THE INTERNATIONAL AND TRANSNATIONAL LAW OF COMPLEX FINANCIAL TRANSACTIONS

This panel was convened at 9:00 a.m., Thursday, April 5, 2018, by its moderator, Kristy Tillman of P.R.I.M.E. Finance Foundation, who introduced the panelists: Robert Pickel of Droit Financial Technologies, LLC; Sharon Brown-Hruska of NERA Economic Consulting; Timothy Massad of the Kennedy School of Government, Harvard University; and Charles W. Mooney of the University of Pennsylvania Law School.

THE IMPACT OF POST-CRISIS REGULATORY REFORMS ON CROSS-BORDER FINANCIAL TRANSACTIONS

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CROSS-BORDER FINANCIAL TRANSACTIONS AND POST-CRISIS REFORM

One of the near casualties of the global financial crisis (Crisis) was the march toward a more principles-based global regulatory structure that simultaneously encouraged cross-border transactions and recognized sovereign authorities over them without the necessity of a one-size-fits-all regulatory framework. The implementation of the G20 reforms for over-the-counter derivatives was far more prescriptive than principled. Post-crisis implementation of the G20 reforms, embodied in the United States in Title 7 of the Dodd Frank Wall Street Reform and Consumer Protection Act, yielded a costly, and in some markets, persistent loss of liquidity and fragmentation as market participants have attempted to sort out complex and sometimes competing regulatory requirements for reporting, trading, clearing, margin, and capital in practice.

At the peak of the global financial crisis, cross-border bank claims, one measure of international confidence in political and financial institutions, reversed its upward trend and flattened, tempered only by the flight to the quality of advanced economies’ debt. Nevertheless, as an economist, I am pleased to report that financial transactions still transcend national borders as competition in global financial and capital markets continues to drive innovation and opportunity. According to the World Bank, cross-border bank claims worldwide doubled from 2001 to 2014.¹ A refocus on policies that facilitate business, and ultimately, are aimed at reducing frictions to trade and investment will enable the return of economic growth rates to pre-Crisis levels and beyond. The increased vibrancy of domestic and global capital markets supports the efficient allocation of capital to regions and industries where that capital is most needed and which can achieve the most growth and the creation of the most jobs.

REGULATORY CHALLENGES TO EFFICIENT GLOBAL CAPITAL MARKETS

As a former financial regulator, however, I am also aware of the challenges posed to the efficient operation of global capital and financial markets by the diversity of legal and regulatory regimes

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applicable to financial transactions. Following the financial crisis, many jurisdictions increased financial regulations with an admirable intent—managing systemic risk—but questionable execution as a result of giving little thought to the costs imposed on financial institutions and the broader economy from reduced lending and financial intermediation. In addition to imposing large costs across jurisdictions from the overall trend toward increased financial regulation, the distinctions in post-Crisis regulations between jurisdictions have created regulatory arbitrage opportunities and competitive disadvantages.

For example, in the United States, Dodd-Frank regulations imposed both strict risk-based capital requirements and a risk-neutral supplementary leverage ratio intended as a “backstop” against efforts by financial institutions to game risk-based capital requirements. However, the United States imposed a leverage ratio that was higher than leverage ratios imposed in the UK and continental Europe, and many banks consider the leverage ratio to be the “binding” capital requirement rather than the risk-based capital requirements.

Critically, the U.S. leverage ratio includes risk-free and risk-reducing portions of the balance sheet as assets against which banks need to hold capital. This had the unintended consequence of making it extremely costly for banks to operate futures commission merchants (FCM), which have become vital to the smooth functioning of the clearing infrastructure, because banks are required to hold capital against segregated customer initial margin. However, customer margin, which is referred to as segregated because it is kept separate from the banks’ own capital backing derivative transactions, is a risk-reducing asset. With U.S. banks facing higher leverage ratio requirements than foreign competitors and being forced to hold capital against risk-mitigants, it is unsurprising that many U.S. banks have exited the futures commission merchant business. This has reduced domestic FCM options available to U.S. futures clients from one hundred to fifty-five, and given a shot in the arm to foreign competitors whose futures markets appear much more attractive.

REGULATORY COORDINATION AND MARKET FRAGMENTATION

Failures in post-Crisis regulatory coordination have had the unfortunate effect of fragmenting markets for particular types of financial products and transactions. For example, policymakers and regulators required that swap market participants comply with trade execution requirements, clearing requirements, margin requirements, and reporting requirements that differed across jurisdictions. As U.S. Commodity Futures Trading Commission (CFTC) Chairman J. Christopher Giancarlo warned in a speech in 2017, “the flawed swaps trading rules imposed by the CFTC in 2013 have put America at a disadvantage globally” and “have contributed to the continuing fragmentation of global [swap] markets into a series of distinct liquidity pools that are less resilient to market shocks and less supportive of global economic growth.” Such global competitive disadvantages, whether self-created by U.S. implementation of Dodd-Frank or arising from actions or decisions made outside U.S. control, are of serious concern to the current U.S. administration.

Other ongoing regulatory changes have also risked fragmenting markets or providing competitive advantages based on regulatory arbitrage. For example, the U.S. Department of Labor’s fiduciary rule may affect investment advisers and the structured products industry by determining which financial products can be sold, to whom, by whom, and under what circumstances in the United States. However, the rule’s full implementation was delayed until 2019 by the Trump

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administration to consider the full costs and benefits of the rule, and on March 15, 2018, a panel on the Fifth Circuit Court of Appeals vacated the Fiduciary Rule in its entirety. The Department of Labor has indicated it will not enforce the rule while it reviews options such as seeking en banc review or petitioning the U.S. Supreme Court.

At the same time, Europe’s Packaged Retail Investment and Insurance Products Regulation, called PRIIPs, will create a host of disclosure requirements for financial products sold to retail investors, including structured products, with likely consequences for securitizations across the continent. The differences between U.S. and European regulatory frameworks may create a niche for lawyers and consultants working with firms engaged in securitizations and the sale of structured products, as may likely litigation related to alleged violations of the fiduciary rule or the PRIIPs Regulation.

INTERNATIONAL MONEY LAUNDERING, VIRTUAL CURRENCY AND DATA PROTECTION REGULATION

Not all regulatory concerns come from post-Crisis regulations. Many regulatory authorities around the globe have tightened anti-money laundering (AML) rules or increased anti-money laundering enforcement activities substantially over the past two decades. This has resulted in financial institutions “de-risking” on an international scale, as many banks in advanced economies stopped providing certain services to firms and individuals in weaker anti-money laundering jurisdictions. For example, many large international banks have withdrawn from providing correspondent banking services to entire regions or industries in response to regulatory liability concerns. Ensuring that financial institutions comply with Know Your Customer and transaction monitoring requirements is essential to preventing money laundering and countering the financing of terrorism, but regulators should work with financial institutions to devise reasonable compliance frameworks rather than using the threat of costly enforcement actions to frighten large international banks into wholesale “de-risking” and ceding sizable markets to foreign competitors subject to weaker AML oversight.

Finally, it is worth considering the intersection between financial technology, regulation, and litigation. At present, blockchain-based virtual currencies called cryptocurrencies have been the subject of both intense media attention and, lately, international regulatory attention. Tax and AML authorities have generally been quick to assert their jurisdiction over cryptocurrencies as assets subject to tax laws and transaction monitoring requirements, although regulators have had varying degrees of success across jurisdictions. Commodities and securities regulators have also begun to assert themselves, with the CFTC declaring that virtual currencies are commodities, the U.S. Securities and Exchange Commission declaring initial coin offerings to be securities offerings, and some international financial regulators going so far as to raid virtual currency exchanges, as Japan’s Financial Services Agency has following costly hacks.

Intriguingly, in Europe, financial regulators may be less restrictive toward cryptocurrencies than their data protection regulators. Europe’s General Data Protection Regulation requires that companies completely erase the personal data of any citizen who requests that they do so. However, blockchain-based virtual currencies like Bitcoin may be unable to comply with the data protection regulation—altering past entries on a blockchain is intentionally made extremely difficult on most major cryptocurrencies to ensure that transactions are not modified after the fact by fraudsters. The problem goes beyond cryptocurrencies, as countless financial technology applications based on blockchain technology are under development. Absent regulatory clarifications exempting

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3 World Bank Report, supra note 1, at 105–06.
blockchains or providing a workaround, blockchain-based financial technology innovations may be inhibited by a legal and regulatory grey-zone or ban across Europe even as they continue to advance in jurisdictions like the United States.4

ENFORCEMENT AND LITIGATION IN CROSS-BORDER TRANSACTIONS

In terms of securities and finance litigation involving international markets or transactions, several recent cases highlight ongoing issues. In alleged benchmark manipulation cases, the global nature of both the firms setting the benchmarks and the counterparties and investors utilizing the benchmarks has resulted in jurisdictional conflicts—for example, should a foreign bank with U.S. assets whose accused employees were working out of a foreign office be sued in a U.S. court by a putative class consisting primarily of foreign citizens and entities? In addition, complex discovery issues can arise in such cases.

In alleged benchmark or index manipulation cases I have advised counsel on, a common theme is the use of “screens” to identify any purported anomalies in a given benchmark as evidence of potential manipulation in order to pursue expansive discovery requests against financial institutions. With respect to U.S. subsidiaries of foreign banks, when relevant documents are mostly located abroad, discovery can be an involved and laborious process, particularly when document requests run into complex foreign privacy laws. As the LIBOR cases wind down due to settlements, a host of other benchmark cases have been brought related to both interest rates and settlements in commodities, like precious metals. Based on my experiences in such cases, I fully expect both international jurisdictional disputes and discovery tussles to emerge in such cases. Absent government cooperation to resolve jurisdictional disputes, an independent forum like P.R.I.M.E. Finance, an organization I have long been associated with as an expert, can facilitate efficient dispute resolution.5

One particularly interesting issue in cases alleging international market manipulation is whether transactions can be defined as “domestic transactions” for purposes of application of U.S. securities laws or the Commodity Exchange Act (CEA). For example, in a putative class action filed by five Korean futures traders against Tower Research Capital alleging spoofing and the creation of artificial market prices, the federal district court initially dismissed the case on the ground that the Commodity Exchange Act does not apply extraterritorially. However, on March 29, 2018, the Second Circuit Court of Appeals overturned this ruling on the ground that the Korean futures transactions were “matched” in the United States on CME Globex before being cleared and settled in Korea.6 As a former commissioner and acting chairman of the CFTC, this is an issue I believe is worth watching. Many trades are matched on U.S. markets but ultimately cleared and settled abroad, so if other courts adopt similar reasoning, it stands to reason that the CEA and CFTC regulations regarding disruptive trading and manipulation could be applied to a larger range of transactions, potentially expanding the reach of spoofing and manipulation litigation in U.S. courts.