory challenge in monitoring both capital and liquidity.[303]

The institution-specific cooperation agreements suggested above, if they enabled home and host supervisors to engage in collaborative examinations of individual G-SIFIs, could be of considerable benefit in facilitating consistency and transparency within each institution. But an additional mechanism is necessary to ensure uniform implementation of the new standards among different G-SIFIs. As bank analysts have recently noted, for instance, there are currently substan-

---

299 As former WTO Legal Affairs Director Bruce Wilson has found in his study of WTO-member-state compliance with adverse dispute settlement body findings, the speed with which states comply depends greatly on whether they can effect changes through administrative rather than legislative action. Wilson, *supra* note 25, at 399.

300 *See supra* note 149 and accompanying text.

301 *See* Stefan Walter, Sec'y Gen., Basel Comm. on Banking Supervision, Address to the Financial Stability Institute at the Conference on Basel III: Basel III: Stronger Banks and a More Resilient Financial System 5 (Apr. 6, 2011), *available at* http://www.bis.org/speeches/sp110406.pdf ("[T]he failure to implement Basel III in a globally consistent way will again lead to a competitive race to the bottom and increase the risk of another crisis down the road.").

302 *Financial Regulatory Reform Hearing*, *supra* note 41, app. at 199 (statement of Daniel K. Tarullo, Member, Board of Governors of the Federal Reserve System).

303 *Id.*

tial disparities in asset risk weighting between U.S. banks and foreign counterparts that are not explained by differences in accounting standards or institutional risk profiles.[304] Furthermore, bank supervisors have been unable to discern the precise reasons for this gap due to the complexity and opacity of banks' balance sheets and risk models.[305]

If this situation persists, it could well undermine institutional and governmental confidence in the Basel III process and prevent full and consistent implementation of its standards. With this possibility in mind, FRB Governor Tarullo has wisely proposed that Basel's Standards Implementation Group (SIG) institute strong and transparent frameworks for effective cross-country monitoring.[306] Tarullo argues that "this process should go beyond traditional stocktaking exercises to include a careful assessment of the methodologies" that national regulators use to assess banks.[307] In his view, the SIG must develop a mechanism to validate the "actual risk-weighted assets calculated by individual banks."[308]

Major jurisdictions should give strong consideration to creating this kind of validation body in some form, whether it be located within Basel's SIG or instituted as part of the treaty-based framework we suggest above. In either case, the validation body should be empowered to review and rate the capital and liquidity position of each G-SIFI's subsidiaries and branches, and it should be allowed to publicly highlight noncooperative jurisdictions and institutions upon findings of capital and liquidity deficiencies that national authorities do not remedy.[309]

D. A Mutual Recognition Approach for Over-the-Counter Derivatives

Unlike supervision and resolution, which demand close international coordination to address potentially time-sensitive deteriorations of G-SIFIs and to counteract unilateral impulses in such situations, a formal, treaty-based structure is not necessary for effective cross-border regulation of OTC derivatives. Instead, the initial goal should be to achieve a system of substantive convergence between key jurisdictions, with an eye to creating the requisite conditions for a multilateral

---

304 *Id.*

305 *Id.*

306 *Id.* at 200–01.

307 *Id.* at 201.

308 *Id.*

309 To ensure the fairness of this process, policymakers could consider establishing a confidential appeal procedure within the FSB to allow national regulators to challenge capital or liquidity findings they consider erroneous.

mutual recognition regime with oversight and administration through the FSB.

Under mutual recognition agreements, one state agrees to recognize that another state's regulation is a suitable substitute for its own.[310] Although the EU has long used mutual recognition in its internal market policies, the United States has used it far more sparingly—the only agreement in recent years was between the SEC and its Australian counterpart on the regulation of broker-dealers and exchanges.[311] As Professor Pierre-Hugues Verdier has argued, there are certainly drawbacks to mutual recognition, most notably enforcement and verification problems, given that states are effectively reliant on each other to maintain the regulatory standards set forth in the agreement.[312] But for OTC derivatives, the case for mutual recognition seems to outweigh those potential risks, which can be mitigated in several ways.

Most significantly, the fact that the FSB and national authorities are effectively creating a regulatory regime from whole cloth is a point in favor of mutual recognition. OTC derivatives regulation marks a vastly different challenge from resolution authority or capital and liquidity regulations, where similar legal frameworks were already in place before the regulatory reform process began.[313] Compounding the novelty of OTC derivatives regulation is the fact that it is so incredibly complex and diverse, covering a range of substantially different products and markets. Taken together, these factors indicate that achieving harmonization in this field of regulation would take years, if it were even possible.

Moreover, mutual recognition helps to retain a modicum of flexibility in the development of financial regulation.[314] Flexibility is an attractive feature in such a new field given the relatively high probability that unforeseen negative effects will arise when implementing so many rules at once. It also better suits the dynamic and evolving nature of the derivatives business because establishing a rigid framework could hamper the development of products that would enhance the ability of governments, businesses, and investors to mitigate risk.[315]

---

310 *See* Pierre-Hugues Verdier, *Mutual Recognition in International Finance*, 52 HARV. INT'L L.J. 55, 57 (2011).

311 *See id.* at 57–58.

312 *See id.* at 59.

313 While it is true that OLA and the FSB's model resolution regime are unique in many ways, they nonetheless draw strong inspiration from the FDIC's well-established process of resolving depository institutions and thus differ from the relatively more *sui generis* nature of proposed OTC derivatives regulation.

314 *See* Verdier, *supra* note 310, at 65.

315 *See* Roberta Romano, *Against Financial Regulation Harmonization: A Comment*, *in* 3 LAW AND ECONOMICS OF GLOBAL FINANCIAL INSTITUTIONS 27, 43–44 (Peter Nobel et al. eds.,

In the short run, the financial community can address the enforcement problem of mutual recognition by including only advanced jurisdictions in the arrangement, while progressively seeking to include emerging economies as their regulatory systems mature or as their derivatives activity become systemically important. A mutual recognition agreement between the United States and the EU, for instance, would be a logical starting point. Such an agreement should, at a minimum, address licensing requirements for swaps dealers and participants, margin requirements for specific instruments, designation of central counterparties, trade reporting requirements, and information sharing protocols. Additionally, a partial remedy to the verification problem is to coordinate the mutual recognition regime through the FSB and establish an independent audit mechanism there, similar to the proposal for capital and liquidity, as discussed above.[316]

Conclusion

Thus far, key jurisdictions have tried to coordinate financial regulatory reform efforts called for by the G-20 through soft-law principles and guidance to be enacted nationally. This approach has already yielded substantial, troubling divergences in critical areas of regulation, as the foregoing discussion has demonstrated. Notwithstanding the numerous rulemaking deadlines and the breakneck pace of national reform processes, policymakers must pause to reconsider the global strategic picture.

This Article does not purport to cover all areas of financial regulation with important international implications. Rather, the underlying objective of this Article has been to illustrate that substantial divergences in critical regulatory areas have already emerged, that policymakers need not take a "one-size-fits-all" viewpoint on legal arrangements for coordinating such regulation, and that certain areas—G-SIFI supervision and resolution in particular—call for more formal legal arrangements than others.

Our treaty-based proposals do not misapprehend, as some might claim, the incentives for countries to defect from international agreements in the midst of a crisis. Indeed, a principal reason to create formal mechanisms for supervisory collaboration and independent validation of standards implemention is to minimize the likelihood that recovery and resolution will be needed in the first place. But

2010) (contending that financial innovation in derivatives, enabled by the lack of rigid regulatory harmonization, has created "substantial social value by lowering transaction costs and permitting efficient risk-sharing").

316 *See id.* at 59 (noting that states delegate monitoring to collective institutions to mitigate verification problem).

even where crises do emerge, having committed to a treaty framework for resolutions will enable states to safeguard against their own tendencies to grant forbearance to home institutions, obtain a source of legitimacy for taking corrective action if they are host to a troubled institution (and the home jurisdiction is uncooperative), and provide a central process to facilitate and demand cooperative measures during difficult, time-sensitive situations.

Even though these measures, like any treaty arrangement, cannot provide an absolute guarantee of state compliance, we must recall that the current system of voluntary commitments provides effectively no deterrence to noncooperation in times of crisis. As the events of 2008 demonstrated, that system yielded an unpredictable, disorganized, and value-destroying response to G-SIFI failure. At the very least, instituting a form of our treaty proposal will raise the legal and reputational costs of unilateral action, thus creating a more powerful inducement for states to cooperate as compared to the status quo. By extension, our proposal will provide markets with greater certainty as to how regulators will handle the resolution and recovery of G-SIFIs.

At a fundamental level, policymakers must not lose sight of the glaring inadequacy of piecemeal national regulation in overseeing the complex global activities of G-SIFIs. The discordant and often disastrous handling of G-SIFI failures in the last crisis should raise serious concerns about the current, domestically oriented approach to reform, notwithstanding G-20 efforts. This is not to discount the importance of sovereignty and national control over financial companies, which are very important to many national economies. Rather, as this Article has argued, the value of sovereignty in global financial regulation is no longer absolute and must be weighted—on a strategic, tailored basis—against countervailing costs of unilateral action.