Regulating a Global Market: The Extraterritorial Challenge of Dodd-Frank’s Margin Requirements for Uncleared OTC Derivatives & A Mutual Recognition Solution

The OTC derivatives market is fluid, global and characterized by cross-border transactions. Title VII of the Dodd-Frank Act aims to reduce systemic risk inherent in this market, which exacerbated the 2008 financial crisis, by imposing various requirements upon market participants, including margin requirements on uncleared OTC derivatives. Margin requirements protect against potential losses from counterparty default by requiring parties to exchange payments as collateral for their obligations under a derivative contract. Yet because much of the OTC market consists of cross-border transactions, which implicate multiple regulatory regimes, inadequate coordination with other jurisdictions could lead to regulatory arbitrage, gaps or conflicts and undermine the goals of this regulatory requirement. Moreover, the extraterritoriality provisions of Title VII, as analyzed in light of recent case law, indicate that the jurisdictional scope of Dodd-Frank’s margin requirements may be ambiguous and uneven. To avoid the dangers of inconsistent regulatory standards, minimize legal uncertainty and reduce systemic risk in the OTC derivatives market, foreign and domestic regulators should strive for application of comparable domestic margin regimes to cross-border uncleared OTC derivatives contracts in the context of mutual recognition. Mutual recognition is a method of international regulatory coordination that entails an agreement among two or more countries to recognize the adequacy of each other’s regulation as an equivalent substitute for their own.

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INTRODUCTION

By early 1998, Brooksley Born, then Chairwoman of the Commodities Futures Trading Commission (CFTC), foresaw a serious risk hidden in what was then an unregulated1 “dark market”: opaque, complex financial instruments able to trigger sudden and significant2 financial losses.3 Born believed that a lack of transparency, oversight and protections against fraud and manipulation in the over-the-counter (OTC or off-exchange) derivatives market posed a threat to financial stability.4 Born pushed to have the CFTC release a concept paper that would expose the opacity, interconnectedness and size of the OTC derivatives market in order to assess the need for its regulation.5 The CFTC had “no preconceived result in mind,” 6 yet Born faced forceful opposition from other executive branch agencies7


2. The first instance of a major derivatives-related loss to a public institution was in 1994 when Orange County, California lost $1.5 billion from interest rate swaps. Brett D. Fromson, More Big Losses Expected from Derivatives Trading, WASH. POST, Dec. 3, 1994, at H7 (“The investment approach was to buy about $20 billion of bets that interest rates would keep declining, wagers that were financed with $7.5 billion of taxpayer money and another $12 billion of money borrowed from big Wall Street firms. Interest rates, however, rose and the bets turned out to be wrong.”).


4. Id.

5. Over-the-Counter Derivatives, 63 Fed. Reg. 26,114 (May 12, 1998). The concept paper solicited public comment in order to aid the Commission in an evaluation of its existing regulatory structure governing OTC derivatives. The CFTC sought to address the fact that OTC derivatives can “present significant risks if misused or misunderstood by market participants.” Id. at 26,115. The concept paper documented the boom in OTC derivatives after 1993 and cited studies showing hundreds of significant losses in financial derivative transactions, explaining that recent high-profile financial losses have drawn attention to “potential problems and abuses in the OTC derivatives market.” Id.

6. Id. at 26,114, 26,116.

7. Federal Reserve Board Chairman Alan Greenspan, Treasury Secretary Robert E. Rubin and Securities and Exchange Commission Chairman Arthur Levitt were united in opposition to the concept release. Aaron Lucchetti & Michael Schroeder, CFTC Reviews
as well as from Congress, fueled by Wall Street lobbying. Lawrence Summers, then Deputy Secretary of the Treasury, even called Born during the standoff to say, "I have 13 bankers in my office, and they say if you go forward with this you will cause the worst financial crisis since World War II."

The release of Born's concept paper by the CFTC in May of 1998 did not spawn a crisis. Instead, the warning fell on deaf ears, such that Born's initiative to regulate OTC derivatives was effectively dead on arrival. Yet soon after the publication of the CFTC concept paper, the first manifestation of Born's prediction appeared. September 1998 saw the near-collapse of the prominent hedge fund Long-Term Capital Management (LTCM), the failure of which was a direct result of losses from its massive positions in OTC derivatives. Yet instead of adding market protections after this scare,

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10. See Roig-Franzia, supra note 3; Michael Schroeder, CFTC Chairwoman Won't Halt Study of OTC Derivatives Rules, WALL ST. J., June 11, 1998, at C1 (noting that Greenspan, Rubin and Levitt asked Congress to maintain the current regulatory regime and recommended legislation to stop the CFTC's study); CFTC Extends Period For Public Comment On OTC Derivatives, WALL ST. J., Sept. 14, 1998, at C22.


12. LTCM held over $1 trillion in derivatives contracts. Matthew Leising & Roger Runningen, Brooksley Born 'Vindicated' as Swap Rules Take Shape (Update1), BLOOMBERG
Congress passed the Commodity Futures Modernization Act of 2000 (CFMA), further insulating the OTC derivatives market by exempting from regulation OTC derivatives trading between qualified market participants. 13 Thereafter, the OTC derivatives market grew by an order of magnitude from $88.2 trillion in December 1999 to $683.7 trillion in June 2008, all without U.S. government oversight. 14

OTC derivatives are private contracts—not traded on regulated exchanges—that are typically bilaterally negotiated with custom-tailored terms. 15 Like exchange-traded derivatives, the value of an OTC derivative depends on the value of an underlying financial or economic interest. 16 However, the greater complexity and opacity of OTC derivatives inhibits price discovery and magnifies potential risks. 17 And while exchange-traded derivatives have historically been subject to self-regulatory requirements—including clearing, minimum capital, and margin requirements—the OTC derivatives market long eluded such safeguards. Beginning in the late 1980s, the OTC derivatives market grew under the auspices of a series of deregulatory reforms 18 that culminated in the passage of the CFMA, adding leverage and systemic risk to financial markets. 19


17. See, e.g., Tanya Styblo Beder, Stop the Derivatives Witch Hunt, CORP. CASHFLOW MAG., Oct. 1, 1994, at 79 ("Riskier derivatives often include very high degrees of leverage, exotic cash-flow patterns or are based on obscure markets. To value such derivatives, firms often depend on sophisticated to mathematical models, creating the risk that the model's value may be different than that ultimately obtained in the market.").

18. See supra notes 1–2.

One decade after Brooksley Born warned of the need for OTC derivatives regulation, her great fear became manifest in the worst American financial crisis since the Great Depression. Many believe that the OTC derivatives market, fueled by the CFMA, exacerbated the 2008 financial crisis. Professor Lynn Stout suggested that the OTC derivatives market magnified the size and scope of the 2008 financial crisis, and noted the contrast that although the value of all U.S. subprime mortgages outstanding was $1.3 trillion in 2007, the crisis "erased $11 trillion in household wealth and required $3.3 trillion in government intervention." As CFTC Chairman Gary Gensler explained, "[t]hough there were many causes to the crisis in 2008, it is evident that [OTC] swaps . . . played a central role." 

In response to the 2008 financial crisis, Congress passed and President Barack Obama signed the Dodd-Frank Wall Street Reform

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20. Former CFTC Commissioner John Tull concluded that, "[h]ad lawmakers] listened to [Born], I think [the 2008] catastrophe could have been averted." Leising & Runningen, supra note 12.

21. FIN. CRISIS INQUIRY COMM’N, THE FINANCIAL CRISIS INQUIRY REPORT xxiv, xv–xxviii (2011) [hereinafter FINANCIAL CRISIS INQUIRY REPORT] ("We conclude over-the-counter derivatives contributed significantly to this crisis. The enactment of legislation in 2000 to ban the regulation by both the federal and state governments of over-the-counter (OTC) derivatives was a key turning point in the march toward the financial crisis."). The International Monetary Fund (IMF) concurred that growth in certain OTC derivative markets was a "key factor[] contributing to the [2008] crisis." IMF COUNTRY REP. No. 10/247, UNITED STATES: FINANCIAL SYSTEM STABILITY ASSESSMENT, 29–30 (2010) ("The oversight of these markets, the prudential regulation of firms trading in them, and the market conduct rules governing market participants fell behind, resulting in important regulatory gaps."). See also Lynn Stout, Derivatives and the Legal Origin of the 2008 Credit Crisis, 1 HARV. BUS. L. REV. 1, 3–4, 28 (2011) ("R]egardless of whether or not the 2008 crisis might have been avoided but for the CFMA, the CFMA is necessary to explain the enormous scale of the crisis."); Gary Hamel, The Banking Crisis: Made in Washington, WALL ST. J. (Apr. 1, 2009), http://blogs.wsj.com/management/2009/04/01/the-banking-crisis-made-in-washington ("The failure to regulate swaps and the lack of a transparent market contributed mightily to the banking crisis and to the costs of cleaning it up."); Alan S. Blinder, The Two Issues To Watch on Financial Reform, WALL ST. J., Apr. 22, 2010, at A23 ("[T]he Commodity Futures Modernization Act of 2000 placed most derivatives beyond the reach of regulators. What a mistake! Creative derivatives such as the notorious CDOs (collateralized debt obligations) and CDSs (credit default swaps) played huge roles in propagating and magnifying the financial crisis.").

22. Stout, supra note 21, at 28–29 ("In sum, although many different factors contributed to the 2008 crisis, the CFMA’s legalization of OTC derivatives trading plays a key role in explaining the sheer size and scope of the disaster.").

and Consumer Protection Act (Dodd-Frank Act or DFA) on July 21, 2010. Derivatives reform constitutes a central pillar of the law, which effectively repealed the CFMA. Title VII of the Dodd-Frank Act, also known as the Wall Street Transparency and Accountability Act of 2010, seeks to reduce systemic risk in the derivatives markets, increase transparency and promote market integrity by establishing a comprehensive regulatory framework which will, “for the first time, bring[] oversight to the heretofore unregulated swaps markets.” To accomplish these goals, Title VII creates four new categories of regulated entities that engage in high volumes of derivatives activities or have significant derivatives exposures—swap dealers, security-based swap dealers, major swap participants and major security-based swap participants—and links to these entities the application of nearly all new derivatives regulations, including requirements with respect to registration, capital, margin, risk management, segregation and liquidity. Title VII also mandates that market participants clear certain standardized derivatives contracts through regulated clearing organizations, trade certain contracts on transparent exchanges and


25. See DAVIS POLK & WARDWELL LLP, SUMMARY OF THE DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT 52 (July 21, 2010), available at http://www.davispolk.com/files/Publication/7084f9fe-6580-413b-b870-b7c025ed2ecf/Presentation/PublicationAttachment/1d4495c7-0be0-4e9a-ba77-f786fb90464a/070910_Financial_Reform_Summary.pdf.


29. Dodd-Frank Act § 723, 7 U.S.C. § 2(h) (imposing clearing requirements on certain swaps). Clearing is a system through which “the bilateral credit exposures of participants arising from the transactions cleared are effectively eliminated and replaced by a system of guarantees, insurance, or mutualized risk of loss.” Clearing organizations act as central counterparties (CCPs), which “interpose themselves between counterparties to financial contracts, becoming the buyer to the seller of the contract and the seller to the contract’s
report certain transactions on a real time basis.31

The clearing requirement for standardized derivatives will effectively extend the time-proven stability of clearinghouses32 to a larger number of derivatives contracts.33 Yet some derivatives contacts, including "bespoke" OTC contracts that cannot be standardized, will not be required to be cleared.34 Currently, a large portion of the derivatives market consists of highly customized OTC derivatives contracts that are neither standardized nor currently required to be cleared.35 For example, only 11% of all credit default swap trades

buyer. In the absence of a CCP, each market participant bears the risk, known as counterparty credit risk, that one or more of its counterparties will default. By interposing itself between participants and thereby assuming counterparty credit risk, a CCP enables market participants to accept the best bids and offers without concern that a counterparty may default. By assuming counterparty credit risk and enforcing participation standards and margin requirements, CCPs also can help diminish systemic risk in market settlement activities. In addition, establishment of a CCP can lower systemic risk by instituting procedures for the orderly close out of the positions of any participant who defaults and by mutualizing the cost of the close-out process.” MELANIE L. FEIN, SECURITIES ACTIVITIES OF BANKS § 14.02 (4th ed. 2012). The clearing requirement does not apply to transactions where one counterparty is not a financial entity and is using swaps to hedge or mitigate commercial risk. See 7 U.S.C. §§ 2(h)(7)(A)(ii), 2(h)(7)(C)(iii). This exemption is commonly known as the “end-user exemption.” See End-User Exception to the Clearing Requirement for Swaps, 77 Fed. Reg. 42,560 (Jul. 19, 2012) (amending 17 CFR pt. 39).


31. Dodd-Frank Act § 729, (imposing reporting and recordkeeping requirements on certain uncleared swaps); Dodd-Frank Act § 723, (imposing reporting requirements on certain cleared swaps); Dodd-Frank Act § 766, (imposing reporting and recordkeeping requirements on certain security-based swaps).

32. Stout, supra note 21, at 4, 14–17 (explaining how, since the nineteenth century, commodity exchanges functioned as clearinghouses for futures contracts).

33. See Dodd-Frank Act § 723, 7 U.S.C. § 2(h); Stout, supra note 21, at 34 (“The [Title VII] clearing requirement is the functional equivalent of the old CEA requirement that speculative commodity futures be traded only on organized exchanges . . . . Sections 721, 723(a), and 725(c) of Title VII then make clear that, to be registered with the CFTC as a “derivatives clearing organization” (DCO), an organization must either be a recognized futures exchange or perform the same sorts of trade-guarantee and private enforcement functions that have been performed by exchanges since the nineteenth century.”).

34. Stout, supra note 21, at 36 n.158.

35. See infra Part I. However, the percentage of cleared derivatives is likely to increase. The CFTC has issued rules establishing the first clearing determination under Dodd-Frank, requiring certain credit default swaps and interest rate swaps to be cleared by DCOs, and more clearing determinations will be forthcoming as well as from the SEC. See Press Release, U.S. Commodity Futures Trading Comm’n, CFTC Issues Clearing Determination for Certain Credit Default Swaps and Interest Rate Swaps (Nov. 28, 2012),
in the first half of 2012 were cleared.\textsuperscript{36} Under the new requirements, entities that engage in uncleared derivatives must comply with additional safeguards—among them margin requirements—because uncleared derivatives pose a greater risk to market participants and the financial system.\textsuperscript{37} The challenges presented by these additional protections are the primary subject of this Note.

One key element of the clearing organizations’ risk-management programs is a margin requirement, under which one party must make payments to the other as collateral for that party’s obligations under the derivative contract.\textsuperscript{38} In this way, margin requirements protect market participants from counterparty credit risk, price fluctuations and losses that can arise from undue leverage, and help protect the financial system as a whole.\textsuperscript{39} Because the non-standard segment of the market will not be subject to the strictures of a clearing organization, margin requirements on OTC derivatives are a critical element of derivatives reform.

Margin systems normally entail two types of margin requirements: initial and variation margin. Initial margin functions as collateral to protect against potential losses from counterparty default, requiring one or both parties to set aside assets in the amount of a percentage of the contract’s notional value,\textsuperscript{40} typically upfront at the initiation of a trade or transaction, often subject to re-calculation and additional posting requirements during the life of the trade.\textsuperscript{41} In the

\textit{available at http://www.cftc.gov/PressRoom/PressReleases/pr6429-12}


\textsuperscript{37} Dodd-Frank Act §§ 731, 764; \textit{Sec. EXCH. COMM’N & COMMODITY FUTURES TRADING COMM’N, supra} note 28, at 25–26.

\textsuperscript{38} CFTC Margin Proposal, \textit{supra} note 26, at 23,733. Dodd-Frank Act § 725(c) (mandating each derivatives clearing organization to require margin from its members and participants that is “sufficient to cover potential exposures in normal market conditions”). \textit{See infra}, Part I.B.1.

\textsuperscript{39} \textit{Sec. EXCH. COMM’N & COMMODITY FUTURES TRADING COMM’N, supra} note 28, at 25; CFTC Margin Proposal, \textit{supra} note 26, at 23,733.

\textsuperscript{40} \textit{Melanie L. Fein, SECURITIES ACTIVITIES OF BANKS} § 14.01 (4th ed. 2012) (“The ‘notional’ value of a derivatives contract is the value of the underlying assets used to compute the stream of payments that the derivatives contract is expected to produce.”).

\textsuperscript{41} CFTC Regulation 1.3(ccc) defines “initial margin” as “money, securities, or property posted by a party to a futures, option, or swap as performance bond to cover potential future exposures arising from changes in the market value of the position.” 17 C.F.R. § 1.3(ccc) (2013). \textit{See also} Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants and Capital
event of a default, parties use initial margin to cover any loss incurred, or to replace the open position, and the value of initial margin amounts is typically calculated to satisfy the possible range of movement of a particular instrument over a period of time sufficient to closeout or replace the trade. Variation margin requires parties to "mark" open positions to their current market value periodically (typically daily) and make payments to account for any change in value since the previous exchange. The purpose of variation margin is to reduce the risk and size of a default by preventing losses from accumulating over time, in order to reduce via periodic payments the final close-out amount of a transaction the value of which has changed significantly, and perhaps more importantly, to re-

Requirements for Broker-Dealers, 77 Fed. Reg. 70,213, 70,257 (Nov. 23, 2012) (to be codified at 17 C.F.R. pt. 240) [hereinafter SEC Margin Proposal] ("The potential future exposure is the amount that the current exposure may increase in favor of the dealer in the future. This form of credit risk arises from the potential that the counterparty may default before providing the dealer with additional collateral to cover the incremental increase in the current exposure or that the current exposure will increase after a default when the counterparty has ceased to provide additional collateral to cover such increases and before the dealer can liquidate the position.").

42. CFTC Margin Proposal, supra note 26, at 23,733.

43. See, e.g., Protection of Cleared Swaps Customer Contracts and Collateral and Conforming Amendments to the Commodity Broker Bankruptcy Provisions, 77 Fed. Reg. 6,336, 6,338 (Feb. 7, 2012) (amending 17 CFR Parts 22 and 190) (requiring DCOs to set minimum collateral levels for certain swaps using a methodology "designed to estimate the amount of loss a portfolio of swap positions may incur, calculated at a statistical confidence level no less than 99%, over a holding period generally between one and ten days, depending on the time it is estimated to take to liquidate the swaps in the portfolio"). See also infra note 124.

44. SEC Margin Proposal, supra note 41, at 70,241 n.257 ("The market value of an OTC derivatives contract also is referred to as the replacement value of the contract as that is the amount the nonbank [security-based swap dealer] would need to pay to enter into an identical contract with a different counterparty.")

45. CFTC Margin Proposal supra note 26, at 23,733; CFTC Regulation 1.3(fff) defines variation margin as "a payment made by a party to a futures, option, or swap to cover the current exposure arising from changes in the market value of the position since the trade was executed or the previous time the position was marked to market." 17 C.F.R. § 1.3 (fff) (2013). See also SEC Margin Proposal, supra note 41, at 70,241 n.257 ("The current exposure is the amount that the counterparty would be obligated to pay the nonbank [security-based swap dealer] if all the OTC derivatives contracts with the counterparty were terminated (i.e., the net positive value of the OTC contracts to the nonbank [security-based swap dealer] and the net negative value of the OTC contracts to the counterparty). The amount payable on the OTC derivatives contracts (the positive value) is determined by marking-to-market the OTC derivatives contracts and netting contracts with a positive value against contracts with a negative value.")
balance the exposure of each counterparty to the other when engaged in a volatile transaction.46

In order to impose new derivatives regulations, such as margin requirements, on the OTC market, regulators must address a serious complication: globalization. More so than other financial markets, the OTC derivatives market is fluid, global and characterized by cross-border transactions.47 Because cross-border transactions implicate multiple regulatory regimes, a lack of coordination with other jurisdictions could significantly undermine the goals of domestic regulation and potentially drive international market participants away from trades that may be subject to U.S. regulation, to the detriment of the U.S. derivatives markets and larger economy.48 International coordination requires sensible application of intersecting domestic regimes. Inconsistent regulatory standards could lead to regulatory arbitrage, gaps or conflicts.49 Yet the jurisdictional scope

46. See id.

47. See infra Part I.

48. SEC. EXCH. COMM’N & COMMODITY FUTURES TRADING COMM’N, supra note 28, at 1 (“The global nature of OTC derivatives requires comprehensive international cooperation and coordination.”).

49. Press Release, Sec. & Exch. Comm’n, Joint Press Statement of Leaders on Operating Principles and Areas of Exploration in the Regulation of the Cross-Border OTC Derivatives Market (Dec. 4, 2012), http://www.sec.gov/news/press/2012/2012-251.htm [hereinafter Joint Press Statement on the Regulation of the Cross-Border OTC Derivatives Market]. This press statement was the result of a meeting on November 28, 2012 between Leaders of authorities with responsibility for the regulation of the OTC derivatives markets in Australia, Brazil, the European Union, Hong Kong, Japan, Ontario, Quebec, Singapore, Switzerland and the United States. The leaders acknowledge “that the OTC derivatives market is a global market and firmly support the adoption and enforcement of robust and consistent standards in and across jurisdictions [in order] to mitigate risk, improve transparency and protect against market abuse, and to prevent regulatory gaps, reduce the potential for arbitrage opportunities, and foster a level playing field for market participants, intermediaries and infrastructures.” More recently, financial regulators from Brazil, the European Union, France, Germany, Italy, Japan, Russia, South Africa, Switzerland and the United Kingdom wrote a letter to U.S. Secretary of the Treasury Jack Lew expressing their “concern at the lack of progress in developing workable cross-border rules as part of reforms of the OTC derivatives market.” The letter warns that a lack of regulatory coordination will result in fragmentation and inefficiency, which in turn will impair risk-management and “dampen liquidity, investment and growth.” The letter articulates what these regulators view to be the core principles on which cross-border rules should be based, chiefly that: “Cross border rules should be adopted that, if they were replicated by all other jurisdictions, would not result in duplicative or conflicting requirements, or regulatory gaps.” The letter advocates for equivalence arrangements and warns that “[a]n approach in which jurisdictions require that their own domestic regulatory rules be applied to their firms’ derivatives transactions taking place in broadly equivalent regulatory regimes abroad is not
of Title VII is both uneven and ambiguous. This lack of clarity creates uncertainty and confusion for market participants aiming to comply with new laws and minimize business costs, because they are unable to predict whether certain cross-border activity may trigger additional regulations. In addition, few foreign jurisdictions have derivatives regulatory regimes as fully developed as Title VII, making multilateral coordination even more difficult. Facing these novel challenges, how can U.S. regulators effectively address the cross-border regulation of derivatives? This Note pursues this question by examining the extraterritorial scope of margin requirements under Title VII.

Margin is an attractive candidate for exploring the necessity for clear, comprehensive and consistent cross-border coordination because it is a race-to-the-top type of requirement. For example, when a cross-border derivative contract triggers multiple regulatory regimes, the counterparties must comply with the most conservative margin requirement, or run the risks of noncompliance. As a result, market participants with a tangential relationship to more conservative regimes, such as that of the United States, will take additional steps to avoid coming within the jurisdiction of that regime. In other words, conservative margin requirements could push some derivatives activity into more liberal corners of the global market. While other requirements under Title VII may share this trait, margin has a direct impact on the cost of each transaction, making it a salient subject for this analysis.

This Note argues that mutual recognition is the most viable solution to the extraterritorial uncertainty and international coordination problem with respect to Title VII’s margin requirements for uncleared derivatives. Mutual recognition is a method of international regulatory coordination that entails an agreement among two or more
countries to recognize the adequacy of each other’s regulation as an equivalent substitute for their own. Part I describes the current financial and legal context out of which OTC derivatives regulation and rulemaking are emerging, and the relevant rules governing margin requirements and extraterritoriality. Part II examines Title VII’s extraterritoriality provisions in light of recent case law and shows that Title VII’s extraterritorial scope may create an asymmetrical and ambiguous border. Thus absent cross-border coordination, Title VII could impose conservative margin requirements on only a portion of the global OTC market, which could prompt avoidance of the U.S. market and diminish the efficacy of this regulatory requirement. Finally, Part III argues that a mutual recognition approach to margin requirements on uncleared derivatives is the best strategy for international coordination aimed at reducing systemic risk in the global derivatives market.

I. THE EVOLVING LANDSCAPE OF OTC DERIVATIVES REGULATION, DODD-FRANK AND EXTRATERRITORIALITY

The OTC derivatives market is massive, global and often risky, demanding the attention of financial regulators. As of June 2012, the notional value of outstanding OTC derivatives was estimated at $639 trillion, with a gross market value—measured by the replacement cost of current contracts—of $25 trillion. Market participants in 13 countries account for the majority of this volume. The most common instruments in this market are interest rate swaps, foreign exchange swaps and credit default swaps, accounting respectively for notional values of approximately $494 trillion, $67 trillion and $27 trillion.


55. Id. at 5. These countries are Australia, Belgium, Canada, France, Germany, Italy, Japan, the Netherlands, Spain, Sweden, Switzerland, the United Kingdom and the United States. Id. at 5 n.5.

56. Id. at 2–3. The phenomenon of OTC derivatives playing a measurable role in the
OTC derivatives are traded in an increasingly global market: out of $26.9 trillion total notional amounts outstanding in credit default swaps (CDSs) worldwide during the first half of 2012, for example, $21.6 trillion of those swaps were entered into by counterparties located in different countries.\textsuperscript{57} Moreover, recent events underscore that significant complexity and risks persist in the OTC market: the J.P. Morgan portfolio that incurred a staggering $5.8 billion in losses during the first half of 2012 was comprised of CDS indices and other CDS-related instruments.\textsuperscript{58} Given the size and increasing reach of the OTC market, the history of its regulation is crucial to any understanding of future regulatory movement.

\textit{A. History of Over-the-Counter Derivatives Regulation}

A derivative is a "financial instrument whose value depends on or is derived from the performance of a secondary source such as an underlying bond, currency, or commodity."\textsuperscript{59} Derivatives are commonly used to hedge pre-existing risks, such as when a textile mill buys cotton futures to hedge against rising cotton prices, but they can also be used in profit-seeking, or speculation.\textsuperscript{60} Put simply, derivatives transactions are "a zero-sum game in terms of traders' net returns,"\textsuperscript{61} thus risk-averse parties commonly look to speculators to

\textsuperscript{57} \textit{Statistical release: OTC Derivative Statistics at End-June 2012, supra} note 36, at Table 8. Note also that the global CDS market is young. In 2000 it was too insignificant to measure. By 2001 the CDS market recorded notional amounts outstanding of under $1 million, and by 2007 notional amounts outstanding had skyrocketed to over $62 trillion.


\textsuperscript{59} \textit{Black's Law Dictionary} 509 (9th ed. 2009). The focus of this Note is on swaps and security-based swaps, which are the categories of derivatives regulated under Title VII. 7 U.S.C. § 1a(47) (definition of "Swap"), 15 U.S.C. § 78c(a)(68) (definition of "Security-based swap").

\textsuperscript{60} Timothy E. Lynch, \textit{Gambling by Another Name; The Challenge of Purely Speculative Derivatives}, 17 STAN. J.L. BUS. & FIN. 67, 73, 75–76 (2011).
unload their risk.62

Purely speculative derivatives contracts—those where neither party hedges a pre-existing risk—perhaps account for derivatives’ notoriously dangerous reputation.63 Like a bet between gamblers,64 both parties to a purely speculative contract are seeking profit based on heterogeneous expectations,65 and it is “mathematically impossible” for them both to win.66 Unlike hedging, which increases social welfare by reducing aggregate risk,67 pure speculation instead diminishes speculators’ welfare by subjecting them to new artificial risks (both market risk and counterparty risk68) without generating any aggregate economic wealth.69 Such outsized counterparty risk, combined with the scope and interconnectivity of modern derivatives markets, adds systemic risk to the larger financial system. Therefore, “the welfare consequences of a derivatives market can depend, as an empirical matter, on whether the market is dominated by risk-reducing hedging or risk-increasing speculative transactions.”70

In light of this duality, speculative derivatives contracts were unenforceable at common law. Trading in speculative derivatives, viewed as a rent-seeking activity equivalent to gambling, was banned “to discourage the waste of valuable human capital.”71 judges felt

61. Stout, supra note 21, at 9. Professor Timothy Lynch points out that purely speculative derivatives contracts are less than zero-sum, after taking into account transaction costs. Lynch, supra note 60, at 73.

62. Hazen, supra note 13, at 436 (“Speculators have thus been characterized [as] ‘people who accept the risk hedges do not want.’”).

63. Lynch, supra note 60, at 71–72. Illustrating this point, $150 million of John Paulson’s massive $3 billion income in 2007 was derived from a purely speculative derivative contract, a subprime-mortgage-related synthetic CDO, with German bank IKB Deutsche Industriebank AG. The bank lost approximately $4 billion in 2007 and was bailed out that year. Id. at 69–70. The losses incurred by Orange County, LTCM and AIG are other examples of speculative derivatives trading. Id. at 89–90.

64. See Hazen, supra note 13, at 434 (using a baseball illustration to explore “how much of the distinction between bona fide hedging (or insurance) and gambling is in the eye of the beholder”).

65. Lynch, supra note 60, at 82.

66. Stout, supra note 21, at 9.

67. Lynch, supra note 54, at 78.

68. Id. at 93.

69. Stout, supra note 21, at 10. Lynch, supra note 60, at 73. Even more risk is created if parties use leverage to enter into the contract. Id. at 93.

70. Stout, supra note 21, at 4.

71. Id. at 13.
that such contracts "promote[d] no legitimate trade" and "discourage[d] the disposition to engage in a steady business or labor."72 Hostility toward speculative derivatives contracts continued through the twentieth century under the Commodities Exchange Act (CEA). The CEA placed "an absolute ban on ‘off-exchange futures’ (OTC derivatives) . . . [which], for many decades, kept derivatives speculation from posing significant problems for the larger economy."73

Private enforcement mechanisms arose early on because of the prohibition at common law.74 Speculative trading occurred on organized exchanges, called "clearinghouses," where exchange members guaranteed contract performance via guarantee funds and often loss-sharing agreements.75 This structure "effectively cabined and limited the social cost of derivatives speculation risk."76 Thereafter, speculative derivatives trading occurred solely on organized and regulated exchanges, until Congress gradually lifted the ban on OTC contracts.

The transition to regulatory liberalization began in 1989, when the CFTC created a "safe harbor" provision for qualifying OTC derivatives transactions.77 In the Futures Trading Practices Act of 1992, Congress granted the CFTC broad authority to exempt OTC derivatives from CFTC regulation.78 In 1993, the CFTC took another step by promulgating its Part 35 regulation, which exempted a wider group of qualifying OTC derivatives from government regulation.79 This change triggered an upsurge in trading of OTC derivatives, particularly interest rate swaps. Barely a year later, in 1994, the market for interest rate swaps showed signs of its fragility, when Orange County, California announced $1.5 billion in losses in its pension fund.80 Interest rate derivatives losses were also at the heart of the 1998 collapse of hedge fund Long-Term Capital Management.81

72. Id. (quoting Melchert v. Am. Union Tel. Co., 11 F. 193, 195 (C.C.D. Iowa 1882) and Justh v. Holliday, 13 D.C. (2 Mackey) 346, 349 (1883) (internal quotations removed)).

73. Id. at 5.

74. Id. at 14–15.

75. Id. at 4.

76. Id.


80. Fromson, supra note 2; FINANCIAL CRISIS INQUIRY REPORT, supra note 21, at 47.

81. Stout, supra note 21, at 27.
Nevertheless, these early warnings were not yet enough to spur a legislative reaction; the momentum continued.

Liberalization of the derivatives market culminated on December 21, 2000, when President Bill Clinton signed into law the Commodity Futures Modernization Act of 2000. The CFMA fully excluded from regulation, and thus from the prohibition against off-exchange derivatives, a wide range of OTC derivative transactions between qualifying counterparties. It also deregulated "hybrid instruments," or banking products that have certain features of futures contracts. In effect, the CFMA legalized purely speculative OTC trading in all financial derivatives and excluded or exempted such contracts from substantive regulation under U.S. securities and commodities laws.

Consequently, the OTC derivatives market expanded by an order of magnitude after this legislative change—growing in notional value from $88.2 trillion in December 1999 to $683.7 trillion by June 2008. This increase in derivatives trading was accompanied by an increase in attendant risk. Derivatives losses subsequently became the source of several major corporate scandals, including Enron, Bear Sterns, Merrill Lynch and AIG. Indeed, the IMF deter-

84. Greene, et al., supra note 83, at 12-8, 12-62.
85. Stout, supra note 21, at 22; Greene et al., supra note 83, at 12-63 & n.252 (stating that former CEA §§ 2(d), 2(g), and 2(h) exempted from CEA jurisdiction many bilateral swaps between eligible contract participants).
86. See supra note 14.
87. Gensler, supra note 23. (Swaps added leverage to the financial system with more risk being backed by less capital . . . Swaps—developed to help manage and lower risk for end-users—also concentrated and heightened risk in the financial system and to the public.)
88. Schroeder & Ip, supra note 8.
89. Financial Crisis Inquiry Report, supra note 21, at 291; Nelson D. Schwartz & Julie Creswell, What Created This Monster? N.Y. Times (Mar. 23, 2008) (Sunday Business), at 8 (“Bear Stearns’s vast portfolio of [derivative] instruments was among the main reasons for the bank’s collapse . . . . ‘The rescue was absolutely all about counterparty risk. If Bear went under, everyone’s solvency was going to be thrown into question. There could have been a systematic run on counterparties in general,’ said Meredith Whitney, a bank analyst at Oppenheimer. ‘It was 100 percent related to credit default swaps.”)
90. Financial Crisis Inquiry Report, supra note 21, at 202–04, 256–59; Carrick Mollenkamp & Serena Ng, Merrill Takes $8.4 Billion Credit Hit – It Plunged Into CDOs In ’03, Hiring Pioneer Of The Debt Securities WALL ST. J., Oct. 25, 2007, at A1; Serena Ng & Carrick Mollenkamp, Wall Street Wisardry Amplifies Credit Crisis – A CDO Called Norma
minded that the CFMA created regulatory gaps in the OTC markets, concluding that "the lack of collateral requirements for certain significant market participants in bilaterally-settled OTC derivatives contributed to the undetected buildup of leverage" leading up to the 2008 crisis.92

Yet attributing the risk concentrated in the rapidly growing derivatives market to transactions conducted on exchanges misses the nature of the market's weaknesses. Notably, no derivatives clearing organization required government support following the 2008 financial crisis, while firms with crippling OTC derivatives losses did require such support.93 In fact, during the crisis, exchange-traded derivatives maintained liquidity and narrow bid-ask spreads, both of which allow for easy price discovery and strong risk management.94 Conversely, trading volumes in the OTC derivatives market fell sharply and in some cases ceased altogether,95 worsening the panic.96


91. FINANCIAL CRISIS INQUIRY REPORT, supra note 21, at xix, xxiv–xxv, 50 (“In the run-up to the crisis, AIG, the largest U.S. insurance company, would accumulate a one-half trillion dollar position in credit risk through the OTC market without being required to post one dollar's worth of initial collateral or making any other provision for loss.”). Id. at 352 (“AIG's failure was possible because of the sweeping deregulation of over-the-counter (OTC) derivatives, including credit default swaps, which effectively eliminated federal and state regulation of these products, including capital and margin requirements that would have lessened the likelihood of AIG's failure.”); Stout, supra note 21, at 26.

92. INT'L MONETARY FUND, supra note 21, at 30.

93. See Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 76 Fed. Reg. at 23,733.

94. Id. at 15. The "bid-ask spread" is the "difference between the price at which dealers are willing to buy contracts (the bid price) and the price at which they are willing to sell them (the ask price)." It is a signal of market liquidity, because dealers will lower their bid price and increase their ask price in order to account for the additional risk they bear when markets are illiquid. FINANCIAL CRISIS INQUIRY REPORT, supra note 21, at 364–65.

95. INT'L MONETARY FUND, supra note 21, at 17. See, e.g., FINANCIAL CRISIS INQUIRY REPORT, supra note 21, at 343, 365 (“Lehman, like other large OTC derivatives dealers, experienced runs on its derivatives operations that played a role in its failure. Its massive derivatives positions greatly complicated its bankruptcy, and the impact of its bankruptcy through interconnections with derivatives counterparties and other financial institutions contributed significantly to the severity and depth of the financial crisis.”).

96. FINANCIAL CRISIS INQUIRY REPORT, supra note 21, at 386 (“The scale and nature of the over-the-counter (OTC) derivatives market created significant systemic risk throughout the financial system and helped fuel the panic in the fall of 2008: millions of contracts in this opaque and deregulated market created interconnections among a vast web of financial institutions through counterparty credit risk, thus exposing the system to a contagion of spreading losses and defaults. Enormous positions concentrated in the hands of systemically
The 2008 crisis revealed fundamental weaknesses in the OTC market, including lack of price transparency, opacity of risk characteristics and insufficient collateralization. Inadequate regulation exacerbated the inherent risk of the large new OTC market, and the lack of publicly available information on derivatives transactions and counterparty credit exposure heightened general market uncertainty at the time. Inadequate margining practices were “a key vulnerability.”

B. Title VII of the Dodd-Frank Act

Enacted in response to the 2008 financial crisis, Title VII of the Dodd-Frank Act created a new regulatory framework for OTC derivatives in order to reduce systemic risk, increase transparency and promote market integrity in this formerly unregulated area. DFA Title VII effectively repealed the CFMA, subjecting the American derivatives market to a raft of new statutory and regulatory restrictions and requirements. In keeping with historical jurisdictional divisions between the CFTC and SEC, Title VII separates derivatives into three categories: “swaps,” “security-based swaps” and “mixed swaps.” Swaps include credit default swaps, interest

significant institutions that were major OTC derivatives dealers added to uncertainty in the market. The ‘bank runs’ on these institutions included runs on their derivatives operations through novations, collateral demands, and refusals to act as counterparties.”).

97. INT’L MONETARY FUND, supra note 21, at 17. See also FINANCIAL CRISIS INQUIRY REPORT, supra note 21, at xxiv (“[There was] uncontrolled leverage; lack of transparency, capital, and collateral requirements; speculation; interconnections among firms; and concentrations of risk in [the OTC derivatives] market.”).

98. See INT’L MONETARY FUND, supra note 21, at 17; Schwartz & Creswell, supra note 89, at 8 (“[The OTC derivatives market] is a stealth market that relies on trades conducted by phone between Wall Street dealer desks, away from open securities exchanges. How much changes hands or who holds what is ultimately unknown to analysts, investors and regulators.”)

99. See INT’L MONETARY FUND, supra note 21, at 17.

100. CFTC Margin Proposal, supra note 26, at 23,733 (“Title VII of the Dodd-Frank Act amended the CEA to establish a comprehensive regulatory framework to reduce risk, increase transparency, and promote market integrity within the financial system . . . .”); Gensler, supra note 23; FIN. STABILITY OVERSIGHT COUNCIL, 2011 ANNUAL REPORT, at i (2011).

101. See DAVIS POLK & WARDWELL LLP, supra note 25.

rate swaps and total return swaps the value of which depend on a broad range of asset categories, but exclude certain futures and forwards and derivatives based on a single security or a narrow-based security index. Security-based swaps are derivatives tied to the value of a single security or loan, a narrow-based security index or events relating to a securities issuer. Mixed swaps contain characteristics of both categories. Title VII gives the CFTC and the SEC a mandate to establish parallel regulatory regimes, as the primary regulator for swaps and security-based swaps, respectively. The two agencies will jointly regulate mixed swaps. Certain regulatory requirements, among them capital and margin, will be determined by "prudential regulators" (including the Federal Reserve Board, the Office of the Comptroller of the Currency (OCC), the Federal Deposit Insurance Corporation (FDIC), the Farm Credit Administration and the Federal Housing Finance Agency) for entities subject to those agencies’ primary jurisdiction but also engaging in covered derivatives activity.

Title VII provides: (1) mandatory clearing through central clearing organizations and mandatory trading through regulated exchanges or swap execution facilities, subject to certain exceptions; (2) mandatory registration and comprehensive regulation of swap dealers and major swap participants; (3) rigorous real-time reporting and recordkeeping requirements; and (4) enhanced CFTC and SEC rulemaking and enforcement authority with respect to registered entities and intermediaries subject to each Commission’s over-

subject to Title VII regulations promulgated by the prudential regulators. See DAVIS POLK & WARDWELL LLP, supra note 25, at 52–53.

103. 7 U.S.C. § 1a(47); DAVIS POLK & WARDWELL LLP, supra note 25, at 53.
104. 15 U.S.C. § 78c(a)(68); DAVIS POLK & WARDWELL LLP, supra note 25, at 54.
106. GREENE ET AL., supra note 83, at 12-8.
108. 7 U.S.C. § 1a(39) (definition of “Prudential regulator”); 15 U.S.C. § 78c(a)(74); For swaps see Dodd-Frank Act § 731 and for security-based swaps see Dodd-Frank Act § 764.
109. For swaps see Dodd-Frank Act § 723(a) and for security-based swaps see Dodd-Frank Act § 763(a).
110. For swaps see Dodd-Frank Act § 731 and for security-based swaps see Dodd-Frank Act § 764.
111. For swaps see Dodd-Frank Act §§ 727, 729, 730 and for security-based swaps see Dodd-Frank Act §§ 764, 766.
sight. Title VII includes both requirements that will prevail broadly across an entity’s activities—such as the requirement to register as a swap dealer or major swap participant, capital requirements and risk-management requirements—and requirements that will apply on a transaction-by-transaction basis—including clearing, margin and reporting rules.

The Title VII regulatory framework aims to mitigate systemic risk inherent in the current market structure by targeting the counterparty risk posed by speculative derivatives contracts. The central difference between derivatives transactions accomplished through clearing organizations and derivatives trading in the OTC market is that clearing organizations intermediate the credit risk posed by the counterparties, while at the same time collateralizing both credit and market risk, in part via imposed margin requirements; the OTC market leaves counterparties fully bilaterally exposed. Yet not all derivatives are currently required to be cleared, nor are all counterparties required to clear even those instruments designated by the CFTC or SEC for mandatory clearing. There also exists a risk of regulatory


113. Cross-Border Application of Certain Swaps Provisions of the Commodity Exchange Act, 77 Fed. Reg. 41,214, 41,223–24 (July 12, 2012) (to be codified at 17 C.F.R. ch. 1) (introducing the conceptual distinction between “entity-level” and “transaction-level” requirements). Entity-level requirements include: (i) Capital adequacy; (ii) chief compliance officer requirements; (iii) risk management; (iv) swap data recordkeeping; (v) swap data reporting; and (vi) physical commodity swaps reporting (“Large Trader Reporting”). Id. at 41,224–25. Transaction-level requirements include: (i) Clearing and swap processing; (ii) margining and segregation for uncleared swaps; (iii) trade execution; (iv) swap trading relationship documentation; (v) portfolio reconciliation and compression; (vi) real-time public reporting; (vii) trade confirmation; (viii) daily trading records; and (ix) external business conduct standards. Id. at 41,225–27.

114. See Dodd-Frank Act § 725 (“Derivatives clearing organizations”).

115. See CFTC Margin Proposal, supra note 26, at 23,733.

116. For example, DFA Section 723(a) exempts derivatives contracts from the clearing requirement if one of the two parties to the swap “is using swaps to hedge or mitigate commercial risk.” Dodd-Frank Act § 723(a). This exemption is commonly known as the “end-user exemption.” See End-User Exception to the Clearing Requirement for Swaps, 77 Fed. Reg. 42,560 (Jul. 19, 2012) (amending 17 CFR pt. 39). This exception is not to be used by “financial entities” and is instead limited to end users. See The Commodities Exchange Act of 1936, 7 U.S.C. § 2(h)(7)(A). The end users exception is intended to cover non-financial companies that use uncleared swaps to “hedge risks associated with their underlying business, such as manufacturing, energy exploration, farming, transportation, or other commercial activities.” See End-User Exception to the Clearing Requirement for Swaps, supra.
arbitrage, shifting away from the cleared to the uncleared market to avoid onerous margin requirements of clearing organizations. Requiring margin on uncleared derivatives would serve to alleviate some of the increased risk of uncleared derivatives transactions, by quantifying and collateralizing both market and credit risks, and it therefore serves as a linchpin in derivatives reform.

1. Margin Requirements on Uncleared Derivatives under Title VII

Section 731 of the Dodd-Frank Act amended the Commodity Exchange Act by adding Section 4s, which provides for the registration and regulation of swap dealers and major swap participants. Among the regulatory requirements enumerated, Sections 4s(e)(2)(A)(ii) and 4s(e)(2)(B)(ii) provide that prudential regulators (for banks) and the CFTC (for non-banks) must adopt rules for both initial and variation margin requirements for swap dealers and major swap participants on all uncleared swap transactions. Section 4s(e)(3)(A) explicitly acknowledges the “greater risk to the swap dealer or major swap participant and the financial system arising from the use of swaps that are not cleared.” Section 4s(e)(3)(C) allows noncash collateral, so long as the prudential regulators and the CFTC find it consistent with preserving the financial integrity of the derivatives markets and the stability of the U.S. financial system.

DFA Section 764 amended the Securities Exchange Act of 1934 (SEA) by adding Section 15Fs, which mandates the registration and regulation of security-based swap dealers and major security-based swap participants. The requirements in this section mirror those in Section 731; indeed, the Act requires that regulators under both sections must “to the maximum extent practicable” maintain comparable minimum initial and variation margin requirements.

117. See Stout, supra note 21, at 36, n.158; Kristin N. Johnson, Things Fall Apart: Regulating the Credit Default Swaps Commons, 82 U. COLO. L. REV. 101, 175 (2011).

118. Regulatory Reform and the Derivatives Market: Hearing Before the Comm. on Agric., Nutrition, and Forestry, 111th Cong. 8 (2009) (statement of Gary Gensler, Chairman, Commodity Futures Trading Commission), at 89 (“It is important that tailored or customized swaps that are not able to be cleared or traded on an exchange are sufficiently regulated.”).

119. Dodd-Frank Act § 731 (emphasis added).

120. Id.

121. Id.

122. Dodd-Frank Act §731 and §764 (Commodity Exchange Act § 4s(e)(3)(D)(ii) and Securities Exchange Act § 15F(e)(3)(D)(ii)).
The CFTC, the SEC and the prudential regulators have each proposed, but not finalized, margin requirements for uncleared derivatives within their purview.\textsuperscript{123} The proposed margin requirements are substantially greater than comparable requirements for cleared derivatives, which will raise the cost of risk management for uncleared derivatives.\textsuperscript{124} The purpose of these heightened requirements for uncleared derivatives is to push market participants towards trading in cleared instruments, to the extent possible, and to collateralize the risks of OTC derivatives otherwise. Because margin requirements must be interpreted and observed on a transaction-by-transaction basis, understanding the scope of transactions covered by these rules is critical for market participants to know when structuring their business, particularly with respect to cross-border transactions.

2. Title VII Extraterritoriality Provisions

The efficacy of margin requirements on uncleared derivatives must be considered in light of today’s prevailing uncertainty regarding, and legal constraints on, the jurisdictional scope of the Dodd-Frank Act. Uneven regulatory standards imposed upon a fluid, global market like the one in which OTC derivatives trade will undermine Dodd-Frank’s objectives of mitigating risk and increasing systemic stability. This concern is especially acute with respect to transaction-specific requirements, because derivatives contracts commonly implicate more than one jurisdiction.

The Dodd-Frank Act addresses the extraterritorial applicability of Title VII provisions relating to swaps and security-based swaps, and rules and regulations promulgated thereunder, in Sections 722(d)\textsuperscript{125} and 772(b),\textsuperscript{126} one each for the CFTC and SEC’s parallel


\textsuperscript{124} Initial margin for cleared derivatives must be at least sufficient to cover potential future exposures assuming a one-day liquidation period for agricultural, metals, and energy cleared swaps and a five-day liquidation period for all other swaps. 17 C.F.R. § 39.14(g)(2) (2013). Under the proposed rules, initial margin for uncleared derivatives must be at least sufficient to cover potential future exposures for a 10-day liquidation period. CFTC Margin Proposal, \textit{supra} note 26, at 23,746 (to be codified at 17 C.F.R. § 23.155(b)(2)(vi)); Prudential Regulators Margin Proposal, \textit{supra} note 123, at 27,590.

\textsuperscript{125} Section 722 of the Dodd-Frank Act, entitled “Jurisdiction,” amended Section 2 of the Commodity Exchange Act, 7 U.S.C. § 2, by adding at the end the following:
regulatory regimes. Subject to exceptions for anti-evasion rules and regulations, these provisions require that Title VII, and rules and regulations promulgated thereunder, shall not apply to, for CFTC-regulated swaps, "activities outside the United States unless those activities have a direct and significant connection with activities in, or effect on, commerce of the United States," and, for SEC-regulated security-based swaps, "any person insofar as such person transacts a business in security-based swaps without the jurisdiction of the United States." The wording of the statute itself contradicts the notion that Dodd-Frank alone could adequately regulate a market comprised of multinational participants and cross-border transactions. In addition, the jurisdictional scope thus stated does not clearly delineate which global entities and cross-border transactions are or should be covered by Title VII. This extraterritorial ambiguity hinders the

(i) APPLICABILITY.—The provisions of this Act relating to swaps that were enacted by the Wall Street Transparency and Accountability Act of 2010 (including any rule prescribed or regulation promulgated under that Act), shall not apply to activities outside the United States unless those activities—(1) have a direct and significant connection with activities in, or effect on, commerce of the United States; or (2) contravene such rules or regulations as the Commission may prescribe or promulgate as are necessary or appropriate to prevent the evasion of any provision of this Act that was enacted by the Wall Street Transparency and Accountability Act of 2010.

Dodd-Frank Act § 722(d).

126. Section 772 of the Dodd-Frank Act also amended Section 36 of the Securities Exchange Act of 1934, 15 U.S.C. § 78mm, by adding at the end the following:

(c) RULE OF CONSTRUCTION.—No provision of this title that was added by the Wall Street Transparency and Accountability Act of 2010, or any rule or regulation thereunder, shall apply to any person insofar as such person transacts a business in security-based swaps without the jurisdiction of the United States, unless such person transacts such business in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate to prevent the evasion of any provision of this title that was added by the Wall Street Transparency and Accountability Act of 2010. This subsection shall not be construed to limit the jurisdiction of the Commission under any provision of this title, as in effect prior to the date of enactment of the Wall Street Transparency and Accountability Act of 2010.

Dodd-Frank Act § 772(b).

127. Dodd-Frank Act §§ 722(d), 772(b). See also Dan Berkovitz, CFTC General Counsel, Comments at the Public Roundtable to Discuss International Issues Relating to the Implementation of Title VII of the Dodd-Frank Act 9–10 (Aug. 1, 2011), http://www.cftc.gov/ucm/groups/public/@swaps/documents/dsSubmission/dsSubmission21_080111 1-trans.pdf ("A key inquiry therefore is to determine which activities outside the U.S. meet these tests.").

128. To this point, on July 21, 2012 and January 7, 2013 the CFTC published proposed interpretive guidance which explains how the CFTC intends to interpret Dodd-Frank Section 722(d), the provision addressing extraterritoriality with respect to CFTC-regulated swaps. See Cross-Border Application of Certain Swaps Provisions of the Commodity Exchange Act, 77 Fed. Reg. 41,214 (July 12, 2012) (to be codified at 17 C.F.R. ch. 1); Further
international coordination necessary to achieve comprehensive regulation of the OTC derivatives market. Further, recent case law has compounded the uncertainty created by these new provisions, as will be explored later.

Despite the bifurcated approach taken by Title VII, which divides regulatory authority between the CFTC and SEC following the traditional division of jurisdiction between commodities and securities, many substantive aspects of its regulatory requirements imposed on the two derivatives markets—swaps and security-based swaps—are identical. However, extraterritorial applicability is not one such area. The two provisions addressing the extraterritorial application of Title VII contain one major asymmetry: Section 722(d) grants the CFTC explicit authority to regulate offshore activities with a "direct and significant" connection to or effect on U.S. commerce.129 In contrast, Section 772(b) provides the SEC with no such power. Instead, the operative language of DFA Section 772(b)130 is identical to that of SEA Section 30(b)—prohibiting application of the Act "to any person insofar as he transacts a business in securities without the jurisdiction of the United States," unless he does so in violation of regulations promulgated by the SEC "to prevent . . . evasion of [the Act]"—which was interpreted by the U.S. Supreme Court in Morrison v. National Australia Bank.131 This similarity, which will be dis-

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130. Section 772(b) of the Dodd-Frank Act prohibits application of Title VII "to any person insofar as such person transacts a business in security-based swaps without the jurisdiction of the United States, unless [he does so in violation of rules or regulations promulgated by the SEC] to prevent the evasion of any provision [of Title VII]." Dodd-Frank Act § 772(b).

cussed in Part II, makes it unlikely that the SEC would interpret the regulations born of this provision to regulate overseas activity.\footnote{See infra Part II.A.1–3.}

3. Interpretative Guidance on Extraterritorial Scope of Title VII

The CFTC has issued proposed interpretive guidance on the cross-border application of its rules and regulations promulgated under Title VII, including margin requirements,\footnote{See Cross-Border Application of Certain Swaps Provisions of the Commodity Exchange Act, 77 Fed. Reg. 41,214 (July 12, 2012) (to be codified at 17 C.F.R. ch. 1).} and as this Note was going to publication the SEC proposed rules and interpretive guidance for parties to cross-border security-based swap transactions.\footnote{See Press Release, Sec. & Exch. Comm’n, SEC Proposes Rules for Cross-Border Security-Based Swap Activities (May 1, 2013), http://www.sec.gov/news/press/2013/2013-77.htm; Cross-Border Security-Based Swap Activities; Re-Proposal of Regulation SBSR and Certain Rules and Forms Relating to the Registration of Security-Based Swap Dealers and Major Security-Based Swap Participants (proposed May 1, 2013) (to be codified at 17 CFR Parts 240, 242, and 249), available at http://www.sec.gov/rules/proposed/2013/34-69490.pdf.} In its proposed interpretive guidance, the CFTC has clearly and firmly indicated its intentions to interpret the jurisdictional mandate of 722(d) broadly.\footnote{See Cross-Border Application of Certain Swaps Provisions of the Commodity Exchange Act, 77 Fed. Reg. 41,214, 41,228-31 (July 12, 2012) (to be codified at 17 C.F.R. ch. 1).} Reading the language of a “direct and significant” connection with activities in, or effect on, commerce of the United States to encompass effectively all transactions that have an articulable U.S. nexus, the CFTC has tied the cross-border application of its swaps regulations to the concept of a “U.S. person.”\footnote{Id. at 41,1219, 41,1222–23.}

Essentially, any entity that is considered to be a “U.S. person” will be bound to comply with the full panoply of CFTC regulation—including both “entity-level” and “transaction-level” re-
requirements—while even non-U.S.-person entities that engage in swap transactions with "U.S. persons" will be required to comply with "transaction-level" requirements, some of which apply to entities broadly and require so much in the way of compliance that they will likely become the de facto modus operandi for any non-U.S.-person market participant that continues to engage in swaps with U.S. persons. The extraterritorial reach of the CFTC’s Title VII regulations—including margin requirements—thus turns on the scope of the "U.S. person" definition, which has not been finalized. The broader the definition, the more likely it is that entities will be subject to multiple, and possibly conflicting, regulatory regimes.

Margin requirements are categorized as "transaction-level" requirements under the proposed guidance and thus may also apply to some non-U.S.-person entities. Because counterparties to a cross-

138. Id. at 41,1224, 41,227–28, 41,230.

139. Id. at 41,1228–29 (proposing to impose transaction-level requirements clearing requirements on certain non-U.S. entities for all of their swaps with U.S. persons, other than foreign branches of U.S. persons, as counterparties, and expressing intent not to permit substituted compliance for transaction-level requirements in most cases for swaps between certain non-U.S. entities and U.S. persons).

140. For example, the clearing requirement mandates that all swaps that the CFTC has determined are required to be cleared must be submitted for clearing to a derivatives clearing organization, subject to exceptions. To minimize the risk of accidental noncompliance, entities continuing to engage in swaps with U.S. persons may be more inclined to submit for clearing all swaps encompassed by CFTC clearing determinations. See id. at 41,226, 41,228.


142. The CFTC intends to impose margin requirements on (1) all swap transactions between non-U.S. swap dealers or non-U.S. major swap participants and (i) counterparties that are U.S. persons, other than foreign branches of U.S. persons, (ii) non-U.S. counterparties that are guaranteed by (or otherwise supported by) a U.S. person, (2) all swap transactions involving a U.S. "affiliate conduit," (3) all swap transactions entered into by foreign branches and agencies of U.S. persons, except if the aggregate value of all such swaps in an "emerging market" is less than 5% of the aggregate notional value of all swaps of that U.S. swap dealer, and (4) swap transactions involving a foreign affiliate or subsidiary of a U.S. swap dealer (i) when the swap transaction is booked in the U.S. and (ii) when the swap transaction is not booked in the U.S. but the foreign affiliates or subsidiaries either individually or in the aggregate meet the definition of a swap dealer and the swap transaction is with a non-U.S. person guaranteed by a U.S. person. See Cross-Border Application of Certain Swaps Provisions of the Commodity Exchange Act, 77 Fed. Reg. 41,214, 41,228–31 (July 12, 2012) (to be codified at 17 C.F.R. ch. 1). Swaps involving a U.S. affiliate conduit
border derivative contract must comply with the most conservative margin requirement, if the United States imposes the most stringent margin requirement, it is likely that non-U.S.-person entities with a tangential relationship to the United States will avoid transactions that trigger U.S. regulatory jurisdiction. As a result, absent clear and consistent cross-border coordination, this race-to-the-top requirement could lead to regulatory gaps in the global OTC market or overlapping and potentially conflicting regulations. In this way, uncoordinated promulgation of margin requirements among jurisdictions would vitiate their core purpose, which is to offset the greater risk to market participants and the financial system arising from the use of uncleared derivatives.  

In an effort to avoid such problems, under certain circumstances the CFTC may waive some Title VII requirements for certain non-U.S.-person market participants if they are in “substituted compliance” with a comparable regulatory requirement of a foreign jurisdiction. Specifically, the CFTC intends to permit non-U.S. swap dealers and non-U.S. major swap participants to substitute compliance with the requirements of a foreign regulatory regime, “in lieu of compliance with the CEA and Commission’s regulations, if the Commission finds that such requirements are comparable to cognate requirements under the CEA and Commission regulations.” These “comparability determinations” will be made “on an individual requirement basis,” rather than evaluating the foreign regime as a whole. The CFTC proposed guidance specifies the circumstances under which it intends to permit substituted compliance for various requirements, including margin requirements.

are those in which: “(i) A non-U.S. counterparty is majority-owned, directly or indirectly, by a U.S. person; (ii) the non-U.S. counterparty regularly enters into swaps with one or more other U.S. affiliates or subsidiaries of the U.S. person; and (iii) the financials of such non-U.S. counterparty are included in the consolidated financial statements of the U.S. person.” Id. at 41,229.

143. Dodd-Frank Act §§ 731, 764.


145. Id. at 41,229.

146. Id.

147. Id. at 41,228. Generally, substituted compliance with respect to margin requirements will be available for: (1) swap transactions between non-U.S. swap dealers or non-U.S. major swap participants and non-U.S. counterparties guaranteed by a U.S. person, (2) swap transactions involving U.S. affiliate conduits and (3) swap transactions between a foreign branch or agency of a U.S. person and a non-U.S. person counterparty. Id.
Moreover, while an analysis of the SEC proposed rules and guidance is beyond the scope of this inquiry due to the timing of the SEC proposal, it is notable that the SEC proposal differs from the CFTC approach, at least insofar as it treats margin as an “entity-level” requirement, \(^{148}\) rather than “transaction-level,” and takes a more territorial approach with a narrower definition of “U.S. person” \(^{149}\) than that in the CFTC proposal. \(^{150}\) In sum, the ambiguous and divergent Dodd-Frank provisions addressing the extraterritorial application of Title VII have allowed extraterritorial uncertainty to persist, impeding progress towards international coordination and threatening to undermine the stated legislative purpose of margin requirements. \(^{151}\) The CFTC proposed guidance raises fundamental international regulatory issues, many of which remain unresolved, and practical concerns are especially urgent, as many non-U.S. market participants must comply with swap-related regulations. \(^{152}\) A detailed examination of the Title VII jurisdictional provisions in light of recent case law interpreting similar provisions should shed light on Title VII’s cross-border applicability and reveal in more depth how the current extraterritorial uncertainty threatens the efficacy of margin requirements on uncleared derivatives.


\(^{149}\) DAVIS POLK & WARDWELL LLP, supra note 148, at 2.


\(^{152}\) See, e.g., Scott D. O’Malia, Commissioner, U.S. Commodity Futures Trading Comm’n, Public Policy Keynote Address before 2011 Int’l Swap and Derivatives Ass’n, Annual North America Conference: Can the CFTC See the Big Picture? (Sept. 13, 2011), available at http://www.cftc.gov/PressRoom/SpeechesTestimony/opomalia-7 (“Unless the Commission resolves extraterritoriality and inter-affiliate issues, market participants cannot definitively answer these questions and cannot move forward to design the most cost-efficient methods of compliance.”).
II. THE PROBLEM OF DOMESTIC MARGIN REQUIREMENTS IN A GLOBAL OTC MARKET

The global nature of the OTC derivatives market complicates domestic regulatory efforts and could undermine the risk-mitigating effects of margin requirements on uncleared derivatives. In 2011, over half of derivatives positions held by major American financial institutions were in non-U.S. branches or subsidiaries.\footnote{153} Indeed, just before the 2008 financial crisis, "over one-fifth of U.S. [asset-backed securities were] estimated to have been held abroad."\footnote{154} CTFC Chairman Gensler recently remarked that "[t]wenty-first century finance knows no true geographic borders. Money and risk can move around the globe with a touch of a button. Moreover, the U.S. and European financial systems are interconnected through many linkages, including, significantly, the swaps market."\footnote{155}

OTC derivatives contracts may present significant global regulatory concerns: "a single swap may be negotiated and executed between counterparties located in two different countries, booked in a third country and risk-managed in a fourth country, thereby triggering swaps regulation in multiple jurisdictions simultaneously."\footnote{156} Moreover, the fluid nature of OTC derivatives contracts further complicates the regulation of the OTC derivatives market.\footnote{157} Because these instruments are not traded on exchanges, it is would be difficult to determine a single geographic situs for many OTC derivative transactions. Further, swaps commonly traded over-the-counter are long-lived contracts that are "characterized by ongoing payments, deliveries or other obligations between the parties throughout their

\footnote{153. Brush, supra note 129. As of September 30, 2011, 62% of Goldman Sachs's derivatives positions, totaling $134 billion in notional value, were in non-U.S. branches or subsidiaries; for Morgan Stanley, 77% of $101 billion; J.P. Morgan Chase & Co., 59% of $188 billion; Citigroup, 53% of $102 billion; and Bank of America, "half" of $125 billion.}

\footnote{154. INT'L MONETARY FUND, supra note 21, at 43.}

\footnote{155. Gensler, supra note 23. See also Edward F. Greene, Resolving Regulatory Conflicts Between the Capital Markets of the United States and Europe, 2 CAPITAL MARKETS L. J. 5, 11 (2007).}


\footnote{157. INTERNATIONAL MONETARY FUND, supra note 21, at 43 ("The growth in transactions booked in offshore tax havens illustrates the channels that have opened for regulatory and tax arbitrage and underscore the importance of U.S. participation in international efforts toward coordinated and consistent supervisory and regulatory policies.").}
long duration [which] may result in regulation of the swaps relationship over the course of many years, rather than primarily at the time of the execution of the transaction as with the purchase or sale of cash instruments.”\(^{158}\) If the relevant facts to determine the applicable regulatory regime—such as the U.S.-person status of a counterparty under the CFTC’s proposed cross-border guidance—shift, the applicable regime may follow suit, subjecting counterparties to an entirely different set of requirements midway through the life of a transaction. The longer duration of contractual relationships between many swap counterparties underscores the importance of stability and soundness in today’s effort in regulating such cross-border transactions, as well as the desperate need for a set of uniformly applicable standards to determine the scope and applicability of various regulatory regimes.

A. The Implications of Morrison and its Progeny for the Extraterritorial Scope of Title VII

On June 24, 2010, less than a month before President Obama signed the Dodd-Frank Act, the U.S. Supreme Court decided *Morrison v. National Australia Bank* and ruled on the extraterritorial applicability of the Exchange Act’s antifraud provisions for the first time.\(^{159}\) The case involved an unusual scenario—a “foreign-cubed”\(^{160}\) securities fraud class action—yet the Court’s decision made an impact far beyond its unique set of facts.\(^{161}\) The extraterritorial applicability of DFA Title VII is one such area of law affected

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158. *Id.*


by *Morrison*. In order to focus the discussion of *Morrison* on its implications for Title VII extraterritoriality, global derivatives regulation and margin requirements for uncleared OTC derivatives, this Note will explain only portions of the case relevant to such discussion.

1. The Presumption Against Extraterritoriality

As a threshold matter, *Morrison* held that a law’s extraterritorial applicability is a question of what the relevant legislation states, rather than subject-matter jurisdiction. The Court explained that subject-matter jurisdiction pertains solely to a court’s “power to hear a case.”*162* The cornerstone of the *Morrison* decision was its reaffirmation of the Supreme Court’s longstanding presumption against extraterritoriality.*163* The Court restated this canon of statutory interpretation as a bright-line rule: “When a statute gives no clear indication of an extraterritorial application, it has none.”*164* The

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162. *Morrison*, 130 S. Ct. at 2877. Although this distinction seems relatively minor, it has surfaced as a point of contention in interpreting subsequent statutory provisions that purport to extend the law’s application extraterritorially. In particular, Section 929P(b) of the Dodd-Frank Act sought to circumvent *Morrison* by explicitly allowing the extraterritorial application of U.S. antifraud laws in cases brought by the SEC or Department of Justice. See Dodd-Frank Act § 929P(b), 15 U.S.C. § 77v(c) (Supp. IV 2010) (entitled “Extraterritorial Jurisdiction of the Anti-fraud Provisions of the Federal Securities Laws”); 156 CONG. REC. H5237 (daily ed. Jun. 30, 2010) (statement of Rep. Kanjorski) (“This bill’s provisions concerning extraterritoriality, however, are intended to rebut that presumption by clearly indicating that Congress intends extraterritorial application in cases brought by the SEC or the Justice Department.”). However, whether by accident or not, the heading of that section includes the word “jurisdiction.” Accordingly, the provision has been widely criticized, with some scholars arguing that it has no legal impact in altering the law’s extraterritorial scope. See, e.g., George T. Conway III, *Extraterritoriality after Dodd-Frank*, HARV. L. SCH. FORUM ON CORP. GOVERNANCE & FIN. REG. (Aug. 5, 2010, 8:58 AM), http://blogs.law.harvard.edu/corpgov/2010/08/05/extraterritoriality-after-dodd-frank/. If this were to be the case, the provisions in Title VII that seem to address its extraterritorial application—Dodd Frank Act, Sections 722 and 772—would fall prey to the same labeling flaw. Because both provisions fall under sections plainly entitled “Jurisdiction,” one could argue that neither provision alters the extraterritorial scope of Title VII. However, in light of such clear Congressional intent for the law to apply abroad in the circumstances described, this argument appears unlikely to prevail.

163. *Morrison*, 130 S. Ct. at 2877 (“Legislation of Congress, unless a contrary intent appears, is meant to apply only within the territorial jurisdiction of the United States.”).

164. *Id.* at 2878. The Supreme Court recently invoked this canon again, emphasizing the “presumption that United States law governs domestically but does not rule the world,” *Kiobel v. Royal Dutch Petroleum Co.*, 133 S. Ct. 1659, 1664 (2013) (quoting *Microsoft Corp. v. AT & T Corp.*, 550 U.S. 437, 454 (2007)).
Court also analyzed examples of statutory language that does, or does not, rebut the presumption against extraterritoriality. This analysis sheds light on how the two DFA Title VII provisions on extraterritorial applicability must be interpreted.

In deciding the extraterritorial reach of the SEA’s antifraud provisions, the Court in Morrison examined SEA Sections 30(a) and 30(b), which bear a striking resemblance to DFA Sections 722(d) and 772(b), respectively. The Court first examined SEA Section 30(b). Section 30(b) provides that the SEA does not apply “to any person insofar as he transacts a business in securities without the jurisdiction of the United States,” unless he does so in violation of the SEC’s anti-evasion rules and regulations with respect to the SEA.165 The Court interpreted SEA Section 30(b) to be “directed at actions abroad that might conceal a domestic violation, or might cause what would otherwise be a domestic violation to escape on a technicality,” and held that it did not overcome the presumption against extraterritoriality with respect to the SEA’s antifraud provisions.166 The operative language of SEA Section 30(b) is identical to that of DFA Section 772(b): Title VII does not apply “to any person insofar as such person transacts a business in security-based swaps without the jurisdiction of the United States,” unless he does so in violation of the SEC’s anti-evasion rules and regulations with respect to Title VII.167 Therefore, one would expect the provisions to hold the same jurisdictional meaning. In this way, Morrison suggests that DFA Section 772(b) permits extraterritorial application only for anti-evasion rules and regulations related to SEA provisions added by Dodd-Frank, to the same extent that extraterritorial application is already allowed for all other SEA anti-evasion rules and regulations.168 In addition, this resemblance indicates that DFA Section 772(b) does not rebut the Court’s presumption against extraterritoriality in instances of statutory violation, rather than statutory evasion. Thus, like the SEA antifraud provisions, which are not extraterritorial despite SEA Section 30(b), DFA provisions with respect to the SEC’s regulation of securi-

165. See 15 U.S.C. § 78dd(b) (2006) (“The provisions of this chapter or of any rule or regulation thereunder shall not apply to any person insofar as he transacts a business in securities without the jurisdiction of the United States, unless he transacts such business in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate to prevent the evasion of this chapter.”).

166. Morrison, 130 S. Ct. at 2882–83 (“And if the whole Act applied abroad, why would the Commission’s enabling regulations be limited to those preventing ‘evasion’ of the Act, rather than all those preventing ‘violation’?”)

167. Dodd-Frank Act § 772(b).

ty-based swaps will also not apply abroad despite Section 772(b).

Further supporting this conclusion, the Court discussed a provision describing the purposes of the Exchange Act, which states that "transactions in securities as commonly conducted upon securities exchanges and over-the-counter markets are affected with a national public interest." The Court held that this provision did not rebut the presumption against extraterritoriality, and noted that "[n]othing suggests that this national public interest pertains to transactions conducted upon foreign exchanges and markets." This reasoning suggests that the Court would also interpret Dodd-Frank's neutral provisions on OTC derivatives markets only to apply to domestic OTC derivatives markets. Accordingly, Morrison appears to prohibit the extraterritorial application of Title VII, including margin requirements, at least insofar as it modifies the Exchange Act to govern security-based swaps.

In contrast to its analysis of SEA Section 30(b), the Court highlighted SEA Section 30(a) as an example of a statutory provision that contained the critical element: "a clear statement of extraterritorial effect." SEA Section 30(a) provides that the Exchange Act's prohibitions apply to broker and dealer transactions "on an exchange not within or subject to the jurisdiction of the United States," when such transactions involve any security "the issuer of which is a resi-
dent of, or is organized under the laws of, or has its principal place of
business in, a place within or subject to the jurisdiction of the United
States.”173 The Court held that Section 30(a)’s “explicit provision
for a specific extraterritorial application” rebutted the presumption
against extraterritoriality.174 This holding suggests that the language
of DFA Section 722(d) might also rebut the presumption against ex-
traterritorially. Section 722(d) states that Dodd-Frank’s swap-related
provisions apply to “activities outside the United States” when they
“have a direct and significant connection with activities in, or effect
on, commerce of the United States.”175 Like the language in SEA
Section 30(a), which refers to transactions on foreign exchanges in-
volving a United States security, the language in DFA Section 722(d)
also refers to foreign activity, namely that with a “direct and signifi-
cant” connection to or effect on American commerce. As both sec-
tions contain language providing for extraterritorial application in a
limited context, this similarity indicates that 722(d) may also consti-
tute the requisite “clear statement of extraterritorial effect.” There-
fore, unlike Section 772(b), Section 722(d) is likely to overcome the
Court’s presumption against extraterritoriality.

When considering the extraterritorial applicability of Title
VII’s margin requirements, the foregoing analysis of Morrison shows
that the asymmetry between the CFTC’s jurisdictional grant in Sec-
tion 722(d) and the SEC’s jurisdictional grant in Section 772(b) ef-
effectively creates an uneven border between what must and what need
not comply with Title VII margin requirements. If it is true that Sec-
tion 722(d) rebuts the presumption against extraterritoriality and its
Section 772(b) counterpart does not, the same type of extraterritorial
swap activity that is subject to Title VII margin requirements need
not comply if it instead deals in security-based swaps. An uneven ju-
risdictional scope, such as that of Title VII, complicates efforts to co-
ordinate regulation internationally and may undermine Dodd-Frank’s
risk-mitigation objectives.

Moreover, while it sanctioned foreign application of a law
containing an “explicit provision for a specific extraterritorial appli-
cation,”176 the Court in Morrison emphasized that “when a statute
provides for some extraterritorial application, the presumption
against extraterritoriality operates to limit that provision to its

174. Id. (emphasis added).
176. Morrison, 130 S. Ct. at 2883 (emphasis added).
722(d) constitutional many be the extent "direct and significant" requirement is adequately circumscribed to be considered a "specific extraterritorial application." The segment of regulated conduct is more narrowly defined in SEA Section 30(a) than in DFA Section 722(d), and in this way Section 722(d) is not equivalent to the "explicit provision for a specific extraterritorial application" in SEA Section 30(a). The breadth of conduct that may fall within DFA Section 722(d)’s "direct and significant" ambit could lead courts to instead decide that that the provision is inadequately specific.

2. The Transactional Test

Of additional relevance to an analysis of Title VII’s extraterritorial scope, the Court in Morrison introduced a new test for distinguishing between what is a domestic and what is an extraterritorial application of law. Because much global activity will involve some contact with the territory of the United States, the Court looks to the “‘focus’ of Congressional concern” in deciding a statute’s applicability, and decided that the “focus” of the Exchange Act is "upon purchases and sales of securities in the United States." In its central holding, the Court determined that SEA Section 10(b) applies only to “[1] transactions in securities listed on domestic exchanges[] and [2] domestic transactions in other securities.” In light of the probability that Title VII, insofar as it amends the SEA and governs security-based swaps, has only domestic applicability, this “transactional” test will likely determine the contours of its scope. To the extent that the transactional test constitutes persuasive authority in the interpretation of statutes other than the Exchange Act, it will also be relevant in determining Title VII’s extraterritorial scope with respect to CFTC-regulated swaps. Due to the cross-border nature of many derivatives transactions, a significant portion of market activity

177. Id. (citing Microsoft Corp. v. AT&T Corp., 550 U.S. 437, 455–456 (2007)).
178. Moreover, the questions of whether the CFTC proposed cross-border guidance is constitutional under existing law and precedent and whether it is within the scope of Section 722(d) are salient issues, but beyond the scope of this inquiry.
179. Id. at 2884.
180. Id.
181. See supra Part II.A.1.
will likely be affected by how the transactional test is interpreted.\(^{182}\)

Given that uncleared OTC derivatives are by definition not traded on an exchange, they are more appropriately analyzed under the second prong of *Morrison*’s transactional test, “domestic transactions in other securities.”  \(^{183}\) In explaining this prong, the Court reasoned that “the exclusive focus on domestic purchases and sales is strongly confirmed by [SEA Sections] 30(a) and (b), discussed earlier.” \(^{184}\) The Court explained that “[u]nder both provisions it is the foreign location of the transaction that establishes (or reflects the presumption of) the Act’s inapplicability, absent regulations by the Commission.” \(^{185}\) Because this key reasoning derives from statutory provisions other than the substantive provision at issue in *Morrison*, SEA Section 10(b), the “domestic transactions” requirement can be read to apply to the entire Exchange Act. \(^{186}\) However, *Morrison* did not further define “domestic transactions in other securities.” In light of the slippery, cross-border nature of some derivative transactions, *Morrison*’s failure to define this key term to add to the existing uncertainty surrounding the extraterritorial scope of Dodd-Frank’s derivatives reform.

Finally, in analyzing the extraterritorial scope of other statutory provisions, such as margin requirements on uncleared derivatives, it is noteworthy that the Court introduced the transactional test in a case interpreting the SEA’s antifraud provisions. In establishing the test, the Court sought to avoid “interference with foreign securities regulation that application of § 10(b) abroad would produce.” \(^{187}\) This statement reflects the Court’s clear intention to minimize its application of the antifraud provisions abroad, absent statutory language with “a clear statement of extraterritorial effect.” \(^{188}\) Because fraud prevention is likely the most justifiable scenario in which the Court might apply U.S. securities laws extraterritorially, \(^{189}\) the use of

\(^{182}\) See *supra* notes 57–58 and accompanying text.

\(^{183}\) *Morrison*, 130 S. Ct. at 2884.

\(^{184}\) *Id.* at 2885. See *supra* Part II.A.1.

\(^{185}\) *Morrison*, 130 S. Ct. at 2885.

\(^{186}\) *Id.* This reasoning has been interpreted in subsequent cases to restrict the extraterritorial scope of the Securities Act. See, e.g., S.E.C. v. Goldman Sachs & Co., 790 F. Supp. 2d 147, 164 (S.D.N.Y. 2011) (“Section 17(a) of the Securities Act does not apply to ‘sales that occur outside the United States’”). The Court also noted that the Securities Act of 1933 contains the same focus on domestic transactions. *Id.* at 2884.

\(^{187}\) *Id.* at 2886.

\(^{188}\) *Id.* at 2883.

\(^{189}\) I would like to thank Professor Edward Greene for pointing this out to me.
the transactional test in this case suggests that the Court may be unlikely to find justifiable any extraterritorial application exceeding the transactional test for other statutory provisions, absent a clear statement of extraterritorial effect.

3. Morrison’s Progeny

Since the Supreme Court handed down its decision in Morrison on June 24, 2010, a number of lower court cases have interpreted Morrison’s holding and analysis, including the new transactional test. These cases have added to the legal understanding of both whether a statute rebuts the presumption against extraterritoriality and whether a particular application of a statute is considered domestic or extraterritorial under the transactional test. Because uncleared OTC derivatives are by definition not traded on an exchange, this section will focus on the second prong of the transactional test, “domestic transactions in other securities.”

Unsurprisingly, a central issue in the aftermath of Morrison is how to determine when a transaction is considered “domestic.” Morrison itself provides little guidance on this point, because the security at issue in that case was traded on exchanges. Yet unlike transactions on an exchange, it can be difficult to pinpoint both when and where off-exchange transactions technically occur. This is especially true for OTC derivatives, which commonly involve a several steps and individuals in multiple countries; thus, subsequent interpretation of Morrison’s holding is helpful in considering what aspects of a derivative transaction are determinative of whether or not it is a “domestic transaction.”

A consensus is emerging on how to decide what qualifies as a “domestic transaction” for the purposes of the second prong of the transactional test announced in Morrison. In Absolute Activist

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190. Morrison, 130 S. Ct. at 2875.

191. See Joshua Boehm, Private Securities Fraud Litigation after Morrison v. National Australia Bank: Reconsidering a Reliance-Based Approach to Extraterritoriality, 53 HARV. INT’L L.J. 501, 517 (2012) (“Unlike exchange transactions[,] it is often unclear when an OTC purchase or sale occurs, thus creating an additional question for courts to answer before they can consider the actual location of the transaction.”).

192. See, e.g., Absolute Activist Value Master Fund Ltd. v. Ficeto, 677 F.3d 60, 68–69 (2d Cir. 2012); Quail Cruises Ship Mgmt. Ltd. v. Agencia de Viagens CVC Tur Limitada, 645 F.3d 1307, 1310 (11th Cir. 2011). In addition, the U.S. District Court for the Southern District of New York has consistently held that to qualify under Morrison’s second prong, a party must incur “irrevocable liability to purchase or sell the security in the United States.” Basis Yield Alpha Fund (Master) v. Goldman Sachs Group, 798 F. Supp. 2d 533, 537
Value Master Fund Ltd. v. Ficeto, the Second Circuit recently articulated a clear standard: “a securities transaction is domestic when the parties incur irrevocable liability to carry out the transaction within the United States or when title is passed within the United States.” For irrevocable liability, it is sufficient either “that the purchaser incurred irrevocable liability within the United States to take and pay for a security, or that the seller incurred irrevocable liability within the United States to deliver a security.” In the same breath, the court held irrelevant to the location of a given transaction “the identity of the parties, the type of security at issue, or whether each individual defendant engaged in conduct within the United States,” as well as the parties’ residency or citizenship, whether the securities were heavily marketed in the United States and whether U.S. investors were harmed by the transaction. It has also been widely accepted that a purchase order in the United States for a security traded abroad is not sufficient to qualify as a domestic transaction.

Similarly, in Quail Cruises Ship Mgmt. Ltd. v. Agencia de Viagens CVC Tur Limitada, the Eleventh Circuit held that the location where the transaction closes (where the transfer of title occurs) is dispositive for the purposes of the Morrison test. At issue in this case was a “foreign-cubed” transaction: a purchase of a Bahamian corporation’s shares by another Bahamian corporation from a Brazilian corporation. Although the agreement was signed in Spain and


193. Absolute Activist Value Master Fund, 677 F.3d at 69 (2d Cir. 2012) (This test derived from the Exchange Act’s definitions of “buy” and “purchase,” which suggest that “the act of purchasing or selling securities is the act of entering into a binding contract to purchase or sell securities.”). 194. Id. at 68 (noting that the point of irrevocable liability is used to determine both the timing and locus of a purchase and sale).

195. Id. at 69–70.


197. Quail Cruises, 645 F.3d at 1310 (defining “closing” as where “the transaction [was] consummated” and defining “sale” as “the transfer of property or title for a price”) (citing Black’s Law Dictionary 291, 1461 (9th ed. 2009)).

198. Quail Cruises Ship Mgmt. Ltd. v. Agencia de Viagens CVC Tur Limitada, 732 F.
Uruguay, the transaction closed in Miami, Florida, and thus the transaction was consummated in the United States. The transaction agreement itself confirmed that the transfer of title did not occur until the closing. Reasoning that the transfer of title constitutes a sale, the court held that the transaction occurred in the United States.

Interestingly, one case has considered the question of when a security-based swap qualifies as a "domestic transaction" under the transaction test's second prong. In Elliott Associates v. Porsche, the U.S. District Court for the Southern District of New York held that over-the-counter security-based swaps that reference securities traded on a foreign exchange are not "domestic transactions." Instead, the court interpreted "domestic transaction[s] in other securities" to include "‘purchases and sales of securities explicitly solicited by the issuer in the U.S.,’ rather than transactions in foreign-traded securities—or swap agreements that reference them—where only the purchaser is located in the United States." In Porsche, the plaintiffs signed confirmations for security-based swap agreements in New York, but this act was insufficient to make the agreements "domestic transactions." The court reasoned that, because the security-based swap agreements were "economically equivalent" to the purchase of the foreign stock, they were "essentially ‘transactions conducted upon foreign exchanges and markets,’ and not ‘domestic transactions.’"

Applying Porsche's "economic equivalence" theory to the Title VII derivatives provisions would further narrow the SEC's regulatory authority with respect to derivatives. In effect, rather than regulating all security-based swaps that satisfy the Ficeto test for "domestic transactions," this interpretation adds an additional requirement: the SEC would be authorized to regulate domestic security-based swap transactions only if the underlying security is traded on a U.S. exchange. Such a result test would exacerbate the asymmetry

Supp. 2d 1345, 1347 (S.D. Fla. 2010) vacated and remanded, 645 F.3d 1307 (11th Cir. 2011).

199. Quail Cruises, 645 F.3d at 1310.
200. Id.
201. See id.
203. Id. (quoting Stackhouse v. Toyota Motor Co., WL 3377409 (C.D. Cal. July 16, 2010)).
204. Id. at 474.
205. Id. at 476.
between the SEC and CFTC regulatory purview for security-based swaps and swaps, respectively, given the likelihood of a broader extraterritorial reading of 722(d) under Morrison.

Inverting the scenario in Porsche would lead to an equally arbitrary result. The court’s reasoning in Porsche would suggest that Title VII could apply to foreign security-based swap transactions—so long as they reference a U.S. security. Put simply, Title VII would cover all security-based swaps that reference U.S.-traded securities, regardless of where in the world the actual transactions take place. Given the fact that security-based swaps based on U.S. securities could trade anywhere in the world, this result would contradict Morrison itself, where the Court “reject[ed] the notion that the Exchange Act reaches conduct in this country affecting exchanges or transactions abroad.”206 Like the outcome in Quail Cruises, a foreign-cubed case in which the court held SEA Section 10(b) applicable, the reasoning in Porsche indicates that the transactional test may in certain circumstances expand the extraterritorial application of U.S. securities laws, the opposite of its intended effect. This example illustrates the difficulty of delineating a clear jurisdictional boundary for derivatives regulation.

4. Implications of Morrison for the Extraterritorial Application of Title VII Margin Requirements

The foregoing discussion on the legal constraints that govern Title VII’s jurisdictional scope evidences the urgent need for coordination among foreign and domestic regulators in order to achieve the intended risk-mitigating effects of margin requirements on uncleared derivatives. This analysis of Title VII’s extraterritoriality provisions in light of Morrison shows that DFA Sections 722(d) and 772(b) combine to create an asymmetrical border, covering some non-U.S.-person entities trading swaps and all domestic entities trading swaps and security-based swaps. Moreover, Morrison and its progeny underscores the difficulty in distinguishing to what extent DFA Section 722(d) rebuts the presumption against extraterritoriality, or exactly how far the CFTC regulations may reach in covering non-U.S.-person entities. Thus, absent cross-border coordination, Title VII and its resulting regulations could impose margin requirements, a substantial regulatory burden, on only a portion of the global OTC market, which could disrupt the market and trigger a flight from U.S. OTC derivatives markets.

For OTC derivatives market participants, the most immediate effect of Morrison and its progeny is tremendous legal uncertainty regarding the extraterritorial applicability of Title VII, especially given the ambiguous meaning of “direct and significant” (for swaps) and “domestic transactions” (for security-based swaps). Such regulatory uncertainty heightens the risk of regulatory gaps, overlaps or conflicts and adds confusion for market participants. It is evident that domestic regulation alone cannot achieve the risk-mitigating purpose of margin requirements on uncleared derivatives. This is especially true for security-based swaps, given the limited statutory authority provided by DFA Section 772(b). Cross-border coordination and domestic coordination between the CFTC and SEC are thus necessary, especially with respect to margin requirements, in order to forestall regulatory arbitrage and contain the systemic risks of uncleared derivatives.

B. The Necessity of Cross-Border Cooperation in Regulating Uncleared Derivatives

Cross-border derivative transactions involve decisions as to what determines the terms of the transactions, including terms explicating what margin regime applies to the transaction; however, the extraterritorial scope of Title VII as prescribed by Congress remains unclear. This set of circumstances has left key issues unanswered: Who will set margin requirements on uncleared derivatives in a cross-border setting? Will the standards adopted in the U.S. apply not only to domestic entities but also to their foreign subsidiaries and affiliates? Before regulators can answer any of these questions, however, they must address a threshold issue: the limits of domestic law and the concomitant need for cross-border cooperation.

1. Comity Constraints on the Extraterritorial Application of Domestic Regulation and the Current State of International Regulation

Today’s global regulatory landscape is best described as a “decentralized legal framework shaped primarily by national regula-

tors.\textsuperscript{208} This legal framework reflects the predominance of national sovereignty in international relations since the Treaty of Westphalia in 1648.\textsuperscript{209} In order for independent nations to coordinate within such a system, a body of customary international law has developed over the years.\textsuperscript{210} Customary international law has a binding force equivalent to that of treaty law.\textsuperscript{211}

The Supreme Court has long enforced principles of customary international law,\textsuperscript{212} including the principle of international comity.\textsuperscript{213} Justice Antonin Scalia once described comity as "the respect

\begin{itemize}
\item \textsuperscript{208} Verdier, supra note 52, at 56.
\item \textsuperscript{209} See John W. Foster, The Evolution of International Law, 18 YALE L.J. 149, 153 (1909) ("The Congress of Westphalia, convoked to bring the Thirty Years' War to an end, was one of the most memorable events in European history and marked the real beginning of international law. Grotius and the earlier publicists had done much to create a public sentiment in favor of a more rational and humane political system, but international doctrines only become laws when recognized and put in practice by the assent of sovereign States. After much time spent in determining the ceremonials attendant upon the meetings, a treaty of peace was at last signed in 1648. Its important provisions were the recognition of the independent sovereignty of the States of Europe; their right to exercise exclusive jurisdiction within their own territory; the regulation of the intercourse of these States; the right of each State to negotiate its own treaties; and the establishment, nominally at least, of religious toleration.").
\item \textsuperscript{210} RESTATEMENT (THIRD) OF FOREIGN RELATIONS LAW § 102 (1987) ("Customary international law results from a general and consistent practice of states followed by them from a sense of legal obligation."). See, e.g., The Schooner Exch. v. McFaddon, 11 U.S. 116, 137 (1812) ("A nation would justly be considered as violating its faith, although that faith might not be expressly plighted, which should suddenly and without previous notice, exercise its territorial powers in a manner not consonant to the usages and received obligations of the civilized world.").
\item \textsuperscript{211} Curtis A. Bradley & Jack L. Goldsmith, Customary International Law As Federal Common Law: A Critique of the Modern Position, 110 HARV. L. REV. 815, 818 (1997) (citing RESTATEMENT (THIRD) OF FOREIGN RELATIONS LAW § 102 cmt. j (1987)) ("Despite its relatively amorphous nature, CIL has essentially the same binding force under international law as treaty law.").
\item \textsuperscript{213} The classical doctrine of comity was originally described as "the recognition which one nation allows within its territory to the legislative, executive or judicial acts of another nation, having due regard both to international duty and convenience, and to the rights of its
sovereign nations afford each other by limiting the reach of their laws." 214 Fundamentally, this principle urges Congress to take into account the legitimate sovereign interests of other nations when drafting legislation and requires courts to “avoid unreasonable interference with the sovereign authority of other nations” when interpreting Congressional legislation. 215 Stated differently, a nation “may not exercise jurisdiction to prescribe law with respect to a person or activity having connections with another state when the exercise of such jurisdiction is unreasonable.” 216 The U.S. Supreme Court has in recent years invoked “considerations of comity” to limit the extraterritorial application of domestic law. 217

In accordance with principles of international comity, U.S. financial regulation has historically followed a “national treatment” 218 model, which treats foreign and domestic businesses the same when they participate in local markets and gives deference to home country regulators with respect to business conducted abroad. 219 For example, tasked with the primary goal of protecting U.S. investors, the SEC “generally applies a uniform standard to every market participant [within its jurisdiction].” 220 However, the national treatment model assumes that a given transaction takes place within only one jurisdiction, thus it is an inadequate approach to regulating cross-border activity. In a deviation from the national treatment model, the CFTC has proposed an interpretation of Dodd-Frank

own citizens or of other persons who are under the protection of its laws.” Hilton v. Guyot, 159 U.S. 113, 164 (1895).


219. Stout, supra note 21, at 35.

220. Greene, supra note 155, at 7. However, foreign companies are exempt from some requirements: proxy rules, quarterly reporting, reporting requirements for transactions by statutory insiders pursuant to Section 16 of the Exchange Act, compensation disclosure requirements, and accounting compliance with U.S. GAAP. Id.
that will apply Title VII’s swap-related provisions to a wide range of overseas and cross-border transactions involving U.S. persons. Yet any extraterritorial application of Title VII must still comply with the principle of international comity and the “need to avoid unnecessary interference with the interests of other nations.”

2. Practical Problems with the Extraterritorial Application of Domestic Regulation

In addition to potential violations of international comity, the extraterritorial application of domestic law raises numerous practical problems. In a letter to European and U.S. regulators, major trade associations cautioned that extraterritorial application of domestic law “is a fundamental concern in a global market like derivatives, where it is common for counterparties based in different parts of the world to transact with each other.” The group highlighted the practical dangers of divergence, including duplicative registration requirements, potential overlap and conflict in regulatory requirements for market participants in foreign jurisdictions, discriminatory rules against certain foreign participants, as well as more general concerns of protectionism, fragmentation, and regulatory arbitrage.

A number of past policy debates are relevant in light of the international implications of present-day financial reforms. In opposition to the Sarbanes-Oxley Act, for example, New York City Mayor Michael Bloomberg and U.S. Senator Charles Schumer issued an extensive policy report arguing that heavy domestic regulation imposes international competitiveness burdens, incurs significant financial costs for business, and would erode American’s status as the preeminent financial services market. Specifically mentioning extraterritori-

221. See supra Part I.B.3.
222. Buxbaum, supra note 212, at 7.
223. Leaders from the International Swaps and Derivatives Association (ISDA), Global Financial Markets Association (GFMA), European Banking Federation (EBF), Alternative Investment Management Association (AIMA), Futures and Options Association (FOA), Investment Management Association (IMA), Wholesale Market Brokers’ Association (WMBA) and London Energy Brokers’ Association (LEBA) authored the letter. Letter to Commissioner Barnier and Secretary Geithner on Extra-Territoriality, at 2 (July 5, 2011), available at http://www.isda.org/ (type “Letter to Commissioner Barnier and Secretary Geithner on Extra-Territoriality” into the search box at the top of the page; press search; click on hyperlink to access PDF) (on file with the Columbia Journal of Transnational Law).
224. Id.
toriality, the report argues that “the increasing extraterritorial reach of U.S. law and the unpredictable nature of the legal system were . . . significant factors that caused New York to be viewed negatively” by business leaders.226

Conversely, the potential benefit from international cooperation has never been greater. Efficient global markets with adequately managed risk has the potential for unprecedented economic growth and prosperity. In a recent report on U.S. financial stability, the IMF pointed out that interlinkages with foreign derivatives markets “increase the premium on mutually consistent macroeconomic and financial policies.”227

The practical and even conceptual limitations of purely domestic regulation underscore why the United States alone cannot effectively address the systemic risks of a fully global market. In addition, the prospects of extraterritorial application of margin requirements raises fundamental issues of customary international law. Supranational regulation is not a politically feasible solution in the present geopolitical framework, as nation-states do not relinquish sovereignty lightly. Thus in order to maximize efficiency and stabilize risk, financial regulators must achieve either harmonization or convergence in the context of mutual recognition.

3. The Prospects of International Harmonization

Simply defined, harmonization “seeks to achieve substantial similarity in multiple regulatory systems so that market participants face no additional burden in pursuing cross border activities.”228 Ideally, a harmonized regulatory system would minimize transaction costs for market participants trading globally while maintaining a minimum level of risk protection. Substantive harmonization is especially important to minimize opportunities for regulatory arbitrag in the context of uncleared derivatives, which is a particularly fluid market as uncleared derivatives can be executed anywhere in the world and the referenced instrument does not affect margin requirements. The Dodd-Frank Act recognizes the need for greater international cooperation in DFA Section 752, entitled “International Harmonization,” which requires that U.S. regulators “consult and coordinate with foreign regulatory authorities on the establishment of

226. Id. at 75.
227. INT’L MONETARY FUND, supra note 21, at 43.
228. Greene, supra note 155, at 6.
consistent international standards with respect to the regulation of derivatives and market participants.\textsuperscript{229}

Regulatory harmonization is attractive in theory; however, full substantive harmonization is cumbersome, at best, and unlikely to emerge from the current geopolitical climate.\textsuperscript{230} Most foreign and domestic regulators have acknowledged that "complete harmonization—perfect alignment of rules across jurisdictions—is difficult as it would need to overcome jurisdictions' differences in law, policy, markets and implementation timing, as well as to take into account the unique nature of jurisdictions' legislative and regulatory processes."\textsuperscript{231} This is certainly the case for margin requirements, where regulators face detailed issues such as what type of assets should eligible collateral when counterparties are required to post margin, what amount should necessary, whether the collateral should be segregated and whether it may be rehypothecated. Further, the slow action—or absence of any action at all—on the part of some regulators around the world would make implementation timing a fatal flaw with respect to Dodd-Frank's margin requirements for uncleared OTC derivatives. Timing is a salient consideration for margin requirements because margin has a direct impact on the cost of a transaction, making it highly attractive for market participants to shift away from jurisdictions with stringent margin requirements.

Recent history, moreover, shows that harmonization is difficult to achieve and maintain. "Transnational regulatory networks" (TRNs) such as International Organization of Securities Commissions (IOSCO), Basel Committee on Banking Supervision (BCBS) and the International Association of Insurance Supervisors (IAIS) emerged in the 1970s to facilitate cooperation in addressing cross-border issues. In their attempts to harmonize national financial regulations through the adoption of international standards, these organizations have been hindered by difficult distributive issues, a lack of political and legal authority and serious monitoring and enforcement problems.\textsuperscript{232} Often, in order to resolve disagreement among countries while drafting international standards, TRNs will avoid provi-

\textsuperscript{229} Dodd-Frank Act § 752. In addition, Section 719(c) requires the CFTC and SEC to conduct a study on international swap regulation that identifies areas of regulation that could be harmonized. This requirement resulted in an informative joint report. See SEC. EXCH. COMM'N & COMMODITY FUTURES TRADING COMM'N, supra note 28.

\textsuperscript{230} See Joint Press Statement on the Regulation of the Cross-Border OTC Derivatives Market, supra note 49.

\textsuperscript{231} Id.

\textsuperscript{232} Verdier, supra note 52, at 57, 61.
sions to which individual countries object. Consequently, the final product articulates standards at a high level of generality.233

Similarly, Europe’s experience in harmonizing its financial regulations illustrates how the lack of a central enforcement authority, paired with wide-ranging interpretation and application of rules, will likely fail to produce uniform regulations across a number of countries.234 For example, Europe’s Financial Services Action Plan (FSAP) was a “comprehensive initiative designed to create a single European market for wholesale financial services, open and secure retail markets, and appropriate prudential rules and supervision . . . .”235 Because member states retain significant legislative authority, however, effective EU legislation is very difficult.236 Although it brought securities regulation among European countries closer together, FSAP demonstrated how difficult it is for numerous and diverse countries to agree on and consistently implement the same rules.

In summary, international comity and practical necessity of regulating the global OTC derivatives market necessitate cross-border cooperation among domestic regulators in order to implement and enforce regulatory standards that maximize efficiency and systemic stability. While consistent international standards are an admirable goal, substantial obstacles stand in the way of complete substantive harmonization on a near-term basis. Accordingly, regulators should consider to alternative methods of cross-border cooperation.

III. EVALUATING A MUTUAL RECOGNITION APPROACH TO MARGIN REQUIREMENTS ON UNCLEARED DERIVATIVES

This Note argues that a mutual recognition approach is the most viable solution to the extraterritorial uncertainty and international coordination problem with respect to Title VII’s margin requirements for uncleared derivatives. Mutual recognition is best defined as “an understanding among two or more states under which each recognizes the adequacy of the other’s regulation or supervision of an activity or institution as a substitute for its own.”237 This in-
volves an initial determination by a host country regulator that an entity’s home jurisdiction’s regulatory regime is “sufficient to regulate market participants from that jurisdiction without the imposition of additional regulation by the host country regulator to protect its investors.” Recognition of comparable regulatory regimes in this way allows market participants from the home country to access the host country’s markets through an exemption from some or all of the host country’s regulations. This type of regulation can exist on either a mutual (reciprocal) or unilateral basis. Unlike harmonization, which seeks to eliminate substantive regulatory divergence among countries, mutual recognition requires only “equivalent” or “comparable” regulatory regimes.

A. Examples of Mutual Recognition in The United States

Although mutual recognition is without precedent in the context of cross-border derivatives regulation, there are several instances in which the approach has been employed in the United States. These examples help to illustrate the concept. Mutual recognition can exist on either a bilateral or multilateral basis. The European Union and ASEAN are examples of the latter.

1. CFTC Part 30

The CFTC Part 30 rules are an early example of mutual recognition in the United States. Under the Part 30 rules the CFTC may permit persons who would otherwise be required to register as Commodities Trading Advisors (CTA) to be exempt from registration as a CTA, provided that the CFTC has determined that they are

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238. Greene, supra note 155, at 6.
239. Verdier, supra note 52, at 63.
240. Id.
241. In addition, mutual recognition frameworks have been implemented elsewhere in the world, including a regime for disclosure and accounting standards in the European Union. See Greene, supra note 155, at 9.
242. Id. at 57.
243. CFTC Regulations, 17 C.F.R. § 30.10 (2013); Greene et al., supra note 83, at 17-129 & n.590.

LAW & CONTEMP. PROBS. 263, 268 (2005) (explaining that mutual recognition “consensually transfers authority from the host state to the home state: instead of the former applying its laws extraterritorially to protect its residents, the latter applies its laws extraterritorially to protect others”).
subject to a comparable regulatory regime in their home jurisdiction. To qualify as such a regime, non-U.S. regulators must apply for a CFTC evaluation of local regulations, after which the Commission will determine if it is "comparable, or broadly equivalent, to the CFTC regulations imposed on US firms." In addition, such exempted advisors are required to file certain information with domestic authorities and adequate information sharing arrangements between the non-U.S. regulator and the CFTC must be in place.

The Part 30 rules have continued relevance today. In November of 2010, the CFTC proposed to use the Part 30 comparability analysis to determine whether to register a foreign board of trade under Section 738 of Dodd-Frank. Because the Part 30 rules were not addressed in Title VII, it is unclear what, if any, role they have with respect to resolving the extraterritorial challenge of prudential derivatives regulation after Dodd-Frank. However, CFTC Chairman Gary Gensler has stated that "[t]he Dodd-Frank Act gives the CFTC the flexibility to recognize foreign regulatory frameworks that are comprehensive and comparable to U.S. oversight of the swaps markets in certain areas."

2. SEC and Australia Agreement

U.S. regulators took their boldest step thus far towards im-

244. Greene et al., supra note 83, at 17-129 n.590.
246. Greene et al., supra note 83, at 17-129. See also Petitions for Exemption, 17 C.F.R. § 30.10 (2013). The CFTC has stated that the minimum elements of a comparable regulatory program would include the following:

(1) registration or licensing to ensure the qualifications of persons who will solicit or accept customer orders;
(2) minimum financial requirements for persons who accept customer funds;
(3) rules to protect customer funds from misapplication;
(4) recordkeeping and reporting requirements;
(5) minimum sales practice standards, including disclosure of the specific risks of foreign futures and foreign options; and
(6) compliance procedures.

Interpretive Statement with Respect to the Commission's Exemptive Authority Under § 30.10 of Its Rules, 17 C.F.R. pt. 30, Appendix A.

248. Gensler, supra note 23.
249. Gensler, supra note 23.
plementing mutual recognition in the financial regulatory context on August 25, 2008. On that day, the U.S. Securities Exchange Commission, the Australia government and the Australian Securities and Investments Commission (ASIC) entered into a mutual recognition arrangement, which entailed a memorandum of understanding to consider permitting U.S. and eligible Australian stock exchanges and broker-dealers to operate in both jurisdictions without, in certain aspect, being regulated separately in both countries.\(^ {250} \) The agreement also provided for enhanced regulatory and enforcement cooperation between the SEC and ASIC.\(^ {251} \) This agreement was the intended to "serve[] as a pilot exercise in building a cross-border regulatory infrastructure to address the increasing globalization of our securities markets."\(^ {252} \)

The conceptual underpinnings of this early mutual recognition framework were outlined in an academic article by two senior officials at the SEC.\(^ {253} \) The officials explained that, in order to achieve the SEC's fundamental mandate—protecting investors, ensuring the efficiency and transparency of U.S. markets and facilitating capital formation in the United States—the SEC and foreign regulators must adapt their regulatory methods so as to accommodate the new interconnectivity of capital markets.\(^ {254} \) To accomplish this task, they proposed a framework that consists both of exemption requirements for regulated entities and "regulatory preconditions" required of the home jurisdiction in order to achieve comparability.\(^ {255} \) At the heart of the framework is a bilateral comparability assessment "to determine the degree to which the two jurisdictions' trading rules, prudential requirements, examinations, review processes for corporate filings, and other requirements are comparable" and to compare enforcement capabilities and philosophies.\(^ {256} \) This mutual recognition framework also requires unambiguous arrangement to


\(^{251}\) Id.

\(^{252}\) Id. (quoting Ethiopis Tafara, then-Director of the SEC's Office of International Affairs).


\(^{254}\) Id. at 31–32.

\(^{255}\) Id.

\(^{256}\) Id. at 58.
share enforcement- and supervisory-related information.\textsuperscript{257}

The SEC’s mutual recognition agreement with Australian authorities established a track through which stock exchanges and broker-dealers from each country would be able to operate in both countries without being subject to separate regulation in both countries. At the time of its signing, the two countries expected to begin considering applications for exemptions in early 2009. Unfortunately, only weeks later the world’s attention was captured by the financial crisis, and the Obama administration has yet to take further steps on this agreement.

\textbf{B. Advantages of a Mutual Recognition System}

Mutual recognition has several advantages over alternative regimes, including substituted compliance. Although similar, mutual recognition is distinct from the concept of substituted compliance as defined in the CFTC cross-border proposed guidance. Under the CFTC’s proposed guidance, the CFTC will examine individual requirements of foreign regulatory regimes to determine whether they are “comparable to cognate requirements under the CEA and Commission regulations.”\textsuperscript{258} Unlike substituted compliance, which thus depends on equivalence determinations “on an individual requirement basis,”\textsuperscript{259} mutual recognition is based on an equivalence determination that examines the regime as a whole. Foreign regulators have voiced their concerns with the CFTC’s narrow equivalence approach.\textsuperscript{260} In addition, mutual recognition entails an agreement entered into by two states, whereas substitute compliance, as defined in the CFTC proposed guidance, involves a unilateral determination by

\begin{compactitem}
\item \textsuperscript{257} \textit{Id.} at 32.
\item \textsuperscript{259} \textit{Id.}
\item \textsuperscript{260} \textit{See, e.g.}, Comment Letter from Financial Services Agency, Japan & Bank of Japan http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=58383&SearchText=(“We believe this determination should be made on a country-by-country basis, and in a comprehensive manner, from the viewpoint of whether or not foreign regulation is broadly in alignment with US regulation and consistent with the overall objectives of the G20 commitments . . . . Furthermore, when certain requirements under Japanese regulations are not identical to those of the US at a particular point in time, it would not be acceptable for us that the [CFTC] applies its regulations in addition to Japanese regulations in place to address the differences. In other words, substituted compliance should respect foreign regulations as a set, not on a piecemeal basis.”).
\end{compactitem}
the CFTC rather than a mutual agreement between the U.S. and non-U.S. jurisdictions. A focus on comparable regulatory outcomes with all affected jurisdictions having a voice in the matter, rather than rule-by-rule comparisons effectuated only by the CFTC, is a more sustainable approach to this type of arrangement.

1. Efficient Global Markets

Mutual recognition would reduce duplicative regulatory-related transaction costs, such as the additional effort necessary to bring accounting details, prospectus content and periodic disclosure reports in conformance with each country’s specific regulatory requirement.\footnote{Greene, supra note 155, at 6.} By reducing this type of jurisdictional barrier, mutual recognition would likely decrease the overall cost of raising capital and further-integrate global capital markets, enabling more efficient use of capital. Such increased efficiency would be accompanied by a greater equivalence of risk-management regulations globally, which would help to ensure the stability of future global economic growth.

Moreover, reducing unnecessary regulatory barriers would enhance the competitive advantages of U.S. markets by making it less cumbersome for foreign market participants to trade in the United States or with U.S. persons.\footnote{Id. at 31 ("The importance of reducing arbitrary regulatory barriers—whether by harmonization, unilateral recognition or mutual recognition—is increasing from the US perspective. While European and other non-U.S. issuers were previously willing to subject themselves to US regulation in order to access the capital markets in the United States, this willingness appears to be decreasing. In recent years non-US issuers considering cross-border financings are increasingly seeking foreign listings outside the United States.").} By contrast, unilateral imposition of margin requirements would be both under- and over-inclusive, harming the competitiveness of U.S. market participants in the process, at least until the majority of global jurisdictions have implemented similar regulatory reforms. Trading would likely migrate to Asia to avoid strict U.S. and E.U. rules, and foreign branches of U.S. entities would become too encumbered to compete.\footnote{Jones, supra note 19 ("I would call it a competitive nightmare," said one attorney at a Wall Street bank [...] "In Europe, the U.S. banks are going to be on the Dodd-Frank playing field, and European banks are going to be on a very different playing field, which is much less tilted against them.").}

Similarly, improving international regulatory coordination through mutual recognition would eliminate duplicative regulation and reduce the regulatory gaps or "blind spots" that are characteristic
of the global OTC market. By thus streamlining the process for U.S. market participants trading overseas, U.S. investors would be better able to reap the rewards of participating in the global market. Accordingly, coordinated international regulation in the context of mutual recognition should be an attractive option to U.S. market participants.

2. Administrability Advantages

Mutual recognition enhances the administrability of cross-border regulatory regimes governing OTC derivatives. Reducing needless regulatory barriers will facilitate compliance, and information-sharing agreements and deference among foreign and domestic regulators will lessen the substantial enforcement burdens of the global OTC market. A mutual recognition framework would thus mitigate the likelihood of regulatory conflicts and gaps and discourage regulatory arbitrage, which can significantly undermine investor confidence globally. By insulating the financial system from these dangers, mutual recognition would instead facilitate international cooperation and encourage uniformly high regulatory standards in the global market. At the same time, the optionality to decline recognition of another country’s regime allows domestic regulators to retain ultimate control over the safety and stability of the domestic market within their purview.

Moreover, an assessment of comparable regulatory outcomes under mutual recognition would likely be less cumbersome to administer and more effective than the regulation-level comparability assessment proposed by the CFTC’s concept of substituted compliance. Similarly, unlike an unwieldy harmonization process, under a mutual recognition system domestic regulators retain significant authority to mold their country’s access to global markets according to domestic priorities. This coordinated approach will also allow diversity of

264. Tafara & Peterson, supra note 253, at 32.
265. Greene, supra note 155, at 34.
266. See Jones, supra note 19 (noting that one such gap, due to a lack of coordination between U.S. and E.U. regulators, contributed to AIG’s downfall: “The insurer booked many of its swaps in Europe, where regulators in 2007 decided that U.S. authorities should have oversight. That transatlantic split ‘excluded any comprehensive examination and regulation’ of AIG’s credit-default swaps, the U.S. Congressional Oversight Panel said in a June 2010 report.”).
267. Id. at 33.
268. Id. at 32.
regulation, which can foster a more innovative regulatory environment and more effectively protect against systemic risk.

3. Fairness and Comity

By definition, regulators under a mutual recognition regime must take into account the sovereign interests of other countries. In this way, a mutual recognition approach to cross-border regulation would uphold longstanding principles of international comity. Although markets and societies are becoming increasingly borderless, national sovereignty remains a cornerstone of the modern international system. As such, it is critical that nations, particularly the economic leaders, respect these core principles.

In an economic sense, mutual recognition promotes fairness by leveling the playing field for financial markets, exchanges and participants across national boundaries. By giving all participants an equal opportunity, regulatory flatness could yield surprisingly positive market results.

C. Challenges of a Mutual Recognition System

While mutual recognition is a promising solution to regulating globalized OTC markets, it is unlikely to be a perfect one. The difficulty of determining what exactly constitutes a "comparable" foreign regulatory regime is among the most obvious critiques. A certain degree of variation among jurisdictions will likely persist. In light of this fact, the need would arise for a multilateral agreement to address basic coordination issues for transactions subject to mutual recognition systems.

Moreover, after comparability among jurisdictions has been established, it is unclear how regulators will decide which country’s transaction-specific requirements should apply to various types of cross-border derivatives contracts. In this way, transaction-specific requirements raise more complexities than do entity-specific requirements such as the registration requirements at issue in the U.S.-Australia agreement. Moreover, with respect to margin specifically, such technicalities must be addressed for both initial and variation margin.

Further, an uncoordinated proliferation of bilateral mutual

recognition agreements could pose a novel type of coordination problem when a transaction triggers the jurisdiction of more than two countries. Coordination among bilateral treaties would thus be necessary to smooth barriers for individual transactions, and would drastically facilitate global operations for entities that transact with parties in many different countries. It would be important that such coordination set minimum standards for prudential requirements such as margin requirements on uncleared derivatives. Without multilateral coordination addressing such scenarios, some regulatory gaps in global regulation may still emerge.

CONCLUSION

There is no easy solution to this regulatory puzzle. OTC derivatives trading is a global business, and domestic regulation cannot alone manage the systemic risk created by this interconnected market—effective market-wide regulation is necessary. Margin requirements can curb the heightened risks posed by uncleared derivatives, yet the efficacy of this risk-management tool depends upon measured application of domestic regimes—"a lack of coordination between both foreign and domestic regulators could soon lead to a disruption of the derivatives markets."271

The ambiguous extraterritorial scope of Title VII has impeded progress towards the development of a stable derivatives market, and uneven imposition of margin requirements could cause irrevocable damage to the U.S. financial industry and the economy at large. Morrison demonstrates that Title VII’s requirements, at least with respect to SEC-regulated security-based swaps, could be interpreted as having only domestic effect. The Supreme Court’s new transactional test still adds uncertainty regarding the extraterritorial applicability of Title VII. Even if Title VII rebuts the presumption against extraterritoriality with respect to its requirements for CFTC-regulated swaps, principles of international comity require appropriate deference to foreign regulatory sovereignty—a second factor limiting Title VII’s

270 J.P. Morgan Chase CEO Jamie Dimon remarked in the spring of 2008, "[w]e have a terribly global world and, over all, financial regulation has not kept up with that . . . . I can’t even describe the seriousness of that." Schwartz & Creswell, supra note 89, at B1, B7–B8.

application abroad. Unilateral U.S. action imposing costly margin requirements on uncleared transactions could thus trigger a flight from U.S. derivative markets. To avoid the dangers of divergence among jurisdictions, minimize legal uncertainty for businesses and reduce systemic risk in the OTC derivatives market, foreign and domestic regulators—Congress included—must cooperate and strive for application of comparable domestic margin regimes to cross-border uncleared OTC derivatives contracts in the context of mutual recognition.272

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