THE FINAL VOLCKER RULE AND ITS IMPACT ACROSS THE ATLANTIC.

The shaping of extraterritoriality in a world of dynamic structural banking reforms.

Elisabetta Cervone

University of Milan/World Bank

Elisabetta.cervone@unimi.it
Abstract

The Volcker Rule could potentially apply to the global structure of a foreign bank with U.S. branches or any business of foreign banks with U.S. counterparties. While concerns of an adverse extraterritorial impact appear to have mitigated in the final Volcker Rule, they still matter. This paper, in considering the different approaches adopted by the US and the EU toward extraterritoriality, namely unilateral extraterritoriality in the US and mutual recognition based on equivalence in the EU, emphasizes the fact that, even when there is no global standard – as in current structural reforms – mutual recognition based on equivalence would be a slow, complex process toward harmonization, but it might work. The purpose of this paper is to explore the prospects of harmonization and the development of global standards via extraterritoriality in banking structural measures, providing a view on the role national regulations as potential source of international financial law.
Table of Contents

Introduction .............................................................................................................................................. 4

PART I .......................................................................................................................................................... 6

THE FINAL VOLCKER RULE AND ITS APPLICATION TO FOREIGN BANKS ...................................................... 6
I. Basic rationale of the structural reforms ................................................................................................. 6
II. Regulatory disparities in transatlantic reforms: Volcker Rule versus EU Proposals ............................. 8
III. Volcker rule’s extraterritoriality ............................................................................................................ 12

PART II ........................................................................................................................................................ 15

“LOCALIZATION”, EXTRATERRITORIALITY AND THE AIM FOR EFFECTIVE GLOBAL STANDARDS AND COORDINATION ........................................................................................................... 15
I. Economic history and the unavoidability of “localization” ...................................................................... 15
II. The danger of “unilateral extraterritoriality” .......................................................................................... 17
III. Toward equivalence and mutual recognition (or substituted compliance) in developing global standards .................................................................................................................................................................................. 22

CONCLUSION .............................................................................................................................................. 25

BIBLIOGRAPHY .......................................................................................................................................... 27
**Introduction**

Extraterritoriality has become a hot topic in banking structural reforms, especially with the intensification of regulation in both sides of the Atlantic. We are confronted with the adoption, or planned adoption, of structural banking measures in several jurisdictions, which are considering whether to implement regulations that impose restrictions on the scope of banking activity, or have already taken concrete steps towards doing so. This paper focuses on the reforms in the U.S., UK and EU because those will be the ones creating more concerns in term of impact on systemic stability in other countries. These initiatives include the so-called Volcker rule in the United States, the Banking Reform Act (implementing the ‘Vickers’ report’) in the United Kingdom and the European Commission proposal on bank structural reform.

These structural reforms differ in scope and strictness: some diversification in national approaches is inevitable, reflecting existing differences in banks’ business models, size and concentration of banking system, level of development of financial markets and prevalence of non-bank financial intermediaries. Then, in dealing with “global banks”, extraterritoriality issues arise, such as under the Volcker Rule, which could potentially apply to the global structure of a foreign bank with U.S. branches or any business of foreign banks with U.S. counterparties.

There is the possibility that not having uniform approaches would affect efficiency and competitiveness of financial institutions, and may even create new opportunities for regulatory

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1 Proposal from the Commission for a Regulation of the European Parliament and of the Council on structural measures improving the resilience of EU credit institutions, Brussels, 29.1.2014 COM(2014) 43 final 2014/0020 (COD), available at [http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2014:0043:FIN:EN:PDF](http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2014:0043:FIN:EN:PDF). The proposal was first transmitted to the Council on 29 January 2014. The proposal has been hotly debated both in the ECON Committee and the Council and is facing a great deal of criticism. The ECON Committee published a draft report on the Commission’s proposal: the Hökmark report on Bank Structural Reform. The European Parliament’s rapporteur on bank structure reform, Gunnar Hökmark, in his draft report, proposed a number of significant amendments, including changes that would weaken the objectives, scope, definitions, mechanism and sanctions in the Commission's original proposal. The justification provided is that universal banks play an important role in financing commercial investments and that the drivers are residual systemic risks (i.e. risks that may remain even after the application of existing frameworks such as capital requirements or resolution planning). However, the vote in Committee which took place 26 May 2015 resulted in the ECON Committee rejecting the report by one vote: 30-29 with one abstention. The decision on future progress will be left to the ECON coordinators, which usually meet with the ECON Chair during every Strasbourg week to decide on the major procedural steps for the committee. There remains the necessary political intention to make progress on bank structural reform, so the idea that this file will be withdrawn by the Commission is somewhat exaggerated. On June 19th 2015 the ECOFIN Council agreed its negotiating stance.
August 10th, 2015

arbitrage. Almost all participants, home and host, advanced and emerging markets, acknowledged the potential for significant cross-border spillover and expressed concern regarding the cumulative cost implications of multiple national rules imposed on internationally active banks.

There is need to create global standards to avoid regulatory fragmentation. There is skepticism, however, about the slow pace of international soft law and in international regulators’ ability to have the right incentives to control systemic risk. In addition, territoriality, especially in banking structural reforms, often matters and a decision to apply a domestic framework extraterritorially may depend on whether this is necessary to achieve the (largely domestic) goal of the regulation.

The purpose of this paper is to explore the prospects of harmonization and the development of global standards via extraterritoriality in banking structural measures, providing a view on the role national regulations as potential source of international financial law. Although scholars have long recognized the extraterritorial effects of various financial rules, extraterritoriality is generally examined in the context of the conflicts of law literature. This paper intends, instead, to explore the possibilities of extraterritoriality as a regulatory strategy, specifically looking at equivalence clauses used to export the national regulatory model. In terms of curving systemic risk – which is the principal purpose of both the Volker Rule and the EU Proposal – the two sets of legislation are functional equivalent. Mutual recognition would have to be based on acceptance that, while those specific regulations may differ, both the US and the EU regulators can have confidence in one another’s regimes to achieve broadly comparable outcomes. If global standards existed, mutual recognition among those regulators would have greatly increased regulatory effectiveness and efficiency, especially given the increase of complexity of regulations affecting cross-border transactions and firms. Where a common, cross-jurisdiction issue is identified but there is no global standard – as in current structural reforms - it is equally important that policymakers work toward mutual recognition of local standards.

The answer, in terms of bottom-up approach toward harmonization, is not straightforward. The rules examined in this paper all attempt to reduce exposure to market risk as one part of reducing too-big-to-fail and each regime will likely have implications on the behavior of banks. The common element of the various initiatives examined is a mandatory separation of commercial banking from certain securities markets activities. However, while the US approach to banking
structure and resolution, embodied around the Volcker Rule, is meant to prevent banks from engaging in proprietary trading in securities, the EU still-evolving system of banking structure and resolution reform places more emphasis on enhanced capital for core deposit-taking functions.

Concerns are relevant. While strict extraterritoriality of the Volcker rule has been reduced in the Final Rule implementing it, still too much rigidity exists in it. Many provisions of the Final Rule have been greeted with disappointment by an industry that has lobbied intensely against it. While it does offer some concessions to non-US banking organizations (so called Foreign Bank Organizations or FBOs), at the same time, it introduces them into a US-centric compliance and reporting regime that will inevitably conflict with home country customs and requirements. This rigid approach to regulation may hinder future crisis management.

This paper is divided into two parts. Part I - after first providing a high-level comparison of the structural regulatory measures adopted or to be adopted in the US and in the EU on banking structural measures – highlights those provisions in the Final Rule implementing the Volcker Rule that are likely to have the greatest extraterritorial impact on non-US banks. In this part, the analysis is meanly based on the Preamble to the Final Rule, which discusses many of the issues raised by commenters and explains the US regulatory agencies’ response to those comments. Part II intends, then, to investigate the role of the US and EU “territorial” authority. Their different approach to extraterritoriality is examined and compared. In particular, the paper explores the equivalence regime adopted by the EU banking structural reforms as a possibility to enhance global standards in the longer term.

PART I

THE FINAL VOLCKER RULE AND ITS APPLICATION TO FOREIGN BANKS

I. Basic rationale of the structural reforms

Restrictions on banks’ business lines have been relaxed since the 1970s, in parallel with the deregulation of financial markets. There was broad consensus that banks offering a full range of
financial services can provide the largest economic benefits in a rapidly growing global economy. Diversification of business lines, innovations in risk management, market-based pricing of risks and market discipline were seen as effective safeguards against financial risks associated with the rapid expansion of large universal banks.

The financial crisis has triggered a reassessment of the economic costs and benefits of the involvement of universal banks in proprietary trading and other securities markets activities. Many large universal banks shifted too many resources to trading books, supported by cheap funding. The complexity of many banks weakened market discipline, while their interdependence increased systemic risk, contributing to contagion within and across firms. While the crisis has shown the need to strengthen market-based pricing of risk and market discipline, the heavy burden of bank losses imposed on taxpayers has raised questions about the separation of certain banking activities.

The basic rationale for the structural bank regulation initiatives is to insulate certain types of financial activities regarded as especially important for the real economy or significant on consumer/depositor protection grounds, from the risks that emanate from potentially riskier, but less important activities. These initiatives are designed to reduce these risks in several ways. First, and most directly, they can shield the institutions carrying out the protected activities from losses incurred elsewhere. Second, they can prevent any subsidies that support the protected activities (e.g. central bank lending facilities and deposit guarantee schemes) from lowering the cost of risk-taking and encouraging moral hazard in other business lines. Third, they can reduce the complexity and possibly size of banking organizations, making them easier to manage, more transparent to outside stakeholders and easier to resolve; this in turn could improve risk management, contain moral hazard and strengthen market discipline. Fourth, they can prevent the aggressive risk culture of the riskier activities from infecting that of more traditional banking business, thus reducing the scope for conflicts of interest. In addition, smaller institutions would reduce the risk of regulatory capture.

The common element of all the proposals is to restrict universal banking by drawing a line somewhere between “commercial” and “investment” banking businesses. The proposed changes do not go as far as the previous strict separation of commercial from investment banking that
existed in some jurisdictions, such as the US. Restrictions on universal banking would be new, however, for many countries, notably a number of continental European ones.

II. Regulatory disparities in transatlantic reforms: Volcker Rule versus EU Proposals

Beyond the above evidenced basic similarities, structural reform initiatives differ in scope and strictness.2

The Dodd-Frank Act was enacted on July 21, 2010.3 Section 619 of Act added a new section 13 (so called “Volcker Rule”4) to the Bank Holding Company Act of 1956 (“BHC Act”).5 The Volcker Rule prohibits any banking entity from engaging in proprietary trading or from acquiring or retaining an ownership interest in, sponsoring, or having certain relationships with a hedge fund or private equity fund (“covered fund”), subject to certain exemptions.

In December 2013, five financial regulatory agencies6 adopted the long-awaited Final Rule (the “Final Rule”)7, which implemented the Volcker Rule. The Final Rule prohibits any banking entity8 from engaging in proprietary trading;9 requires firms with significant trading operations to

4 Prior to the passage of the Dodd-Frank Act, key financial regulatory figures investigated what contributed to the systemic failure of the U.S. financial sector. In January 2009, a group of experts led by former Federal Reserve Chairman Paul Volcker published a report for the Group of Thirty recommending that large, high-risk proprietary trading activities of systemically important financial institutions should be restricted. At that time, a significant percentage of many bank holding companies’ revenue was attributed to proprietary trading. As the head of the President’s Economic Recovery Advisory Board, Chairman Volcker conveyed the recommendation of the Group of Thirty to Congress.
6 The Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency (OCC), Federal Deposit Insurance Corporation (FDIC), the Commodity Futures Trading Commission (the “CFTC”) and the Securities and Exchange Commission (SEC) (collectively, the Agencies).
7 The Final Rule became effective on July 21, 2015, after years of delays. This major Dodd-Frank Act milestone was reached after a nearly two-year rulemaking process during which the agencies assessed the approximately 18,000 comment letters submitted in response to the proposed rule and debated their different perspectives on the possible contours of a Final Rule. http://www.ey.com/Publication/vwLUAssets/EY-_US_agencies_agree_on_final_Volcker_Rule/$File/EY-GRN-US-agencies-agree-on-final-Volcker-Rule.pdf
8 The term “banking entities” includes FDIC-insured depository institutions, U.S. bank holding companies, non-U.S. banks with a U.S. branch or agency, and any affiliates of the foregoing around the globe, whether or not they are organized or located in the U.S.
report to the relevant Agency a number of quantitative measurements that are designed to assist
the Agencies and banking entities in identifying prohibited proprietary trading that might occur
in the context of exempt activities;\(^9\) prohibits any banking entity from acquiring or retaining an
ownership interest in, or having certain relationships with, a hedge fund or private equity fund
(“covered fund”), \(^{10}\) subject to some exemptions;\(^{11}\) requires banking entities to establish an
internal compliance program designed to help ensure and monitor compliance with the
prohibitions and restrictions of the statute and the Final Rule.\(^{12}\)

By including virtually all dealing positions, the Volcker rule definition of “proprietary trading” is
extremely broad. \textit{However,} this prohibition is subject to exemptions for underwriting,\(^{14}\) market-
making activities\(^{15}\), risk-mitigating hedging\(^{16}\), activities of foreign banking entities solely outside
the U.S., and certain other activities. The Final Rule makes other exemptions\(^{17}\) and clarifies
which activities are not considered proprietary trading\(^{18}\), provided certain requirements are met.
Like the Volcker Rule, the Final Rule limits these exemptions if they involve a material conflict

\(^9\) Under the statute, “proprietary trading” involves acquiring or taking positions as principal in any security, derivative, option or contract for sale of a commodity for future delivery for the purposes of selling the security or position in the near term or otherwise with the intent to resell to profit from short-term price movements.

\(^{10}\) The reporting requirements would be phased in based on the type and size of the firm’s trading activities.

\(^{11}\) Under the Final Rule, the definition of covered funds encompasses any issuer that would be an investment company under the Investment Company Act if it were not otherwise excluded by two provisions of that Act, section 3(c)(1) or 3(c)(7). Included in the definition of covered funds are also certain foreign funds and commodity pools, but they are defined in a more limited manner than under the proposed rule.

\(^{12}\) Exemptions are for investments made in connection with organizing and offering a covered fund, making and retaining \textit{de minimis} investments in a covered fund, activities of foreign banking entities solely outside the U.S., and certain other activities.

\(^{13}\) Compliance requirements vary based on the size of the banking entity and the amount of activities conducted, reducing the burden on smaller, less complex entities. Banking entities that do not engage in any activity subject to the Final Rule, other than trading in exempt government and municipal obligations, would not be required to establish a compliance program.

\(^{14}\) This exemption would require that a banking entity act as an underwriter for a distribution of securities (including both public and private offerings) and that the trading desk’s underwriting position be related to that distribution. Consistent with the Dodd-Frank Act, the underwriting position must be designed not to exceed the reasonably expected near-term demands of customers.

\(^{15}\) Under this exemption, a trading desk would be required to routinely stand ready to purchase and sell one or more types of financial instruments. A market-making desk may hedge the risks of its market-making activity under this exemption, provided it is acting in accordance with certain risk-management procedures required under the Final Rule.

\(^{16}\) This exemption applies to hedging activity that is designed to reduce, and demonstrably reduces or significantly mitigates, specific, identifiable risks of individual or aggregated positions of the banking entity.

\(^{17}\) For example, it is allowed trading on behalf of a customer in a fiduciary capacity or in riskless principal trades and activities of an insurance company for its general or separate account.

\(^{18}\) Such activities include trading solely as an agent, broker, or custodian; through a deferred compensation or similar plan; to satisfy a debt previously contracted; under certain repurchase and securities lending agreements; for liquidity management in accordance with a documented liquidity plan; in connection with certain clearing activities; or to satisfy certain existing legal obligations.
of interest, a material exposure to high-risk assets or trading strategies or a threat to the safety and soundness of the banking entity or to U.S. financial stability.

Because of the reach of the term “banking entity,” all of a covered banking organization’s operations around the world may be subject to the Volcker Rule’s restrictions, even if the organization, or the activities in question, has limited connection with the U.S. However, the Final Rule does offer some concessions to non-U.S. banking organizations (hereinafter “FBOs”). These concessions and the extraterritorial effects in general of the Volcker rule and the Final Rule will be analyzed later.

Compared to the Final Rule, structural reform initiatives in the EU, especially the Banking Reform Act in the United Kingdom (implementing the “Vickers Report”) and the European Commission Proposal (following the “Liikanen Report”), differ in scope and strictness.

Reforms dealing with the trading activities of banking firms have been enacted by the Vickers Commission in the United Kingdom and recommended by the Liikanen Group in the European Union. However, neither of these approaches expressly prohibits a consolidated banking firm from engaging in proprietary trading. Rather, these reforms bear closer resemblance to the traditional U.S. banking structure concept of ring-fencing depository institution subsidiaries of bank holding companies. Most notably, under both Vickers and Liikanen, banking firms would be able to continue to engage in proprietary trading, but would simply be required to do it outside of the retail deposit-taking unit of the organization.

In January 2014, the European Commission, following the Liikanen Report, proposed a set of structural reforms for the EU banking sector that would prohibit certain large European banking

\[\text{\footnotesize 19 See supra note 8.}\]

\[\text{\footnotesize 20 The reform in UK was passed in December 2013, implementing the key recommendations of the 2011 report by the Independent Commission on Banking (the ‘Vickers’ report).}\]

\[\text{\footnotesize 21 Commissioner Barnier announced in November 2011 the setting up of a High-Level Expert Group ("HLEG") with a mandate to assess the need for structural reform of the Union banking sector, chaired by Erkki Liikanen, Governor of the Bank of Finland. The then so called ‘Liikanen report’ was presented in October 2012.}\]

\[\text{\footnotesize 22 The reforms in the United Kingdom under the Banking Reform Act are largely consistent with those by the European Commission, though they are somewhat broader. They require that retail banking activities in the United Kingdom are ‘ring-fenced’ into an entity that is legally and operationally separate from the bank's investment banking and high-risk wholesale banking activities. Intragroup exposures between the ring-fenced entity and the rest of the bank will be limited, and ring-fenced entities will be prohibited from operating outside the European Economic Area (EEA). An in-depth exploration of the economic underpinnings of the reforms is provided in Vickers, ‘Some economics of banking reform’, University of Oxford Department of Economics, Discussion Paper Series, 632 (2012).}\]
firms from operating standalone proprietary trading desks. The EU proposal introduces the concept of a ‘core credit entity’ and requires trading activity or the holding of shares in a hedge fund to be located outside this core entity. The two entities can reside within one group, but the core credit entity would not be permitted to hold equity in the trading entity.

The EU Proposal is somewhat broader in scope than the Volcker rule, because it seeks to carve out both proprietary trading and market-making, without drawing a distinction between the two. However, it is also less strict because it allows these activities to coexist with other banking business within the same group as long as these are carried out in separate subsidiaries.

The EU Proposal is also narrow in its content, in application of the principle of proportionality. First, the proposed Regulation prohibits only large Union credit institutions and banking groups from carrying out proprietary trading and certain related activities. Second, in view of the challenges derived from the difficult distinction between proprietary trading and other similar trading activities, market making in particular, a narrow definition of activities subject to the prohibition is provided. Third, the EU proposal allows national authorities broad ability to grant exceptions. Finally, and most importantly for extraterritoriality effects, the European Commission can approve an exemption for banks in a jurisdiction where an equivalent regime is in place as of January 2014 (foreign branches and subsidiaries can likewise be exempted).

The Volcker Rule appears to differ from the EU Proposal in a number of significant respects.

Compared with the EU Proposal, the Final Rule seem to be narrow in scope, but it is quite strict in general. The Final Rule applies a broader definition with respect to EU rules of prohibited trading: it forbids the coexistence of such trading activities and other banking activities in different subsidiaries within the same group; it similarly prevents investments in, and sponsorship of, entities that could expose institutions to equivalent risks, such as hedge funds and private equity funds. Also, the current US legislation does constrain the activities of depository

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23 L Gambacorta and A van Rixtel, fn 2.
24 The proposal limits contagion within the group by requiring, in particular, that the subsidiaries be self-sufficient in terms of capital and liquidity and that transactions between the legal entities take place on market terms.
25 Under the principle of proportionality set out in Article 5 of the Treaty of the European Union, the content and form of Union action must not exceed what is necessary to achieve the objectives of the Treaties.
Institutions. For example, US regulation restricts banks’ dealings with affiliates, which can be seen as a degree of ring-fencing.26

III. Volcker rule’s extraterritoriality

There has been recent controversy about what many call the extraterritorial effects27 of certain provisions of the Dodd-Frank Act, including the Volcker Rule. The Volcker Rule effectively does apply extraterritorially. According to the Volcker rule, any non-U.S. banking entity that operates a branch or agency office in the U.S., or that controls a U.S. subsidiary bank, and the parent of each such entity (“foreign banking organization” or “FBO”), is subject to the Final Rule’s restrictions. The legal foundation of the Volker Rule rests on a combination of inherent sovereignty and territorialism. Under it, the U.S. regulates its own banks, even when they act abroad (i.e., an assertion of national sovereignty), but it oversees foreign banks when they are acting on U.S. soil (i.e., a territorial approach).28 We call this approach “unilateral extraterritoriality”.

26 In particular, dealings between banks and their affiliates are limited and constrained by the Fed’s Regulation W, which implements sections 23A and 23B of the Federal Reserve Act of 1933, which section 608 of the Dodd-Frank Act has substantially widened and strengthened. See Vickers, fn 22, for further details.
27 Broadly, “extraterritoriality” refers to laws passed by national legislatures that, whether by intention or indirectly, impose their laws and regulations on persons or activities outside their borders. Extraterritoriality challenges the traditional “Westphalian” concepts of sovereignty in two ways: first, by the intrusion of one country’s rules into another country’s business, which many see as an affront to sovereignty and, second, by the difficulty of limiting legislation to one country in an increasingly globalized economy, which may make it difficult to achieve the goals of legislation in a comprehensive way. Extraterritoriality may be therefore defined as a situation in which regulation adopted in one jurisdiction affects directly or indirectly, and to a material extent, activities or entities in other jurisdictions. A significant decision of the United States Supreme Court requires that legislation includes explicit intent to claim extraterritorial jurisdiction: Morrison v. Nat’l Austrl. Bank Ltd., 130 S.Ct. 2869 (2010). The Dodd-Frank Act explicitly authorized extraterritorial reach of certain provisions, but also acknowledges the need to take into account extraterritorial effects and mandated US regulatory agencies to seek international harmonization with their international counterparts – Sections 719(c), 752(a) of the Dodd-Frank Act. Institute of International Finance, Memorandum to the Financial Stability Board: Containing Extraterritoriality to Promote Financial Stability, October 2012, p. 2. For a fuller discussion of issues of extraterritoriality arising from current US legislation, with extensive discussion of the literature and legal theory on the subject, see Edward F. Greene and Ilona Pothia, ‘Examining the Extraterritorial Reach of Dodd-Frank’s Volcker Rule and Margin Rules for Uncleared Swaps – a Call for Regulatory coordination and Cooperation’ (2012) Capital Markets Law Journal, Vol. 7, No. 3, 271.
Likely, fears of an adverse extraterritorial impact of the rule have been eased when financial regulators jointly issued the Final Rule in December 2013. The case for the extraterritorial application of the Volcker Rule to FBOs seems limited, comparing to the Proposed Rules.

*First*, as provided in the Volcker rule, the Final Rule permits FBOs to engage in proprietary trading “solely outside of the United States” (the “SOTUS” exemption). The proposal would have prohibited proprietary trading where the transaction in question was entered into outside of the U.S. by a FBO if the trade “touched” the U.S. in any of a number of ways, including if it cleared through a U.S. exchange. The Final Rule, instead, is less restrictive than proposed in interpreting the “SOTUS” exemption. The Final Rule adopts now a risk-based, rather than transaction-based, approach to the SOTUS standard and generally does not apply to activity that does not involve decisions made, or risk booked, in the U.S. Foreign transactions conducted by FBOs may be exempted from the restriction if no financing for the transactions is provided by U.S. affiliate and the purchase is not conducted through any U.S. entity. In addition, transactions could be exempted if FBOs use U.S. based exchanges, central counterparties or unaffiliated market intermediaries: clearing a trade through a U.S. exchange or swap execution facility on an anonymous basis does not impact SOTUS status under the Final Rule. This risk-based approach is consistent with the SOTUS exemption for proprietary trading in the statute, which focuses on trading as principal where the purpose is to benefit from short-term price movements.\(^{29}\)

\(^{29}\) Executive summary to the Final Rule. See also the Preamble:

The Final Rule adopts a risk-based approach to implementation that relies on a set of clearly articulated characteristics of both prohibited and permitted activities and investments and is designed to effectively accomplish the statutory purpose of reducing risks posed to banking entities by proprietary trading activities and investments in or relationships with covered funds. [emphasis added]

\(^{30}\) The statute does not make, however, this exemption available to U.S. banking entities or their foreign subsidiaries and affiliates. By statute, the prohibition on proprietary trading applies to the consolidated, worldwide operations of U.S. firms. The foreign subsidiaries or affiliates of a U.S. banking entity may engage in trading activity with a foreign banking entity outside of the United States so long as the foreign subsidiary or affiliate of the U.S. banking entity conducts the activity in accordance with the provisions of the Final Rule other than the SOTUS exemption. There is a critical issue that complicates proprietary trading by non-U.S. banks with any U.S. counterparty nexus. A non-U.S. banking entity can clearly trade with the U.S. broker-dealer subsidiary of a U.S. banking organization, but it is less clear that it can freely trade with the U.K. subsidiary of the same U.S. banking organization without obtaining representations that none of the counterparty’s personnel involved in a particular trade are located in the United States. Notwithstanding that the Proprietary Trading SOTUS Exception is meant to permit trading outside of the United States, it may be easier (in some circumstances) for a U.K. bank to trade with the New York-based broker-dealer subsidiary of a U.S. banking organization than with the London desk of the same bank. See Linklaters, *The Final Volcker Rule and Its Extraterritorial Consequences for Non-U.S. Banks*, December 20, 2013.
Second, the Final Rule differs from the proposal on concerns on trading sovereign debt. Foreign authorities and banks were also concerned about the adverse impact of the Proposed Rule on the liquidity of sovereign debt markets, but the Final Rule appears to have mitigated these concerns. Foreign sovereign bonds are now exempted from the ban on trading by FBOs (within reasonable limits). It is permitted trading by the U.S. operations of a FBO (other than an insured depository institution) in obligations of the home authority of the FBO; in addition, the Final Rule provides an exemption which would permit foreign subsidiaries (or foreign securities broker-dealer) of U.S. banks trading in obligations of the host country of the foreign subsidiaries (or foreign broker-dealer).  

Third, the Final Rule permits a FBO to acquire or retain any ownership interest in, or act as sponsor to, a covered fund so long as the activity is conducted “solely outside of the United States” and no ownership interest in the covered fund is offered for sale or sold to a resident of the U.S.

Fourth, the Final Rule differs from the proposal on foreign public funds. Closely related to the foreign fund exemption is the definition in the Final Rule of foreign public funds. The Proposed Rule did not define as covered funds U.S. mutual funds and similar retail investment structures, 

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31 This exemption promotes safety and soundness and financial stability by allowing the U.S. non-insured depository institution operations of FBO to facilitate the depth and liquidity of sovereign debt of the home country of the FBO (roughly parallel to the exemption for trading in U.S. obligations).

32 This second exemption similarly promotes safety and soundness and financial stability by allowing U.S. banking entities to own and operate banks and securities broker-dealers overseas that are permitted to facilitate liquidity in the sovereign debt of the host country of the foreign entity. For example, the UK bank subsidiaries of U.S. banks may engage in proprietary trading of UK Government securities. In addition, U.S. affiliates of non-U.S. banks may do the same with Government securities of their home countries. This liberalization may address many concerns of non-U.S. governments about the potential effect on their home country sovereign debt markets (however, it appears that a US bank’s London subsidiary would not be authorized to engage in proprietary trading in sovereign debt of other European countries).

33 The Final Rule permits a FBO to rely on this exemption only if:
(a) The banking entity (including relevant personnel) that makes the decision to invest or act as sponsor is not located in the U.S.;
(b) The investment or sponsorship, including any related hedging transactions, is not accounted for as principal in the U.S.;
(c) Ownership interests in the covered fund are not targeted to residents of the U.S.; and
(d) No financing for the banking entity’s ownership or sponsorship is provided by a U.S. affiliate of the foreign banking entity.

The Final Rule would, however, allow a U.S.-based employee or subsidiary of the foreign banking entity to perform so-called “back office” administrative functions, such as clearing and settlement or maintaining and preserving records of the fund, so long as the employee or subsidiary is solely involved in providing administrative services to, and does not have any customer relationship with investors in the fund, and the transaction is not booked on the accounts of a U.S. entity.
but captured highly similar non-U.S. structures. While some suggested that FBOs could organize and invest in those structures (such as non-U.S. mutual funds and UCITS) pursuant to the foreign fund exemption, the Agencies answered definitively in the Final Rule that such structures are not covered funds and are therefore entirely outside the scope of the Final Rule.  

PART II

“LOCALIZATION”, EXTRATERRITORIALITY AND THE AIM FOR EFFECTIVE GLOBAL STANDARDS AND COORDINATION

I. Economic history and the unavoidability of “localization”

The aim would be to have global consistency in structural reforms to reduce the risks of a crisis, given the close connections among financial markets. As a response to the financial crisis, and because of the continued growth of too-big or too-complex-to-fail banks in relation to the size of the financial system, international institutions\(^{35}\) have been working on a number of initiatives to improve the resilience of the financial sector and not long ago called for a broad and global debate on bank business models, which includes a review of bank structural measures. However, there is skepticism about the slow pace of international “soft law”. Despite efforts to create a global regulatory agenda, national or regional regulators are coming first in reforming the structure of the banks.

Local regulatory reforms are influenced by the different shapes of national banking systems, which largely reflect economic history and the different roles banks have played in financing economic development. Banking systems have developed differently in Anglo-Saxon countries compared to continental Europe. Whereas nearly all attention as regards structural reform has focused on the Volcker rule, that rule builds on a long U.S. history of bank structural

\(^{34}\) Milbank, Still Global: The Final Volcker Rule and its Impact on Foreign Banks, Financial Institutions Regulation Group Client Alert, December 2013

\(^{35}\) Such as the FSB, the Bank for International Settlements, the International Monetary Fund and the Organization for Economic Cooperation and Development.
regulation. Accordingly a discussion of the Volcker rule should be placed in that broader context.

The US also has rules governing transfers between the different parts of a banking group, which are aimed at isolating the insured depository institution from excessive risks arising from the larger financial firm of which it is part (BHC, FHC) and to prevent the transfer of the subsidy arising from federal assistance to non-depository financial institutions. Restriction and isolation of the core banking activities within broader financial groups constitute one of the three pillars on which US structural regulation is built. The other two pillars are the separation of banking from commerce and limits on the institutional concentration of the banking and financial sector.

In continental Europe, industrialization occurred later and substantial amounts of capital were needed to catch up with the industrial forerunners and given that capital markets were less

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37 In the US, prior to industrialization, banks were typically small and focused on retail clients. The larger financing needs related to industrialization was predominantly served by capital markets whose access was provided by broker/dealers. Then, at the turn of the century, banks started to consolidate. During that process, some banks gained national prominence and became the main providers of funding to the large US corporate trusts. The growing power of the largest banks and their close integration with the largest corporates provoked an increasing reaction, with the establishment of the Federal Reserve System in 1913 ending the ‘central bank’ role provided by the JP Morgan and other large New York banks, and the Sherman Antitrust Act breaking up the trusts and limiting the influence of banks. These changes culminated with the 1933 Glass-Steagall Act, which fully prohibited banks from engaging in securities business. In the 1960s, as US commercial banks felt disadvantaged vis-à-vis its competitors both nationally and internationally due to restrictions on their ability to expand their activities, US regulators were prompted to gradually become more permissive as to the extent to which US banks could engage in prohibited activities. These restrictions were substantially liberalized by the 1999 Gramm-Leach-Bliley Act, which finally eliminated the prohibition of banks from entering into non-banking activities. As a result, US banking groups can organize themselves as financial holding companies, and are then able to provide a universal set of services in different functional subsidiaries. Nevertheless, structural remnants have remained that restrict and isolate core banking activities. While the banking group (BHC and FHC) may engage in a wide range of financial activities, the insured depositary institutions still face activity restrictions that limit their focus to core banking activities (e.g. taking deposits, lending) and other incidental activities (e.g. custody and asset management).
38 See Section 23A and Section 23B of the Federal Reserve Act and Regulation W of the Federal Reserve (which explains and simplifies the interpretation and application of these two acts).
39 In the US a company that controls a bank holding company (BHC) cannot engage in activities of a commercial nature, be it directly or indirectly through a subsidiary.
40 US market concentration has historically been limited by e.g. geographic restrictions that limited the ability of banks to establish or buy branches in other states. The 1994 Riegle-Neal Act liberalized these interstate branching limits. See Commission Staff Working Document Impact Assessment Annexes 1 – 4 Accompanying the document Proposal for a Regulation, January 2014.
developed, banks became the main source of financing to the large corporates who required a universal set of services.\footnote{For further details, see Commission Staff Working Document Impact Assessment Annexes 1 – 4 Accompanying the document Proposal for a Regulation, January 2014.}


\section*{II. The danger of “unilateral extraterritoriality”}

This “localization”, and differences in local regulatory reforms that depend on it, could be a serious threat to banks. Such reforms, even when well designed, may make the system as a whole more, instead of less, risky. There could be a tendency to negotiate specific one-off exceptions. Migration and fragmentation are constantly issues for the private sector, with pressures on their regulators to favor their own jurisdiction. How to protect the “local” financial system can then be at odds with making markets more competitive. At what point the benefits of an open, global financial system with movement of resources and risk diversification begin to be outweighed by financial protectionism?

While the rationale behind the extraterritorial effects of the Volcker Rule is that these activities involve a high degree of risk and would pose systemic risk to the U.S. financial system, when the U.S. regulates a U.S. entity’s conduct, wherever that conduct takes place and whether conducted by the U.S.-based parent or its non-U.S. affiliates, it regulates conduct outside the U.S. in a manner that may be inconsistent with the rules applicable in the jurisdiction in which the conduct takes place.

The Final Rule has - as also acknowledged in the summary to the Final Rule - a more “open” regulatory philosophy, which would encourage competition and enhance liquidity\footnote{Allowing foreign banking entities to conduct proprietary trades on U.S. exchanges and clearing facilities allows these exchanges and facilities – which are generally not subject to section 13 and do not take the risks section 13 is} and
transparency\textsuperscript{44} in the market. While acknowledging that the Final Rule has lessened the extraterritorial effects, the approach adopted by the U.S. regulators is still too restrictive and it would cut off U.S. financial markets from foreign capital and result in U.S. financial markets moving offshore. Its extra-territorial approach is at odds with historical approaches to determining the locus of activities (which had generally relied on where decisions were made and risk booked) and imposes additional hurdles for FBOs seeking to rely on the SOTUS exception.

The Final Rule, in fact, permits a FBO to rely on the exemption (without having to show that the trade falls into another compliance-laden exemption, such as market-making, etc.) only if:

(a) the FBO acts as principal in the purchase or sale, including any related hedging transactions, outside the U.S.;
(b) the personnel of the banking entity (or its affiliates) that arrange, negotiate, execute or decide to undertake the trade are not located in the U.S.,
(c) the banking entity that makes the decision to purchase or sell is not located in the U.S.;
(d) no financing for the banking entity’s purchase or sale is provided by a U.S. affiliate of the FBO; and
(e) the purchase or sale is not conducted with or through any “U.S. entity”, which includes any entity (including a branch of a foreign bank) that is located or organized in the U.S., or is controlled by or acting on behalf of another U.S. entity (with some exceptions)\textsuperscript{45}.

\textsuperscript{44} In addition, trading on U.S. exchanges and clearing facilities promotes transparency and, conversely, prohibiting foreign banking entities from trading on U.S. exchanges and clearing facilities would likely reduce transparency for trading in financial instruments in the U.S. At the same time, to the extent U.S. intermediaries that might be a counterparty to foreign banking entities as participants in the exchange or central counterparty are U.S. banking entities subject to section 13 of the BHC Act, those U.S. banking entities would remain subject to all the restrictions of the draft Final Rule. Consequently, the exemption would not introduce new risks to the U.S. financial system. All of these considerations support the Agencies’ exercise of their exemptive authority under section 13(d)(1)(J) to allow such trading by foreign banking entities on U.S. exchanges and clearing facilities as provided in the Final Rule. See Executive summary to the rules.

\textsuperscript{45} The exceptions are the following:

i) the non-U.S. operations of a U.S. entity may be a counterparty so long as no personnel involved in the arrangement, negotiation or execution of the trade are located in the U.S.,
The above assertion of unilateral extraterritoriality would enhance the concern that the U.S. approach ignored national sovereignty and represented a return to prior tradition of U.S. imperialism.\textsuperscript{46}

\textit{First}, the definition of U.S. entity in prong (e) is broad, reaching both the U.S.-based broker-dealer affiliates of FBOs and any affiliate of any U.S. banking organization or broker-dealer. Thus, any trade intermediated or facing those entities would not qualify for SOTUS.

\textit{Second}, it does not appear that the SOTUS exemption for trading with U.S. entities through market intermediaries ((e)(ii) and (iii)) is broad enough to allow access to the U.S. market without use of the other exemptions. Both prongs of the exemption require the transaction to be cleared, but there will remain a wide variety of transactions, especially in the OTC derivatives field, that will remain bilateral. If trading desks of FBOs outside the U.S. must use the exemptions for market-making, underwriting or hedging to trade in uncleared instruments with counterparties inside the U.S., they apparently will be forced to implement the detailed U.S.-specific Volcker compliance regime in their home (and other host) countries. Their only alternative will be to access the liquidity of the U.S. markets through the non-U.S. offices of U.S. banks.

\textit{Third}, the availability of the SOTUS exemption continues to depend on the physical location of FBO personnel involved in a trade. If an FBO’s personnel located in the U.S. “arrange, negotiate or execute” a trade, SOTUS is unavailable for that trade, This location-based restriction means that U.S.-based personnel cannot solicit, sell or arrange trades - no matter how little involvement such people otherwise had with the trade.- without triggering the more onerous compliance obligations of the Final Rule\textsuperscript{47}. This focus on personnel location presents a obstacle for FBOs that wish to manage part of their business in the U.S. while booking trades outside of the U.S.

\textsuperscript{ii)} FBOs may use an unaffiliated market intermediary located in the U.S. as principal followed by the prompt clearing and settlement of such trade through a clearing agency or derivatives clearing organization; and

\textsuperscript{iii)} FBOs may use an unaffiliated market intermediary located in the U.S. as agent to effect an anonymous trade on an exchange or similar platform followed by the prompt clearing and settlement of such a trade through a clearing agency or derivatives clearing organization.

\textsuperscript{46} By 2012, some in the financial press were asserting that “[t]he United States is coming to be seen as a global threat, acting unilaterally with aggressive new market rules . . . [with] [t]he new buzzword . . . [being] ‘extraterritoriality,’ or ET.” See Huw Jones, ‘ET, the New Alien Scaring Global Markets’, REUTERS, Feb. 5, 2012, http://www.reuters.com/article/2012/02/05/us-financial-regulation-et-idUSTRE8140DV20120205.

\textsuperscript{47} Though such personnel could engage in back-office functions such as trade clearing or settlement, without being seen to be arranging, negotiating or executing a trade. See Preamble at 421.
While the stated purpose of this provision is to keep the risk of non-U.S. proprietary trades outside of the U.S., it is hard to see how having U.S. personnel perform some (or any) function as part of a trade increases any U.S. risk. In fact, this provision appears to contradict another statement in the preamble, relating to the non-U.S. trading activities of U.S. banking entities, that “[t]he risks of proprietary trading would continue to be borne by the U.S. banking entity whether the activity is conducted … through units physically located inside or outside of the United States.” That statement recognizes that risk lies where trades are booked, rather than where some personnel sit. Consequently, the Final Rule will require FBOs to use one of the other exemptions from the proprietary trading ban if any U.S.-based personnel or entities are modestly involved in the transaction. 48

Fourth, the Final Rule adds a requirement, to be satisfied to have a SOTUS exemption, that the trade not be financed “directly or indirectly” by the U.S. branch or agency of an FBO. It is difficult to justify this provision: the preamble merely states that it is not intended to restrict the ability of U.S. branches and agencies of FBOs to provide funding to their foreign head offices. 49

Finally, notwithstanding the Agencies adopted many of the comments submitted by FBOs on the Proposed Rule, the Final Rule still creates significant compliance and reporting burdens for such organizations outside the US, with very little deference to the equivalence of home country legislation. FBOs with substantial trading operations in the U.S. will now have to submit to the relevant Agency periodic reports on the proprietary trading activities that each trading desk conducts under available exemptions (these reports are intended to assist the Agency in determining whether the banking entity is complying with the proprietary trading provisions of the Final Rule). 50 Notably, the Final Rule requires this data on a trading desk basis, which is defined in part as the “smallest discrete unit of organization” of an FBO that trades a financial

48 See Linklaters, fn.30.
49 Preamble at p. 422, fn 15 22.
50 Within a relatively short timeframe, FBOs will have to develop systems that will enable them to gather a tremendous amount of data and make various detailed calculations on a daily basis since the reports must include seven quantitative measurements, including, among other things, the position limits for each trading desk, the value-at-risk of the trading activities of each desk, and the extent to which trades at each trading desk are customer-facing. Milbank, ‘Still Global: The Final Volcker Rule and its Impact on Foreign Banks’, Financial Institutions Regulation Group Client Alert, December 2013.
product. So, even if an FBO currently collects any of this data on a consolidated basis, it may still face considerable systems challenges to reorganize the data on a trading desk basis.\textsuperscript{51}

The Volker rule’s restrictions could rise concerns on an intrusive application of U.S. rules extraterritorially. Extraterritoriality needs to be selective. Unilateral extraterritoriality should be limited to instances where there are genuine jurisdiction-specific issues to be addressed. On the U.S. side, there was the fear that absent extraterritoriality coverage, major financial institutions could park their higher risk operations outside the U.S. and thus escape one of the main goals of the Dodd-Frank Act, i.e. to avoid systemic risk.\textsuperscript{52} Systemic risk is then the public good that provide a rationale for a more aggressive approach to extraterritorial financial regulation.

Unquestionably, the U.S. has an interest in regulating the offshore activities of its own banks (and their subsidiaries and affiliates). \textit{However}, reckless activity by a non-U.S. bank abroad (even though it has some presence in the U.S.) seems generally unlikely to impose significant costs on the U.S., unless the scale of the foreign bank’s activities in the U.S. is very large. Here, the Dodd-Frank Act may reach too far. The case for the extraterritorial application of the Volcker Rule to foreign banks is limited. It should extend only to the offshore activities of U.S. banks (and their subsidiaries and affiliates) and possibly to foreign banks with a major presence in the U.S. Only to the extent that the counterparty’s failure can endanger a U.S. institution does a basis exist (even under the statutory language of the Dodd-Frank Act) for the U.S. to bar the foreign entity from proprietary trading. Thus, even if the foreign bank’s trading activities were planned and orchestrated in the U.S., they do not seem likely to threaten the safety and soundness of the U.S.’s financial markets.\textsuperscript{53}

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\textsuperscript{51} Milbank, fn 50.
\textsuperscript{52} At the open meeting of the CFTC on July 12, 2013, at which the “cross border final guidance” was approved, CFTC Chairman Gary Gensler emphasized in his initial statement the danger that large U.S. financial institutions could and did trade through off-shore subsidiaries and affiliates, particularly ones organized in unregulated jurisdictions, such as the Cayman Islands. See U.S. Commodity Futures Trading Comm’n, ‘Open Meeting To Consider Cross-Border Final Guidance And Cross-Border Phase-In Exemptive Order’ 9–11 (2013).
\textsuperscript{53} In addition, structural reforms complement and strengthen the range of non-structural measures agreed under the G20 agenda, such as policies on capital and liquidity, risk management, and resolution of failed institutions. It is not clear what value structural separation brings in addition to higher capital requirements, recovery and resolution planning, and the more intensive supervision of systemically important banks.
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III. Toward equivalence and mutual recognition (or substituted compliance) in developing global standards

Being major financial nations, the U.S. and the EU have the right incentives to curb systemic risk, because they are exposed to it. Their assertion of extraterritorial jurisdiction is necessary to create a governance structure under which highly mobile financial institutions cannot flee to less regulated venues. However, authorities with such high-quality regulatory regimes should more frequently rely – rather than in the “unilateral extraterritoriality” approach adopted by the U.S. in the Volcker Rule - on mutual recognition arrangements with one another and on bilateral negotiations among them and with other major financial centers. The “unilateral extraterritoriality” approach differs consistently with the EU approach to the regulation of foreign banks in banking structural reforms.

The EU adopts a mutual recognition approach based on equivalence decisions. The EU Proposal does have extraterritorial effects. It will apply to EU credit institutions and their EU parents, their subsidiaries and branches, including in third countries. It will also apply to branches and subsidiaries in the Union of banks established in third countries. Such a broad territorial scope is justified to ensure a level playing field and avoid the transfer of activities outside the Union to circumvent these requirements. However, differing from the Volcker Rule, the EU Proposal has no unilateral extraterritorial effects. Foreign subsidiaries of EU banks and EU branches of foreign banks could be exempted if they are subject to measures that in the opinion of the Commission are deemed to have equivalent effect to those in the Regulation (Articles 4 and 27). Article 4(2) foresees another potential exemption: supervisors have been granted the power to exempt from separation foreign subsidiaries of groups with an EU parent if those are autonomous (with autonomous geographic decentralized structure pursuing a “Multiple Point of Entry” resolution strategy) and if the impact of their failure would have limited effects on the group as a whole. By applying the separation requirement throughout the global corporate group irrespective of geographic location, the potential for banks circumventing separation by locating particular activities outside the EU is eliminated.
An alternative route to mutual recognition is through the concept of “substituted compliance”, which has been introduced and advocated by prominent doctrine in U.S. and applied for the first time explicitly in the CFTC interpretive guidance on Cross-Border Application of Certain Swaps Provisions. According to the “substitute compliance” approach, a foreign entity may comply as to certain entity level requirements with its home country rules provided those are comparably robust. Mutual recognition and substituted compliance agreements allow market participants from one jurisdiction to operate in another as long as they comply with their (essentially equivalent) home country rules, to promote cooperation. In principle, U.S. financial regulators could have potentially pursued a “substituted compliance” or mutual recognition approach, as the EU, with respect to the Volcker Rule, but they did not.

By supplementing the broad territorial coverage with a third country equivalence regime, the possible extraterritorial concerns of third country jurisdictions are mitigated. By requiring foreign banks to separate their operations in the Union, a level playing field in the internal market is also ensured and thereby the risk of unfair competition is minimized.

The EU proposal on banking structural reforms does not envisage each party making binding declarations of the equivalence of the other’s entire regulatory and supervisory framework, but rather carrying out a detailed assessment of the consistency of the implementation of each standard. This approach allows the parties to respect each other’s regulatory models and legal traditions, without changing the existing legislation and without slowing down the current regulatory process. At the same time this approach can ensure, if certain conditions are met, that different rules can work together, provided that they are made consistent.


55 According to the Preamble of the proposed EU Regulation:

The Commission should cooperate with third-country authorities in order to explore mutually supportive solutions to ensure consistency between the provisions in this Regulation and the requirements established by third countries. To that end, the Commission should be able to determine that a third country legal framework is equivalent to this Regulation, also with respect to its legal, supervisory and enforcement arrangements. [Emphasis added]

56 According to the SEC Commissioner Gallagher:
In recent regulatory reforms dealing with international actors, such as credit rating agencies,\textsuperscript{57} the EU has taken care that mutual recognition is not perceived to depend upon the direct equivalence, clause by clause, of the foreign regulations to be recognized; rather it has been judged in terms of consistency of goals and comparability of outcomes. Requiring highly literal, provision-by-provision “equivalence” determinations can paradoxically increase rather than decrease extraterritorial effects, and, at worst, lead to extraterritorial conflicts among jurisdictions.

This approach realizes that a strict equivalence regime would be difficult to achieve today, when all countries are tasked with upgrading their financial systems. Mutual recognition and substituted compliance were developed in an environment in which countries would incentive each other to raise standards by offering foreigners easier access to domestic markets once regulations in their home countries were equivalent to their own. In a world of dynamic market reform, instead, mutual recognition and substituted compliance programs should become more robust, and provide procedural mechanisms for coordinating rule-making and administrative processes in an ongoing, collaborative process.

It is true that it is impossible for one jurisdiction to recognize another’s regulatory regime as equivalent if the latter has not yet taken any commensurate action. However, we should not expect that, absent extraterritorial regulation by the U.S., EU banks will go unregulated. To the extent that regulators have considerable discretion in appraising functional equivalence, then it seems relevant that Europe has developed a functionally similar (while far from strictly equivalent) structural protection that parallels the Volcker Rule: the “ring-fencing” safeguard limits who within banks may engage in proprietary trading.

Internationally, we must find a new way: we must swap our regulatory hubris for humility, and work to find common ground with our international counterparts on areas where cooperation based on mutual respect and recognition can bear the most fruit. One idea along these lines would be to include financial services regulation in the pending Transatlantic Trade and Investment Partnership treaty, or “TTIP”.


On one hand, both the US and the EU jurisdictions appear to be adopting different standards and approaches with regard to the regulation of FBOs. The UK Regulation and the EU Proposal, respectively, would “ring-fence” proprietary trading and market-making outside of the retail bank, but not exclude them from the banking organization as a whole. We therefore still face a situation in which US rules prohibit banks from conducting particular activities while UK and EU rules would instead ring-fence particular activities from retail banks.

On the other hand, however, at least they both aim to same goal of reducing systemic risk. Indeed, the EU’s decision to “ring-fence” its banks proves this. From this perspective, the U.S. may be justified in prohibiting the affiliates and subsidiaries of U.S. banks from engaging in proprietary trading abroad, but it has much far less justification in seeking to preclude FBOs from doing so. At most, it can assert that proprietary trading within the U.S. endangers its interests. Thus, the more limited reach of the Volcker Rule with respect to FBOs may be justified.

**CONCLUSION**

This paper aimed to raise the attention to the practical complexities and inefficiencies arising from the extraterritorial reach of the so called Volcker Rule. Such “unilateral extraterritoriality” leads to regulatory fragmentation. In addition to the costs imposed on banks and the loss of efficiency in the market, it impinges on the sovereignty of non-US jurisdictions and may conflict with their own regulatory regimes and policy goals.

This paper has analyzed the extraterritorial regime based on “enlightened equivalence”, as opposed to “unilateral extraterritoriality” – which has been applied in the EU banking structural reforms.

In terms of curving systemic risk – which is the principal purpose of both the Volcker Rule and the EU Proposal – the two sets of legislation are functional equivalent. Either mutual recognition or substitute compliance would have to be based on acceptance that, while those specific regulations may differ, both the US and the EU regulators can have confidence in one another’s regimes to achieve broadly comparable outcomes. If global standards existed, mutual recognition
among those regulators would have greatly increased regulatory effectiveness and efficiency, especially given the increase of complexity of regulations affecting cross-border transactions and firms. Where a common, cross-jurisdiction issue is identified but there is no global standard – as in current structural reforms - it is equally important that policymakers work toward mutual recognition of local standards.

The ability of one jurisdiction either to determine equivalence or to enter into mutual recognition arrangements with third countries will have a material impact on the ability of cross-border financial services activity to flourish in the post-financial crisis era. Once the ground rules are set by those nations with the right incentives (such as the EU and the US) – nations which should be proactive in opening a dialogue to define what should constitute “sufficient” functional equivalence – they should then approach other countries to follow their standards, rather than await a global consensus and harmonization.

The “enlightened” equivalence regime, as envisioned in this paper and as adopted by the EU, would lead to more (not less) financial stability in banking structural reforms. It would close loopholes, avoid regulatory arbitrage, stop efforts to force the EU and US into a competitive downgrading of regulation, establish better mechanisms for supervisory cooperation and swift reaction to market developments, provide more predictable, consistent and stable regulatory approaches. Ultimately, this assertion of “enlightened” extraterritorial authority may be an interim stage in the longer term development of adequate international “soft law” standards. Mutual recognition of equivalent standards process is slow, complex, but it might work, also in a new contest such as the one of banking structural reforms.

To demonstrate that the proposed approach is the most appropriate to regulate the area, I pursued a close examination of the development of the EU and US regulatory structural reforms. Because of enhanced transparency and consultation among stakeholders during the regulatory process, the data collection process to answer my research questions has been far easier than in the past.
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