

Coffee on Extraterritorial Financial Regulation

John Coffee Jr (Columbia Law School) has posted Extraterritorial Financial Regulation: Why E.T. Can't Come Home on SSRN.

Systemic risk poses a classic “public goods” problem. All nations want systemic stability, but most would prefer that other nations pay for it, allowing them to “free ride.” Moreover, because global financial institutions can park their higher risk operations almost anywhere, some nations can profit from regulatory arbitrage by keeping their regulatory controls laxer than in the more financially developed nations (which bear the principal share of the costs from financial contagion). As a result, the free riders do not need to internalize the full costs of systemic risk, but profit from imposing costs on others.

Under these conditions, all the preconditions for a “tragedy of the commons” are satisfied, because (i) the nations that profit from regulatory arbitrage cannot be excluded from offering under-regulated markets, and (ii) they do not need to internalize the costs they impose on others. While the “tragedy of the commons” literature has been much used in environmental law and related fields, it applies equally well to international financial markets. The solution to this problem lies in finding ways to tax the free riders or otherwise subject them to stronger controls. But here is exactly where current “soft law” approaches to international financial regulation fail. Because “soft law” is almost by definition non-binding and unenforceable, it cannot control a financial services industry that wishes to pursue highly profitable, higher risk strategies.

Aspirational theorists of international “soft law” thus misconceive the problem. To expect “soft law” to be kinder and gentler than formal law and to give every nation an equal voice is to prescribe the essential conditions for a “tragedy of the commons.”

Instead, as this article argues, only the major financial nations have the right incentives to curb systemic risk, precisely because they are exposed to it. Thus, bilateral negotiations among them (particularly between the U.S. and the E.U.)

and the assertion of extraterritorial jurisdiction by them is necessary to create a governance structure under which highly mobile financial institutions cannot flee to less regulated venues. Ultimately, this assertion of extraterritorial authority (which both the U.S. and the E.U. have now done) may be an interim stage in the longer term development of adequate international “soft law” standards. But, absent the assertion of such authority, the commons will predictably collapse again into tragedy.

This article examines recent negotiations over the international regulation of OTC derivatives markets and the uncertain status of the Volcker Rule as cases in point. With respect to the latter, it poses the question: how should a legal regime of “substituted compliance” deal with the Volcker Rule where no other nations has adopted or proposed a close financial equivalent? Finally, it asks: how “extraterritorial” does U.S. law need to be and proposes some limits.