"GAMBLERS AND MERCHANTS"
THE POLITICS OF IMPLEMENTING POST-CRISIS OTC REGULATORY REFORM: THE US and EU.

A Dissertation
Submitted to
the Temple University Graduate Board

In Partial Fulfillment of the
Requirements for the Degree
DOCTOR OF PHILOSOPHY
POLITICAL SCIENCE

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by
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December 2021

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ABSTRACT

This study investigates the political sources of change in the regulatory authority for over-the-counter (OTC) derivatives that were brought about by the global financial crisis of 2008. OTC contracts have grown in popularity since the 1980s as firms in advanced market economies have increasingly used them to mitigate their exposure to international economic volatility. However, their proliferation also contributed to complex webs of financial interconnectedness that served to exacerbate the global financial crisis. In the wake of the crisis, public officials across the industrialized economies sought to reform this vast market, which previously had been exempt from direct public regulatory oversight. This dissertation documents a marked shift in regulatory authority after the crisis from a regime that reflected the preferences of the United States and United Kingdom for a deregulated model to a regulatory model that reflected new regulatory preferences in the United States and the European Union. The dissertation examines alternative explanations for this shift to a new Transatlantic regulatory consensus. It finds limited support for materialist theories based on market power, which contend that the degree of convergence around the preferences of one country should be proportional to its market power. Instead, it finds support for an agent-centered historical institutionalist approach that explains the shift in regulatory authority with attention to how marginalized regulatory actors mobilized to have their preferences realized during the implementation of post-crisis OTC reform in the United States and the European Union.

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ACKNOWLEDGMENTS

When I was an undergraduate in college, there was an informal consensus emerging that the causes of rampant speculation that led to the global financial crisis weren't necessarily economic, but political in nature. Therefore, I was lucky enough that when I started grad school I knew what it was that I wanted to study. I was also fortunate and privileged enough to meet a number of people during this process that I'm indebted to for their help with this dissertation.

First, I'd like to thank my Ph.D. advisor/supervisor Richard Deeg, for being a mentor ever since I was bitten by the bug during an undergraduate seminar on the Politics of Modern Capitalism. I can't possibly thank you enough for your countless insights in helping me develop this dissertation from its nascency. I'm eternally grateful as well for your encouragement in nurturing my continued interest in the nexus between markets and comparative politics.

To Orfeo Fioretos: Thanks for your thoughtful feedback and comments throughout the entire draft process. Thank as well for your invaluable counsel in helping me navigate grad school and for being the "I" in IPE, for this project. I'm also deeply grateful to you for helping me to develop the quality of my writing early on. My mind shines brighter on the page than when I started.

To Sandra Suárez: Thanks for planting an early seed that helped me think about the interaction between firms and the state. Special thanks as well for pushing me to develop the empirics in this study and for encouraging me to finish. I especially appreciated your support and feedback at key junctures in the process, which were perfectly timed and well-suited to the task at hand.

To Kevin Delaney: Your helpful comments, feedback and all around enthusiasm as I neared my defense, felt like a breath of fresh air.

Thanks to Robin Kolodny for getting me to consider how firms use the courts to further their ends during implementation, particularly in the US. Thanks as well to Mark Pollack, Hillel Soifer, Roselyn Hsueh and Alistair Howard at Temple for either reading a prospectus draft or generally informing my intellectual development along the way. Also thanks to my fellow grad students in the Dept. of Political Science at Temple University for your wonderful camaraderie and feedback during coursework and early draft presentations of this dissertation. A special thanks is also due to Brandon LaBarge for helping me situate this dissertation within the broader context of my life.

I'd like to thank my mother, Elizabeth Hebert for her unconditional love and perennial faith in me. I'd also like to thank my mother-in-law Hannah Schwartz for much the same reasons. I'm especially grateful to my children, Catherine and Ben for their boundless love and support in encouraging me to finish my dissertation. A father couldn't ask for better cheerleaders.

Finally, I'd like to thank my wife and best friend Heather Hebert, for biting the bullet with me as I embarked upon the process of pursuing a PhD. I distinctly remember you asking at the time, if I was sure this was something I wanted to do. In retrospect, it's funny how completing something can significantly reduce your uncertainty. This project would not have been possible without your seemingly endless supply of patience, love and support.

DEDICATION

This dissertation is dedicated to the memory of Merrill Schwartz, and our discussions about US politics, transatlantic dynamics, and European integration from the perspective of a 20th century American stock broker.

LIST OF ABBREVIATIONS

AFME Association for Financial Markets in Europe
AIG American International Group
ARM Approved Reporting Mechanism
BaFin Federal Financial Supervisory Authority of Germany
CCP Central Counter Party
CDO Collateralized debt obligations
CDS Credit-default-swaps
CDU Christian Democratic Union of Germany
CESR Committee of European Securities Regulators
CFTC Commodities Futures Trading Commission
SEC Securities and Exchange Commission
CME Chicago Mercantile Exchange
CRA Credit Ratings Agency
EBA European Banking Authority
EC European Commission
EFAMA the European Fund and Asset Management Association
EIOPA European Insurance and Occupational Pensions Authority
EMIR European Market Infrastructure Regulation
EP European Parliament
ESA European Supervisory Authorities
ESFS European System of Financial Supervision
ESMA European Securities and Markets Authority
EU European Union
FCA Financial Conduct Authority
FSA Financial Services Authority
G20 Group of Twenty
HFT High-frequency trading
HI Historical Institutionalism
IIB Institute of International Bankers
ICAP Intercapital
ICE Intercontinental Exchange
IMF International Monetary Fund
IPE International Political Economy
IR International Relations
ISDA International Swaps and Derivatives Association
ISDA International Swaps and Derivatives Association and
LIBOR London Inter-Bank Offered Rate
LSE London Stock Exchange
LTCM Long Term Capital Management
MEP Members of the European Parliament
MiFID Markets in Financial Instruments Directive
MiFiR Market in Financial Instruments Regulation
MSP Major Swaps Participants

NFCs Non-Financial Companies
NYFR New York Federal Reserve
NYSE New York Stock Exchange
OECD Organization for Economic Cooperation and Development
OSA Omnibus Segregated Account
OTC Over-the-Counter
OTF Organized Trading Facility
SEF Swaps Exchange Facilities
SIFMA Securities and Financial Markets Association
SMSG Securities and Markets Stakeholder Group
UK United Kingdom
US United States
VOC Varieties of Capitalism

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1. INTRODUCTION

The Research Question: Changes in Regulatory Authority

No issue crystallizes the idea of financial globalization in recent decades more than the spread of unregulated or over-the-counter (OTCs) derivatives. Since the 1980s, these financial contracts linked to some underlying asset or indices have helped globally oriented investors mitigate their risk exposure to international economic volatility. However, their utility was ultimately called into question by public officials when they were responsible for exacerbating the global financial crisis of 2008 through complex webs of financial interdependence in industrialized economies. While most citizens in these countries had never heard of financial derivatives before, the fact that they were now being asked to bail out global investment banks' speculative activity on Wall St. was enough to warrant their inclusion into the lexicon of many citizens in the industrialized world. According to Birkland a focusing event is one that is "sudden; relatively uncommon; can be reasonably defined as harmful or revealing the possibility of potentially greater future harms; has harms that are concentrated in a particular geographical area or community of interest; and that is known to policy makers and the public simultaneously ".[1]

The focusing events surrounding the extent to which OTCs were exacerbating the crisis, thus laid bare for public officials in these countries the realities of this complex

[1] Birkland, Thomas A. (1998). "Focusing Events, Mobilization, and Agenda Setting" *Journal of Public Policy,* Vol, 18, No.1 pp.53-74. Also, Kingdon, John W.1995.*Agenda, Alternatives and Public Policies.* 2nd ed. New York: Harper.; Suarez, Sandra. 2014. "Symbolic Politics and the Regulation of Executive Compensation: A Comparison of the Great Depression and the Great Recession." *Politics & Society* 42.1 pp.73-105.

financial interdependence. This created a difficult dilemma for transatlantic authorities who now had to reconcile the institutional disparities of an informal transnational system that had allowed complex cross-border contracting to coexist alongside each country's distinct existing domestic regulatory models. These developments would have significant institutional implications for the international dynamics that would ensue with global OTC reform.

An international consensus was reached by the G20 (an international forum for governments from the world's 20 wealthiest economies) to formally address OTCs as one of the main pillars of global financial reform at the Pittsburgh summit in September 2009.[2] To the leaders of these countries however, the response to this focusing event linking OTCs to the worst financial crisis since t1930s was not a new international financial regime akin to the post-war Bretton Woods system.[3] Rather, what occurred at the time was an internationally driven move to re-assert national authority over the parameters of regulating global finance.

Their role in the financial crisis also marked the start of an historical shift in the regulatory authority for OTCs. In the pre-crisis era, this authority had resided with a

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[2] As part of their broader emphasis on reforming international financial regulation, the leaders of the G20 made the following recommendations for OTCs: "All standardized OTC derivative contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties by end-2012 at the latest. OTC derivative contracts should be reported to trade repositories. Non-centrally cleared contracts should be subject to higher capital requirements." FSB (2009) G20 Leaders' Declaration-Pittsburgh 2009. *Financial Stability Board* <https://www.fsb.org/wp-content/uploads/g20_leaders_declaration_pittsburgh_2009.pdf>.

[3] Helleiner, Eric & Stefano Pagliari. (2010). "Crisis and the reform of international financial regulation" *Global Finance in Crisis: The Politics of International Regulatory Change.* Eric Helleiner, Stefano Pagliari and Hubert Zimmerman (*eds). Ch1.*New York: Routledge.

transnational network of private industry experts overseeing the vast global market.[4] At the time, these policymakers had proffered market-based regulatory solutions that left the global market largely unregulated, despite some early signs that OTCs were prone to spreading cross-border financial contagion. Moreover this *laissez-faire* approach towards global finance had been directly sanctioned by international financial institutions with the support of the United States and the United Kingdom, both of which had long been home to the lion's share of the world's OTCs. In contrast, global financial reform vis-à-vis the G20's involvement also saw the ascendancy of German and French officials who now sought to bring speculative activity in the City of London under greater European oversight. Their increased role in OTC policy-making marked a notable shift away from UK preferences towards those of the European Union, which along with the US now represented the new transatlantic locus of authority for OTCs in the post-crisis era.[5] Therefore, in line with the G20's move to bring OTCs under public oversight, it was the EU's ascendancy and the UK's relative decline that marked the greatest shift in regulatory authority from the pre-crisis era.

This disparity between authority relations for OTCs and the geography of the market represents something of a puzzle. Materialist theories based on market power posit that authority relations in international disputes over global regulations are a

[4] Tsingou, Eleni. 2006. "The Governance of OTC Derivatives Markets. In P. Mooslechner, H. Schuberth & B.Weber (Eds.), *The Political Economy of Financial Market Regulation. The Dynamics of Inclusion and Exclusion* (pp. 89-114). Cheltenham, UK: Edward Elgar. Also Tsingou, Eleni (2010) "Regulatory reactions to the global credit crisis: Analyzing aa policy community under stress" in *Global Finance in Crisis: The Politics of International Regulatory Change.* Eric Helleiner, Stefano Pagliari and Hubert Zimmerman (*eds). Ch2. P21.*.New York: Routledge.

[5] Helleiner, Eric and Stefano Pagliari (2011) "The End of an Era in International Financial Regulation? A Postcrisis Research Agenda" *International Organization* 65, Winter 2011, pp. 169-200. See also Posner, 2018.

function of a country's relative internal market size and that this is determinative only in instances where there is a significant differential between the two.[6] Empirically however, OTCs have never been a significant driver of financial services on the European continent. Instead, approximately two-thirds of the world's OTC transactions are conducted either in London or New York. [7] Therefore, if the market power thesis were correct, we should have seen a continuation of American and British regulatory authority for the global OTC market. What explains these changes we see occurring in the regulatory authority for OTCs?

Argument in Summary

This dissertation investigates the political sources of change in the regulatory authority for implementing OTC reform between 2009 and 2016. It argues that the extent to which OTCs were exacerbating the crisis, effected a shift in regulatory authority that continued to play out against the backdrop of national/international traditions of regulatory policy-making for financial services in industrialized economies on both sides of the Atlantic. This shift occurred alongside the development of the G20's OTC reform agenda which would eventually prove incompatible with the way in which cross-border OTCs had been conducted historically. The dissertation examines alternative explanations for the new transatlantic consensus for OTCs, finding limited support for materialist theories based on market power. Instead, it finds more support for an agent-

[6] Drezner, Daniel (2007) *All Politics is Global: Explaining International Regulatory Regimes*. Princeton: Princeton University Press. P.36. Also: Simmons, Beth (2001) "The International Politics of Harmonization: The Case of Capital Market Regulation" *International Organization,* Vol. 55, No. 3 (Summer), pp.589-62.

[7] Bank for International Settlements (2019) "Triennial Central Bank Survey of Foreign Exchange and Over-the-counter (OTC) Derivatives Markets in 2019." *Bank of International Settlements* <https://www.bis.org/statistics/rpfx19.htm> Accessed 7 Aug 2020.

centered historical institutionalist approach with attention to how marginalized regulatory actors mobilized to have their long-standing preferences towards OTCs realized during the implementation of post-crisis reform.

The contingent nature of the crisis also produced significant temporal variations in how it was experienced on both sides of the Atlantic. While the spread of the initial crisis in the US served as a focusing event for global OTCs, policy discussions at the time were couched primarily in terms of the negative speculation by global investment banks in New York and London. This led to a sense of complacency from officials in Brussels that the financial contagion that started leaking from the US subprime market in 2008 would largely be confined to the City of London. As a result, European efforts to implement the G20's OTCs agenda proceeded at a decidedly slower pace than their American counterparts. When problems with Greece began pointing to a deeper problem in the European-wide market for sovereign debt in January 2010 however, officials in Brussels began to realize that the speculation from OTCs-in this case, credit default swaps held against sovereign debt- was destabilizing sovereign debt markets and exposed major European bans to potentially huge losses. This created strong incentives to increase the tempo of OTC reform in the EU. Therefore, there was not one but two focusing events for OTCs-on each side of the Atlantic.

American officials initially addressed OTC reform within a broader reform Act: the Dodd-Frank Wall St. Reform and Accountability Act (Dodd-Frank). However, even before the ink dried, the parochial nature of this new regulatory regime begat a series of coordination problems internationally. The EU's passage of its own reform framework, the European Market Infrastructure Regulation (EMIR) came about in 2012 just as a

series of smaller transatlantic OTC-related scandals led the primary US regulator for OTCs to begin promulgating extraterritorial rules governing their use by American market participants in foreign jurisdictions. This triggered a backlash by European and Asian regulators who resented the heavy handed effort by the Americans to regulate the global market. As a result, foreign firms began refusing to enter into contracts with US firms even as the G20's original deadlines for implementation came and went. Global industry trade associations responded to the US extraterritorial rule making by initiating what would be several legal challenges to the US regulator in court. Additionally, the UK's marginalization in EU regulatory debates over OTCs would deprive the US of a sympathetic ear in transatlantic deliberations and ultimately served to push the Europeans even further from harmonization with the US-led effort. A recommitment by the US and EU to a 'Common Path Forward' in the summer of 2013 was well-intentioned, but quickly succumbed to the ongoing difficulties of reconciling complex cross-border contracting.

Preserving an open global financial order required a reciprocal system of mutual recognition between the two largest regulatory regimes that allowed for diverse regulatory models while simultaneously treating each other's rules as functionally equivalent. Yet, such coordination was proving elusive. Ironically, an effort by the EU in late 2013 to impose its own extraterritorial rules on its firms transacting in Asia suffered the same fate from regulators in that region. A repeal of specific elements of Dodd-Frank by legislators in the US in 2014, along with looming deadlines for equivalency determinations on both sides of the Atlantic, served to sharpen the resolve of regulators who initiated a series of intergovernmental meetings in Europe to facilitate an agreement.

In Feb. 2016, some six years after the G20 summit and more than eight years since the start of the crisis, the United States and European Union finally reached a mutual accommodation accord for OTCs.

In retrospect, the broad international consensus among wealthy nations led by the two largest financial regulatory regimes should have created strong structural incentives towards coordination on implementing global OTC reform. However, many of the reform initiatives for OTC trading, central clearing, post-trade reporting and capital requirements created a complex thicket of overlapping and in some instances, incompatible financial standards across the two primary regulatory regimes.[8] The headaches for market participants trying to reconcile these disparities were matched only by those felt by the transatlantic authorities, whose regulatory preferences were focused on developing new rules for OTCs, while also seeking to secure competitive advantages for their own firms.

Over time, the magnitude of the regulatory divergence between the two regulatory regimes was large enough that it began to fragment the global OTC market. In essence what this did was it began to create isolated regulatory fiefdoms, something that the G20 agreement had specifically sought to avoid when it recommended that, "our national authorities implement global standards consistently in a way that ensures a level playing field and avoids fragmentation of markets, protectionism, and regulatory arbitrage".[9]

In the years before the crisis, the US and the EU had addressed harmonization problems by developing a reciprocal system of mutual recognition that allowed for

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[8] Central clearing: whereby counterparties to a contract place funds into a central counterparty (CCP) in effect giving them skin in the game, would emerge as a dominant theme in the transatlantic regulatory process.
[9] FSB (2009) G20 Leaders' Declaration-Pittsburgh 2009. *Financial Stability Board* <https://www.fsb.org/wp-content/uploads/g20_leaders_declaration_pittsburgh_2009.pdf>.

diverse national regulatory models while simultaneously treating each other's rules as functionally equivalent.[10] However, conflict between the two main regulatory regimes intensified to the extent that OTC reform took longer than all other issues associated with global financial services reform. Moreover, this conflict had effects on Asia as well, where national regulators in the region had looked to the coordination between the US and EU as a bellwether for the development of their own nascent regulatory regimes for OTCs. The cumulative effect of these developments was such that crisis-induced changes in the regulatory authority for OTCs eventually contributed to the political contestation that ensued between the two sides. This not only set back the trajectory of transatlantic coordination, but also threatened to unseat the very international consensus that had initiated the shift.

Explanations for Changing Regulatory Authority

This review of the literature analyzes the two main relevant explanatory frameworks for the changes in regulatory authority we see occurring in post-crisis OTC reform. The market power thesis and historical institutionalism (HI) both attempt to explain international regulatory developments based on state preferences derived from the Varieties of Capitalism (VOC) approach, reviewed here as well. VOC posits that states preferences for global regulatory initiatives will reflect their own long-standing

[10] Fioretos, Orfeo (2016) "Retrofitting Financial Globalization: The Politics of Intense Incrementalism after 2008" in *Historical Institutionalism and International Relations: Explaining Institutional Development in World Politics.* Oxford University Press. P.85.

domestic institutional market arrangements markets that are the source of competitive advantages for their firms in the global economy.[11]

Both Market power and HI however, have different orientations to VOC and therefore ultimately point to different determinants of regulatory authority. Materialist-based theories like Market Power place material interests first and foremost in determining international regulatory outcomes. As a result, it doesn't explicitly model state preferences. Rather, preferences are addressed *ex post* with assumptions derived from VOC taken as given. In contrast, HI suggests that actors existing investments in institutions should loom larger as they weigh various regulatory proposals. Therefore, it not only takes VOC's assumptions *ex ante* but as the review below suggests, also builds on them through a more open conception of time that helps explain the institutional changes we see occurring with OTC reform.

Historical Institutionalism also builds on explaining how Market Power works as well. While the two make different predictions about the primary cleavages we should see occurring both initially as well as over time, neither directly maps onto the empirical record for post-crisis OTCs (see chart below). Rather, both explain different elements of the OTC reform process. Therefore HI can be seen as an important compliment to IPE approaches to explain international regulatory regimes like those based on market

[11] Fioretos, Orfeo (2001). "The Domestic Sources of Multilateral Preferences: Varieties of Capitalism in the European Community". *Varieties of Capitalism The Institutional Advantages of Comparative Advantage.* Peter A. Hall and David Soskice *eds.* Ch.6 pp.213-246. Oxford University Press.

power.[12] After a review of the literature, I propose an agent-centered HI approach to reconcile some of the missing elements of OTC reform.

Material Capacity and Market Power

The first explanation considered here for the changes we see in regulatory authority for OTCs comes from authors working in the materialist IR tradition who cite traditional power politics among great powers as central to outcomes in the international political economy.[13] According to the market power thesis, the harmonization of international regulatory standards will reflect the preferences of a dominant regulatory innovator, usually a state with the largest internal markets. In this regard, states with large capital markets gain leverage over competitor countries to facilitate the adoption of their preferred regulatory standard through the threat of exit or by withholding access to foreign firms.[14] This work built on existing perspectives that sought to address the impact that the structural power of western-based finance had on the international political economy.[15] Therefore, an observable implication of the market power thesis is that the degree of convergence around the preferences of one actor should be directly proportional to the degree of market power imbalance with another other actor.

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[12] Fioretos, Orfeo (2010). 'Capitalist Diversity and the International Regulation of Hedge Funds' *Review of International Political Economy.* 17(4) pp.696-723.

[13] Gilpin, Robert. (1975). *US Power and the Multinational Corporation.* New York, Basic Books. See also: Krasner, Stephen D. (1991). 'Global Communications and National Power: Life on the Pareto Frontier', *World Politics,* 43(3): pp.336-66.

[14] Gruber, L. (2000) *Ruling the World: Power Politics and the Rise of Supranational Institutions,* Princeton: Princeton University Press. Also, Simmons 2001.

[15] Strange, Susan (1996) *The Retreat of the State: The diffusion of power in the world economy,* Cambridge, Cambridge University Press.

Despite market power's observable implications for converging regulatory outcomes, important refinements to the theory have stressed that this dynamic only obtains when there are significant disparities in the relative bargaining power between two states. For example, Drezner argues that domains with large enough internal markets like the EU can successfully resist the preferred regulatory standard of the US and therefore, US/EU agreement will be a necessary condition for an expansion of international rules.[16] However, given that OTCs in the pre-crisis era had yet to come under EU-level authority, it was the UK not the EU that matched the US in terms of its material capacity for derivatives contracting. Therefore according to the market power thesis, we should have expected the primary cleavage in coordinating OTC reform to fall along Anglo-American lines. By extension, any subsequent agreement between the two great financial powers should have been a necessary condition for an expansion of international OTC regulation. While the crisis did in fact reveal cracks in the Anglo-American façade of OTC regulatory preferences, as noted above broader European support from the EU was a necessary condition for an expansion of international rules for OTCs.

Materialist theories like market power however, fail to address changes to authority relations within the EU that were affected by the crisis and the effect this had on the relative bargaining power of key European member states. This study, by analyzing the national origins of EU level preferences, suggests that the financial crisis in 2008 shifted the relative influence of key EU member states as it pertains to regulating

[16] Drezner, Daniel (2007) *All Politics is Global: Explaining International Regulatory Regimes*. Princeton: Princeton University Press. P.36.

derivatives.[17] This, in turn, negatively impacted the trajectory of transatlantic mutual accommodation. Structural or systemic approaches like those based on market power are also less adept at explaining how member states within the EU exercise their power in negotiating with the US, or with each other for that matter. We see this in the extent to which other European countries with financial centers (France and Germany) were necessary in securing US cooperation for this effort. These dynamics occurred despite both countries relative lack of material capacity relative to the US and UK's financial markets for most of the decade preceding the crisis.[18]

Thus, according to the market thesis, we should not have expected to see the continental countries punching above their weight in facilitating international financial regulatory reform to the extent that they did. This speaks to the contingency associated with the crisis in first bridging the diverse preferences of EU member states before exercising their joint market power in negotiations with the US. Moreover, the crisis saw the marginalization of the UK-home to the largest amount of the world's derivatives activity in EU deliberations.[19] This suggests that relative market power alone was insufficient in explaining the European response towards derivatives.

The crisis and the subsequent expansion of EU financial regulatory authority for OTCs, expanded the relative institutional capabilities of the continental countries to drive

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[17] Quaglia, Lucia (2012). "The 'Old' and 'New' Politics of Financial Services Regulation in the European Union". *New Political Economy,* Vol. 17, No.4, pp.515-535.

[18] Fioretos, Orfeo (2010). 'Capitalist Diversity and the International Regulation of Hedge Funds' *Review of International Political Economy.* 17(4) pp.696-723.

[19] Helleiner, Eric & Stefano Pagliari. (2010) "Crisis and the reform of international financial regulation" *Global Finance in Crisis: The Politics of International Regulatory Change.* Eric Helleiner, Stefano Pagliari and Hubert Zimmerman (*eds). Ch1.*New York: Routledge.

the European reform agenda. This not only marginalized the relative influence of the UK, but also boosted their relative influence in EU interactions with the US. As the case studies below will demonstrate, the ascendant continental countries of Germany and France were successful in countering the preferences of the UK over the policy trajectory for OTCs particularly in deliberations in the European Commission. In short, it was more than just market size that mattered with OTC reform. It was also the institutional layers in which the UK was embedded within the EU at the time which delimited its ability to be a rule-maker in post-crisis OTC reform.

Without an explicit theory of institutions driving state preferences, market power alone cannot capture the requisite nuance in explaining the subsequent divergence between the two largest regulatory regimes. The need to identify state preferences is particularly important in the case of the US/EU where there is no clear preponderance of market power.[20] This is especially relevant further downstream in the policy process during implementation when the form that common rules will take is determined by the nature of state preferences. Because the Market Power thesis is first and foremost a structural theory based on the material capacity of great financial powers, it explicitly avoids modeling state preferences for a given institutional arrangement. It instead addresses these *ex-post*, resting on assumptions driven by the VOC approach which I unpack in the next section.

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[20] As Fioretos notes, "A complete account of why a particular outcome prevails in cases where power is more evenly distributed requires a theory of state preferences that accounts for the preferences of both the side making a proposal and the side that has to endorse that proposal to make an agreement sustainable over time." Fioretos, Orfeo (2010) 'Capitalist Diversity and the International Regulation of Hedge Funds' *Review of International Political Economy.* 17(4) p.700.

Varieties of Capitalism

In contrast to the materialist IR approaches, comparativists focus on the extent to which divergent or convergent responses to economic globalization are affected by domestic institutions embedded within a country's political economy. Scholarship in the literature on comparative capitalisms has demonstrated that despite the seeming convergence towards a single form of financial liberalization, developed countries often choose to pursue this objective in a manner that is consistent with their existing domestic institutions.[21] While IR scholars have conceptualized domestic institutions as an independent or intervening variable affecting international relations, comparativists have traditionally worked in the other direction, preferring to think about the extent to which globalization affects the domestic political structure of nation-states.[22] Therefore scholars have suggested that events like a global financial crisis are viewed by comparativists as, "an undifferentiated shock that reverberates through domestic institutional configurations"[23].

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[21] See: Lütz, Susanne. 2004. "Convergence within Diversity: The Regulatory State in Finance." *Journal of Public Policy,* Vol. 24, No, 2. pp. 169-197. Deeg, Richard and Susanne Lütz. 2000. "Internationalization and Regulatory Federalism in Financial Systems: The United States and Germany at the Crossroads?" *Comparative Political Studies* 33 (3): 374-405. Also see Vogel, Steven K. 1997, "International Games with National Rules: How Regulation Shapes Competition in 'Global' Markets". *Journal of Public Policy, Vol. 17, No.2* (May-Aug. 1997).

[22] For the Open Economy Politics approach to domestic institutions see: Lake, David A. (2006) "International Political Economy A Maturing Interdiscipline" *Oxford Handbook of Political Economy.* Barry Weingast & Donald A. Wittman eds. Ch. 42. Pp.758-777. Oxford University Press.

[23] Farrell, Henry and Abraham Newman (2010) "Making Global Markets: Historical institutionalism in international political economy" *Review of International Political Economy* 17:4 October: 609-638.

Perhaps the most widely cited work in this vein is the now familiar Varieties of Capitalism (VOC) approach posited by Hall and Soskice.[24] This work produced a resultant typology of market types: Liberal Market Economies (LMEs) and Coordinated Market Economies (CMEs) across five institutional spheres of the political economy. LMEs (of which the US and UK are often cited as exemplars) consist of institutional arrangements characterized by arm's-length formal contracting among firms, alongside competitive market arrangements predicated on the ability of neoclassical assumptions of supply and demand to send accurate price signals to firms. These arrangements guide economic actors' efforts to coordinate their endeavors within the country's production regime. In contrast, CMEs (Germany is a prime example) rely more on the strategic interaction among firms and other actors to coordinate endeavors and construct their core competencies. Also, relationships across firms in CMEs are more collaborative than competitive using non-market modes of coordination where network-based information sharing and relational or incomplete contracting are more advantageous in developing these competencies. France, given its long history of state-mediated *dirigiste* industrial policy was relegated to a third, less common statist type.

As a firm-centered framework, companies' preferences for government regulation are affected by their existing investments in assets specific to a country's institutional structure, which are the source of their comparative advantage in the global marketplace. In turn, governments will be inclined to support regulatory initiatives only "when they do not threaten institutions most crucial to the competitive advantage their firms enjoy"[25].

[24] Hall, Peter and David Soskice. 2001. *Varieties of Capitalism.* Oxford University Press.
[25] Hall, Peter and David Soskice. (2001). *Varieties of Capitalism.* Oxford University Press. P.52.

Therefore, in attempting to explain the shifts in authority we see occurring with OTCs, we should see national models of reform consistent with their mode of capitalist institutional development. This approach would therefore predict that LMEs like the US and UK would, *ceteris paribus,* be generally less restrictive than CMEs in the degree to which they would restrain the dynamism of their financial services sectors and all the more so given their oversized role in playing host to the global OTC market.

The typological distinctions between Germany and France laid out by VOC, as well as the UK's unique role within the EU at the time complicates an application of this mode of inquiry towards the EU. A long-standing debate among European scholars has focused on the extent to which the EU project represents a neo-liberal project built around liberating markets. The counter to this is that it represents a natural extension of coordinated market institutions given its prominent role in constructing regulation.[26]

Another problem for VOC is its weakly defined role for the state in setting national preferences, given its place of primacy in what we see occurring with regulatory authority for OTCs. This is especially intriguing given divergence theorists contention that the degree of state action is implicitly one of the defining features differentiating liberal and market economies.[27] More importantly as Deeg has suggested, VOC does not

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[26] For the neoliberal views on the EU see: Scharpf, Fritz (2010). "The Asymmetry of European Integration, or Why the EU Cannot Be a 'Social Market Economy'. *Socio-Economic Review* 8 (2) April. For the coordinated perspective see Bretherton, Charlotte & John Vogler, *The European Union as a Global Actor.* New York, Rutledge 1999. Also, Posner, Elliot (2018). "Is a European approach to financial regulation emerging from the crisis?" *in Global Finance in Crisis: The Politics of International Regulatory Change.* Eric Helleiner, Stefano Pagliari, and Hubert Zimmerman. New York; Routledge. Ch.7 pp.108-120.
[27] For a discussion see: Schmidt, Vivien A. (2007). "Changes in Comparative Political Economy: Taking Labor Out, Brining the State Back In, Putting the Firm Front and Center". Paper for the European Studies Association Meeting in Montreal. May 17-20.

account for the agency of state actors to act autonomously of firm preferences.[28] Nor does it explain how state regulatory actors adjudicate between competing interests during the reform process. This is especially problematic, as regulators pursue the regulatory reform agenda delegated to them by legislators, despite attempts by financial market actors to push back against these reforms.

VOC's game-theoretic framework, also has problems addressing institutional change. For example, VOC implicitly rests on an assumption of institutions as self-reinforcing for economic actors who absent a large exogenous shock will largely eschew wholesale institutional change.[29] Therefore, institutions are conceived of as coordinating mechanisms which sustain distinct behavioral equilibria marked by long periods of institutional stability.[30] However as Conran and Thelen argue, it has problems explaining transitions from one equilibrium to another.[31] Moreover, its limitations with regard to institutional design and the subsequent gaps associated with the inherent ambiguity of institutions and rules, instead translate to a crude form of functionalism which seems divorced from the way institutions actually work.

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[28] Deeg, R. (2006). 'Governance and the Nation-State in a Global Era' in Governance in der politischen Ökonomie: Struktur und Wandel des modernen Kapitalismus. Susanne Lütz ed.

[29] Deeg, R.& Jackson G. (2007). 'The State of the Art: Towards a more dynamic theory of capitalist variety' *Socio-Economic Review,* 5 pp. 149-179.

[30] For a review of the three institutionalisms see Hall & Taylor 1996 For this view of Rational choice Institutionalism, See: Levi, Margaret. (1997). "A Model, a Method, and a Map: Rational Choice in Comparative and Historical Analysis." In *Comparative Politics: Rationality, Culture, and Structure,* ed. Mark Irving Lichbach and Alan S. Zuckerman. Cambridge: Cambridge University Press, 19-41.P.27.; Scharpf, Fritz Wilhelm. (1997). *Games Real Actors Play: Actor-Centered Institutionalism in Policy Research.* Boulder, CO: Westview Press P.10. Shepsle, Kenneth A. (1989). "Studying Institutions Some Lessons from the Rational Choice Approach." *Journal of Theoretical Politics* 1(2):131-147. P.145.

[31] Conran, James and Kathleen Thelen. (2016). "Institutional Change", in *The Oxford Handbook of Historical Institutionalism.* Orfeo Fioretos, Tulia G. Faletti and Adam Sheingate *(eds.)* Ch.1 *pp.51-70.* Oxford University Press.

Comparative approaches like VOC have also been criticized for their adherence to methodological nationalism in a world of complex economic and financial interdependence particularly in the context of the EU.[32] As such, it still fails to consider the extent to which actors across countries engage and are affected by cross-border network effects. These types of feedback inducing network effects increased over time as more and more market actors from various countries contracted with counterparties in London and New York (see chapter 2). The increasing returns from this type of transnational market activity that marked the construction of a global market would ultimately challenge the ability of national policymakers to address OTC reform vis-à-vis the re-assertion of national authority proffered by the G20. As we shall see in the post-crisis chapters on the US and EU, OTC reform was replete with instances of both market and state regulatory actors whose preferences for a given regulatory framework at home were affected by regulatory decisions made across the Atlantic and within Europe. The inability of VOC to take these sorts of cross-border dynamics into account has been a source of criticism for scholars seeking to explain the nature of cross-border economic/financial interdependence.

In sum, comparativist approaches like VOC have helped to identify the institutional landscape of a country's political economy as the origin for divergent responses to the market forces of financial globalization. It has produced the theoretical

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[32] Deeg, Richard and Eliot Posner (2016). "Durability & Change in Financial Systems in *The Oxford Handbook of Historical Institutionalism*. Orfeo Fioretos, Tulia G. Falleti & Adam Sheingate *eds.* pp438-452. Also see: Lütz, Susanne (2004). "Convergence within Diversity: The Regulatory State in Finance." *Journal of Public Policy,* Vol. 24, No, 2. pp. 169-197. Also See: Farrell, Henry and Abraham Newman (2010). "Making Global Markets: Historical institutionalism in international political economy" *Review of International Political Economy* 17:4 October: 609-638.

insight that regulatory diversity to these forces is a predictable result of these institutions. However, VOC's relatively closed conception of time and its subsequent focus on institutional equilibria fails to capture the changes in authority we see occurring over time with OTC reform. This is most likely attributable to its weak role for the state, the primary actor associated with post-crisis reform. Moreover, its adherence to methodological nationalism is also out of step with a reform effort born in the ashes of a crisis spawned by the financial interdependence of cross-border contracting by firms in market economies.

Historical Institutionalism

The role played by various domestic institutional configurations have led some to equate VOC with historical institutionalism (HI) which also shares an emphasis on the institutional embeddedness of political economies.[33] Whereas the market power thesis rest on assumptions about domestic institutions derived from VOC *ex post*, historical institutionalism takes these as *ex ante.* In doing so, HI builds on VOC's basic insight that state preferences for domestic and international agreements will reflect the types of long-standing financial institutions and market arrangements that are the source of their competitive advantage, while using regulation to preserve these advantages. As a result, institutions are conceived as being analytically prior to material interests in actors' consideration of how best to pursue regulatory initiatives.

[33] Thelen, K. and Steinmo, S. (1992) Historical Institutionalism in Comparative Politics, in S. Steinmo et al. (eds.), *Structuring Politics: Historical Institutionalism in Comparative Analysis.* Cambridge: Cambridge University Press, 1-32. Also, Pierson, P. (1994) *Dismantling the Welfare State? Reagan, Thatcher, and the Politics of Retrenchment.* Cambridge: Cambridge University Press.

Institutions are commonly conceptualized as a given set of rules, norms or expectations that have causal effects on patterns of action.[34] However, one of the fundamental insights of HI is that there is no such thing as a neutral rule.[35] While VOC sees them as equilibria-inducing mechanisms for coordination, historical institutionalism sees them best conceptualized as "distributional instruments laden with power implications"[36]. As a result, institutions often reinforce existing power disparities. They do so through a process of positive feedback in which actors' prior investments in extant institutions produce increasing returns over time.[37] This in turn, helps account for why certain interests are entrenched vis-à-vis certain institutional configurations through their defense of these investments. Moreover, this view is generally consistent with path dependent accounts of post-crisis financial reform and explains why more radical change in many issue areas of finance was not more forthcoming in its wake.[38]

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[34] North, Douglass C. (1990). *Institutions, Institutional Change and Economic Performance.* Cambridge University Press.

[35] Pierson P. (1997). 'Path dependency, increasing returns, and the study of politics.' Cent. Eur. Stud. Work. Pap. No. 7.7 (September). Cambridge, MA: Cent. Eur. Stud., Harvard Univ. Also: Thelen, K. (1999) "Historical Institutionalism in Comparative Politics" *Annual Review of Political Science.* 2:369-404.

[36] Mahoney, James and Kathleen Thelen (2010). *Explaining Institutional Change: Ambiguity, Agency, and Power.* Cambridge University Press. P.8 See also: Hall, P.A. (1986). *Governing the Economy: The Politics of State Intervention in Britain and France.* New York: Oxford University Press.; Skocpol, Theda (I995). "Why I am an Historical Institutionalist." *Polity* 2.8:103-106; Also, Mahoney, James (2010). *Colonialism and Postcolonial Development: Spanish America in Comparative Perspective.* New York: Cambridge University Press.

[37] Arthur, Brian (1994). *Increasing Returns and Path Dependence in the Economy.* Ann Arbor: University of Michigan Press. Also: Pierson, Paul (2004). *Politics in Time: History, Institutions and Social Analysis.* Princeton: Princeton University Press.

[38] Moschella, Manuella and Eleni Tsingou (2013). "introduction: the financial crisis and the politics of reform: explaining incremental change" *Great Expectations, Slow Transformation: Incremental Change in Post-Crisis Regulation.* Manuella Moschella and Eleni Tsingou eds. Ch1 pp.1-33. Colchester, UK ECPR Press.

What also distinguishes Historical Institutionalism from VOC are the analytical bets it places on temporality and endogenous sources of institutional change. HI has a long tradition of recognizing that institutions adopted at an earlier point in time are significant factors in making certain outcomes more or less likely later on. The reason institutions are ultimately self-reinforcing is based on existing positive-feedback mechanisms which preclude other events from happening further downstream in the process. Therefore the timing and sequence of institutional development can have significant downstream effects. A requisite corollary of this is that temporal sequencing can also produce decreasing returns as well in the form of negative feedback over time. This eventually erodes support for prior political arrangements undermining existing power disparities. Moreover, as has been suggested:

> Because institutions instantiate power, they are contested. Losers in one round do not necessarily disappear but rather survive and find ways not just to circumvent and subvert rules, but to occupy and redeploy institutions not of their making. [39]

In sum, their ability to reflect and re-allocate power not only renders institutions as endogenous to political arrangements, but also that the more open conception of time contributes to their sequential development creating "varied patterns of political authority and contestation"[40]. We should therefore expect to see the relative institutional position of formerly marginalized actors increased *vis-à-vis* the political developments associated with the crisis.

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[39] Conran, James and Kathleen Thelen. (2016). "Institutional Change", in *The Oxford Handbook of Historical Institutionalism.* Orfeo Fioretos, Tulia G. Faletti and Adam Sheingate *eds.* Ch.1 P.57. Oxford University Press. See also: Thelen, Kathleen (1999). "Historical Institutionalism in Comparative Politics" *Annual Review of Political Science* 2: 369-404.

[40] Fioretos, Orfeo. (2019). *Timefulness in International Relations Theory.* Paper presented for the Time and International Politics Workshop. Georgetown University; 6 November, 2019.

While its origins were in the comparative and American subfields of political science, in recent years HI has made significant inroads explaining international regulatory developments.[41] Some of this work has used the VOC's clash of capitalisms framework to explain the institutional persistence of national financial systems and the extent to which these have affected EU-level financial regulatory outcomes. Notable work in this vein has found this to be the case in financial services policy-making addressing hedge funds, capital reserves, and takeovers.[42] However, attempts to extend this line of inquiry into other issue areas like banking have found less robust support.[43] This work stresses two aspects that are relevant to this study: 1) The role of regulatory authorities in defining and enforcing regulation and 2) the manner in which the financial services industry and other groups are incorporated into the policy-making process. Both of which are historically contingent and ultimately affect and are affected by how the sequencing of reform implementation is mediated.[44] These conceptual developments are significant as they expand VOCs theoretical insights to consider more fully the role of the

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[41] Fioretos, Orfeo (2010) 'Capitalist Diversity and the International Regulation of Hedge Funds' *Review of International Political Economy.* 17(4) pp.696-723. Also: Fioretos, Orfeo (2011a). "Historical Institutionalism in International Relations" *International Organization* 65 (2).

[42] Fioretos, Orfeo (2010) 'Capitalist Diversity and the International Regulation of Hedge Funds' *Review of International Political Economy.* 17(4) pp.696-723. Also see: Zimmerman, Hubert (2010). "Varieties of global financial governance? British and German approaches to financial market regulation" *in Global Finance in Crisis: The Politics of International Regulatory Change.* Eric Helleiner, Stefano Pagliari, and Hubert Zimmerman. New York; Routledge. Ch.8 pp.121-136. Also: Howarth, David and Lucia Quaglia (2013) "Banking on Stability: The Political Economy of New Capital Requirements in the European Union" *Journal of European Integration* 35(3).

[43] Buckley, James & David Howarth (2010). 'Internal Market: Gesture Politics? Explaining the EU's Response to the Financial Crisis.' *Journal of Common Market Studies.* Vol. 48 Annual Review pp.119-141.

[44] Fioretos, Orfeo (2010) 'Capitalist Diversity and the International Regulation of Hedge Funds' *Review of International Political Economy.* 17(4) pp.696-723.

state in establishing regulatory reform. This period, marked by the re-assertion of national authority in financial regulation, also saw a requisite shift towards delegating greater authority to regulators, given the perception that they had previously been captured by the preferences of global finance.[45]

Because this work takes VOC as its conceptual starting point, it also shares some of it pathologies. Despite the internal shift towards explaining institutional change, HI still tends towards path-dependency in explaining crisis-induced developments particularly when used in conjunction with VOC. One such noteworthy example is that it does not address why either LME would accept direct regulation of OTCs as it predicts both countries maintaining their preference for indirect regulation of derivatives; something that Market Power is silent on as well. VOC-driven HI also cannot explain some of what we see occurring in the EU with OTC reform. For example, it does not account for why a CME like Germany, with more of a mixed tradition of direct regulation would accept or even propose more stringent regulation than its French counterpart. It also doesn't explain why the UK as an example of an LME, would ever support more expansive regulatory initiatives over its financial sector within the context of the EU as well. It also predicts that over time the primary cleavage within the EU over reform should resemble the clash of capitalisms, referenced above. A such, it doesn't explain why the Netherlands or Sweden (both designated as CMEs by Hall & Soskice) would align themselves with an LME like the UK in EU deliberations. Therefore, the key theoretical aim is elucidating precisely how actors are simultaneously able to interact

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[45] Baker, Andrew (2010). "Restraining regulatory capture? Anglo-America, crisis politics and trajectories of change in global financial governance" *International Affairs* 86:3 pp.647-663.

with the institutional forces of both stability and change, as well as how their preferences affect or are affected by both.

As the chart below highlights, both market power and HI make different predictions about the primary cleavages we see occurring over OTCs. While market power posits an initial crisis-induced snapshot of clash between the United States and the United Kingdom, HI predicts a clash of capitalist by type. Over time however, market power predicts that the growth of internal markets within both LMEs and CMEs, will also be accompanied by an increasing reluctance to accept internationally promulgated rules. In contrast, HI suggests that as implementation progresses over time, increased lobbying by the industry accompanying its expansion will also increase a country's likely acceptance of such rules. This starts to point at the complimentary nature of both theoretical approaches in explaining OTC regulatory reform outcomes. However, while each taps into different elements of OTC reform, both are still largely couched in transatlantic terms. The growing financial interdependence of complex contracting globally meant that global reform would never be limited solely to the US and the European countries. Moreover, as the empirical chapters demonstrate, new frontier markets for derivatives in Asia represented not only new business opportunities for western financial firms, but would also significantly affect the sequencing of global OTC reform. Therefore, the implication for this study is that the agent-centered HI approach I lay out in the next section can accommodate these empirical developments as well.

Relevant theoretical framework	Theory of state preferences based on:	Predicts Primary Cleavage between:		How has global OTC reform empirically challenged this thesis?	
		Snapshot	Over Time	Main pillars of G20 OTC reform agenda	Implementation
Market Power Drezner, 2007	Material Capacity Based on relative Size of the industry	US vs. UK Clash of Great Financial Powers	Growth of internal markets should decrease both LMEs and CMEs willingness to accept intl. regulation.	Doesn't explain convergent preferences between US and EU. Doesn't explain US and UK acceptance of direct regulation over OTCs.	Explains conflict and fragmentation between US and EU. Doesn't explain internal EU dynamics beyond VOC. Doesn't explain autonomy of smaller markets ie; Asia
Historical Institutionalism Fioretos, 2001, 2010.	Existing institutional investments both domestic & intl-that are source of a country's competitive advantage.	LMEs vs. CMEs Clash of Capitalisms	Expansion of industry and subsequent lobbying should increase propensity of govt. to support expansion of international regulatory requirements.	Explains why US was willing to support intl. rules that mitigate systemic risk.	Doesn't explain why some CMEs would support UK in EU deliberations. Explains growing incentives over time for mutual accommodation.

Table. 3 Relevant theoretical frameworks.

Agent-Centered Approach

This study utilizes an agent-centered HI framework to explain the changes we see occurring in the authority relations associated with OTC reform. In doing so, it concentrates on the dynamic interaction between agents and institutions to explain the changes in authority relations both within and across the dominant regulatory regimes associated with global financial regulatory reform for OTCs. A widely recognized aspect in the literature on the creation of global regulation is the importance of active policy entrepreneurs and the ideas they support in contributing to regulatory outcomes.[46] The review above has already touched on some of HI's core analytical concepts for explaining the causal primacy of institutions, their ability to instantiate power, and its focus on temporality. I continue to build on some of these insights, arguing for a greater causal role for agency and ideas in the context of national authority in post-crisis attempts to regulate complex cross-border contracting.

Endogenous modes of institutional change often entail highly political and conflictual processes of enforcement and interpretation. This is because actors with divergent and often conflicting interests don't merely apply formally codified rules; they have to interpret, enforce and enact them in ways that reflect the political contestation that results from these preferences. This, Thelen explains, is why "losers" persist within institutional environments where they unsuccessfully resisted the imposition of rules by the winners in past contests.[47] They do so to carry out the fight from within the

[46] Mattli,W. and Woods, N. (eds) (2009). *The Politics of Global Regulation,* Princeton: Princeton University Press.

[47] Thelen, Kathleen (1999). "Historical Institutionalism in Comparative Politics" *Annual Review of Political Science* 2: 369-404.

institutions by renegotiating and reinterpreting the rules ex post as a source of institutional change. Therefore we should expect to see the legitimacy crisis for existing institutions that occurred during reform enhancing these actors relative power to shape subsequent change.

The response to the path dependent view of institutions as constraining over time was met by a wave of criticism from institutional scholars utilizing insights from constructivism in order to develop alternative accounts to explain institutional change.[48] Such accounts eschew such a constrained view of agency by portraying the institutional contexts that political actors operate within as relatively fluid and ideational thus affording them the ability to interpret their environment and affect change accordingly. The analytical move by constructivists however, often conflates institutions with ideas seeing "rules and norms largely as ideational constructs and not as defining elements of institutions, as most institutional analysts would see them"[49]. Bell however, argues that there is a more flexible agent-centered strand of historical institutionalism that allows for the dialectical interaction between agents and institutions as modern constructivism does, but also incorporates wider structures e.g.; global markets.[50] In this way, institutional and

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[48] Hay, Colin. (2004). 'Ideas, Interests and Institutions in the Comparative Political Economy of Great Transformations', *Review of International Political Economy* (11): 204-226. Also: Mark Blyth, (2002). *Great Transformations: Economic Ideas and Institutional Change in the Twentieth Century*. Cambridge: Cambridge University Press. As well as: Vivien Schmidt, (2010). 'Taking Ideas and Discourse Seriously: Explaining Change Through Discursive Institutionalism as the Fourth ''New Institutionalism'' ', *European Political Science Review*, 2 pp.1–25.

[49] Bell, Stephen (2012). 'The Power of Ideas: The Ideational Shaping of the Structural Power of Business' *International Studies Quarterly*, 56, pp.661-673. P.667.

[50] Bell, Stephen (2011). 'Do We Really Need a New 'Constructivist Institutionalism' to Explain Institutional Change?' *British Journal of Political Science.* Vol.41, Issue 4, October. pp.883-906.

structural environments exert real effects by shaping actor interpretations through the imposition of costs and benefits that shape the scope of bounded discretion they face.

Historical Institutionalism also has a long tradition of conceptualizing institutional change as the product of critical junctures. Capoccia and Kelemen define these junctures as "relatively short periods of time during which there is a substantially heightened probability that agents choices will affect the outcome of interest"[51]. The emphasis on agency in the work on critical junctures came from the recognition by scholars that prior structural conditions are not necessarily determinative in such contexts and that subsequently different institutional developments are possible.[52] Soifer has built upon the idea of permissive conditions, which Capoccia and Kelemen agree are of vital import to critical junctures, given their ability loosen institutional or structural constraints on agency. This loosening then facilitates the subsequent productive conditions that bring about change.[53]

One of the findings of this study is that given the complexity of implementing OTC reform, as well as actors attempts to induce friction into the institutional proceedings, the delays in implementation meant that OTCs were still largely unregulated some four years after the initial crisis began. As a result, a series of ongoing scandals associated with derivatives had the effect of contributing to new permissive conditions, expanding the agency of public officials tasked with reform. The contingent nature of the

[51] Cappocia, Giovanni and Daniel Keleman. (2007). "The Study of Critical Junctures: Theory, Narrative and Counterfactuals in Institutional Analysis." *World Politics* 59 (3): 341-369. P.350.

[52] Goldstone, Jack A. (1998). "Initial Conditions, General Laws, Path Dependence, and Explanation in Historical Sociology". *American Journal of Sociology* 104 (3):829-845. Also: Mahoney, James. (2000). "Path Dependence in Historical Sociology." *Theory and Society* 29 (4): 507-548.

[53] Soifer, Hilel David. (2012). "The Causal Logic of Critical Junctures". *Comparative Political Studies* 45 (12): 1572-1597.

2010 Greek crisis in the EU as well as the London whale scandal in 2012 which led to the US's extraterritorial rule-making both featured a key role for unregulated OTCs that can be captured through this lens. Furthermore, the productive conditions that followed would ultimately produce institutional change that in some ways conflicted with the original G20 OTC reform agenda. This ultimately undermined its focus on preventing market fragmentation, protectionism and regulatory arbitrage during implementation.

This is where the concept of a focusing event from the public policy literature stated at the outset, helps refine HI's temporal emphasis on institutional change and the conditions that make it possible. In this regard, both the collapse of AIG in the US, as well as the Greek sovereign debt crisis, can be seen as focusing events placing pressure on regulators and public officials to address unregulated OTCs.[54] In turn, this pressure contributed to the permissive conditions affecting regulatory outcomes over time, which ultimately conflicted with the sequencing of global reform.

Ideas are also an important corollary to this mode of inquiry. Blyth suggests that what matters during a critical juncture is the politics of ideas as actors promote new institutions to solve the crisis.[55] In the context of agency, the degree of transformative or consolidative change within institutions is often determined by how leaders frame the

[54] This is closely related to the idea that crisis-induced reform for OTCs was driven by increases in the issue's salience by the general public. See: Pagliari, Stefano (2013). "Public Salience and International Financial Regulation: Explaining the International Regulation of OTC Derivatives, Rating Agencies, and Hedge Funds". Ph.D Thesis: University of Waterloo. Ontario, Canada.

[55] Blyth, Mark (2002). *Great Transformations: Economic Ideas and Institutional Change in the Twentieth Century,* Cambridge University Press. Also Blyth, Mark (2007). "Power, puzzling or persuading? The mechanisms of building institutional orders. *International Studies Quarterly.* Vol.51 Issue 4 pp.761-777.

crisis within the public arena, which provides legitimacy for either institutional path.[56] This is especially relevant during economic or financial crises in which "the ideational terrain is where the main political battles are fought during a critical juncture"[57]. These analytical moves reflect not only the recent trends in historical institutionalism towards a more distinctive focus on agency, but also support arguments in favor of including more of an explicit focus on how ideas work in the context of historical institutionalism.[58]

In sum, Historical Institutionalism's ability to address temporality and endogenous sources of institutional change make it well suited to address the changes in regulatory authority we see occurring with OTC reform. This study's agent-centered focus helps accommodate the integral role for state regulatory actors that was largely absent in the pre-crisis era scholarship.[59] HI has also built and expanded on some of VOC's core insights, allowing for explanations that can accommodate both the forces of stability as well as those of change. Its distinctive focus on temporality and endogenous change is well suited to explain how the authoritative preferences of key actors changed as a result of the contingent role that OTCs played in the crisis. Additionally, the work on critical junctures, used in conjunction with the notion of focusing events also explains

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[56] Krebs, Ron. (2010). "International Conflict and the Constitutional Balance: Executive Authority after War". In *War's Wake: International Conflict and the Fate of Liberal Democracy,* ed. Elizabeth Kier and Ron Krebs. New York: Cambridge University Press, 187-210.

[57] Capoccia, Giovanni (2016). "Critical Junctures" in *The Oxford Handbook of Historical Institutionalism.* Orfeo Fioretos, Tulia G. Faletti and Adam Sheingate *(eds.).* Ch.5 pp.89-106. Oxford University Press.

[58] Blyth, Mark; Oddný Helgadóttir, and William Kring (2016). "Ideas and Historical Institutionalism". in *The Oxford Handbook of Historical Institutionalism.* Orfeo Fioretos, Tulia G. Faletti and Adam Sheingate *(eds.).* Ch.8pp.142-162.

[59] A notable exception in the IR literature on financial services regulation is: Singer, David A. (2007). *Regulating Capital: Setting Standards for the International Financial System"* Ithaca: Cornell University Press.

how existing constraints established by the sequencing of global reform were loosened, increasing the agency of regulatory actors tasked with reform. In turn, actors that were opposed to these efforts sought to induce institutional friction into the proceedings as the ideational scope of OTC reform was contested. As a result, the agent-centered HI approach used in this study taps into both how actors in complex institutional environments attempt to use their relative market power as leverage to induce harmonization, as well as why they are sometimes unsuccessful in doing so. In this way, HI helps refine materialist explanations by demonstrating how institutions might serve as conduits for the translation of market power. Moreover, its ability to explain institutional change suggests that HI also helps us refine our understanding of Varieties of Capitalism in that it helps explain how diverse capitalist models adapt their approach to financial globalization through domestic and international institutional arrangements.

This study builds on existing scholarship on the global post-crisis financial reform of OTC markets. The earliest work noted the shift away from Anglo-American preferences marked by the historical shift towards US/EU preferences.[60] This was all the more remarkable given how these preferences in the pre-crisis era were transmitted through the largely private transnational network for OTC policy-making that existed.[61]

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[60] Helleiner, Eric & Stefano Pagliari. (2010). “Crisis and the reform of international financial regulation” *Global Finance in Crisis: The Politics of International Regulatory Change.* Eric Helleiner, Stefano Pagliari and Hubert Zimmerman (*eds). Ch1.*New York: Routledge Also See: Helleiner, Eric & Stefano Pagliari (2011) ‘The End of an Era in International Financial Regulation? A Postcrisis Research Agenda’ *International Organization, 65 Winter 2011,* pp. 169-200.

[61] Tsingou, Eleni. (2006). “The Governance of OTC Derivatives Markets. In P. Mooslechner, H. Schuberth & B. Weber (Eds.), *The Political Economy of Financial Market Regulation. The Dynamics of Inclusion and Exclusion* (pp. 89-114). Cheltenham, UK: Edward Elgar. Also: Tsingou, Eleni (2003) ‘Transnational policy communities and financial governance: the role of private actors in derivatives regulation’ University of Warwick.

This study's findings are also congruent with analyses pointing to domestic level factors like public salience and the role played by industry firms.[62] In contrast, it breaks with this work through a stronger focus for state regulatory actors tasked with reform. Furthermore, much has been written about the subsequent conflict and market fragmentation that ensued with OTC reform, some of which also points to domestic institutional factors that contributed to these problems.[63] However, much of the empirical work supporting these arguments is somewhat cursory and limited to chapters in edited volumes. More recent scholarship has focused on the intergovernmental networks established during post-crisis reform to address this conflict and fragmentation.[64] This work however, has more to say about the channels through which mutual accommodation occurred than the deeper sources of institutional change linking the pre and post crisis eras. Therefore, this analysis expands on early work highlighting the internecine European dynamics between market-making and market-shaping countries in Europe.[65] It also builds on subsequent work that points to the predominant role of the transatlantic

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[62] See: Pagliari, Stefano (2013). "Public Salience and International Financial Regulation: Explaining the International Regulation of OTC Derivatives, Rating Agencies, and Hedge Funds". Ph.D Thesis: University of Waterloo. Ontario, Canada. Also: Pagliari, Stefano and Kevin Young (2013). "the Wall-Street—Main Street nexus in financial regulation: Business Coalitions Inside and Outside the Financial Sector in the Regulation of OTC Derivatives" in *Great Expectations, Slow Transformation: Incremental Change in Post-Crisis Regulation.* Manuella Moschella and Eleni Tsingou eds. Colchester, UK ECPR Press, Ch.6 pp.125-148.

[63] Mügge, Daniel (2014). *Europe and the Governance of Global Finance.* Oxford University Press. Also: Helleiner, Eric Stefano Pagliari and Irene Spagna. 2018.*Governing the World's Biggest Market: The Politics of Regulating Derivatives After the 2008 Crisis.* Oxford University Press.

[64] Knaack, P. (2015). 'Innovation and Deadlock in Global Financial Governance: Transatlantic Coordination Failure in OTC Derivatives Regulation'. *Review of International Political Economy*, 22(6), 1217-1248. See also: Quaglia, Lucia (2020) 'The Politics of regime Complexity in International Derivatives Regulation' Oxford University Press.

[65] Quaglia, Lucia (2012). "The 'Old' and 'New' Politics of Financial Services Regulation in the European Union". *New Political Economy,* Vol. 17, No.4, pp.515-53

relationship between the US and EU over global OTC reform, which has also availed itself of HI's tools in explaining change over time.[66]

Methods

As noted above, this study's dependent variable is the observed changes we see occurring in the regulatory authority for OTCs over time. Additionally, the theoretical framework laid out in the last section points to a proposed hypothetical relationship between institutions and agents whose preferences are ultimately seen as authoritative in determining international regulatory outcomes. The empirical chapters that follow utilize a qualitative case study approach to explain these regulatory developments for OTCs.

The cases studies in this project are laid out as follows. The first is a consolidated historical look at the development of the global OTC market in the pre-crisis era up to and including the initial crisis. As such, it adopts comparative focus on how the US, UK, Germany, and France all varied in their institutional approach to innovations in global finance occurring at the time. Next, the second and third case studies are demarcated along American and European lines, addressing the post-G20 OTC regulatory developments associated with its implementation in the US and EU respectively. Each of the case studies were then subjected to structured focus comparisons in which general questions associated with the research objective were asked of each case study. Namely, how did countries pursuit of financial globalization (vis-à-vis regulatory institutions) affect whose preferences were ultimately seen as authoritative? This guided the

[66] Posner, Eliot (2018). 'Financial Regulatory Cooperation' in *Governing the World's Biggest Market: The Politics of Regulating Derivatives After the 2008 Crisis.* Helleiner, Eric Stefano Pagliari and Irene Spagna. Eds. 2018. Oxford University Press.

subsequent inclusion of additional relevant data thereby "making systematic comparison and cumulation of the findings of the cases possible"[67].

In the post-crisis era, its precisely the higher levels of institutionalization for OTCs we see these countries engage in that drives the outcomes we see occurring in regulatory authority. In Europe, member states share their sovereign authority with varying EU-level institutions. While the European Commission has significant autonomy to develop policy initiatives, the role of national leaders in the European Council within the Commission helps temper this somewhat. Moreover, representatives in the European Parliament which ultimately has to vote on any legislative proposals furthered by the Commission seek to ensure that any EU-level reforms are consistent with national prerogatives. These higher levels of institutionalization for OTCs translated not only to weaker authoritative preferences for the UK, but also higher levels of relative authority for the weaker market participants of France and Germany on the continent. While the US remained one of the two most influential regulatory regimes for OTCs in the post-crisis era, like the UK it too experienced a relative decline in the degree to which its preferences would come to be seen as authoritative. This came about internationally vis-à-vis the combined institutionalization of OTCs through the G20 (which in contrast increased the EU'S influence) as well as its interdependent interactions in developing reform alongside the EU.

While this type of small-N research design is often criticized for limiting the researcher's ability to make causal inferences, George and Bennet have countered that case studies are particularly good at identifying initial scope conditions of theories as

[67] George, Alexander L. & Andrew Bennett (2005). 'Case Studies and Theory Development in the Social Sciences. BCSAI Studies in International Security MIT Press Cambridge. P.68.

well as those of necessity[68]. In turn, they point to the important role of counterfactuals as part of the research objective. Therefore a counterfactual hypothesis considered by this study is: Had the UK not been marginalized to the same extent during reform (consistent with an HI driven hypothesis), the post-crisis divergence and subsequent coordination problems between the two largest regulatory regimes would have been diminished. While OTCs in the pre-crisis era were weakly embedded institutionally within the UK's market relationships with other European countries vis-à-vis the EU, it was deeply embedded in many others. Hence this proved determinative in light of the crisis-induced global regulatory mandate robbing the US of its key European ally in the EU during the implementation of reform. Additionally, had the US not pursued global financial reform through the G20, then (as posited by the market power thesis) the primary cleavage in OTC reform would have been between the US and the UK. While this cleavage existed, as the empirical chapters demonstrate it was nonetheless relegated to the sidelines of global reform. This points to the degree to which the subsequent institutionalization of OTCs ultimately conditioned either country's ability to exert their market power.

This study implements a process-tracing approach to overcome some of the inherent limitations of the case study method, namely its inability to control for omitted variables as well as the inherent problem of generalizing from a small-N study. By using the process-tracing method, the researcher seeks to identify both the casual chain and mechanism (together the intervening causal process) between the IV and the outcome of interest. Bennet and George define causal mechanisms as "unobservable physical, social or psychological processes through which agents with causal capacities operate, but only

[68] George, Alexander L. & Andrew Bennett (2005). 'Case Studies and Theory Development in the Social Sciences. BCSAI Studies in International Security MIT Press Cambridge. P.25.

in specific contexts or conditions, to transfer energy, information, or matter to other entities"[69].

The logic driving the emphasis on causal mechanisms is that in process-tracing, predictions are often unique as no other theory would predict the same patterns of events or actor testimony producing a given outcome. As a result, even a thorough process-trace of a single case can provide a strong test of a theory, if it lays out how initial case conditions are translated into case outcomes.[70] Additionally, using process-tracing to identify the key causal mechanisms that mark the shifts in authority we see occurring is particularly well suited at getting to the heart of more combinatorial forms of causation that are the mark of equifinality in the social sciences. It does so through its ability to address causal mechanisms as its approach to causation is developed through a 'causes of effects approach' in contrast to an 'effects of causes' approach typical of most quantitative analyses.[71] Additionally, process-tracing enables the qualitative analyst to both discover and validate causal feedback mechanisms particularly as they relate to the sequencing-based theorizing inherent to HI. The value added is that process-tracing, which can address complex chains of sequential causation, often acts as an adjunct form of analysis. This allows the analyst to triangulate an inferential position based on the contextual assumptions of the underlying case as well as controlling for alternative explanations.

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[69] George, Alexander L. & Andrew Bennett (2005). 'Case Studies and Theory Development in the Social Sciences. BCSAI Studies in International Security MIT Press Cambridge. P.206.

[70] Van Evera, Stephen (1997). *Guide to Methods for Students of Political Science.* Cornell University Press.

[71] Bennett, Andrew & Colin Elman (2007). 'Case Study Methods in the International Relations Subfield' *Comparative Political Studies.* Vol 40 issue 2 pp.170-195. Also Bennett, Andrew and Colin Elman (2006). "Qualitative Research: Recent Developments in Case Study Methods" *Annual Review of Political Science (9) 455-76.*

Data Acquisition

A consideration of the relevant causal mechanisms involved with the shifts we see occurring in the regulatory authority for OTCs over time lead us to examine the relative policy communities associated with OTC reform. Coleman defines a policy community according to the common policy focus shared by actors with "a direct or indirect interest in a policy area […] and who, with varying degrees of influence shape policy outcomes over the long run"[72]. The specialized nature of a complex technocratic regulatory issue like financial services reform and the agent-centered focus of the proposed theoretical framework, guides the subsequent acquisition of both primary and secondary sources to test the predictions driving the study.

Actors who have a direct interest in a given policy area are referred to as the sub-government. The sub-government consists of the primary actors that make policy in a given field: usually government regulators/agencies, interest associations, and business firms. While the "sub" designation denotes the term's origins in comparative policy analysis, for the sake of specifying relevant sources of data, I extend this to include these actors in international proceedings as well.

Primary sources associated with these types of actors were accessed via the US federal government and EU's online archival databases. These sources consisted of primary documents like legislative roll call voting records as well as regulatory documents produced by bodies like the US Congress, the European Council and European Commission as well as the relevant regulatory agencies like the CFTC in the

[72] Coleman, W.D. (1996). *Financial Services, Globalization and Domestic Policy Change,* New York: St. Martin's Press.

US, and ESMA in the EU. Other primary sources were the policy deliberations themselves which in the case of both regulatory regimes were well documented in the run-up to their promulgating laws and rules. At the industry level in both regulatory regimes, regulatory agencies' repositories of their interactions with private firms during public commentary phases served as a useful benchmark to establish and generalize firm preferences towards regulatory proposals. As Van Evera suggests, one of the relevant strengths of the case study method that it allows for specific tests of a theory's predictions through analysis of private speeches and writings of relevant policy actors.[73] Therefore, the primary sources utilized by this study - many of which are direct testimonials from key policy actors in relevant institutional fora- help to overcome the oft-maligned problem of deriving generalizations from such a small number of cases.

In contrast to the sub-government, the attentive public is more loosely defined as the relevant media and expert individuals who do not participate directly in policy-making but nonetheless have an indirect interest in regulatory policy outcomes. The crisis had the effect of increasing the salience on what is generally considered a highly technocratic issue. Despite this, I've tried to make some inferences based on survey polling data of the general public in varying countries when and where it exists. Other secondary sources were numerous articles from periodicals with a specialized focus on financial services and markets. An initial corpus of 1600+ articles from the database ebsco was obtained based on a search based on the relevant keywords: "OTCs", "derivatives", and "regulation". The longitudinal bounds of this keyword search were

[73] Van Evera, Stephen (1997). *Guide to Methods for Students of Political Science.* Cornell University Press.

delimited to the early start of the financial crisis in the US throughout the period of reform implementation, as specified by the analysis.

A third hybrid source of data comes from the derivatives industry itself. These consisted of OTC regulatory reform related documents produced by affected firms and relevant trade associations for an industry-based audience. These were available online through their respective websites. I refer to this as a hybrid form of data because in many instances they would be directly impacted by any subsequent regulation. Therefore, these actors had a direct interest in regulatory reform outcomes and could potentially be considered part of the sub-government designation. However, unlike their direct communications with regulators, these documents were intended to serve their clients in order to help them navigate the complex web of rules being promulgated on both sides of the Atlantic. As a result, their interpretations of the ongoing construction on the two largest regulatory regimes in the world for OTC proved to be a very useful secondary source of information for comparative analysis across the two post-crisis cases.

What follows are the empirical chapters that examine the explanatory causes for the changes we see occurring with OTC reform across time and space. The second chapter addresses OTC policy-making and the political forces driving it in the pre-crisis era up and through the initial focusing event in the US in the fall of 2008, culminating with the shift in authority that contributed to the G20's recommendations at the Pittsburgh Summit a year later. The third and fourth chapters examine how the implementation of the global OTC reform agenda played out in the US and EU cases respectively. I then move on to the concluding chapter, which encapsulates the relevant theoretical insights derived from the empirical analyses as well as some closing thoughts

on the direction of future research guided by the study’s contribution to the literature on financial regulatory reform.

2. PRE-CRISIS OTC POLICY-MAKING

Introduction and Plan of the Chapter

The analysis that follows lays out the trajectory of interests, institutions, and ideas that contributed to the incremental rise of the vast global OTC market in the years before the financial crisis. The broad contours of the narrative are how financial derivatives themselves were an demand-driven response by market actors to adapt to policy-changes in the structure of the international economy. Governments in advanced market economies then varied in the degree to which they altered their existing legal frameworks to accommodate this innovative form of global finance. Their widespread use over time led to a series of derivative-related international crises that brought to light domestic and international regulatory gaps that contributed to the growing risk of cross-border contracting. Addressing these gaps however, would also mean introducing friction into what was fast becoming the world's biggest market. Consequently, early discussions of OTC reform were seen as out of touch with the dominant market-led self-regulatory paradigm proffered by American and British officials at the time. That is, until the financial crisis laid bare the contradictions that now threatened to engulf the "Anglo-American heartland of the global financial system" as well.[74] Therefore the negative externalities of the global OTC market eventually produced a response from public officials to what is commonly perceived as a case of unchecked financial globalization.

The first section addresses the structural changes to the post-war international economic system brought about by the US' unilateral abandonment of the Bretton Woods

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[74] Baker, Andrew (2010). "Restraining regulatory capture? Anglo-America, crisis politics and trajectories of change in global financial governance" *International Affairs* 86:3 pp.647-663.

Regime of fixed exchange rates. This restructuring of international finance triggered a wave of deregulation in developed countries to remove their existing capital controls. However, these moves resulted in significant volatility in global markets creating demand for new innovative financial techniques to address the uncertainty that came with it. Market actors in these countries sought to avail themselves of the new financial derivatives being utilized by their peers in the US to address international interest rate and currency risk. In order to do so however, officials in the UK and Germany first had to alter their existing domestic legal frameworks that prohibited rampant speculation in derivatives contracting. While this deregulatory move helped their nascent futures markets at home, it wasn't long after that the inherent cross-border risk associated with their use became apparent. In contrast, France diverged from other countries through its distinctively multilateral approach to capital liberalization as well as its unique legal approach to contracting. In comparative terms, the distinctiveness of the French approach to financial globalization helped sow the seeds of its future ascendancy for OTCs in Europe.

The US' focus on innovative global finance led it down a distinct policy path from other countries. It accommodated the use of new financial contracting through a series of ad hoc exemptions to the drifting depression-era legislation for commodity derivatives that was now proving inept at addressing these new contracts. This policy path was supported by prevailing ideas from experts and policy-makers about market-based efficiency in the US that encouraged self-regulation for OTCs. These policy preferences were then reproduced through international financial institutions that supported self-regulation at the international level. These preferences even proved

resilient to increasing calls for regulating derivatives in the face of growing evidence about the inherent risks they posed. The result was a permissive regulatory environment that allowed OTCs to flourish across borders in and around the turn of the last century. Despite the explosive growth of the global OTC market however, much of this activity was transacted primarily in the US and UK.

The next section deals with the initial response to the crisis by policy-makers who were slow to acknowledge the extent to which credit derivatives were exacerbating the crisis. The initial insistence of public officials that market-based solutions to the burgeoning crisis were the optimal solution for addressing OTCs, delayed the inevitable regulatory reckoning to come. In the meantime, this delay afforded large broker dealers in the highly concentrated derivatives industry an opportunity to get out in front of self-regulatory initiatives which in turn, helped affect the trajectory of OTC reform going forward. The section also contains a short case study on the collapse of the financial institution Bear Stearns, with a specific focus on the role that its' credit derivatives positions played over the year and a half before the firm's default. Proposed plans to restructure the US financial regulatory system by public officials threatened to put the cart before the horse as the extent of the risk to Bear's counterparties was not yet clear. However, as the crisis ensued, the growing threat of financial contagion from the US subprime crisis through credit derivatives contracts began to threaten not only the US financial system, but European markets as well. The threat of contagion also triggered transatlantic tensions between the US and the UK, its 'junior partner' in promoting financial globalization. The likelihood of public intervention into OTC markets began to reveal rifts within the derivatives industry in support of regulatory reform.

In the final section, I analyze the political developments surrounding the start of the global financial crisis, once again through the explicit lens of policy considerations for OTC market reform. The first part addresses the collapse of insurance giant AIG, which I argue was the focusing event for public officials in the US as they began to realize that the risk embedded within the firm's derivatives contracts began to threaten the entire global financial system. The threat of cross-national contagion then triggered an international response by the 19 wealthiest nations in the world (and the EU) that placed OTC reform near the top of the post-crisis reform agenda through the G20. Issues of transatlantic competition however, came to the fore as the ensuing discussions focused on developing a global clearinghouse for OTCs, a short-lived idea that ultimately succumbed to these competitive pressures. Finally, transnational trade associations for the derivatives industry that had been influential in promulgating the rules governing the international legal basis for OTC contracts, now found themselves marginalized in direct efforts to influence reform policy-making due to the increased scrutiny of all things derivatives in the crisis. Despite their inability to veto the reform effort to bring OTCs under public oversight, these associations were still able to affect the behavior of market actors by issuing further improvements to the existing legal framework for OTCs.

From a historical perspective, post-crisis efforts at policy reform for OTCs stand in stark contrast to the pre-crisis era when there was little to no public oversight. Instead, the financial governance associated with OTC markets-both domestically and internationally-was one in which market actors were afforded significant discretion by policy-makers to police themselves through industry-driven policy initiatives aimed at self-regulation. This approach to regulating derivatives was the product of several

reinforcing trends over time: 1) American support for the ending of the international regime of fixed exchange rates that led to the development of financial derivatives by institutional investors as a means of both hedging against and profiting from the newfound volatility in international financial markets 2) the competitive deregulatory trend in other advanced industrial countries that led to the removal of domestic legal impediments that were originally designed to prevent excessive speculation in traditional derivatives trading in some countries but not others, and finally: 4) the explicit support and sanctioning of industry self-regulation for derivatives by public officials that fostered permissive regulatory environments at the domestic and international levels. These factors contributed to the vast proliferation of global OTC contracts by the end of the twentieth century. However, they were also simultaneously creating points of unprecedented financial interconnectedness among financial systems in these countries. This degree of financial interconnectedness ultimately left the financial centers of developed countries vulnerable to financial contagion. This section addresses each of these historical developments in turn.

The Restructuring of Global Finance

The dominant narrative for the globalization of finance proffered by IPE scholars is one that portrays the last quarter of the twentieth century as having been marked by the re-emergence of global finance after several decades in the wilderness at the hands of post-war WWII policy-makers. In this reading, the exile of global finance was attributable to the development of the embedded liberal order by the victors in the years following the war. This particular political arrangement allowed nation-states to defend the policy autonomy of their domestic welfare states through restrictive economic

policies.[75] However, the resulting Bretton Woods system of stable exchange rates and liberal trade that it produced was found to be incompatible both economically and politically with a liberal financial order free of national capital controls.[76] Politically, a return to the world of global speculative financial flows that had existed during the interwar period threatened to undermine the 'benevolent hegemony' that the US sought to develop after the war. Nowhere was this truer than in Europe and Japan, in which both favored capital controls to protect their nascent economies during their post-war restructuring. Ultimately, international policy-makers during this period agreed that a non-liberal financial order was the price of a liberal trading regime with stable exchange rates.[77]

Over time however, the Bretton Woods system began to break down. The origins of this decline and the subsequent rise of OTCs are rooted in the development of the European market for US dollars during the 1960s. The market for Eurodollars as they would come to be known, was for the most part conducted in the city of London with a plurality of US corporate banks benefitting from operating within the lax regulatory environment of the UK.[78] This oasis, dubbed "an adventure playground" for international

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[75] Ruggie, John (1982). "International Regimes Transactions, and Change: Embedded Liberalism in the Postwar Economic Order." *International Organization* 36: 379-415.

[76] Economic flashbacks from the interwar period about the disruptive effects of speculative capital flows on exchange rates occurred during the European economic crisis of 1947 when New York bankers-then the leading global source of investment-refused to cooperate with European governments in curtailing destabilizing capital flight from their countries. See: Helleiner, Eric (1994). *States and the Reemergence of Global Finance: From Bretton Woods to the 1990s.* Cornell University Press.

[77] Helleiner, Eric (1994). *States and the Reemergence of Global Finance: From Bretton Woods to the 1990s.* Cornell University Press

[78] Helleiner, Eric (1994). *States and the Reemergence of Global Finance: From Bretton Woods to the 1990s.* Cornell University Press. P.8.

investors at the time, was an isolated departure from the conservative world of post-war finance.[79] The American promotion of these Euromarkets in the 60s and the dollar overhang it produced created a series of structural pressures that eventually paved the way for the US removal of capital controls.[80] The Nixon administration's closing of the gold/dollar window in August 1971, brought an end to the Bretton Woods System.[81] This had the effect of returning to a world of floating exchange rates much like the one that had preceded the war. The rapid return of destabilizing speculative financial flows to the global economy in the wake of this policy-shift began to threaten the stability of the global fixed exchange-rate regime. This set the stage for the return of global finance *vis-a-vis* the end of an American hegemony based on the promotion of global trade.

A subset of the scholarship however, has framed the development of the post-war system of international finance by the US in functional terms. The general argument is that the emergence of the Euromarkets contributed to the continuance of American hegemonic imperialism through the deepening of the US' structural and financial power.[82] According to this reading, the US' jettisoning of the Bretton Woods system

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[79] Strange, Susan. (1990). "Finance, Information and Power." *Review of International Studies* 16: 259-74.

[80] "Dollar overhang" refers to a situation where dollars outside the U.S. exceeded American gold reserves. See: Silk, Leonard (1971) "The Dollar Overhang" *The New York Times. 13, Oct.* <https://www.nytimes.com/1971/10/13/archives/the-dollar-overhang-would-a-marshall-plan-in-reverse-help-us-in-its.html> Debt financing for the Vietnam War was also a prime contributor to this pressure.

[81] Ghizoni, Sandra Kollen (2013) "Nixon ends Convertibility of US Dollars to Gold and Announces Wage/Price Controls" *Federal Reserve History.* < https://www.federalreservehistory.org/essays/gold-convertibility-ends>.

[82] See Gowan, Peter (1990).*The Global Gamble: Washington's Faustian Bid for World Dominance*. London: Verso. Also: Konings, Martijn (2011). *The Development of American Finance*. Cambridge: Cambridge University Press; Panitch, Leo and Sam Gindin (2009).'Finance and American Empire', in Panitch and Konings (eds), *American Empire and the Political Economy of Global Finance.* London:

forced other countries to adopt a floating exchange rate regime, in turn causing their domestic economies to abandon their efforts at capital controls. Therefore, the subsequent trade-off was one between domestic monetary policy and the maintenance of exchange rate stability.[83] As a result, the increased global capital flows subjected investors to greater risk through the prospect of capital flight. More importantly however, was that Japanese and Western European attempts to implement Bretton Woods mechanisms for capital controls in light of these increased flows were met with "benign neglect" by the US.[84] This move marked the tacit American commitment to a new view of global finance, one in which the US was placing large bets on New York becoming one of the leading financial centers through the innovativeness of its financial sector. The issue therefore, is whether the US abandonment of Bretton Woods marked the decline of American financial power (the conventional IPE view) or the beginning of its ascendancy. This view of global capitalism as a largely American-led project, was one in which the US sought to construct an external institutional environment complementary to the institutional character of its domestic financial system.[85]

Macmillan. pp. 17–48. Also: Susan Strange, (1987). 'The persistent myth of lost hegemony', *International Organization*, 41 pp. 551–74.

[83] The dependent relationship between capital controls, exchange rates and monetary policy autonomy eventually became known as the "International Trilemma" or the "Impossible Trinity" For a discussion see: Rodrik, Dani. (2000). "How Far Will International Economic Integration Go?" *Journal Of Economic Perspectives*, vol 14 (Winter), pp. 177-86.

[84] Konings, Martijn (2011). *The Development of American Finance*. Cambridge: Cambridge University Press.

[85] Konings, Martijn (2011). *The Development of American Finance*. Cambridge: Cambridge University Press

For the purposes of our discussion, the restructuring of the international system of exchange rates is integral to explaining how these policy outcomes spawned the demand for financial derivatives in a system that had considerably more uncertainty for internationally oriented investors than its predecessor. In short, the end of the Bretton Woods system began to usher in a new era of American sponsored financial globalization, an era that demanded new innovative financial techniques to address the volatility that followed in its wake.

From the standpoint of international investors, the subsequent sequencing that led to the development of financial derivatives can be explained by the following: First, capital mobility caused internationally oriented investors to shield themselves from economic losses due to drastic fluctuations in exchange and interest rates by hedging against risk. Secondly, some international investors sought to profit outright on the differentials of these rates through speculation and arbitrage trading strategies. These two mutually reinforcing factors created the demand for innovative financial instruments like interest rate or currency derivatives. These new financial derivatives would protect investors from their increased exposure to international risk. The development of these instruments by financial services professionals in New York and London therefore was an innovative hedging strategy designed to explicitly address the risk's created by the new international financial system. It was also a way for profit-seeking US investors, much like their predecessors in the Euromarkets, to escape the domestic regulatory limits of the US federal government.[86] However, the requisite speculation that quickly followed

[86] Konings, Martijn (2011). *The Development of American Finance*. Cambridge: Cambridge University Press

left some investors vulnerable to drastic price fluctuations despite and in some instances because of their attempts to hedge against it.[87]

The search for yield however, was not limited to New York and London as some European investors were quick to follow the lead of their Anglo-American counterparts. The international banking crisis of 1974 that began with the collapse of the Herstatt Bank in Germany, was an early sign of the willingness of investors in other countries to pursue the innovative US financial model, as the German firm's losses emanated from the mismanagement of its forwards portfolio (a type of currency derivative) attributable to the failings of market self-regulation in Germany at the time.[88] The Herstatt crisis also demonstrated the growing vulnerability of national financial systems to market activity beyond their own borders as the firm's collapse triggered significant losses for several British banks. As Catherine Schenk notes, "It clearly revealed the interdependent nature of national markets and regulations; in this case, the vulnerability of London to lapses in prudential supervision in Germany"[89]. Seen in this light, both the failings of market self-regulation and the spread of financial contagion across national borders through derivatives foreshadow-some 34 years earlier-the inherent problems of market self-regulation that would become manifest in the 2008 global financial crisis.

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[87] Strange, Susan. (1986). *Casino Capitalism*. New York: Blackwell. Strange provides a cogent analysis of the two-way nature of risk in speculative markets between risk averse investors as providers of funds for speculation and specialist entrepreneurs. pp. 109-111.

[88] Also referred to as: Bankhaus I.D. Herstatt K.G.a.A. See: Mourlon-Druol, Emmanuel (2015). "Trust is good, control is better: The 1974 Herstatt Bank Crisis and its Implications for International Regulatory Reform." *Business History.* Routledge.

[89] Schenk, Catherine R. (2011). "Summer in the City: The 1974 international banking crisis in London and its implications for regulatory reform." Unpublished manuscript. Erasmus Research Institute of Management.<http://www.erim.eur.nl/fileadmin/erim_content/documents/1974_Crisis_and_Response_15_Nov.pdf.> Accessed 19 April, 2018.

The perceived lapse in prudential supervision associated with the Hertsatt crisis triggered greater international coordination among national regulators. The US, UK and Germany all made amendments to their domestic banking regulations in light of the crisis. It also served as the impetus for greater international financial regulatory coordination through the establishment of the Basel Committee on Banking Supervision, a club of central bankers. However, the focus on prudential supervision meant that these adjustments were focused on the actors using financial derivatives and not the instruments themselves. Consequently, a regulatory focus on the nature of contracting itself was decades away in most developed countries. Moreover, these international efforts at coordination would eventually contribute to a market-driven self-regulatory paradigm as policy-makers sought to create a frictionless global market for financial derivatives. One that encouraged the deepening of financial integration in developed countries with participating financial centers through complex contracting.

Competitive Deregulation

In the post-Bretton Woods world, a series of competitive deregulatory moves in advanced industrial nations allowed these countries to pursue US-style financial innovation. The US abolition of capital controls was eventually emulated by the UK in 1979, followed by Australia and New Zealand in 1984-85. In turn, the markets for options and futures trading were making the most significant advances. For globally oriented investors intent on hedging their exposure to the risk created by the removal of these controls, some domestic obstacles remained. For European countries focused on developing their capital markets, pursuing innovative American financial techniques necessitated the removal of domestic gambling laws hindering the development of their

domestic derivatives markets. For example, European countries like Norway, Sweden and Spain were among the first to formally legalize options trading in 1985.[90] In short, these early domestic policy adjustments coincided with the broader rationalization and globalization of financial services occurring at the time.[91] To sketch out the analysis further, I consider the contrast between the cases of the UK and Germany, both of which pursued profits from innovative finance by deliberately constructing regulatory regimes based on the enforceability of derivatives contracts, and the US, which did not.

Intermediate Efforts: UK and Germany

In 1986, the UK ushered in its "Big Bang" financial services policy initiative, a broadly comprehensive plan to transform the British financial system by making London more competitive with other leading financial centers.[92] It also had the effect of consolidating the financial services sector, as the subsequent wave of mergers between the City's traditional merchant banks began to include an increasing number of larger US, European and Japanese banks.

The initiative also had some very specific implications for the enforcement of derivatives trading. Ever since the establishment of the London traded options market (LTOM) in 1978 and futures trading via LIFFE in 1982, financial derivatives in the UK had been subject to legal uncertainty. This uncertainty called into question whether or a contract was legally enforceable under existing law. According to a long standing

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[90] Options are generally more fungible than some of the more exotic types of derivatives which is why they are sometimes referred to as securities. They are distinct from futures contracts which obligate the buyer/seller to purchase/sell a physical commodity or financial instrument at a predetermined future date and price.

[91] Hay, Tony. (1990). *A Guide to European Financial Centers.* Chicago: St. James Press.

[92] Robertson, Jamie. (2016). "How the Big Bang changed the City of London forever" BBC News website. 27 October 2016 <www.bbc.com/news/business-37751599> Accessed 18 April, 2018.

common law tradition, derivatives trading in the UK (and the US as well) had been traditionally subject to rules against difference contracts which mandated that for a contract to be legally enforceable, "one of the parties to the contract had to be using the contract to hedge against a preexisting economic risk"[93].This rule had been developed over time by British judges who were suspicious of purely speculative contracts i.e., derivatives contracts where there is no attempt by either party to hedge against some form of risk. Speculation occurs when an investor, rather than providing investment funds or producing something themselves, profits purely from predicting the future better than others. However, the harsh zero-sum nature of speculation (where one party's trading gains always mirrors the other trading losses) was tempered by the legitimate reduction of the hedger's risk through contracting with a speculative counterparty.[94] Moreover, this rule had long prevented investors from engaging in purely speculative contracts like the naked swaps (in which neither party owns a stake in the derivative being traded) that proliferated both before and during the crisis.

The removal of rules against difference contracts in the UK ultimately created legal certainty for derivatives, allowing British firms to stay nimble in the increasingly competitive world of financial services. Over time, this move would come to reflect the UK's increasingly "light touch" towards financial regulation. By the 1990s, these developments would help turn the city of London into a financial capital that would

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[93] The success of LIFFE as a center for futures trading attracted considerable attention from large American and Japanese banks who were increasingly doing more business in London. See Stout, Lynn A. (2009). "Regulate OTC Derivatives by Deregulating Them." *Regulation*. 32 (3). pp.30-41.

[94] Stout, Lynn A. (2009). "Regulate OTC Derivatives by Deregulating Them." *Regulation*. 32 (3). P.4

finally rival New York. However, the UK's removal of laws prohibiting contracts of difference also had the effect of undermining the mutualization of risk in global derivatives contracting by stacking the deck in favor of speculation over legitimate hedging.

A similar mode of policy change occurred in Germany, where existing gambling laws had also made futures contracts largely unenforceable. This had the effect of limiting investors mainly to options trading on a small number of leading German firms. It also contributed to the impression that its leading financial center Frankfurt (which did not have a futures exchange) was somehow ill-equipped to compete in a globalizing world of financial markets. Seen in this light, the development of a German financial futures exchange was then regarded as an economic necessity for an aspiring financial center in global markets.[95]

In June 1989, the German federal parliament passed an amendment to its Stock Exchange Act, ushering in a new era of financial transacting. This contributed to the development of Germany's domestic futures market by allowing exchanges to expand into derivative product offerings through futures trading. The new German futures exchange, the Deutsche Terminbörse (DTB), began trading futures in January 1990 in the wake of this more lenient legislation.[96] The competitive deregulatory trend towards legalizing derivatives in both the UK and Germany continued expanding towards the rest

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[95] See: Hey, Friedrich E.F. (1989) A New Era of Financial Futures Trading in Germany: Sweeping Changes in the Legal and Business Environment, *Nw. J. Int'l L. & Bus*. Vol. 10, Issue 2. Fall.

[96] Unlike the UK however, Germany wouldn't fully repeal its laws against contracts for difference until 2006. See: CFD Trading and Contracts for Differences "CFDs in Germany". Contracts for Difference.com website< https://www.contracts-for-difference.com/Germany-CFDs.html>.

of the Euro Community. This process occurred gradually eventually culminating in a fully liberal financial order among the developed countries in the west.[97]

Private Rulemaking in the US

The trajectory of domestic derivatives regulatory policy-making in the US during this period took a decidedly different path than its competitors. At the time, derivatives activity in other countries took place almost exclusively on public organized exchanges like the French futures exchange MATIF, which began trading in futures for government bonds in 1986 and Switzerland's futures exchange SOFFEX (est.in 1988). These exchanges were examples of meso-corporatist self-regulating organizations (SRO) that had been modeled on historical New Deal examples in the US, like the Chicago Board of Trade (CBOT) and the Chicago Mercantile Exchange (CME).

The SROs in the US however, were ill suited to the complex financial contracting increasingly used by market participants. These exchanges had originally been developed to oversee derivatives activities in relatively straightforward markets associated with fungible physical commodities, contributing to the development of a robust futures market in the US. In contrast, the new breed of financial derivatives contracts, dealt with a whole host of non-fungible financial assets subject to a dizzying array of complex parameters. As a result, the institutional regulatory orientation towards derivatives in the US began to drift.[98] However, in lieu of explicitly creating legal certainty for financial

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[97] Helleiner, Eric. (1994). *States and the Reemergence of Global Finance: From Bretton Woods to the 1990s.* Cornell University Press P.9.

[98] When a shift in external conditions changes the impact of existing rules despite the rules themselves formally remain the same. See Hacker, Jacob. (2005) "Policy Drift: The Hidden Politics of US Welfare State Retrenchment." In *Beyond Continuity: Institutional Change in Advanced Political Economies,* ed. Wolfgang Streeck and Kathleen Thelen, 40-82. Oxford: Oxford University Press.

derivatives like its competitors, American officials instead chose a series of ad hoc regulatory exemptions for derivatives associated with the increased use of Interest rate swaps.[99]

The lack of an explicit domestic regime legislative regime for financial derivatives in the US paved the way for private rule making by the industry. At the time, the use of financial derivatives was limited to sophisticated institutional investors who were aware of the attendant risks associated with them and therefore any latent threat to systemic risk was theoretically supposed to be minimal. This contributed to the increasing perceptions of policy-makers that the net effect of financial derivatives activity was so marginal that: "regulators were content to let activity occur via private, unregulated deals-or "over-the-counter"-rather than on a public exchange"[100]. Advocates of neoliberal reform at the time also began exerting signify-ant influence in financial policy-making due in part, to financial liberalization's low domestic visibility.[101]

By the 1990s, the privileged regulatory solution was private rule-making, particularly in the United States. US policy-makers promoted private counterparties to monitor the implementation of regulatory standards, while simultaneously incorporating market-based measures of risk. In turn, SROs leaned on their members to encourage self-

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[99] Stout, Lynn A.(2011). "Derivatives and the Legal Origin of the 2008 Credit Crisis" *Cornell Law Faculty Publications* Paper 720: P.19. <h6p://scholarship.law.cornell.edu/facpub/720>

[100] Davies, Paul J. Gillian Tett and Aline Van Duyn.(2008) "A new formula?: Complex finance contemplates a more fettered future". *Financial Times.* 1, October, 2008.

[101] Helleiner, Eric. (1994). *States and the Reemergence of Global Finance: From Bretton Woods to the 1990s.* Cornell University Press.

policing behavior through industry driven codes of conduct.[102] As we will see below, this market-knows-best incentive-based approach to innovative finance was eventually sanctioned at the international level as well by international financial regulatory institutions who promoted a complementary policy orientation for cross-border OTCs. However, the American policy-makers advocating this approach in the name of promoting global finance were seemingly resistant to the empirical reality that the inherent speculation in these financial contracts was nonetheless contributing to an increased vulnerability across the financial systems of industrialized countries.

French Distinctiveness Towards Global Finance

As argued above, the U.S. abandonment of the Bretton Woods system of fixed exchange rates contributed to the development of innovative financial derivatives in a newfound world of financial volatility. Their development was thus a mutually reinforcing process that allowed some investors to hedge against this volatility while simultaneously allowing a counterparty on the other side to profit. Countries that wanted to promote the international competitiveness of their financial centers then embarked upon removing their existing capital controls to take advantage of these dynamics. Then over time-as we saw in the case of the U.K. and Germany-when existing domestic legal impediments prevented their nascent futures markets to keep pace with the innovations in global finance, these were removed as well.

In contrast, the French experience was decidedly different. I address this variation in two steps relating to the two primary economic policy components focused on above. The first is its international approach to capital controls which distinguished it from the

[102] Alexander, Kern; Dhumale, Rahul; & Eatwell, John. (2006). *Global Governance of Financial Systems. The International Regulation of Systemic Risk*. Oxford: Oxford University Press.

US-led promotion of global finance, and the second is its own unique domestic legal basis for the enforcement of contracts. A standard IPE view is consistent with the U.S. promotion of global finance. In this reading, U.S. Treasury Dept. coerced other countries into liberalizing their economies' domestic capital controls by promoting the interests of Wall St. firms through their influence over international organizations. However, Abdelal counters this view by arguing that the liberalization of capital flows instead was a French-led effort to codify international rules for global finance.[103] In doing so, The French sought to increase their own influence over the terms of financial globalization by embedding these rules in relevant international organizations (IOs). European policy makers were therefore responsible for the liberal legal rules of global finance defined by social norms of technocratic policy-making. This in turn, forced the US to promote financial internationalization through ad hoc bilateral negotiations.

The internal dynamics of Abdelal's story of French-led liberalization are rooted in an international approach towards financial globalization that reflects the dynamics of the European project. In his telling, French acceptance of full capital mobility only came about once they were able to secure a *quid pro quo* with the Germans, who had long based their acceptance of monetary union on capital freedom. Moreover, because Germany had already made the necessary adjustments to their own domestic policies on the movement of capital across their borders, the European agreement was largely *pro forma* for the Germans. For the French however, the quid pro quo was a necessary condition to build legitimate support for European-wide capital liberalization. Forward thinking officials from the French-left then promoted this initiative by gradually

[103] Abdelal, Rawi. (2007). *Capital Rules: The Construction of Global Finance.* Cambridge: Harvard University Press.

embedding a managed approach to globalization over time. The focal institutions for this initiative were the three IOs in which the rules for the international monetary system in the post-war era were codified: The International Monetary Fund (IMF) the European Community (EC) and the Organization for Economic Cooperation and Development (OECD). Taken at face value then, the implications of Abdelal's analysis for our study are that France's concerted efforts to embed the rules for capital mobility within the European Community (the historical forerunner to the EU), would tie the fate of capital liberalization in European countries to the larger European project. Furthermore, doing so within the IMF and OECD would also tie its fate to the larger international project of financial globalization as well.

The French were also unique in their legal approach to contracting. Unlike the UK and Germany, the French never had to repeal their existing laws because of fundamental differences in the 1804 French Civil Code's view of contracts. This legal approach referred to as *justice contractuelle*, is ultimately based on considerations of substantive fairness, giving judges significant discretion in interpreting the legality of contracts. Over time, this helped contribute to the perception of the French legal system as antagonistic towards business, particularly financial firms. For example, in the1980s the French government embarked on a series of reforms restricting the ability of firms to conduct hostile takeovers. The French financial sector, whose profits were tied to the fate of these reforms, lobbied aggressively against these efforts. The French courts ultimately did an end run around the protestations of French finance, by relying on precepts derived from

justice contractuelle. As a result, the courts' decision was based on statutory obligations in employment contracting, which even the broader business community condemned.[104]

The discretion afforded to French judges by the Civil code would be a significant factor in mediating cross-border contractual OTC disputes as well. A default by either one or both counterparties to an OTC contract would trigger complex international legal challenges whereby domestic judges in one country would have to interpret which counterparty's home legal framework was most applicable in resolving the default.[105] Rowan notes that due to the degree of interpretation that the French civil code afforded to judges, it long-served as a considerable source of uncertainty for the generally risk-averse international business community. In turn, this autonomy allowed French judges and courts to interfere with the terms of a contract in favor of French firms at the expense of globally oriented investment banks. Moreover, the code had drifted over time from its original guiding principles of substantive fairness to the extent that it no longer reflected its original statutory mandate.[106] Therefore, she argues that the waning influence of the 1804 French Civil Code in international business circles had ultimately contributed to the decision by French officials in 2016 to make the first revisions to the code in over 200 years.

The analysis sketched out above suggests that there is something qualitatively different about the former French approach to contracting which distinguished it from the

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[104] Fioretos, Orfeo (2011b) *Creative Reconstructions: Multilateralism and European Varieties of Capitalism after 1950.* Cornell University Press; P.30.

[105] These types of cross-border legal scenarios is precisely what drove the ISDA to create its master contract template for OTC contracts.

[106] Rowan, Solene (2017) "The New French Law of Contract." *International & Comparative Law Quarterly.* Vol 66, Issue 4, October. pp.805-831.

other countries that adjusted their laws to accommodate innovative contracting. To be clear, I am not wading into a general statement of the distinction between common law vs. civil law legal systems. Both the US and UK have common law systems while the German and French systems are based on civil law. However as we saw, Germany's retooling of its domestic laws for contracts most closely resembled the UK's. Additionally, neither the US nor France formally addressed the issue of legal certainty for contracting through revisions to existing law. Instead, both allowed their institutional orientation towards OTCs to drift over time. The contrast is that the US did so precisely to attract international business whereas the French approach was largely off-putting for global firms. Rather, I am merely suggesting here that French officials and policy-makers diverged from their contemporaries. It resisted alterations to its domestic laws in the face of increasing cross-border contracting through derivatives for so long, quite simply because it didn't have to.

Taken together, these developments have some significant implications for explaining the shift in OTC regulatory authority over time. France's promotion of a liberal order for capital controls within the context of European integration is notably different from the other countries analyzed here, even those within the EU. Moreover, as we shall see the international institutions that it used to punch above its weight in steering financial globalization are distinct from the ones in which the US and to a lesser extent the UK, utilized to promote their view of global finance. The EC, IMF and OECD are all broad-based IOs whose economic expertise is leveraged across a wider array of issues facing developed as well as developing countries. In contrast, the IOs that the Anglo-American countries sought to see their preferences realized through were more club-like

in their exclusivity. This was attributable to their specialized focus on private finance which in turn, precluded countries lacking robust capital markets. The distinctiveness of the French legal model is instructive as well as France proved resilient to the impetus felt by other western countries towards de-regulation in their pursuit of global finance. These developments suggest an alternative path to financial globalization that ultimately went through the continent via multilateral institutions. As we shall see, this goes a long way to explaining why the French were in a position to have their preferences realized with OTC reform during crisis deliberations.

Vulnerability and Interconnectedness

The growth of global credit derivatives markets in the 1990s also portended the increasing vulnerability of participating countries through financial interconnectedness in the new global system. In the early 90s Wall St. firms Bankers Trust and JP Morgan, created credit default swaps CDS as a means for banks to protect their exposure to large-scale corporate loans made to clients.[107] CDS are a derivative most closely associated with the 2008 credit crisis, are a form of protection in which the seller agrees to pay the buyer a specified amount in the event of a credit event. This is usually a default, bankruptcy or restructuring of an underlying loan or bond. Despite the seeming protection that these financial instruments bestowed upon the buyer, a series of high-profile swaps-fueled bankruptcies ensued.[108] However, the Asian Financial Crisis that

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[107] Scheerer, Andre. (2000). "Credit Derivatives: An Overview of Regulatory Initiatives in the United States and Europe." *Fordham Journal of Corporate & Financial Law.* 5 (1). pp. 149-203. For a brief primer on CDS see Wilson, Harry. (2011). "A short history of credit default swaps." *Telegraph* online edition 06 Sep 2011. <http://www.telegraph.co.uk/finance/newsbysector/banksandfinance/8745511/A-short-history-of-credit-default-swaps.html> Accessed 7/19/17 .

[108] These included both non-financial and financial firms: Proctor & Gamble Co, 1994; Barings Bank, 1995. As well as municipal sovereigns: Orange County, CA 1994.

began in 1997 served as the first test of a large-scale credit event as exposure to emerging market debt caused the German *Landesbanken* to suffer heavy losses.[109] The near collapse of LTCM, less than two years later saw the global stakes raised considerably. LTCM's efforts to hedge against a range of volatility in currencies and bonds through OTCs created off-balance sheet exposures that left the firm drastically overleveraged. The trigger for its default was then Russia's devaluation of its currency outside the range of LTCM's proprietary risk modeling efforts. Without direct intervention by the US (Fed Reserve Bank of NY President William McDonough convinced 15 banks to bail out LTCM), the entire global financial system was threatened with collapse.[110] The exposure to risk through derivatives contracting was becoming truly global in scale.

Despite these episodes becoming more frequent in the nineties, increased public oversight of global OTC activity was not a serious consideration on the menu for international regulators. Rather private rule-making by the industry-like in the US-dominated regulatory policy-making internationally through institutionalized self-regulatory initiatives.[111] According to Pagliari, two aspects of the pre-crisis era made it stand out from earlier stages of globalization: The first was the distinct transnational character of the network that had developed during this time period. Industry groups like the International Swaps and Derivatives Association (ISDA), the Futures Industry

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[109] Scheerer, Andre. (2000). "Credit Derivatives: An Overview of Regulatory Initiatives in the United States and Europe." *Fordham Journal of Corporate & Financial Law.* 5 (1). pp. 149-203.
[110] Dungey, Mardi et al. (2002). "International Contagion Effects from the Russian Crisis and the LTCM Near-Collapse." *International Monetary Fund Working Papers. <https://www.imf.org/external/pubs/ft/wp/2002/wp0274.pdf >Accessed 7/19/17.*

[111] Pagliari, Stefano (2013). "Public Salience and International Financial Regulation: Explaining the International Regulation of OTC Derivatives, Rating Agencies, and Hedge Funds". Ph.D Thesis: University of Waterloo. Ontario, Canada.

Association (FIA), the Emerging Markets Traders Association, the Derivatives Policy Group (DPG) and private think tanks like the G30 all served as vital platforms for the main derivatives broker/dealers to promote their self-regulatory initiatives. Organizations like the ISDA were instrumental in the development of cross-border legal foundations to address the increasing volumes of over the counter derivatives transactions that were now occurring outside of regulated exchanges.[112] Together these transnational *epistemic communities* as Peter Haas has referred to them, helped developed the policy orientation towards industry self-regulation in global derivatives markets.[113]

The second unique aspect of the pre-crisis era highlighted by Pagliari was that many of the policy recommendations from this transnational network were indirectly sanctioned by international regulatory institutions with Anglo-American support. For example, despite the proliferation of corporate swaps-scandals in the nineties both the Basel Committee on Banking Supervision (BCBS) and the International Organization of Securities Operators (IOSCO), endorsed limited regulatory oversight for OTCs.[114] Instead, consistent with the dominant market-led self-regulatory paradigm at the time, these bodies advocated leveraging the expertise and knowledge of financial market actors

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[112] For example, consider the ISDA's master agreement for OTCs, which serves as a standardized contractual template for much of the world's derivatives trading, often taking place across national multiple regulatory regimes with sometimes conflicting laws of legal contractual liability for participants. Helleiner et al. have noted that despite it often being trumpeted as an example of transnational rule-making, the agreement was influential due to it becoming "embedded in national legislation in countries across the world and enforced by national courts" p.7: Helleiner, Eric Stefano Pagliari and Irene Spagna. 2015.*Governing the World's Biggest Market: The Politics of Regulating Derivatives After the 2008 Crisis.* Oxford University Press

[113] Haas, Peter. (1992). "Epistemic Communities and International Policy Coordination." *International Organization,* 46 (1), pp. 1-35. See also: Coleman, 1996; and Tsingou, 2006.

[114] At the time, these two bodies were the leading intergovernmental fora for their issue domains in banking and securities respectively.

to police themselves. Moreover, the endorsement of self-regulation by these international regulatory institutions reflected the preferences of the countries with the two dominant financial centers, namely the US and the UK whose influence also held the most sway in these club-like institutional for a.[115] In sum, the policy trend towards private rule-making in the US and UK that had allowed these countries to pursue global finance migrated to the level of transnational networks where it was ultimately legitimized by international financial regulatory institutions, who sanctioned this behavior. This global self-regulatory paradigm allowed private OTC contracts to proliferate free from public oversight despite the increasing vulnerability across national financial systems.

Legal Uncertainty in the US and Central Clearing

Despite their explosive growth, derivatives became a focal point of political contestation in the US. A series of highly-publicized defaults associated with the use of swaps in the early-mid 90s (see above) triggered increasing calls for officials to regulate derivatives. Much of the debate centered around the inability of the US' drifting legal framework for traditional commodities-based derivatives in under the Commodities Exchange Act. Officials arguments started echoing the sentiments of market actors that this Depression-era legislation was increasingly ill-equipped to address contemporary financial derivatives. A series of legal challenges ensued in which futures contracts were potentially unenforceable, lending credence to the notion that the US' ad hoc exemptions

[115] Helleiner, Eric & Stefano Pagliari. (2010) "Crisis and the reform of international financial regulation" *Global Finance in Crisis: The Politics of International Regulatory Change.* Eric Helleiner, Stefano Pagliari and Hubert Zimmerman (*eds). Ch1.*New York: Routledge.

(see above) to the legal certainty question for financial derivatives was insufficient.[116] Sensing an opportunity, public officials in the US started advocating for reform through direct regulatory oversight for OTCs. A coalition of futures dealers and exchanges that had suffered competitively from the proliferation of private bilateral trading by large investment banks, mounted an effort to bring OTCs under the regulatory umbra of their regulator the Commodity Futures Trading Commission (CFTC). However, the banks' broker-dealers divisions, who were becoming the prime movers in OTC markets opposed this effort. They ultimately benefitted from the support of the President's Working Group (PWG) who successfully pressured Congress to block the regulatory turf grab in Nov. 1998.[117]

However, there were other alternatives to direct regulatory oversight for derivatives. One such policy proposal floated at the time was that in lieu of being listed on an exchange, contracts should be subject to central clearing through an SRO acting as a clearinghouse. As another historical convention developed during the Great Depression,

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[116] This point was argued by the PWG with robust support from a number of trade associations representing the derivatives broker dealers and large-scale investment banks whose derivatives divisions had created significant competition for futures dealers and the exchanges. The exemption facilitated by the PWG in 1998 was applauded by financial organizations like: the American Bankers Association, ABA Securities Association, Bond Market Association, Emerging Markets Traders Association, The Financial Services Roundtable, The Foreign Exchange Committee, Futures Industry Association, International Swaps and Derivatives Association, and the Securities Industry Association. See: Securities Industry Association (2000). "Testimony of Marc Lackritz, President Securities Industry Association "Regarding the Report of the President's Working Group on Financial Markets Entitled Over-The-Counter Derivatives Markets and the Commodity Exchange Act Before the House Agriculture Committee Subcommittee on Risk Management, Research and Specialty Crops United States House of Representatives" 15, February 2000. < https://www.sifma.org/wp-content/uploads/2017/05/testimony-of-marc-e-lackritz-president-securities-industry-association-over-the-counter-derivatives-markets-and-the-commodity-exchange-act.pdf>.

[117] The PWG was created in 1988 by the Reagan administration with a mandate to address US vulnerability to international markets in the wake of the stock market crash of the previous year. As such, it represents an attempt at domestic regulatory coordination between the CFTC, the Securities and Exchange Commission (SEC) the Federal Reserve Bank and the Treasury Dept. For a discussion of the legal rationale for the CFTC's authority see: PWG (1999). "Over-The-Counter Derivatives and The Commodity Exchange Act" *Report of The President's Working Group on Financial Markets.* Board of Governors. November, 1999.

a clearinghouse acts as a central counterparty (CCP) to a derivatives contract. The CCP ensures that the terms of the contract are met in the event of default by one or both counterparties. Its ability to do so is predicated on a collective pool of capital from counterparties who are required to contribute as a condition of membership. In functional terms, central clearing gives counterparties skin-in-the-game promoting effective self-regulation by mutualizing the inherent risk in derivatives contracts.

The entrenched broker dealers immediately pushed back against the central clearing initiative. Their argument to officials was that the requisite standardization to make a derivative contracts suitable for central clearing would ultimately impair their ability to tailor contracts to the individual requirements of their counterparties. Moreover, their ability to issue these bespoke contracts represented a source of significant competitive advantage for US investment banks in the global marketplace for financial services. This argument eventually found purchase with US officials as the primary beneficiaries of the status quo were able to resist the efforts to bring even indirect public oversight of OTCs. The broker dealers' early resistance to central clearing here would ultimately prove ironic when the financial crisis and calls to regulate OTCS nearly a decade later would see central clearing as an idea whose time had finally come.

The market-based logic that supported the regulatory status quo for OTCs in the U.S. had a strong base of support from experts. For example, market actors, public officials and academics all suggested that despite their inherent risk, derivatives allowed financial institutions-who would otherwise have had to hold onto risk in its entirety-to

successfully distribute this risk throughout the financial system.[118] In his 1998 testimony on regulating OTCs before the House Committee on Banking and Financial Services, US FED chair Alan Greenspan argued that subjecting innovative financial instruments to outdated depression era institutions was inappropriate. Citing the existing bias towards sophisticated institutional counterparties (see above) Greenspan had argued that "there appears to be no need for government regulation of off-exchange derivative transactions between institutional counterparties […] due to their ability to easily recognize the risks to which they would be exposed by failing to make their own independent valuations of their transaction"[119]. Greenspan's position was supported at the time by the conventional wisdom in economics and business schools based on the perception that advances in the risk-modeling utilized by credit-rating-agencies (CRAs) had contributed to the disintegration of risk, thereby negating the necessity of subjecting OTCs to central clearing.[120] This assertion would be seriously undermined less than a month later when LTCM's risk-modeling would be called into question (see above). In short, the overwhelming consensus among market actors, public officials, and academics at the time was that OTCs should remain subject to self-regulation.

Despite the epistemic consensus on regulating OTCs, the perception that the US' continued use of ad hoc regulatory exemptions to address them was politically untenable.

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[118] Larsen, Peter Thal. (2008). "Payback time: Banks have a battle ahead to restore their financial standing." *Financial Times.* Online edition. 07 Jan. 2008.

[119] Greenspan, Alan.(1998). "The Regulation of OTC derivatives*" Testimony of Chairman Alan Greenspan.* Before the Committee on Banking and Financial Services, U.S. House of Representatives. July 24, 1998. <http://www.federalreserve.gov/boarddocs/testimony/1998/19980724.htm> Accessed 7 July 2017.

[120] Kroszner, Randall (1999). Can the Financial Markets Privately Regulate Risk?: The Development of Derivatives Clearinghouses and Recent Over-The-Counter Innovations. *Journal of Money, Credit, and Banking.* Vol. 31, No.3 August 1999, Part2.

As a result, advocates of market-based self-regulation continued pressing to secure legal certainty for swaps contracts. The passage of the Commodities Futures Modernization Act (CFMA) in 2000 saw them rewarded for their efforts. In doing so, private market actors successfully applied Greenspan's logic for the necessity of self-regulation for OTCs in their interactions with legislators. Upon debating the legislative initiative, Congress had accepted the industry's argument that given their inherent complexity self-regulation was preferrable, quite simply because they were the only ones who could understand them.[121]

Much of the flawed logic of not subjecting OTCs to central clearing, as well as the notion that self-regulation was a sufficient condition for risk mitigation in financial systems was predicated on the assumption that the credit ratings that these investors were receiving were of sufficient quality, something that in hindsight, we now know is not always the case. Greenspan also asserted at the time that the huge volume of OTC transactions occurring at the time, reflected the judgment of OTC counterparties "that these instruments provide extensive protection against asset concentration risk*"* [122]. In retrospect, this was at best a half-truth given that it only took into consideration one of the counterparties to a traditional derivatives transaction (the counterparty seeking to hedge its exposure). What it failed to acknowledge was the vast profits accruing to speculators that also contributed to the spectacular growth occurring in the market.

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[121] For an analysis see: Deeg, Richard. (2012)"The limits of liberalization? American Capitalism at the Crossroads". *Journal of European Public Policy* First. Pp.1-20. Deeg notes that there was little political support for regulation in the US despite the systemic risks that the near collapse of LTCM posed and the accompanying rescue orchestrated by the Fed that year. 2012:15.

[122] Greenspan, Alan.(1998). "The Regulation of OTC derivatives*" Testimony of Chairman Alan Greenspan.* Before the Committee on Banking and Financial Services, U.S. House of Representatives. July 24, 1998. <http://www.federalreserve.gov/boarddocs/testimony/1998/19980724.htm> Accessed 7 July 2017.

Greenspan's singular focus on the legitimate hedging function of derivatives also ignored the increasing proliferation of naked swaps, something that common law judges in the US had originally sought to prevent through the development of rules against difference contracts (see above). Despite his arguments to the contrary however, leaving derivatives unregulated would ultimately contribute to the concentration of risk both within and across national financial systems leading up to the crisis.

A Global Market in Bloom

In general, there are four types of derivatives: forwards, futures, options and swaps. While a contract's terms reflects the specific needs of its counterparties, they also distinguish how they're traded as well as the degree of counterparty risk involved. This is the risk that one or both counterparties might default on the terms of the contract. For example, forwards and futures are similar in that they're both agreements to sell an asset at a future date. Futures contracts are often standardized which enable them to be traded on publicly monitored exchanges that mandate specific margin requirements to mitigate the likelihood of either counterparty's default. Forwards however, often entail a greater degree of bespoke customization and are often traded privately between counterparties usually with no margin required. Therefore, forwards are thought of as having higher levels of counterparty risk than their futures cousins. In contrast, options gives the buyer the right, but not the obligation to buy an underlying asset at an agreed upon price and date. They are also differentiated by its stated terms which allow the holder to either buy (call option) or sell (put option). Options can either be traded on exchange (listed options) or OTC, again dependent upon the degree to which the contract's terms are bespoke. Finally, swaps are an agreement to exchange a series of cash flows tied to a given asset

for a set period of time. There are two important things to consider: The first is that futures are generally associated with public exchanges, while forwards, options and swaps trading-with some exceptions-have historically been associated with the OTC market. The second is that the global OTC market dwarfs its exchange traded counterpart[3].

The permissive domestic and international regulatory environments facilitated by the self-regulatory paradigm in the last section, helped accelerate the exponential growth of OTC markets. By the end of the decade, OTC derivatives markets came to dwarf their exchange-traded cousins. Daily turnover during this period increased by approximately 50% to $1.3 trillion between April 1995 and April 1998.[123] The turn of the century saw a further continuance of this trend. Between 2001 and 2004, the size of the OTC market increased by approximately 80%, with interest rate derivatives by far the largest segment of the market.[124] By the time the crisis started to fully manifest itself in 2008, notional amounts for all types of OTC derivatives stood at $683 trillion.[125]

In the lead up to the crisis however, the strongest growth by far had been in the credit default swaps (CDS) segment of the market. Credit derivatives are specifically designed to address the credit risk of an event like the default of a corporate or sovereign

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[123] Schinasi, Garry J. et al. (2000). "Modern Banking and OTC Derivatives Markets: The Transformation of Global Finance and its Implications for Systemic Risk". *International Monetary Fund Occasional Paper, p.203.*

[124] German OTC activity was the notable exception at the time having fallen during the same three years from 12.7% to 3%. See: Williams, Peter (2004). "The foreign exchange and over-the-counter derivatives markets in the United Kingdom." Bank of England *Quarterly Bulletin.*

[125] Bank for International Settlements, (2009). "OTC derivatives market activity in the second half of 2008". *BIS:Monetary and Economic Department Report May 2009.* It is important to note however that notional amounts are a measure of market activity, not necessarily economic risk or exposure to risk. In this regard, the outstanding market value of contracts is a better measure. At over $30 trn., the outstanding market value of contracts in OTC markets at the time, still dwarfed the US economy.

borrower.[126] CDS in particular, were quickly becoming increasingly popular with institutional investors who helped contribute to their phenomenal growth from $0.7 trillion in 2001 to $4.5 trillion by the end of 2004.[127] One of the most disconcerting aspects of the growing market for CDS at the time however, was the extent to which these institutions lacked any direct links to the underlying asset. Unlike typical derivatives contracts in which at least one counterparty has an interest in the underlying, "naked CDS" were now proliferating, contributing to the unfettered speculation that helped fuel the crisis. This took the form of cross-border contracting by financial counterparties in different countries creating in effect, a single global OTC market in credit derivatives. However, this market was so intertwined that a crisis in one country had the effect of inducing one in another.

While the OTC market was global in scope, it's also important to consider that in the years before the crisis it was highly concentrated within two countries. In the two decades prior, only the US and the UK had pursued domestic deregulatory adjustments and the promotion of self-regulatory initiatives to the extent that it produced capital markets both sophisticated and deep enough to facilitate complex bilateral OTC derivatives trading. The rewards for doing so were great. In 1998, OTC activity in the UK accounted for 35% of the daily global turnover followed by the US 17% and Japan 7% respectively. While German officials had been intent on boosting developing its own

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[126] This can also refer to any one of various instruments and techniques that separate and transfer this risk to an entity other than the lender or debtholder.

[127] Bank for International Settlements, (2004). "Triennial and semiannual surveys on positions in global over-the-counter (OTC) derivatives markets at end- June 2004 Concentration measures for OTC derivatives markets from December 1998 to June 2004." BIS, Monetary and Economic Dept. Report Dec. 2004.

domestic futures market, things changed after the developments in Europe of 1992. Articles 59 and 60 of the EEC convention had now afforded actors the freedom to engage in financial futures trading anywhere in the European Community free from legal obstacles. Consequently, German officials now couched the competitiveness of Frankfurt's financial services sector in European Terms. In turn, Germany's domestic derivatives activity was limited to the exchange-traded variety as was France's (given the factors discussed above). The few German or French globally oriented banks operating in OTC markets however, largely did so in either London or New York. By 2004, 42.6% of global OTC trading occurred in the UK while the US' global market share was 23.5%[128]. As of this writing, the UK remains the largest market for global OTC trading.

The concentration for OTC markets was mirrored at the national level as well. For example, US investment banks emerged as the largest players acting as major participants within the city of London, echoing the historical experience that began with the development of the Eurodollars market.[129] The global activity by American banks was transpiring as revaluation gains from overseas OTC activities began far outstripping domestic derivatives business.[130] Moreover, the degree of intra-market concentration

[128] (Williams, 2004)

[129] Thom, Jamie, and Louise Boustani. (1998)"The Foreign Exchange and Over-the-Counter Derivatives Markets in the United Kingdom," Bank of England *Quarterly Bulletin,* Vol. 38 (November), pp. 347–60.

[130] United States, Board of Governors of the Federal Reserve System (1999). "International Activities of U.S. Banks and in U.S. Banking Markets," *Federal Reserve Bulletin,* Vol. 85 (September), pp. 599–615.

within the US was even more striking with American banks holding over 95% of the banking system's notional derivatives exposure by the year 2000.[131]

The cross-border links associated with the rapid growth in OTC activity, along with the increasingly concentrated US OTC market was now cause for alarm. The Bank for International Settlements (BIS) in 2005 issued an alert regarding what it perceived as an early warning sign over the threat of increasing counterparty risk to the global financial system. This was defined as the inherent risk exposure of counterparties to a contract given that one of them might not live up to its contractual obligations.[132] However, these calls by the BIS went largely unheeded by participating countries at the time.

Taken together, the developments above paint a portrait of a global OTCs as a uniquely recombinant or hybrid form of open governance associated with the financial globalization of derivatives. This form of hybrid governance for the global OTC market has unique implications for the EU's financial system. It allowed for the continental countries to both preserve their distinct national regulatory models for domestic financing, while simultaneously allowing their more globally oriented firms to take advantage of innovating contracting with Anglo-American banks in London. Market actors in Germany and France looking to engage in traditional futures and options contracts could do so domestically through each country's existing public exchanges. However, for more venturous firms looking to engage in complex hedging techniques

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[131] United States, Office of the Comptroller of the Currency, 2000, *OCC Bank Derivatives Report, Second Quarter 2000* (Washington).

[132] Basel Committee on Banking Supervision 2005. "Credit Risk Transfer". *The Joint Forum* <https://www.bis.org/publ/joint13.pdf>.

through bespoke customized contracts, their only recourse was to do so in the casinos of New York and London where innovative finance flourished.

While it would ultimately take the worst global financial crisis in almost 80 years to underscore how just how interconnected their financial systems were through counterparty risk, this wasn't experienced by all four countries to the same extent. As we shall see, the dense contractual links between New York and London meant that the contagion from the U.S sub-prime market was felt most immediately in the UK. While leaders on the continent in the EU initially realized the severity of the crisis in geopolitical terms, it would take another year before they realized the extent of their own exposure to counterparty risk. At which point, EU officials would then recognize that the financial contagion metastasizing through their sovereign CDS debt markets constituted not only a threat to the European financial system, but that this hybrid form of institutional governance for OTCs was also no longer politically tenable.

Crisis: Delayed Reaction and Industry-Led Reform

This section sketches out the trajectory of reform for derivatives from the throes of the domestic crisis in the U.S. in early 2008, through the G20 pronouncement at the Pittsburgh summit in September 2009. These developments saw member countries tasked with reforming their domestic OTC markets. As I argue in this section: policy-makers in the US were slow to acknowledge that credit derivatives were exacerbating the crisis through counterparty risk-the idea that interconnected linkages through derivatives contracts could jeopardize the financial system. Their initial response instead was to continue with the market-led system of oversight and supervision prevalent before the crisis. The derivatives industry, quick to seize the initiative afforded them by policy-

makers, sought to head off the regulatory impulse that was slowly building in favor of regulation. They did so through their time-tested approach to developing market-led initiatives for the CDS market, which was coming under increasing scrutiny. As the ongoing crisis triggered successive defaults by systemically important firms, policy-makers began to concede the need for reform in light of the developing threat to the US financial system. This initially triggered fault lines in the derivatives industry between the large broker dealers who sought to defend the status quo for unregulated OTC markets, and the growing number of futures exchanges that sided with officials on the need for public regulatory oversight for derivatives.

The Case of Bear Stearns in the US

Scholarly work on global financial regulation has noted that the global financial crisis that began in the US in 2008 eventually catalyzed policy-makers' attention around financial regulatory issues.[133] However, this process was not instantaneous and occurred gradually over an extended period. In early 2008, policy-makers in the US were slow to acknowledge the extent to which credit derivatives were exacerbating the crisis. Initially, they resisted the idea of public reform for OTCs choosing to proceed under the existing market-led regulatory paradigm.[134] For example, consider the demise of Bear Stearns as the early starting point of the global financial crisis. The firm eventually collapsed under the weight of its highly-leveraged balance sheet of mortgage backed securities with

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[133] Helleiner, Eric; Stefano Pagliari and Hubert Zimmerman (2010). *Global Finance in Crisis: The Politics of International Regulatory Change.*New York: Routledge.

[134] Pagliari, Stefano. (2013). "Public Salience and International Financial Regulation: Explaining the International Regulation of OTC Derivatives, Rating Agencies, and Hedge Funds". Ph.D Thesis: University of Waterloo. Ontario, Canada.

trillions of dollars of notional exposure to derivatives. These contracts were in the form of credit default swaps meant to hedge against its debt obligations from these investments. This default had the effect of alerting policy-makers to the looming specter of counterparty risk. Therefore, the risk embedded within the firm's CDS contracts, acted as a conduit for the contagion from the US market for subprime mortgages, now slowly leaching into the rest of the American financial system.

Despite the seeming rapidity of its passing however, the financial undoing of Bear Stearns took almost a year to unfold. In June and July of 2007, several of Bear Stearns' hedge fund units had collapsed from exposure to securities derived from the subprime market. It wasn't until their parent company was in its final death throes in March of 2008 however, that the US federal government intervened to prop up the failing firm. The fear was that Bear's collapse would spread to other over-leveraged investment banks like Merill Lynch, Lehman Bros. and Citigroup which in retrospect, would prove prescient[135]. After an emergency meeting, the Federal Reserve ultimately agreed to lend Chase bank $29 billion to purchase Bear Stearns. This in turn, would allow Chase-with government backing-to default on the loan if Bear's assets should prove insufficient to pay it off.[136] However, the private-sector solution engineered by the Fed ultimately proved unable to

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[135] Shedlock, Mike"Fed Fails to Halt Debt Meltdown," Mish's Global Economic Trend Analysis, March, 17, 2008. < https://archive.mishtalk.com/2008/03/17/fed-fails-to-halt-debt-meltdown/> Also see: Amadeo, Kimberly. "Bear Stearns: Collapse and Bailout: How a Bank That Survived the Depression Started the Great Recession". *The Balance, September, 13, 2017.* < https://www.thebalance.com/bearn-stearns-collapse-and-bailout-3305613>

[136] Economist (2008). "JP Morgan Chase Takes Over Stricken Bear Stearns" *The Economist*, March 18, 2008.

stave off the demise of Bear Stearns. This triggered a banking liquidity crisis on Wall St. as banks were unwilling to lend to one another.

Policy proposals for derivatives during the early stages of the mounting credit-crisis in the US were notable for what they omitted namely, publicly reforming the OTC market infrastructure. Calls from officials for more public oversight had been growing in tandem with the perception that unregulated derivatives were exacerbating the crisis, However, Treasury Secretary Henry Paulson initially resisted these calls, doubling-down on private sector solutions from the market. He instead proposed the creation of a dedicated industry co-operative, similar in scope to the Depository Trust and Clearing Corporation (DTCC) based on the belief that the "market would deliver the right outcomes"[137]. In short, despite the inability of the federal government to prevent Bear Stearns from going under and the attendant counterparty risk this posed the initial regulatory response from public officials in the US for OTCs was to continue with the dominant market-based self-regulatory paradigm in pursuit of reform.

In lieu of public oversight for OTCs, Paulson's proposal focused on consolidating the fragmented US financial regulatory system. This consolidation would have entailed merging the Securities and Exchange Commission (SEC) and the Commodity Futures Trading Commission (CFTC) the federal agencies overseeing securities and futures markets respectively, in the US. The persistence of the US functional regulatory model, where separate regulators oversee different types of

[137] An SRO that had been created in 1973 to address the growing number of securities trades that had failed to settle on Wall St. after a sharp increase in securities trading at the time. At this stage of the crisis in 2008, one of the main areas of concern had to do with the processing and confirmation of credit derivatives which had resulted in, "huge backlogs of unconfirmed paper-based trades floating around the system." Therefore, it is plausible to suggest that the Treasury Dept. may have chosen this historical template from the 70's "paperwork crisis" as a remedy to address similar dynamics occurring with credit derivatives in early 2008.

financial firms based on product type, has long been criticized as outdated in an age of interlinked markets.[138] Some had even suggested that the US' functional model was unlikely to be abandoned completely to given the likelihood of regulatory turf wars between the two agencies.[139] Prominent investors quickly criticized the US Treasury's proposal's. These critiques were animated by the idea that OTCs and other innovative forms of finance were based on the underlying belief that markets were self-correcting. However, this dominant intellectual paradigm seemed further removed from reality as the crisis unfolded. Presciently, these critics also warned of the impending meltdown in the credit default swaps market given Bear Stearns' complex web of counterparty exposures that hung over financial markets, "like a Sword of Damocles that is bound to fall, but only after some defaults have occurred"[140].

Global contagion and a Myopic Response

The US proposals were also notable for what they failed to include: an international solution. This was even more surprising given the problems plaguing what was-despite its point of origin in the US-a global derivatives market. Paul Tucker, head of markets at the Bank of England sought to position the UK at the forefront of global OTC reform through his criticism of the US' self-regulatory response. In doing so, he posited a

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[138] Fresh, Adriane and Martin Neil Baily (2009). "What does international experience tell us about regulatory consolidation?" *The international experience with regulatory consolidation. Briefing Paper #6* The Pew Economic Policy Department. Financial Reform Project.

[139] Davies, Howard (2008) "Sharks circle Paulson's Aussie Plan" *Financial Times. London* 02, April.

[140] These criticisms were leveled presciently at the US Treasury's proposal by prominent activist investor George Soros who also speculated that Stearns complex exposure and its threat to systemic risk must have played a role in policy-makers' decisions to bail out the ailing firm. Soros also speculated that Stearns complex exposure and its threat to systemic risk must have played a role in policy-makers' decisions to bail out the ailing firm. See: Soros, George (2008) "The false belief at the heart of the financial turmoil" *Financial Times.* London, 03, April.

global solution to the ensuing regulatory debate by suggesting that what was needed was a new Bretton Woods-style system, given that local attempts to tame the credit-cycle in a world of free capital flows was unlikely to work. However, this type of policy initiative wouldn't happen without US support, which seemed unlikely given that its own domestic regulatory proposals might take years[141].

International regulators quickly pushed back towards the proposal for a global solution to the financial contagion plaguing the CDS market. In doing so, their preference for industry-led initiatives to address market deficiencies mirrored their domestic counterparts in the US. In April 2008, the Financial Stability Forum issued a crisis-related report that consisted of a detailed action plan limiting public authorities to focus on "encourag[ing] market participants to act promptly to ensure that the settlement, legal and operational infrastructure for over-the-counter derivatives is sound"[142]. Similar market-led efforts were evident during this time in the Basel Committee's (BCBS) request for more robust capital requirements for derivatives, as the effects of the crisis began contributing calls to finalize the long-delayed implementation of the Basel II accords.[143]

The looming threat of more public oversight triggered regulatory debates within the industry about its likelihood. At the ISDA's annual meeting in April 2008, Credit Suisse' chief investment officer Paul Callelo warned that increased regulation was

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[141] Jackson, Tony. "Regulation? Plus ca change for investment banks" *Financial Times.* 07 April 2008.

[142] FSF (2008) "Report on the Financial Stability Forum on Enhancing Market and Institutional Resilience" *Financial Stability Forum.* 7 April 2008.

[143] Wellink, Nout. (2008). "Basel II is sophisticated and sorely needed" *Financial Times.* 9 April, 2008.

coming. For some, this was a tough pill to swallow given CDS' remarkable growth in 2007, up 81% to $62,200bn. Bob Pickel, ISDA's chief executive at the time pushed back against the inevitability of regulation, noting that regulators had been curiously silent in discussions to regulate OTCs during the initial crisis. In response, he suggested that the ISDA would apply its considerable lobbying power to fighting the growing regulatory impulse for OTCs.[144] For associations like the ISDA, stronger legal documents like the master agreement it had helped develop (see above) in the years before the crisis were the preferred solution to the contagion plaguing the market for credit derivatives.[145]

Despite the lack of agreement within the derivatives industry over the likelihood of greater regulatory oversight, private market actors wasted little time seizing the initiative afforded to them by the market-led proposals from policy-makers. The Clearing Corporation, a Delaware-based organization owned by some of the largest banks with derivatives trading units like Goldman Sachs, Deutsche Bank and Morgan Stanley as well as inter-dealer brokers like the U.K.'s ICAP and the German derivatives exchange Eurex and Chicago's future exchange CME-sought to head off regulation by initiating the development of a CCP that could potentially serve the global CDS market.

Transatlantic Tensions Emerge

As the credit crisis developed, the search for scapegoats triggered a transatlantic war of words between regulators in the US and the UK. The initial standoff brought to light a fundamental tension between the two countries that were home to the world's

[144] Davies, Paul J. and Gillian Tett. 2008 "Banks eye CDS clearing house" *Financial Times*. 18, April 2008.

[145] Chung, Joanna. Krishna Guha and Gillian Tett. (2008). "The cost of a lifeline Humbled financial groups brace for more regulation. *Financial Times.* 24, April 2008.

largest OTC markets, a tension that would only get worse as the extent of the crisis became evident. During a meeting of the Futures and Options Association in London, CFTC commissioner Bart Chilton criticized his counterparts in the UK's Financial Services Authority (FSA). In doing so, he placed the blame squarely on the UK for its lax oversight and lack of transparency in the City's booming derivatives markets. He also took aim at the FSA's emphasis on deterrence, rather than the US model of enforcement through high-profile prosecutions and fines. At issue, was the CFTC's long standing system of mutual recognition with the FSA, whereby UK futures exchanges offering US investors their products were not required to register as exchanges in the US. Within days, CFTC chairman Walt Lukken issued a public apology to the FSA, naming the British agency as: "one of our most important partners in regulating the global marketplace", citing positive assessments in the past by both the IMF and World Bank on the adequacy of the FSA's regulatory measures for derivatives trading.[146]

As public authorities in the US increased their regulatory scrutiny of all things related to derivatives during the crisis, the transatlantic reconcilement would prove to be short lived. Amidst fears that speculation in oil markets was contributing to high prices, legislators began looking at closing the London Loophole. This long-standing transatlantic regulatory gap, had allowed US traders executing contracts in West Texas crude on London exchanges to routinely escape US oversight. In May 2008, in the wake of a 6 mos. investigation by the CFTC into the likelihood that speculation was affecting

[146] Chilton's statements criticizing a foreign regulator were noted as "highly unusual". Chilton cited the CFTC's adoption of "commitments of traders" reports two years earlier that had not been reciprocated by the FSA. These reports convey the long positions of hedge funds in "key commodity derivatives". Grant, Jeremy. (2008) FSA under fire over derivatives rules". *Financial Times.* 22, April 2008.

oil prices, Carl Levin (D-MI) and Dianne Feinstein (D-CA) together had introduced the "Oil Trading and Transparency Act".[147] Doubling down on his earlier criticism of British regulation, the CFTC's Bart Chilton called for the London Loophole to be closed, while US Senator Richard Durbin introduced legislation in June to give the CFTC authority in overseeing trading in oil markets.[148]

This time, criticism of the FSA was reserved for US legislators during Congressional hearings that summer on the role of speculation in oil markets. They admonished the FSA for its lax oversight of suspected abuse in the UK's energy and commodity markets. The FSA was an independent non-governmental body that was tasked with overseeing ICE Futures Europe, the UK platform of Atlanta-based InterContinental Exchange, where nearly half of the world's crude oil futures were traded.[149] However, this criticism was undermined by the fact that the price of most commodities even those traded on monitored exchanges, had risen sharply in the last year as well. Congress ultimately failed to pass legislation due in part to the findings of

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[147] Blas, Javier et al. (2008). "London Loophole to come under US scrutiny". *Financial Times.* 02 June 2008.

[148] Existing US law had prohibited domestic regulatory bodies from the direct regulation of foreign boards of trade. This allowed US firms to conduct arbitrage in selecting the regulatory environment with the most favorable terms for a given futures transaction See: Chilton, Bart. (2008). "Why the London loophole should be closed". *Financial Times.* 24 June 2008:9.

[149] At the time, the FSA was perceived as having a less-enforcement driven approach to pursuing price manipulation than its US counterpart the CFTC which oversaw Nymex and ICE's US based commodities markets. The CFTC, unlike the FSA required energy exchanges to have position limits to discourage rampant speculation thus avoiding excessive positions in a contract. *Ibid.* See also: Grant, Jeremy. "'London loophole' leaves US at odds with FSA" Financial Times. 07 July 2008:21. The FSA was eventually split into two distinct regulatory authorities after the crisis: The Financial Conduct Authority (FCA) & The Prudential Regulation Authority (PRA) The latter is overseen directly by the Bank of England. See Haill, Oliver (2013) "Why the FSA was split into two bodies" *FT Adviser.* 08, May. <https://www.ftadviser.com/2013/05/08/regulation/regulators/why-the-fsa-was-split-into-two-bodies-SX5toVpnEQtBbYNlcUC9xJ/article.html>.

regulators who had concluded that the rise in oil prices was not attributable to speculation in OTC markets.

In sum, the attribution of blame for the crisis began triggering transatlantic tensions in the countries whose two leading financial centers were home to the bulk of global OTC contracting consistent with the a prediction based on the market power thesis. This complex extraterritorial regulatory relationship allowed US firms operating in London to engage in market activity with even less regulatory scrutiny than their home market. Moreover, given the ensuing crisis' propensity to contribute to the growing regulatory impulse for OTCs, this transatlantic relationship would prove difficult to sustain.

A Focusing Event for OTC Reform in the US

In September 2008, the counterparty risk that market analysts had feared from the Bear Stearns meltdown started to metastasize throughout the US financial system. The collapse of Lehman Brothers, the largest underwriter of sub-prime mortgage-backed securities, triggered a systemic run that threatened the stability of the country's entire financial system. However, even as Lehman was failing, it was the subsequent shock to the large-scale monoline insurer AIG that demonstrated to public authorities the exponential effects of counterparty risk with their credit default swaps positions potentially exposing the entire global financial system to contagion.[150]

[150] While Lehman Bros was a traditional investment bank, A.I.G. was a monoline insurer: firms that came about in the eighties to guarantee the municipal bond market, but who had in the past decade entered the realm of structured finance in search of higher yields. The monoline insurers often wrote credit default swaps that would guarantee against the possibility that mortgage-linked assets-bundled through the process of securitization-would default. The problems with monoline insurers in the US were cited as being responsible for problems occurring in the market for municipal bonds in early 2008. The problem had become so severe that then governor of NY Eliot Spitzer stated that unless the monoline problem was

While the Lehman Bros. debacle is often cited as the starting point of the financial crisis, I argue that instead it was the shock to AIG that ultimately forced public authorities to abandon their commitment to market based solutions for OTCs by committing themselves to extensive public intervention in the markets to mitigate the magnitude and severity of the rapidly spreading crisis. This process during the crisis ensured that the experience with AIG and the threat of global financial contagion through counterparty risk that the firm's large derivatives positions posed, would eventually serve as the focusing event for OTC policy reform.

Despite Lehman Bros. and AIG's susceptibility to the counterparty risk that was rippling through the financial services industry, the variation in the response by the U.S. federal government to the two firms could not have been more different. Less than two days after Lehman Bros. was left to implode, AIG received an $85 bn bail out resulting in nationalization of the ailing firm as it was quickly taken under the wing of the U.S. Treasury dept. The reasons for the discrepancy are threefold: the conditions under which public officials in the US sought to engineer a private-sector rescue of Lehman Bros, the federal government's subsequent perception of the difference in the authority relations between the two ailing firms and the state and finally, AIG's status as a major global counterparty in derivatives whose collapse would represent a threat to the global financial system. I address these here in turn.

When Lehman Bros. began to fail in early September 2008, public officials in the US remained committed to existing market orthodoxy by finding a potential private-

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addressed the effect could be "could be a financial tsunami that causes substantial damage throughout our economy." Tett, Gillian and Aline Van Duyn. (2008). "Almost out of power? Markets assess the costs of a monoline meltdown". *Financial Times.* February, 21, 2008.

sector solution to the deepening crisis.[151] Lehman's dominant position in the market for sub-prime mortgages had left it vulnerable to a growing cascade of loan defaults and the firms had been showing signs of financial distress as early as late spring. On Friday Sept. 12, 2008 with the firm's collapse imminent, Treasury Secretary Paulson and Federal Reserve Chair Ben Bernanke along with his counterpart at the New York Federal Reserve Timothy Geithner summoned the CEOs from the largest investment banks on Wall St. for an emergency meeting at the NYFR building to help engineer a private solution.[152] This rescue effort, would take place over the weekend as officials sought to prevent a Lehman bankruptcy that could potentially trigger a systemic run on US markets upon opening on Monday morning.[153]

Paulson also insisted that there would be no government funds for Lehman's in any deal that may have emerged from the meeting. The Treasury Secretary had been under intense pressure from both sides of the political aisle since the spring. The sources

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[151] This account of the crisis is informed by a series of personal interviews conducted with the principals involved: See Stewart, James B. (2009). "Eight Days: The battle to save the American financial system." *New Yorker.* Sept 21, 2009.

[152] Present at the meeting were: Jamie Dimon of JPMorgan Chase; Vikram Pandit, of Citigroup; Brady Dougan, of Credit Suisse Group; John Thain, of Merrill Lynch; John Mack, of Morgan Stanley; and Lloyd Blankfein, Paulson's successor at Goldman Sachs. Also, present were the ranking officers in New York from several European banks: Deutsche Bank, Royal Bank of Scotland, and BNP Paribas. Representing the government in addition to Paulson, Bernanke and Geithner, was then chairman of the Securities and Exchange Commission Christopher Cox, whose agency had oversight of the large investment banks. Stewart, James B. (2009). "Eight Days: The battle to save the American financial system." *New Yorker.* Sept 21, 2009.

[153] The precedent for Paulson's private-sector plan was the rescue of Long Term Capital Management in 1998, whose own extensive derivatives exposures could have triggered a global financial crisis if it were not for the Federal Reserve of New York under its President William McDonough who convince 15 banks to finance a $3.5 bn bail out in exchange for a 90%ownership stake. Stewart, James B. (2009). "Eight Days: The battle to save the American financial system." *New Yorker.* Sept 21, 2009.

of this pressure were both his decision in March to secure the Bears Stearns/JPMorgan/Chase merger with $29 bn in government financing as well as the Treasury Dept.'s recent promise to back the ailing federal mortgage underwriters Fannie Mae and Freddie Mac with over $200 bn in federal funds. Political pressure on the right came from those who resisted tampering with the free market on neoliberal ideological grounds. For critics on the left however, the bailout equated with corporate socialism for the overpaid elite on Wall Street.[154] Paulson's plan also consisted of finding a private buyer for Lehman. In attempting to do so, he encountered serious difficulty from the two primary contenders due primarily to the lack of government financing (i.e.; Bank of America) and the threat of transatlantic contagion (i.e.; British firm Barclay's).[155]

By the next day, AIG was also beginning to show significant signs of financial distress suggesting that the financial contagion was spreading. Tasked with assessing the state of Lehman's assets, the analysis conducted by the CEOs that weekend suggested that the firm's financial picture was bleaker than initially thought. When the deals with Bank of America and Barclay's finally fell through late on Sunday, Paulson who was still

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[154] Calls to Paulson's office during the Lehman meltdown, many of which were from members of Congress, were running ten to one in favor of letting the investment bank fail. The Wall St. Journal, in an editorial noted that "The government had to draw a line somewhere, […] Treasury Secretary Hank Paulson's refusal to blink won't get any second guessing from us." Stewart, James B. (2009). "Eight Days: The battle to save the American financial system." *New Yorker.* Sept 21, 2009.

[155] Any potential acquisition of Lehman Bros.by Bank of America was contingent upon government financing, which Paulson would not guarantee to secure Lehman's troubled assets. Additionally, Paulson had spent much of Friday Sept. 12, 2008 on the phone with British Chancellor of the Exchequer Allistair Darling about getting the Financial Services Agency in the UK to sign off on the merger which was required under British law. Hector Sants, the head of the FSA had reservations about Barclay's position as the largest British commercial bank. Any exposure to Lehman's toxic assets might put British retail customers at risk. Paulson confided to Treasury officials in the room during his phone conversation with Darling that, "He doesn't want to import the American disease". Stewart, James B. (2009). "Eight Days: The battle to save the American financial system." *New Yorker.* Sept 21, 2009.

committed to the idea that the market would deliver the best outcomes–made the decision to let Lehman Bros. fail. He told the CEO's present to prepare for a Lehman Bankruptcy in the morning.

Public disclosure of the Lehman bankruptcy sent AIG into financial convulsions the following day. Despite the magnified threat of counterparty risk that this represented however, public authorities again demonstrated their ongoing commitment to market orthodoxy by trying to find a private-sector solution to the ailing insurance giant. Therefore, the large-scale shock to the firm represented the focusing event for officials that that the threat of counterparty risk was international in scope and thus would not remain confined to the US. This in turn, led public authorities to abandon their commitment to market-based solutions.

The failure of Lehman Bros. triggered losses in AIG as its shares dropped sixty-one percent, as investor awareness of the ongoing meetings at the New York Fed contributed to the mounting collateral calls. The increasing number of defaults within Lehman Bros. portfolio of mortgage-backed securities was transmitted to AIG through its status as a major counterparty to large volumes of CDS derived from these now toxic assets. However, the Fed's attempts to stimulate the financial system by injecting $70 billion into credit markets had little to no effect. Moreover, the deterioration of credit was spreading across the Atlantic. European central bankers now pleaded with Bernanke to do whatever was necessary to prevent AIG's failure given their fear of the effect it might have on European financial institutions and markets.

The initial response of public officials in the US however, held fast to the existing economic paradigm as Geithner attempted to address AIG's collapse by assembling a

syndicate of private banks to take on the failing firm.[156] As the day wore on however, markets continued their downward trajectory. Firm after firm succumbed to the panic, in turn erasing any private appetite to take on such risk. By the early hours of Tues. (9/15/08), discussions were producing a consensus that AIG's systemic position in the global financial system made the firm too important to fail. With the market still in freefall during business on Tuesday, and the specter of OTC counterparty risk threatening a global contagion scenario, the US government announced that it was taking a controlling 79.9% stake in the failing insurance firm. The process-tracing sketched out above demonstrates how contingent events on the ground during the crisis eventually overrode public authorities' commitment to finding private sector solutions, leaving them with no recourse but to rescue AIG so soon after letting Lehman Bros. fail.

It was also the distinctive differences in the authority relations between each firm and the state, that helps explains the variation in the public response to the firms at the heart of the crisis. For example, the Federal Reserve Act in the US, bestows the Fed with emergency powers which allow it to lend federal funds in unusual and exigent circumstances, but only when such loans are secured to the Fed's satisfaction. Therefore this legislative delegation of authority to the Fed had provided the legal basis for its rescue of Bear Stearns in March, precisely because JPMorgan had guaranteed Bear's obligations until closure of the deal. However, when Secretary Paulson's plan to facilitate a private buyer for Lehman's fell through, any subsequent federal loans would have been unsecured thus removing the legal authority to justify the loan. In contrast, while the massive CDS portfolio AIG's Financial Products division remained outside the Fed,

[156] Up to this point Geithner had steadfastly maintained the stance that there would be no government funds for the insurer.

Treasury, and SEC's regulatory umbra, its main insurance arm was still a large profitable business, giving the Fed a legal basis for the loan.[157] In short, one of the primary reasons that explains the variation in the US federal government's intervention into AIG is that there was the legislative authority to do so. A legal basis for public intervention however, that was arguably absent in Lehman's case.

Finally, another key factor for explaining the variation in public intervention between cases and the one most important for this study is AIG's status as a major global counterparty in global CDS markets. Through its $441bn dollar exposure to CDS and other derivatives, the firm had constructed an elaborate web of counterparty exposure-in some instances hedging its own exposure-that ultimately provided the underlying financial structure for the insurance products that it offered to its clients. While Lehman had a significant amount of notional exposure to CDS in 2005 and 2006, AIG was itself a major counterparty in the structure of the global CDS market whose default would threaten to trigger even more counterparty risk. In a post-crisis presentation to the FED, officials from AIG noted the "potentially catastrophic unforeseen consequences" that may have occurred as a result of the firm's collapse.[158] The implication was that the company's failure to honor its CDS contracts and make its payments would then trigger a crisis of confidence by depositors and a subsequent global bank run. This in turn, would

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[157] Stewart, James B. (2009). "Eight Days: The battle to save the American financial system." *New Yorker.* Sept 21, 2009.

[158] Davies, Paul J. Gillian Tett and Aline Van Duyn.(2008) "A new formula?: Complex finance contemplates a more fettered future". *Financial Times.* 1, October, 2008.

have significant global knock-on effects as many banks and financial institutions would be forced to write down the value of their suddenly unhedged positions.[159]

The threat posed by an AIG default was not merely limited to large investment banks and financial institutions. Much has been written in the years since the crisis about the ongoing financialization of social life.[160] This is defined in the literature as the shift in countries like the US away from traditional modes of capital accumulation that focused on trade and commodity production to one in which profits were now increasingly accumulating through financial channels.[161] We see some evidence of this during the crisis in the extent to which AIG's stock was one the ten most widely held in 401(k) retirement accounts. When addressing House and Senate leadership about the basis for the FED's $85bn dollar loan, Bernanke informed legislators of the threat to ordinary retail investors.[162]

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[159] FED Chair Bernanke noted his concern at the time that AIG's substantial presence in derivatives, debt and insurance markets could exacerbate the fragility in the global financial system, potentially triggering a global banking panic. Stewart, James B. (2009). "Eight Days: The battle to save the American financial system." *New Yorker.* Sept 21, 2009.

[160] Aalbers, M. (2008). "The financialization of home and the mortgage market crisis." *Competition & Change*, 12: 148–66. Ertürk, I., Froud, J., Johal, S., Leaver, A. & William, K. (2008). *Financialization at Work: Key Texts and Commentary*. London: Routledge.; Leyshon, A. & Thrift, N. (2007). The capitalization of almost everything: The future of finance and capitalism. *Theory Culture Society*, 24: 97–115.; Montgomerie, J. (2008). Bridging the critical divide: Global finance, financialization and contemporary capitalism. *Contemporary Politics*, 14: 233–52.

[161] Arrighi, G. (1994). *The Long Twentieth Century*. London: Verso. Also: Krippner, Greta. (2005) "The Financialization of the American Economy" *Socio-Economic Review* 3, 173-208.

[162] According to Bernanke: "There was no precedent. We were aware that lots of banks and investment banks were counterparties and might be at risk, but we didn't do this to save Goldman, or SocGen, or Deutsche Bank. It was far more complex. We were worried about the households with 401(k) plans, life-insurance policies, and pensions." Stewart, James B. (2009). "Eight Days: The battle to save the American financial system." *New Yorker.* Sept 21, 2009.

Despite the Treasury and Fed's recognition about the glaring inconsistency of rescuing AIG so soon after letting Lehman fail, the qualitative differences in the threat assessment of each firm's default would have on the system was significant. One Treasury official noted that the disparity in the response from the federal government at the time was due to the increased magnitude of the problems associated with AIG, something that they had never envisioned[163]. The case of AIG as an instance of a focusing event is an exemplar in this regard because it demonstrates how public officials in the US became aware of the extent to which ordinary retail investors were now susceptible to counterparty risk through OTCS vis-à-vis the financialization of the US economy.

There was also a growing perception among regulators that while derivatives did not cause the crisis, they nonetheless were exacerbating it. During the earliest stages of the crisis there was an assumption made by many experts that because of strong support for unregulated OTCs from the US FED (see Greenspan's comments above), that they would avoid any overt political consequences. Much of the opprobrium from legislators was in fact aimed squarely at CRAs and mortgage brokers as the initial culprits. However as the crisis developed, it began to demonstrate that the opacity of privately negotiated derivatives used to shift credit exposure, also made it extremely difficult to assess the magnitude of this exposure or the inter-linkages between financial institutions. The problem was that this left the banks at a loss in predicting exactly where the subsequent defaults would emerge. Meanwhile their exploitation of accounting and regulatory

[163] Stewart, James B. (2009). "Eight Days: The battle to save the American financial system." *New Yorker*. Sept 21, 2009.

loopholes to conceal the magnitude of their leverage and risk, compounded the problem.[164]

Another characteristic of focusing events is that they often lead relevant actors to, "pay attention to existing but dormant problems, potentially leading to a search for solutions in the wake of apparent policy failure"[165]. As it happens, policy-makers in the US already had an existing policy on hand to address the problems in the CDS markets: central clearing (see above). As previously discussed, the industry-with support from the US Treasury-had already embarked on an effort to develop a central counterparty (CCP) for CDS after the Bear Stearns debacle. This initiative proved prescient in the throes of the crisis when an exchange-based clearing-house successfully wound down many of Lehman Bros. derivatives positions.[166] This helped convince policy-makers of the efficacy of central clearing, pushing it to the top of the OTC reform agenda. One of the key insights into the post-crisis reform effort from scholars was the ability of disadvantaged actors to drive the process of change.[167] We see evidence of this with the promotion of central clearing as a viable policy option. This allowed market actors to influence the trajectory of reform going forward despite the increased scrutiny of all things derivatives.

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[164] Davies, Paul J. Gillian Tett and Aline Van Duyn.(2008) "A new formula?: Complex finance contemplates a more fettered future". *Financial Times.* 1, October, 2008.

[165] Birkland, Thomas A. (1998) "Focusing Events, Mobilization, and Agenda Setting" *Journal of Public Policy,* Vol, 18, No.1 P.55.

[166] Davies, Paul J and Aline Van Duyn. (2008). "Regulators' moves ensure more nerves for dealers in CDS" *Financial Times* 24 September 2008.

[167] Moschella, Manuela and Eleni Tsingou. (2013) "introduction: the financial crisis and the politics of reform: explaining incremental change." In *great expectations slow transformations.* Manuella Moschella and Eleni Tsingou eds. UK, ECPR Press Ch. 1 P.15. Also see Thelen, Kathleen. (1999) "Historical Institutionalism in Comparative Politics" *Annual Review of Political Science.* 2:369-404.
Thelen noted that losers from an institutional arrangement often adapt and work to transform this process.

The influence of the derivatives industry going forward was dependent upon support from policy-makers in the US federal government as they sought to shepherd it through what promised to be a rapidly transforming regulatory environment. In the weeks following Lehman Bros. and AIG, representatives from the Federal Reserve, SEC and CFTC met in New York for a series of closed-door meetings with industry actors to discuss the inevitable regulation that loomed on the horizon. For the large broker dealers, this entailed updating the Federal Reserve on its efforts to address the problems with credit derivatives through self-improvements to the settlement and trading in OTC derivatives. For prospective clearing-houses, the meetings represented an implementation deadline to submit detailed proposals for establishing a CCP to address risk management concerns.[168] In sum, even though market-led reform was about to give way to greater public oversight for OTCs, the early efforts of public officials to shepherd the industry through the process, helped institutionalize their influence going forward. Therefore, the initial continuance of market-led reform by officials in the US gave the industry a head start in regulatory reform. Thus, when officials eventually came to propose a policy initiative promoting central clearing, the industry was already well on its way in doing so.

Cross-National Contagion: Enter the G20

The shocks to the large financial institutions in the U.S. also triggered the first significant international response towards derivatives. As the crisis was causing a chain reaction throughout the US financial system, the threat of expanding global contagion brought the G20 club of wealthy nations to its first meeting in Washington in October 2008. This constituted the first meeting of its leaders since meeting at Cologne, Germany

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[168] Chung, Joann and Aline van Duyn. “Detailed talks begin on credit derivatives clearing house” *Financial Times.* 29 October 2008.

in 1999 in the wake of the Asian financial crisis. It was here that finance ministers from the original Group of 7 (G7) countries (Canada, France, Germany, Italy, Japan, the United Kingdom and the United States) had originally reached a consensus to now include a number of developing nations (Argentina, Australia, Brazil, China, India, Indonesia, Mexico, Russia, Saudi Arabia, South Africa, South Korea, and Turkey) as well as the EU, which represented the rest of Europe as well. While the intent of the G20 meeting in October 2008, was to discuss the broad trajectory of global financial reform going forward, the threat of counterparty risk spreading beyond the US placed OTC's near the top of the agenda.

The G20 pushed back against Anglo-American efforts to steer the direction of global financial regulatory reform. The US was already at a cooperative disadvantage, due to existing perceptions that challenged its legitimacy in promoting global financial reform given recent history.[169] Furthermore, its newly acquired status as the point of origin for what was about to engulf the global financial system only magnified this perception, compounding problems for the soon to expire Bush administration. The UK's ability to influence the proceedings was also limited as well, with then British Prime Minister Gordon Brown's calls for an international regime akin to a new Bretton

[169] One of the ideas associated with the expansion of the G20 in 2008 is the past experiences of several Southeast Asian countries who had followed the policy advice of the IMF prior to the lead up to the Asian Financial Crisis of 1997-98. The point of contention was the degree to which these countries had opened their economies to short-term foreign capital flows at the behest of policy-makers in Washington, a policy that these countries later came to regret. See: Helleiner, Eric & Stefano Pagliari. (2010) "Crisis and the reform of international financial regulation" *Global Finance in Crisis: The Politics of International Regulatory Change.* Eric Helleiner, Stefano Pagliari and Hubert Zimmerman (*eds). Ch1.*New York: Routledge.

Woods falling on deaf ears.[170] Taken together, these developments suggest that due to their role in contributing to the crisis, Anglo-American global financial regulatory preferences were now contested within the G20.

In addition to the question of whether or not the US/UK would be able to set the OTC policy-reform agenda, there are two additional aspects of the initial international response to the crisis that affected the direction of OTC reform during this time. Both of which saw the UK's global regulatory preferences subsumed by growing coordination at the European level. The first were the transatlantic implications of developing central clearing, which triggered resistance from the now ascendant countries of Germany and France. Both countries now saw the US led effort at establishing a global CCP as a threat to the sovereignty of a market denominated in euros. The second was the subsequent challenges faced by policy-makers in Brussels to facilitate a consensus among leading member states on a European CCP. This initiative would in turn, rely on agreement between different segments of the derivatives business there. This pressure helped align European preferences for a continental alternative to US-led global reform proposals, while simultaneously carving out national autonomy for the UK in the process. These two points guide the discussion below.

Unlike the pre-crisis era where global derivatives policy-making was a function of Anglo-American preferences, the new prospect of public oversight signaled a greater role for the EU in OTC policy debates. As noted, the sheer volume of European and

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[170] Brown reiterated the pressing need for an early warning system to combat financial crises. This is something he had touted for years, envisioning a stronger role for the IMF in global financial regulation. However, his credibility to do so during the crisis had sufffered from his own time on the IMF's ministerial steering committee during which he had been unable to do so. See: Anonymous (2008)."Grand Claims, but only tired ideas: The future of global finance will not be saved by slogans" *Financial Times* 17 Oct. 2008: 10.

global derivatives traded in London had contributed to the UK's stature as a natural transatlantic complement to the US in the global OTC policy community. In the decade prior to the crisis however, increased coordination among European countries had translated into increased influence for the EU in other areas of global financial regulatory policy-making. Its invitation to join the G20 in the wake of the Asian Financial crisis in 1999 bears this out as well. These developments happened in tandem with increasing levels of EU financial regulation, ultimately at the UK's expense. Therefore, its ability to have its preferences seen as authoritative in OTC policy-reform debates would give way to the broader trajectory of European institutional integration brought on by the crisis. While the early OTC policy reform talks would still be largely a transatlantic affair, it was now a conversation defined by primarily by the preferences of the US and EU.

US preferences for OTC reform threatened to subvert the effort at coordination between the two regulatory regimes. From the outset, European-level authorities had shared the same interest in international regulatory coordination as their US counterparts in endorsing direct regulation of OTCs. In fact, scholars have noted that Brussel's initial crackdown on unregulated CDS did indeed closely mirror that of the US.[171] While the US-led effort to establish a global CCP for the CDS market was consistent with its long-standing preference for global market-based regulation. Much of the substantive support for the U.S.' argument stemmed from the idea that 60% of the inter-bank volume in credit derivatives was transacted outside the country, requiring large inter-bank dealer

[171] Helleiner, Eric. Stefano Pagliari, and Hubert Zimmerman (2010). Global Finance in Crisis: The Politics of International Regulatory Change. New York: Rutledge. Also see Tait, Nikki. (2008). "Brussels signals crackdown on credit derivatives trading" *Financial Times* 18 Oct. 2008 P.7.

and global cooperation[172]. Moreover, this effort was consistent with the preferences of the large investment banks, which already had a head start in establishing a CCP for the CDS thanks to the Treasury Dept's efforts (see above). Therefore, even at this early juncture, U.S. officials were attempting to steer the trajectory of global OTC reform in a direction consistent with its preferences for hegemony based on the promotion of global finance.

Issues of European sovereignty and international financial competition came to the fore as ascendant continental countries resisted the idea of a U.S.-led CCP proposal. Germany and France had left the initial G20 meeting worried about the US initiative to promote the industry's development of a global CCP. Officials from both countries were especially resistant to the idea of an American-led global clearing initiative that could potentially give US regulators oversight over European derivatives transactions denominated in Euros. Moreover, both German and French officials sensed an opportunity to boost the competitiveness of their financial centers, while simultaneously checking US preferences. In short, despite the threat of transatlantic counterparty risk posed by the problems that were transpiring within the CDS markets, the ascendant European countries sought to check the US led reform effort while policy-makers on both sides of the Atlantic were already contemplating the competitive effects that central clearing might have on the competitiveness of their financial centers going forward.

Market actors operating in Europe opposed the continental countries preference for a European CCP as well. In January 2009, efforts in Brussels to facilitate regulatory cooperation with the industry were stymied as talks broke down between EU officials and the large broker dealers. The main sticking point was the inability of policy-makers to

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[172] Gooch, Michael. (2009). "We must act now to avoid a CDS regulatory time-bomb". *Financial Times 24 Feb. 2009: 24.*

obtain a commitment from CDS dealers for a CDS clearing timetable in light of European officials opposition to dealers' preferences for a global solution that aligned with the US.[173] Behind the scenes, British clearinghouses like LCH Clearnet were working with the US based organization DTCC to establish Synapse a proposed global clearing-house for CDS. Additionally, French ministers had issued a proposal calling on the European Central Bank (ECB henceforth) to establish a European clearing system for credit derivatives. This was eventually expanded to include all OTCs, a move that was decidedly broader in its scope than the US initiative, which focused solely on CDS. Furthermore, the French scheme would be limited to the Eurozone and not the whole EU, setting off British alarm bells that the London would be cut out of the Euro OTC agenda.[174]

UK concerns were eventually addressed with the promulgation of The Delarosiere report in February 2009. Its main findings advocated closer European coordination on these issues while containing language that maintained local home country supervision of clearing and settlement.[175] The following month the European Commission (EC) reached an internal consensus with the derivatives industry on developing a European CCP. But this only came about after industrial non-financial companies (NFCs) exerted significant pressure on the proceedings. They were successful in doing so because the EC had

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[173] In addition to these formal European policy discussions, we see manifestations of these preferences in the coordinated efforts of UK firms like LCH Clearnet who at the time was working with US based organization DTCC to establish Synapse a proposed global clearing house for CDS.

[174] Chung, Joanna, Jeremy Grant, Nikki Tait, and Aline Van Duyn. "Plea for dialogue on regulation of financial sector". *Financial Times, 4 February 2009:6.*

[175] Hughes, Jennifer. (2009) "City seeks 'bark and bite' to build on promising premise" *Financial Times, 26 February 2009:2.*

empathized with their argument that as end-users, they had a legitimate need to utilize financial derivatives as a hedge against their exposure to market volatility.[176] Therefore, the EU's efforts to solicit the industry's cooperation in developing a regional CCP were only successful once the EC had a constituency that supported it in doing so, one whose interests were distinguished from those using OTCs for purely speculative purposes. The instrumentality of end-users and the legitimacy that they brought to European deliberations over OTC reform would eventually play out in the US as well.

With a deal secured in Europe, the continental countries ascendancy vis-à-vis the EU helped them lock-in an American commitment to regulating OTCs. By the time of the G20's second meeting in Washington-in April 2009, the details surrounding the crisis threatened to derail the ability of the U.S. to set the OTC reform policy agenda with the Europeans. In March, the Obama Treasury department had outlined its plans to regulate OTCs/CDS as part of its promised overhaul of US domestic regulation. In doing so, it hoped to use this draft to steer the direction of the upcoming G20 summit. However, there was considerable friction from German prime minster Angela Merkel as well as French president Nicolas Sarkozy, who were both defiant in their resistance to the US led effort. The source of the antagonism was their shared conviction that US officials had contributed to the crisis through their mishandling of financial regulatory supervision. This tension was exacerbated by Obama's mutual frustration with having to bail out several European banks that were significant counterparties to AIG with US taxpayer dollars. Treasury Secretary Timothy Geithner however, was successful in assuaging the European's concerns by insisting that despite greater multilateral coordination derivatives

[176] Grant, Jeremy. (2009). "Interdealer brokers join forces on OTC issues" *Financial Times* 9, March 2009.

regulation would ultimately be a sovereign issue. This set the stage for the international consensus for coordination in central clearing that followed from the second G20 meeting[177].

Ascendant market actors pushed back against the idea that global OTC reform should be a state-driven project. The Working Group on Financial Reform in the US, as well as the EU's DeLarosiere Report had both reached similar conclusions to the G20's proposal on promoting the development of CCPs. The Obama administration called on Congress to make central clearing mandatory, with Treasury Secretary Geithner advocating a greater role for exchanges in derivatives trading.[178] For its part, the EC called for increased standardization in OTC markets and greater use of clearing houses. Private market actors wasted no time pushing back against these proposals. Investors on both sides of the Atlantic had feared that the disproportionate influence of the large broker dealers would now extend to central clearing as well.[179] However, NYSE Liffe, Intercontinental Exchange and London Stock Exchange were three of the world's largest exchanges whose clearing houses stood to be the main beneficiaries of any proposals to move more OTC derivatives into central clearing and exchange trading. They argued that, "market participants should have a role in deciding how far such products are shifted away from the opaque privately negotiated markets"[180]. In sum, ascendant globally

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[177] Helleiner, Eric; Stefano Pagliari and Hubert Zimmerman (2010). *Global Finance in Crisis: The Politics of International Regulatory Change.*New York: Routledge.

[178] Elder, Bryce; Neil Hume. (2009). "Geithner stance hits inter-dealer brokers". *Financial Times, 28 March 2009:18.*

[179] Weizman, Hal and Aline Van Duyn. (2009). "CDS clearing plans bot bulletproof". *Financial Times, 02* July 2009:23.

[180] Grant, Jeremy.(2009) "Exchanges warn on OTC clearing". *Financial Times,* 04 June 2009:23.

oriented firms tried to use their newfound influence to pressure officials for a greater role in the early transatlantic efforts to implement the international consensus on central clearing.

In ongoing European deliberations, the growing rift that had recently come to light between the British and the French became more apparent. Despite its limited role in setting the OTC reform agenda, the UK had broadly echoed the sentiments of both Washington and Brussels with regards to central clearing. This marked a turning point for its Financial Services Authority's (FSA) 'go-it-alone' strategy for financial reform, which industry associations argued could potentially prompt a fragmentation of international rules.[181] The FSA's white paper at the time even supported European efforts to develop recommendations on standards for CCPs. To that end, it justified this its position citing the recent work of the Committee of European Securities Regulators and European System of Central Banks. However, persistent disagreements between the UK and France were seen as having the potential to hinder EU-level clearing efforts. Jean-Pierre Jouyet, chairman of its regulator Les Autorite des Marches Financiers stated that London, "had to accept that Paris has a role" in the clearing of trades denominated in Euros.[182] German officials on the other hand, were decidedly more neutral in this debate. This contributed to growing perceptions that a lack of European coherence on the issue could threaten the development of a European CCP. The threat was that this would force the Europeans to

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[181] Groups voicing their concern about the FSA's unilateral approach to regulating finance were: the London Investment Banking Association, the British Bankers' Association and the ISDA. See: Larsen, Peter Thal. (2009)"UK banks liquidity overhaul facing opposition". *Financial Times* 12 March 2009:22.

[182] Grant, Jeremy, and Brooke Masters. (2009)."London follows where Brussels and Washington have gone before". *Financial Times* 09 July 2009.

cede the initiative to the US global CCP plan.[183] Therefore, the ability of the EU to effectively express its preferences for global OTC reform was being challenged from within by the shifting authority relations between its most influential member states. At the heart of this shift were the effects that the EU's newfound influence was having on France, now on the cusp of its ascendancy for European OTC reform and the UK, which was threatened with decline. The inherent tension between the two was all the more pressing given the upcoming G20 Pittsburgh Summit in September only six weeks away.

ISDA and the Big Bang Protocol

The crisis and an attendant level of increased scrutiny on the financial-services industry did much to delegitimize the transnational network of experts that were responsible for the development OTC policy-making in the pre-crisis era (see section above). To reiterate, the OTC policy-making preferences of these actors were seen as authoritative at the time precisely because they had been sanctioned by international regulatory institutions with the full support of officials from the US and UK. However, as the crisis proceeded to unfold, the broader international community now called these preferences into question. Furthermore, the increased role for the EU in this context also contributed to curtailing the influence of the epistemic communities that had prevailed before the crisis. These developments occurred alongside the shift to publicly regulate OTCs and as a result, significantly delimited the ability of private transnational actors during the crisis to influence the reform policy orientation for the global derivatives market.

[183] Daneskhu, Scheherazade; Jeremy Grant and Peggy Hollinger. (2009). "UK and France told to agree on regulation of OTC derivatives". *Financial Times,* 20 July 2009.

While private market actors were limited in their ability to directly influence OTC policy reform, they still had some indirect tools at their disposal. In April 2009, the ISDA implemented its 'big bang' protocol, an effort to impose a uniform procedure for addressing how CDS contracts are settled when a company goes into default. This large-scale private initiative accompanied similar efforts occurring industrywide to 'net' or tear up outstanding CDS contracts that offset each other. The deadline for implementation triggered a large rush of over 1,500 dealers and investors in the markets for credit derivatives to sign on to the agreement. In doing so, the industry sought to counter "the intense criticism that has emanated from political and regulatory quarters over the industry's alleged role in contributing to the market crisis"[184]. Through these efforts at standardization, the protocol also had the perceived benefit of facilitating the migration of traded contracts to a central clearing counterparty. Therefore, the ISDA sought to put the market on a more solid footing to demonstrate to national regulators and public officials that the scale of outstanding counterparty risk was smaller than initially thought.

The sea change brought on by the crisis to regulate OTCs also portended a greater role for investors, who were now ascendant. Along with banks' balance sheet constraints, the increased regulatory attention on OTCS had begun to change the attitudes of the broker dealers who had originally sought to keep the market opaque and bespoke, while boosting margins and profits at the same time. In the past, these considerations had driven their reluctance to reduce their outstanding derivatives exposure, while simultaneously downplaying infrastructure issues in the industry. For the ISDA, which had long been under the influence of bankers representing the inter-dealer brokers working the trading

[184] Bullock, Nicole; Michale Mackenzie and Gillian Tett. (2009). "Big Bang arrives for credit default swaps industry". *Financial Times,* 08 April 2009:29.

side of the business, the developments surrounding the crisis contributed to the trade association's growing recognition of end-users ascendancy. Then CEO Robert Pickel, acknowledged at the time that, "The buyside will be a very significant part of what we do going forward in a more formalized manner"[185].

Despite the crisis' negative effect on the influence of the private policy network of derivatives experts in the industry, the Big Bang protocol demonstrated that the ISDA was still a significant actor in the derivatives policy realm. While the discrediting of this network and the intrusion of officials into the proceedings delimited the ISDA's ability to directly develop public policy for derivatives, the brief discussion above demonstrates that it was still able to affect the promotion of industry standards. It did so through its reliance on network effects that had persisted despite the shift in the regulatory ethos for OTCs. Furthermore, its efforts at continuing to standardize contracts were congruent with the push for central clearing, which was quickly becoming the central platform for OTC reform. As we shall see, the trade association still retained some of its traditional tools of instrumental policy-making through domestic regulatory forums. Through these channels it could continue influencing the trajectory of OTC reform, especially in the more pluralistic US. However, as OTC reform pushed more contracts onto trading facilities and into central clearing, the standardization of derivatives saw the influence of the ISDA greatly diminished in the OTC policy community relative to its status in the pre-crisis era.

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[185] Bullock, Nicole; Michale Mackenzie and Gillian Tett. (2009). "Big Bang arrives for credit default swaps industry". *Financial Times,* 08 April 2009:29.

Conclusion

In the years after WWII, global finance was in retreat as the post-war liberal trading order proved to be incompatible with a simultaneously occurring liberal financial order. Eventually, Anglo-American support for the Eurodollar markets in the 1960s helped degrade the legitimacy of the post-war order by paving the way for US-led changes to the international system of capital flows. This structural adjustment eventually contributed to the innovative creation of financial derivatives by firms who sought to hedge their exposure to this new volatile system, ushering in a new era of global finance. This analysis cast its lot with arguments that suggest that these developments helped usher in a new era of US hegemony based on the promotion of global finance.

The development of financial derivatives by American firms was met with a series of competitive deregulatory adjustments in developed countries seeking to pursue US- style financial innovation. An analysis demonstrated how policy-makers and officials in the UK and Germany embarked on domestic initiatives to create legal certainty for speculative contracts of difference by removing domestic legal impediments to the growth of their nascent futures markets. In comparison, US officials instead resisted the idea of legal certainty for OTCs. Over time, this allowed existing regulatory institutions-which were unable to keep up with the new ways that derivatives were being utilized-to drift.

An analysis of the historical French experience with financial globalization demonstrated significant variation. Unlike the other countries, which sought to boost the competitiveness of their financial centers by unilaterally removing their domestic capital controls, France did so multilaterally by embedding its preferences for a liberal financial

order within what it saw as relevant post-war international organizations. Additionally, its Civil Code for contracting was distinct in that it afforded courts significant interpretive discretion to the extent that the impetus to revise it by French officials wasn't felt until long after the crisis. Taken together, these developments help explain how divergent historical preferences for financial globalization would impact reform. When the crisis eventually hit, ascendant French officials were able to act successfully towards reform within the EU and as a counter to US preferences vis-à-vis the G20.

The removal of domestic impediments was accompanied by a series of permissive policies at the interstate and transnational levels. A transnational network of private market policy actors and trade associations in the derivatives industry came to define global regulatory policy-making for OTCs. These transnational actors promoted a policy orientation consistent with the preferences for the dominant market-led regulatory paradigm by the US and U.K., who in turn utilized their influence in international financial regulatory institutions to sanction these policies. These developments helped create a relatively frictionless global regulatory environment that was complementary to the domestic restructuring that had helped nascent derivatives markets grow both in and across countries. As more private market actors began utilizing financial derivatives, there was mounting evidence of both the inherent risk associated with financial derivatives, as well as the increasing cross-border vulnerability this posed to other national financial systems. A series of publicized defaults in the late nineties associated with the growing use of swaps triggered calls to regulate OTCs in the US.

An examination of the variation in response by public officials in the US during the 2008 crisis leads to the conclusion that the counterparty risk embedded within AIG's

credit derivatives portfolio posed a significant risk to the broader domestic economy. This eventually forced US officials to abandon their commitment to market-based reform. However as the crisis played out, American officials and their counterparts in the UK began to realize the extent to which the specter of counterparty risk was also responsible for transmitting financial contagion from New York to London. As such, the case of AIG represents the initial focusing event for transatlantic OTC reform as it relates to the developments associated with the crisis that began in the US. However, as I argue in the empirical chapter on the EU, European officials in Brussels would eventually experience their own focusing event for OTCs vis-à-vis the Greek sovereign debt crisis some 16 month later.

As the initial threat of cross-border financial contagion became a reality, the EU saw its influence increased in the context of the newly expanded G20. This was attributable to the large volume of OTCs denominated in Euros traded in London. This in turn contributed to the ascendancy of the continental European countries in challenging the US' and UK's preferences for global financial reform. The cleavages wrought by this challenge were twofold. Internal European preferences diverged along an axis that saw the UK-whose 'light touch' approach to regulation before the crisis was blamed for having helped cause it-on one side, and the now ascendant continental countries on the other. These authority relations between the most influential member states in the EU helped-with US support-to delimit the UK's influence as its calls for a new Bretton Woods fell on deaf ears. In light of these internal EU dynamics, the high transatlantic concentration of global OTCs translated into lead roles for the US and EU in the G20

deliberations. Therefore, the ascendancy of the continental countries vis-à-vis the EU and the G20, saw them successfully checking the preferences of the US as well.

The increased salience associated with the crisis also placed considerable scrutiny on the transnational policy network that had dominated OTC policy-making in the pre-crisis era. Powerful trade associations like the ISDA and DTCC, were given a head start in setting the reform agenda by officials in the US who maintained their commitment to market-based reform in the earliest stages of the crisis. This assisted the industry's efforts to develop central clearing for CDS, which did become a central plank of the OTC reform effort. However, the re-assertion of national authority vis-à-vis the G20 ultimately undermined any serious consideration of global initiatives. Therefore these industry associations saw their transnational role significantly diminished as their ability to successfully oppose the international reform effort was confined to within domestic institutions like the American legal system.

Consistent with a market power prediction, the crisis had indeed caused a rift between the two largest financial powers for OTCs: the US and UK. However, this rift was quickly subsumed by the ascendancy of the EU at the time vis-à-vis the G20 and the broader reform trajectory for global finance that was occurring. These developments not only delimit the predictive power of materialist explanations for what occurred with global OTC reform, they also lend support for the institutional explanation posited by this study. The position of American officials at the time was consistent with their long-standing preference for global market-driven financial regulatory solutions. We see this in their efforts to resurrect the idea of central clearing from domestic US regulatory debates a decade earlier towards its proposal for a global CCP for CDS. However, since

most OTCs in Europe were denominated in Euros, German and French preferences for an EU-based CCP ensured that the American initiative would go nowhere. Therefore despite the continental countries' success in locking-in an Anglo-American commitment to reform trough the G20, the transatlantic cleavage as well as those within authority relations within the EU suggested that global OTC reform would nonetheless maintain its sovereign character. When the crisis challenged whose preferences would be seen as authoritative going forward, it wasn't material capacity that ultimately proved determinative. Rather, it was those actors who were best positioned within existing institutions who would ultimately determine the trajectory of reform.

3. POST-CRISIS OTC REGULATORY REFORM: US

Introduction and Plan of the Chapter

Our first case study looks at the development of derivatives reform in the US in the wake of the G20 Pittsburgh Summit's recommendations for OTC reform. Specifically, it looks at the politics affecting the US' implementation of its main pillars through the legislative development of Title VII of the Dodd-Frank Wall St. Accountability Act and the subsequent process of rule-making. It seems appropriate to start with the US given its role in contributing to the financial innovation that led to the development of financial derivatives in the late twentieth century as well as being ground zero for the financial contagion that ushered in the global financial crisis. It should be noted here at the outset, that derivatives were just one of many complex issues associated with financial reform within the comprehensive text of the post-crisis legislation albeit as I contend here, a significant one.

Almost by default, the complexity of transnational rulemaking that started with US implementation would from the standpoint of financial interdependence, create downstream effects in the policy process that would be difficult to reconcile absent a binding treaty for OTC reform among G20 nations. However, because of the parochial nature of implementation implicit in the G20 reform agenda, qualitatively tracing our first case study entails beginning with the domestic origins and preferences that marked the legislative process in the U.S.

Consistent with a historical institutionalist prediction, we see the formerly marginalized actors in the OTC policy community now in a position to see their preferences realized. We also see the actors in OTC reform using their institutional

position to either increase the tempo of reform or introduce friction into the regulatory policy-making process. In the US case, the implications of these temporal dynamics are linked to the inherently fleeting nature of institutional arrangements associated with the transfer of power across governments over time in liberal democracies.

The chapter proceeds in four parts. The first section focuses on the draft legislation process that began in the House Financial Services Committee to develop Title VII of the Dodd-Frank Wall St. Reform and Accountability Act in the U.S. It was here that a bipartisan consensus began implementing the main pillars of the G20's OTC reform agenda by embedding them within domestic legislation. However, from the outset it became clear that implementing the international consensus reached at the Pittsburgh Summit would only be done so far as it was consistent with U.S. preferences. By choosing to address swaps specifically by name, the US chose to forego the broader focus on OTCs by the G20. In doing so, it sought to delimit any negative effects on the competitiveness of its financial services sector. As a result, the US also established the sequencing that would affect the rest of the reform process for the next 7 years.

Another aspect in line with an historical institutionalist prediction was the simultaneous elements of stability and change. Familiar processes of path-dependence played out in the initial draft legislation through the preservation of the bifurcated system of financial regulation between securities and futures in the US. The resiliency of this system was attributable to the longstanding political dynamics surrounding derivatives that we saw previously. Recall that the futures exchanges had tried a decade earlier to bring OTCs under their regulatory remit in the US through their regulator but had failed (last chapter). Furthermore, the source of their failure had been opposition from the

entrenched OTC broker dealers supported by the US Treasury and the self-market regulatory paradigm that reigned at the time. However, the legislative process initiated by the crisis gave the exchanges a newfound source of support from legislators in the key congressional committees overseeing their regulator. Therefore, the formerly marginalized exchanges were now in a position to benefit from having their regulatory preferences realized.

As a result, legislative actors supporting reform would delegate significant authority to the ascendant Commodities Futures Trading Commission who would become a key regulator for the global OTC market. This also contributed to the sequencing of global reform as it established the US as first mover relative to other participating G20 regulatory regimes. Domestically and internationally, it was the institutional preservation of the bifurcated regulatory system for derivatives in the US that allowed actors to use their institutional position to affect both the trajectory and tempo of OTC reform. For ascendant reformers, this meant persisting with reform in the face of opposing efforts by actors intent on using their ability to directly counter these initiatives when they could, but also by also inducing friction into the proceedings when they couldn't.

As draft legislation evolved, it became apparent that other market actors' ascendancy would also be institutionalized through the CFTC's ascendancy. Similar to what occurred in the European Commission in the run up to the G20 (see last chapter) OTC regulatory reform brought NFCs to the fore while also embedding the relevance of hedging (and ultimately speculation) within the policy process. These market participants used derivatives exclusively to hedge in turn leveraging their new influence to argue against having to incur the more punitive aspects of reform. The actors that stood to lose

the most by the reform effort however, were the large broker dealers divisions of the globally oriented investment banks. Their role in contributing to the crisis meant that they also suffered the reputational effects in the OTC policy community as well. However, despite their marginalized status in OTC debates these actors were still able to function effectively in affecting the trajectory of reform by linking their fate to end-users curtailing the most stringent OTC reform proposals.[186]

The development of the draft legislation also contributed to the end of the bipartisan consensus for financial reform as OTC policy debates increasingly fell along partisan lines. Democratic legislators were also ascendant due to a unified government, giving them an institutional advantage vis-à-vis the committee process that allowed them to establish the tempo of the legislative process. However, their Republican counterparts leaned heavily on the idea that the reform efforts would damage the country even further during an economic downturn. This gave them a relatively low-cost way to indirectly defend the interests of the Wall St. banks that had spent vast sums lobbying them to protect their interests. Reform-oriented actors in key committee chair positions reconciled the disparities between the House and Senate versions of the bill where they facilitated a key compromise to water down some of the more contentious aspects of the draft legislation and allow for its passage.

What resulted from the legislative process in the US that produced the Dodd-Frank Act; was that the authority delegated to the CFTC was layered onto the

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[186] Pagliari, Stefano and Kevin Young (2013) "The Wall-Street-Main Street nexus in financial regulation: Business Coalitions Inside and Outside the Financial Sector in the Regulation of OTC Derivatives" in *Great Expectations, Slow Transformation: Incremental Change in Post-Crisis Regulation.* Manuella Moschella and Eleni Tsingou eds. Colchester, UK ECPR Press, Ch.6 pp.125-148

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Commodities Exchange Act, the Depression era legislation through which its authority resided. While there were new elements associated with the G20 reform agenda that saw the CFTC re-tasked for a new era of financial globalization, the focus on central clearing was solely driven by US preferences informed by the regulatory experiences of the late 90s (see last chapter). This represented new competitive opportunities for the clearing arms of the ascendant exchanges.

The second section focuses on the rule-making stage of the implementation process where opponents of reform were more successful in introducing institutional friction. The Dodd-Frank legislation had been explicit in its prescribed timeline for its implementation which for actors focused on reform, meant proceeding with haste. As a result, a flood of public commentary ensued from private market actors seeking regulatory relief in the form of exemptions and extensions. Some of these petitions came from corporate end-users; NFCS concerned that they would bear the punitive brunt of reform despite using derivatives for legitimate hedging. Others however, were the deliberate efforts of investment banks that sought to impede the regulatory process by deliberately overtaxing the CFTC's meager capacity. This in turn, kickstarted an effort by Republican legislators-who after winning the House in the mid-term elections-were now empowered to starve the middling regulator of funds. Their use of the appropriations process created more friction for actors-whose preference for rapid reform-they argued, would ultimately threaten the US' economic recovery during what was becoming a truly global crisis. Given this constraint, Congressional Republicans also linked their fate to end-users and hedging, as their efforts to impede the tempo of reform laid out the terms of engagement for the rule-making process.

The re-assertion of national authority brought on by the crisis diminished the influence of the transnational market actors. Cut off from their institutional base of support in the transnational policy network that had driven OTC policy-making in the pre-crisis years, their only recourse now was to challenge reform through domestic courts. A series of legal challenges in the US by the derivatives trade associations to the CFTC's delegated authority was an example of their efforts to do so. These actors were successful in utilizing a provision in Dodd-Frank that had mandated that the commission first conduct cost-benefit analyses before promulgating rules taking advantage of the bipartisan nature of the proposal. This demonstrated the early efforts of legislators opposed to reform to embed their preferences into the legislation as well. This provided market actors with an institutional resource further downstream in the regulatory process with which to challenge the trajectory of reform.

The third section shifts the analytical focus to the international effects of the US' cross-border rule-making. Again, leaning heavily into why timing and sequencing matter for explaining regulatory outcomes, we see the extent to which international actors began pushing back against the US' first mover effort for OTCs. The CFTC's cross-border rules were a response to the longstanding vulnerability of the US financial system to the speculative activity of US financial market participants conducting business in London (see last chapter). Scandals tied to risky derivatives bets in the City also contributed to the permissive conditions for reform, by underscoring for them the negative effects of unregulated OTCs, some four years on. The productive conditions that followed saw US regulators trying to reign in American market actors operating abroad by promulgating extraterritorial rules for cross-border swaps. However, in doing so the CFTC was now

acting as *defacto* global regulator, a move that was met with resistance by its counterparts. For foreign regulators in the EU already lagging their American counterparts, the US unilateral attempt to regulate cross-border activity was seen as largely inconsistent with their own regulatory prerogatives. In sum, the US move at extraterritorial rule-making had thrown off the sequencing of global reform.

The US first mover effort for OTCs also had the unintended consequence of significantly undermining the G20 reform agenda, robbing it of a key incentive for harmonization. From the outset, the international consensus for OTC reform had been guided by the idea that coordination among countries and the harmonization of their regulatory regimes should proceed to avoid the threat of regulatory arbitrage. The US extraterritorial rule-making by the CFTC however, now rendered regulatory arbitrage as moot given that anyone engaged in a derivatives contract with a US counterparty would still be captured by the CFTC's rules. Opposition to the US move grew as a coalition of European and Asian regulators pushed back by painting US derivatives counterparties as *persona non grata* in the global OTC market.

The success of international regulators in checking US preferences created an opening for the EU to seek an accommodation with the US. A series of proposed deadlines established by the sequencing of US rule-making underscored the haste felt by US regulators as European officials interests were now aligned with Wall St. firms towards harmonizing reform. Officials in Brussels pushed for substituted compliance among the two regulatory regimes, even trying to shift forums by attaching an OTC deal to transatlantic trade talks. Both efforts however, proved unsuccessful. A scaled back

agreement known as the Common Path Forward saw a vague commitment from both sides to recommit to a coordinated effort at OTC reform.

The final section shifts back to domestic political events in the US as market actors and Republican legislators continued their efforts to curtail the implementation of Dodd-Frank. The investment banks and their relevant derivatives trade associations continued to contest the CFTC's authority using H.R. 1840, the provision embedded within Dodd-Frank. However, this time around their efforts were less successful as the courts now sided with the established authority of the CFTC. Deliberations over the Volcker rule show how Wall St. actors utilized the idea of legitimate hedging again as a foil to pare back some of the rule's more stringent elements. These efforts were also unsuccessful as the CFTC-now supported by the courts-declared that rule-making in the US was now closed. By this point, the Republicans had regained control of both houses of Congress and embarked on directly repealing the swaps push out rule in Dodd-Frank. They did so covertly however, for fear of triggering a public backlash towards their efforts to roll back reform.

The Road to Global OTC Reform Through Dodd-Frank

The earliest stages of implementing the G20's recommendations saw the US embedding its preferences within the draft legislation that would become the Dodd-Frank Wall St. Reform and Consumer Protection Act. As one of a number of issues associated with the global financial crisis, American legislators had sought to implement the G20's recommendations for OTCs as part of the comprehensive regulatory overhaul of the US' financial system that began in the House financial services committee in October 2009.

What would stand out as unique in the draft legislation was its decidedly narrower focus on which types of contracts would be subject to regulatory scrutiny. The G20's communique from the Pittsburgh summit focused explicitly on "all OTC contracts"[187]. However, the initial draft legislation in the House focuses specifically on swaps by name.[188] Also, in the G20 communique any contracts that were standardized were to be traded on an electronic exchange. This move would allow for significant price discovery in the bid markets for these products. Consistent with the U.S. preference to address swaps, these would be referred to in the subsequent legislation as swaps-exchange facilities (SEFs).

The developments highlighted above reflect the efforts by market actors in the US to benefit competitively from reform by embedding their preferences for reform within domestic legislation. Recall from the last chapter the successful US led effort within the G20 to introduce central clearing, an initiative that had been proposed a decade earlier but had met significant opposition. The last chapter also laid out how this was now a largely market-driven initiative by the industry in the early phases of the crisis. Therefore, the derivatives industry itself stood to benefit from any policy effort surrounding central clearing which was taken up by the G20 with support from the US govt. Because the US would be first-mover relative to other regulatory regimes taken

[187] FSB (2009). G20 Leaders' Declaration-Pittsburgh 2009. *Financial Stability Board.* <https://www.fsb.org/wp-content/uploads/g20_leaders_declaration_pittsburgh_2009.pdf>

[188] While credit-default swaps had been identified as the opaque contracts responsible for exacerbating the U.S. borne crisis-still many more swaps were tied to interest or exchange rates and as such were utilized by many types of firms throughout the world to hedge their risk to financial and economic volatility in global markets.

together, these developments demonstrate how the US was ultimately able to affect the sequencing of global OTC reform consistent with the preferences of these market actors.

Despite some technical exceptions, the other pillars of the G20 communique were also embedded within the US legislation in a manner consistent with US preferences.[189] Early debates over exchange-trading focused on whether or not a contract was amenable to standardization. This was potentially problematic given the popularity of bespoke contracts in the pre-crisis era. It was eventually decided that any contracts deemed as standardized would also be subjected to mandatory clearing.[190] Therefore, those standardized contracts accepted by large swaps participants (MSPs) would have to be executed against a central counterparty (CCP) fulfilling the G20's clearing requirement. The end result was that any non-cleared bilateral contract without an electronic exchange would have to pay a significant risk premium in the form of higher margins.[191] Finally, it was determined that the last pillar (trade-reporting) would also be made mandatory as well. The intended aim of these legislative initiatives was that together they would provide US regulators with a better vantage point to scrutinize the interconnectedness of the OTC market.

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[189] A significant source of uncertainty for firms that utilized derivatives going forward, resided in the only pillar of the G20 agenda that wasn't explicitly addressed in the draft legislation for the house financial services bill: capital requirements for non-cleared trades. These would eventually be addressed through the Basel III reforms.

[190] Exchanges make it easier for investors to determine how many contracts can be bought or sold by utilizing standardized terms and specifications for each derivatives contract. This process also entails ensuring that the size of a given contract isn't daunting for small investors. In contrast, customized bespoke contracts can have any number of varying parameters tailor-made for a given investor's individual needs.

[191] These contracts were bilateral in that there were only two (usually large institutional investors) counterparties to a contract. Also, the focus on major swap participants is an extension of the macroprudential risk focus in post-crisis reform as it pertains to derivatives. This can be viewed as analogous to the 'too big to fail' problem over risky trades that could pose systemic risks.

Preserving a Bifurcated Regulatory System

It was the relevant congressional committees that ultimately allowed actors to embed their preferences into legislation that preserved the bifurcated character of financial regulation in the US. Recall that during the earliest stages of the crisis, former Treasury Secretary Hank Paulson had been critical of the longstanding historical bifurcation between securities and futures (derivatives) regulation in America, calling for a consolidation of the US financial regulatory system.[192] This would have brought oversight for both types of financial products under a single regulator, bringing the US into line with the regulatory systems of most major developed economies as well.

As US legislators began the draft legislation that would ultimately become Dodd-Frank, the idea of a consolidated regulator for securities and derivatives was indeed still up for debate. A failed bid by the SEC during the initial stages of the crisis (see last chapter) to bring the vast OTC market under its regulatory umbrella was only the latest example of a long series of turf battles between the large regulatory agency which oversaw securities and its smaller regulatory counterpart for futures derivatives, the CFTC. Furthermore, these turf battles were a historical reflection of the institutional reservoirs of congressional authority that market actors involved with OTC reform in the US would tap into for the realization of their preferences.[193]

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[192] See chapter 2.

[193] For an early empirical analysis of derivatives legislation in the US and a history of the turf wars between the two agencies over derivatives see: Romano, Roberta. (1997). "The Political Dynamics of Derivatives Securities Regulation" *Yale Journal of Regulation.* Vol. 14: 279.Congressional committees in the US often vigorously defend the perks that they receive in their agency oversight, principally the funds they're able to raise from firms the agencies regulate.

For the large investment banks on Wall St, the financial services (F/S) committees overseeing the Securities and Exchange Commission (SEC) were their traditional institutional resource for influencing regulatory policy. The banks' reputation in the OTC policy-making community had suffered considerably during the crisis threatening their ability to block reform. Their standing in Congress should have provided a potent resource to counter this given that the F/S committee in the House was where the sequencing of reform for the U.S. financial system would begin. However, the Obama administration in the fall of 2009 was into its first year in office with a unified government giving Democrats control of both the House and Senate. This in turn, translated into key leadership positions for the relevant committees overseeing financial services reform. For the large investment banks, the problem was compounded by broad public support for reform in light of the crisis which induced a bipartisan consensus for reforming the US financial system.

Contingent events during the crisis also helped to reinforce ideas about which regulator would be best suited to oversee the vast global OTC market. The SEC as a government watchdog, had seen its reputation suffer in the wake of the Madoff Ponzi-scheme scandal the previous year. This was followed by the collapse of several of the firms during the crisis, under its remit. These regulatory developments diminished its status in the eyes of legislative reformers. At the same time, they also contributed to the increased influence of the CFTC in OTC policy-making which was now seen as ascendant. The surge in crude oil prices during the crisis above $147 a barrel in 2008 had put the CFTC in the spotlight, as the commission pursued an initiative to reign in energy trading. The CFTC's relative influence was also bolstered by its connections to the

Agriculture subcommittee on Commodity Exchanges, Energy, and Credit in the midst of a global crisis that was playing out in the commodities markets for oil.

An increasingly broad coalition of NFCs that used derivatives to hedge were also seeing their influence increased as well. Firms across the spectrum of the US economy began seeing their capacity to influence regulatory reform increased, based on their claim that speculation was creating price volatilities in commodities.[194] Additionally, the Treasury Dept.-the principal regulator representing US' interests in international regulatory disputes-had envisioned a primary role for the CFTC. During the crisis, it had submitted legislation to Congress to give the CFTC limited oversight over OTCs. This was due to the large volumes of OTC swaps traded in global markets by US firms seeking to hedge their exposure to financial and economic risk.

It's the difference between the types of derivatives each regulatory agency would eventually oversee and what this would mean going forward that illustrates whose preferences were realized. Under the proposed draft legislation, the SEC and CFTC would share joint authority over swaps. Additionally, the SEC would oversee security-based swaps while would have authority the CFTC over all other swaps, including some derivatives contracts for commodities not covered by conventional definitions.[195] This would have significant implications for international authority relations going forward for OTC reform, especially given that the sequencing established by the US first-mover effort would transform the former middling commission into a *defacto* global regulator.

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[194] Clapp, J. and Helleiner, E. (2012) 'Troubled Futures/The global food crisis and the politics of agricultural derivatives regulation' *Review of International Political Economy* 19 (2): 181-207.

[195] Meyer, Gregory. (2010) "Regulators: US bodies hope for international co-ordination in wake of reform bill" *Financial Times.* 01 June, p.5.

Despite the diminished stature of the large Wall St. banks and the SEC caused by the crisis, legislative actors in the financial services committee opposed to reform were also successful in introducing enough ambiguity into the house's draft legislation. This ensured that the Treasury Dept's efforts to embed more regulatory authority for the CFTC in the bill would be deferred. This also left a considerable amount of discretion for regulators downstream during rule-making. As a result, a key compromise was worked out between the two committees on derivatives, reconciling the two key interests of Wall St. (securities) and Chicago (futures), thus allowing for the passage of the House's draft bill on December 11, 2009.[196] Despite its expanded authority however, the now ascendant CFTC would not be granted oversight of CDS, one of the most politically contentious components of crisis-induced reform.[197]

The Scope of Reform and Privileged Actors

The considerable ambiguity embedded in the early house draft also created significant uncertainty for the NFCs or buy-side firms that utilized derivatives for their day-to-day business. While not ascendant to the same extent as the exchanges who would directly benefit from reform, the shifting institutional landscape of OTC reform and the huge sudden influx of lobbying by non-financial industry groups helped bolster

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[196] Braithwaite, Tom. (2009). "Moderate Democrats cloud Obama reform" *Financial Times* 8 Dec. 2009. P.2. For the legislative text in the US see: 111th Congress (2009-2010). H.R. 4173-Dodd-Frank Wall St. Reform and Consumer Protection Act. <https://www.congress.gov/bill/111th-congress/house-bill/4173/text >For the roll call vote on house bill see: US House of Representatives. (2009). "Final Vote Results for Roll Call 968" H.R. 4173 *The Wall Street Reform and Consumer Protection Act of 2009*11 December 2009. <http://clerk.house.gov/evs/2009/roll968.xml>

[197] Given that the underlying in CDS contracts are not associated with things like commodities (which futures are traditionally based on) or even swaps for financial indices like interest or exchange rates, it therefore seems from appropriate an analytical standpoint that a securities regulator (whose historical role was associated with securities tied to public firms) should oversee these types of derivatives.

the ability of these firms to affect regulatory outcomes[198]. As noted above, the early versions of the US draft bill afforded regulators considerable discretion further downstream in the policy process. This discretion would allow them to designate who was a major participant in the markets for swaps, as well as the subsequent risk premium that they would be forced to pay if they wished to continue doing business as usual. Therefore, reformers' preference was to force transparency on the large investment banks and their derivative dealing subsidiaries who they saw as responsible for causing the crisis. However, the uncertainty this created touched off policy debates about scope of the reform effort. This entailed holding those responsible for the crisis to account, while also limiting the economic impact for actors who used derivatives to hedge their financial risk.

No sooner had it became clear that any subsequent legislation would preserve discretion for regulators, that NFCs started using their newfound influence to affect the reform effort. They lobbied Congress aggressively arguing that their use of OTCs was legitimate, because it helped them to hedge their exposure to volatile international markets beyond their control. In doing so, they sought regulatory exemption from the bill's clearing requirement. At the early house financial services committee hearings, Representatives from these firms testified to legislators that mandated central clearing would ultimately create higher transaction costs in their supply chains. This tactic played out in the EU as well, as industrial companies justified their request to officials for a regulatory exemption from any clearing mandate by arguing that they had not been directly responsible for causing the crisis. This was an idea that was gaining significant

[198] Pagliari, Stefano and Kevin Young. (2013). "The Wall-Street-Main Street Nexus in financial regulation" in *great expectations slow transformations.* Manuella Moschella and Eleni Tsingou eds. UK, ECPR Press pp.125-148.

traction on both sides of the Atlantic. In a period of economic contraction, policy-makers and officials didn't want to exacerbate what was quickly becoming a global economic downturn. The net effect was that these exemptions would significantly limit the scope of who would be captured by the new regulatory regimes. For example, in the US Democrats initial assessments of the House Bill were critical that it exempted nearly half of the $600 bn, of the outstanding derivatives trades.[199]

Newly ascendant regulators however, initially resisted NFCs pleas for a regulatory exemption from the clearing requirement. As discussed above, the CFTC stood to gain a significant amount of authority over the large swath of derivatives transactions through its congressional mandate. As we shall see, this institutional shift would have significant implications for the international relations associated with the global OTC market. Before the reconciliation of the House and Senate versions of the bill however, the newly sworn-in chair of the CFTC Gary Gensler took a hard line against the NFCs effort telling a conference of the Futures Industry Association that any exemptions from Congress should be limited to non-financial entities using swaps to hedge against commercial risks. [200] This argument; that any large player in the market-be they banks or otherwise-taking large and risky positions should not be exempt from any resulting legislation, was an early nod by regulatory authorities to the issue of position limits.[201] Ultimately, the hard line taken by regulatory reformers at the time would have the effect of creating even greater uncertainty for firms who feared being caught up in what they

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[199] Reich, Robert. (2010). "Why Obama Must Take on Wall St." *Financial Times,* 13 Jan. 2010. P.11.

[200] Braithwaite, Tom (2009). "Tug of war over financial reforms in US" *Financial Times,* 22 Oct. 2009 P.3.

[201] Engle, Robert. (2009). "Scope remains to circumvent US bill on OTC derivatives" *Financial Times* 22 Oct. 2009 P.24

perceived to be a punitive quest by policy-makers to regulate anyone but the smallest actors to future OTC trades.

OTCs and the End of the Bipartisan Consensus

The draft legislation process in the House also helped delineate the partisan nature of financial reform, particularly as it pertained to OTCs. For example, the backdrop for punitive regulatory policy-making in the US was the increased political salience triggered by the crisis as well as the populist sentiment it engendered on both sides of the political aisle. This sentiment was fervently picked up by legislators and contributed-at least on te surface-to the surprisingly bipartisan support for regulatory reform in the US. The bill, as it was initially structured, even saw a consolidation of the US regulatory system by delegating authority to a single prudential supervisory body. However, the issue quickly devolved into partisan politics with OTCs becoming one of the main sticking points between the two parties. While Republicans were generally supportive of the bill, they nonetheless began pushing back against Democrats on the details in the draft focusing on derivatives. As Bob Corker (D-TN) stated at the time, “I’m afraid we’re moving towards a partisan process,[…] I think that’s where we’re headed”[202]. In short, the politics of financial reform in the US was beginning to undermine the crisis-induced bipartisan consensus in congress, with supporters and opponents of OTC reform falling increasingly along partisan lines.

Despite their diminished status, private market actors were still able to affect the trajectory of financial reform in the US. With the passage of the House Bill, it became

[202] Braithwaite, Tom & Clive Crook (2009). “Senate to push own finance reform” *Financial Times* 2 Nov. 2009 P.1.

apparent that the financial reform effort being produced by Congress was to going to be weaker than initially envisioned. This was evident in the House bill which as written would exempt nearly half of the $600 bn in derivatives trades. One explanation was that the populist response to the crisis that had created the initial pressure for legislators to reign in Wall ST., was now waning. As former Labor Secretary under the Clinton Administration Robert Reich said at the time, "A major tenet of US politics is that if politicians wait long enough, public attention wanders"[203]. The public's declining political salience for financial reform was understandable given that voters were focused on the 7 million jobs that had been lost since December 2007, with 85,000 jobs lost in the month that the House passed the initial draft bill. For US legislators supporting the status quo, this created a rationale for limiting the economic brunt of reform. Another explanation was the lobbying influence of market actors. In the year up until November 2009, Wall St. firms had contributed $42mn. directly to legislators from both parties in the House and Senate banking committees as well as House/Senate leadership. With regulatory reform looming, the banks increased their spending on lobbying to $344 million in the first 3 quarters of 2009 alone.[204] In light of the public's waning attention, the economic impact of the downturn and the vast sums of money spent on lobbying by Wall St. firms, some had suggested that the bill's passage in the house was far from assured.

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[203] Reich, Robert (2010). "Why Obama must take on Wall St." *Financial Times.* 13 Jan. 2010 P.1. For a discussion of the effects of public salience on financial reform see Pagliari, 2013.

[204] Reich, Robert (2010). "Why Obama must take on Wall St." *Financial Times.* 13 Jan. 2010 P.13.

Another scandal associated with unregulated OTCs curtailed Wall St.'s influence on the legislation. As the bill was set to hit the Senate floor to begin deliberations, the SEC brought a suit against Goldman Sachs alleging that the firm had defrauded investors in a complex derivatives trade. This refocused public attention towards Wall St., contributing to the permissive conditions that gave the ascendant Democrats enough leverage to make the eventual passage of the bill likely, despite the large sums spent by the financial services industry.[205] In sum, contingent events associated with unregulated OTCs during the ongoing crisis continued to impact regulatory outcomes.

As the draft legislation moved on to the Senate, legislators found themselves facing institutional friction that threatened to delay the tempo of reform. The Senate had been slower than the House to produce a draft legislation for financial reform. Early drafts were being written in late 2009, but a pre-occupation with the passage of the Affordable Care Act deferred its reconciliation with the House' bill until after March 2010. Much as had happened in the House, OTCs proved to be a main sticking point in the increasing partisan divide over financial reform in the Senate as well. Moreover, Democrats now faced a slimmer numerical majority in the Senate with Republican legislators possessing enough votes to block any subsequent legislation. This represented a structural source of institutional friction in the Senate that now threatened to slow the tempo of OTC reform.

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[205] Bill Clinton, the former US president, said: "At 10 o'clock on Friday morning, I thought the odds were about 60 per cent or 70 per cent this bill would pass." But then "the odds went up to about 90 per cent, because when the SEC brought that fraud suit against Goldman, I think that was the clincher". See: Braithwaite, Tom (2010)." Treasury chief hardens stance on derivatives" *Financial Times* 19 April 2010 P.3. The SEC charged that Goldman had engaged in securities fraud by suggesting that a hedge-fund Paulson & Co. had invested in a deal based on a derivatives contract tied to a collateralized debt obligation known as Abacus 2007-AC1, when in reality the hedge fund had bet against it. See: Partnoy, Frank. (2010) "Wall Street beware: the lawyers are coming" *Financial Times* 19 April 2010 P.9.

In light of the Democrats numerical deficit in the Senate, The Obama administration leaned in to the legislative debate over financial reform with OTCs as a focal point of the discussion. With the successful passage of the Affordable Care Act behind them, the White House now began to pivot more assertively towards bringing greater transparency to OTCs. Up to this point, the administration's two point men for regulatory reform had been CFTC chairman Gary Gensler and Treasury Secretary Timothy Geithner. For his part, Gensler continued to convince the industry on the inevitability of regulation. At a New York derivatives industry conference, he remarked that despite Wall St.'s resistance to the reform legislation being proposed for OTC markets, the legislative push to increase the transparency of derivatives markets was nonetheless necessary to prevent another crisis.[206] Geithner had been critical of the residual ambiguity in the existing House bill (see above) that had circumvented the Treasury Department's push to promote the CFTC as the focal agency for OTC reform. He assessment at the time of the bill in the Senate was that it stood to bring transparency to the opaque world of derivatives contracting.[207]

Ironically, the Republican leadership in the house and Senate pushed back against the Democratic-led legislation on ideological grounds suggesting that it would amount to a guarantee of future government bailouts for the financial sector. Furthermore, Saxby Chambliss, The ranking Republican member in the Senate Agriculture committee

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[206] Grant, Jeremy. (2010) "Wall St. 'allergic to OTC changes" *Financial Times* 11, March 2010; p.3.

[207] Geithner, Timothy (2010). "How to prevent America's next financial crisis" *Washington Post* 13 April 2010. <https://www.washingtonpost.com/wp-dyn/content/article/2010/04/12/AR2010041203341.html> Accessed 20 April 2020.

accused both Geithner and Gensler of specifically politicizing the process of OTC reform. With completion of the Senate draft bill looming, the more likely explanation for their opposition however, was that it would disrupt the status quo for the entrenched investment banks. For example, the proposed mandate in the draft bill to bring more OTCs onto monitored exchanges threatened to loosen the broker-dealers' existing grip on the market. This also helps explain the significant resistance Geithner was encountering from Wall St. to the CFTC's reform efforts. The political impasse with Republicans saw President Obama himself wading into the policy debates for OTCs, calling for a "a strong mechanism to regulate derivatives. [...] We need to get that [market] into daylight"[208].

Democrats in the Senate, utilized their control of the Agriculture committee to steer the direction of OTC reform in the draft legislation. Republican legislators in the Senate had also been critical of the effect that mandatory exchange-trading and clearing would have on the competitiveness of U.S. financial firms, as the large interdealer OTC brokers they represented now stood to lose control of the market they had once lorded over. [209] Additionally, there were some Democratic Senators who were critical of the Senate's bill as written, given that it would have created a regulatory loophole from the

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[208] Fifield, Anna. (2010)"Republicans dismiss Obama's plan for crackdown on derivatives" *Financial Times* 15 April 2010 P.3.

[209] CFTC chair Gensler's speech at a New York derivatives conference in March had called for increased post-trade transparency stating that "The only parties that benefit from a lack of transparency are Wall Street dealers," "Right now we have a dealer- dominated world, and that nearly drove us off a cliff." See: Van Duyn, Aline (2010). "CFTC urges end to derivatives secrecy" *Financial Times, 9 March 2010.*

clearing requirement[210]. Like its counterpart in the house however, the Agriculture committee in the Senate was newly empowered by its linkages to both the ascendant exchanges as well as the NFCs who fell under its purview. Despite the opposition, the Committee chair Sen. Blanch Lincoln (D-AR) successfully pushed for a provision (dubbed the Lincoln amendment) that would force banks to spin-off their swaps desks- away from their deposit-taking divisions. This move would, in effect, remove the government-backed insurance guarantee for any risky speculative behavior by market participants. As a result, the draft that emerged from the Senate Agriculture committee in April 2010 was in some ways, more stringent than the House version in that it would force more swaps trading onto exchanges. Despite their diminished capacity to influence reform, the large investment banks pushed back echoing Republican legislators that the bill represented a threat to the US' competitiveness in financial services. JP Morgan Chase' finance chief Michael Cavanaugh was critical of the Lincoln amendment, "We are on a dangerous path. This change for the US banks alone will make the US financial system less competitive when compared to its international peers"[211].

The Lincoln Amendment as written, would contribute to the partisan gridlock that threatened to block the passage of the Senate bill. Chris Dodd, the Senate banking committee chairman and lead Senator for the Democrats' financial regulatory reform effort attempted to craft a compromise in the Senate bill by drafting a less onerous

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[210] Sen. Maria Cantwell (D-WASH) had suggested that the bill created a loophole from the clearing requirement. See: Braithwaite, Tom (2010). "Final vote nears on financial reform" *Financial Times* 21 May 2010 P.4.

[211] Braithwaite, Tom & Francesco Guerrera. (2010). "Democrats delay reform legislation" *Financial Times* 20 May 2010 P.7.

amendment. The changes would have delayed for two years banks' dealing in derivatives for their own account. This would in effect, kick the can down the road-leaving regulators significant discretion on whether or not to implement the plan. An expected May cloture vote fell 3 votes short of the 60 necessary to have ended Senate debate on the proposed reforms.

The debate over OTCs in the Senate now brought legislators' temporal preferences for reform to light. Several Democrats had defied their party's leadership over concerns that the bill didn't go further in reforming US finance, adding that it gave the banks more time to make their case with legislators.[212] Maria Cantwell (D-WASH) was critical of the language in the bill as well, which she believed allowed a loophole from the clearing requirement for derivatives.[213] Furthermore, she had opposed the cloture vote on grounds that the Senate had not yet voted on an amendment that would force derivatives to be traded through CCPs. Her opposition to the bill however, was relatively minor compared to the majority of Democratic Senators who were comfortable with it as written. Therefore, the nature of the debate over the tempo of legislative reform in the Senate reflected the idea that it gave the banks and their Republican interlocutors more time to veto the bill by portraying it as an inherent risk to the market. However, reformers' need to make haste was attenuated by a slower tempo that would also allow Democratic reformers more time to toughen the bill even further. In light of this relative

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[212] Three Democrats voted against the cloture with two Republicans supporting.

[213] Braithwaite, Tom (2010)."Final vote nears on financial reform" *Financial Times* 21 May 2010 P.4. Cantwell had also drafted an amendment to the Senate bill that would have reinstalled Glass-Steagel the Depression era legislation that mandated a clear separation between commercial and investment banking.

compromise over the requisite tempo of the draft legislation, the Senate passed its version of the bill in late May.

A congressional conference to reconcile the disparities between the House and Senate versions of the bill, once again saw the newly empowered Agriculture committees affecting the course of legislation. As chairs of the agriculture committees in the Senate and House, both Blanche Lincoln and her counterpart Colin Peterson respectively, controlled the levers of power in the conference reconciliation process.[214] However, Republicans and the financial industry were not without their own sources of institutional support as both the Federal Reserve and Federal Deposit Insurance Corporation (FDIC) were opposed to the Lincoln amendment. This was because the amendment-like the Volcker rule-forbid investments in hedge funds or proprietary trading by deposit-taking banks, which had allowed them to compete with the investment banks in the decade since the repeal of Glass-Steagel.[215] With strong institutional support from the FED and The FDIC, both the amendment and the Volcker rule remained primary sticking points that could potentially block passage of the bill. As a compromise to win over recalcitrant legislators, both initiatives were relaxed allowing for passage in the Senate by a vote of 59-39. President Obama then signed into law, the Dodd-Frank Wall St. Reform and Consumer Protection Act on 7/21/2010. The aspects addressing OTCs and derivatives reside specifically within Title VII-entitled the Wall St. Transparency and Accountability

[214] Politi, James (2010)."Congress poised for final push" *Financial Times* 24 May 2010 P. 8.

[215] For the political developments associated with the Financial Modernization Act of 1999 which repealed Glass-Steagel as well as amended the Bank Holding Company Act of 1956 thus allowing commercial banks to enter the securities and insurance business and vice versa, see: Suarez, Sandra L. and Robin Kolodny (2010). "Paving the Road to 'Too Big to Fail': Business Interests and the Politics of Financial Deregulation in the US" *APSA 2010 Annual Meeting Paper.*

Act. All of the G20's primary pillars for OTC reform that were embedded within the initial draft by the House Financial Services committee were included in the final legislation.

Veto Efforts During Rulemaking

The next section begins immediately following passage of Dodd-Frank as US regulators embarked on the rule-making process. While this required a considerable amount of technical issues to be considered, this was by no means a purely technocratic process. Rather, Dodd-Frank's passage was more of a prelude of things to come than an end to political contestation. The domestic sequencing of global OTC reform consistent with US preferences that we saw in the last section had delegated authority to the CFTC to now implement OTC reform through the rule-making process. However, any residual ambiguity in Dodd-Frank CFTC's new status as lead regulator also meant that any veto efforts to impede the process of OTC reform were now aimed squarely at the fledgling agency.

The first aspect addressed here was that despite the ascendant CFTC's considerable discretion to oversee the US effort to implement OTC reform, the agency otherwise lacked the regulatory capacity to do so. Moreover, as regulators pressed forward with developing rules for OTCs, the implications of the US' domestic sequencing came into sharper focus as well for private market actors who might bear the costs of these proposals. However, the deliberative nature of regulatory rule-making in the US overtaxed the CFTC's meager capacity to handle the deluge of communication from firms seeking regulatory exemptions. This meant that despite the Wall St. banks diminished status, they would still see be able to introduce friction into the regulatory

reform process. Furthermore, their Republican interlocutors in Congress also benefitted from their newfound control of the Appropriations committee, through which they could impede the commission's ability to develop its own regulatory capacity by depriving it of funds. This multi-pronged veto effort took place against the ideational backdrop of crisis-induced reform in the last section as contestation ensued over the requisite tempo of OTC reform.

Diminished Regulatory Capacity

In Dodd-Frank, Congress had instructed the CFTC and SEC to begin implementation by July 2011 giving them over a year to draft rules for swaps. As noted above, the passage of legislation meant that Congress would delegate the bulk of regulatory authority for OTCs to the CFTC, the newly ascendant regulatory agency whose profile had risen considerably during the crisis. The disparities between the commission's new found policy-making relevance however, and the limited resources it had to oversee the huge OTC market were considerable.

Even before the passage of the legislation, Senior officials in Washington had warned of the CFTC's dearth of regulatory capacity.[216] The fledgling commission had long operated in the shadow of the better-funded SEC in terms of its expertise, organizational structure and technology. The fear was that its limited capacity would ultimately impede its ability to fulfill its Congressional mandate. Furthermore, the CFTC

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[216] Meyer, Gregory. (2010). "Watchdog fears overwhelming pressure from bill" *Financial Times* 24 May 2010, P.8. Gensler had noted at the time that the commission's limited resources were already overwhelmed with a series of "Ponzi scheme" case probes in oil and silver markets from 2008. Republican commissioner Scott O' Maila at the time warned that "This agency is about to be hit with a tsunami of trade data" noting the agency's antiquated approach, as it still received account information by fax and had to enter it manually.

would now be responsible for overseeing a market that was ten times larger than its regulated counterpart, with a budget approx. 1/4 the size of the SEC's.[217] In an effort to boost the commission's regulatory capacity, chairman Gensler had requested an additional $90mn. from Congress to expand the commission's staff from 400 to 680. The expansion was particularly costly given that the regulatory agency was forced to compete with Wall St. for lawyers trained in complex financial rule-making and implementation. On its own, the CFTC would have to draft at least 30 groups of rules before the Congressional deadline and another 20 or so that would require joint rule-making efforts with the SEC. Even with the additional staff Gensler noted that this would still be difficult to achieve given that, "We need about 60% more people even though we're taking on seven times as much volume"[218].

As the under-funded CFTC began the rule-making process, Dodd-Frank's residual ambiguity was a source of significant uncertainty for firms. Of particular concern was which firms would be subject to its new swap dealer/MSP designation. The initial statements coming from the CFTC's chairman at the time however, did little to reassure them. Gensler pointed to ISDA data, identifying at least 75 banks which would have to be registered to deal in swaps.[219] In addition to existing large swap dealers, another 20-30 new entities including interdealer brokers, trading platforms, and information providers

[217] The SEC had an annual budget of $1bn while the CFTC's was $261 mn.

[218] Meyer, Gregory. (2010). "Watchdog fears overwhelming pressure from bill" *Financial Times* 24 May 2010, P.8.

[219]This consisted of 25 global firms, 25 non-US banks trading in the US & 25 other US-based banks.

would be subject to the new designation.[220] Gensler had suggested that taken *in toto,* the new swap dealer designation could potentially apply to more than 200 companies.

As ascendant regulators attempted to exert their authority over the market, private market participants opposed the economically punitive aspects of reform while defending their legitimate use of derivatives for hedging. Any firms labeled as an MSP, would have to show that they retained capital in their balance sheets (defined by a given threshold), as well as posting significant collateral to cover any potential losses from derivatives. However, the idea of being forced to post more cash against trades was a bridge too far for large NFCs given the increased costs of doing business. Companies like Boeing and IBM pushed back against the move by lobbying aggressively to escape the MSP label.

These firms also found willing defenders in newly empowered Republicans who had recently won control of the House in the Congressional mid-terms. As the party's leading contender for chairman of the House financial services committee, Spencer Bachus (R-AL) continued pointing to the idea of legitimate hedging. He insisted that NFCs using derivatives to hedge, should not have to post increased margin and cash collateral against their trades as doing so would create an excessive financial burden. Gensler sought to assuage the legislator's concerns by insisting that only a limited number of NFCs would face the most financially onerous regulations on derivatives trading.[221] The SEC joined the CFTC, asserting that very few parties would be caught by

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[220] Aline van Duyn (2010) "Swap dealer' tag plan for 75 banks" *Financial Times* 17 Sept. 2010, P.22.
[221] Van Duyn, Aline (2010). "CFTC urges end to derivatives secrecy" *Financial Times, 9 March 2010; P.22.*

the major swap participant rule.[222] In sum, the persistent ambiguity over the issue of who exactly would have to pay higher costs associated with clearing and whether this would apply to legitimate derivatives users, was still a persistent source of institutional friction for OTC policy-making and its attendant politics.

In contrast, the issue of how swaps were to be traded was not politically contested given that the large investment banks on Wall St. were now rule-takers. The Dodd-Frank legislation contained language that any standardized swaps should be traded on electronic exchanges referred to as SEFs. However, what was distinctive about the US' early approach to SEFs was that they would use a combination of traditional voice broking as well as new electronic systems.[223] The effect that this would have is that SEFs would now be an third-party intermediary between the banks/dealers and their buyside clients, namely hedge funds, managers and corporations. In turn, banks would have to direct their prices to the SEFs who would now transact swaps between these clients and the sell-side. Initial assessments of how this new regime of financial regulation would negatively affect the profits of the 8 largest banks in the US were between $19.5bn and $22bn.[224] The analysis assumed that a significant portion of bank activity would move towards clearing houses as the additional transparency engendered by Dodd-Frank cut the banks' margins in half. Additionally, the reforms would affect banks historical broking services model for clients that wanted to trade derivatives on traditional exchanges. This would give the

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[222] Braithwaite, Tom. (2010)."Republicans urged to protect funding for futures watchdog" *Financial Times,* 22 Nov. 2010, P.2.

[223] Voice broking consisted of banks who would market swap prices on their computer screens directly to clients over the phone.

[224] Braithwaite, Tom (2010). "New rules set to hit profits at big banks, says S&P" *Financial Times,* 3 Nov. 2010, P.20.

ascendant exchanges themselves a key role as OTCs were now brought into clearing houses.[225] Nowhere do we see officials openly challenging this restructuring of the existing trading models utilized by banks, quite simply because to do so would have been anathema for legislators in light of the populist animus sweeping Washington D.C. towards all things Wall ST. at the time. In short, without a Congressional defense for its existing trading model, banks had no other option but to contemplate the impact of reform on their existing business models without a direct political challenge to CFTC rule-making.

Challenging The Tempo of Reform

As the differences between the two early efforts at rule-making demonstrate: If the regulators were the primary agents associated with rule-making, then Republicans and the Wall St. banks were the actors that utilized their institutional resources to create friction as they sought to impede the rule-making process. As we saw, the increasingly populist response towards the financial crisis mitigated the ability of the Wall St. banks efforts to directly block reform. This in turn, also prevented Republicans in Congress from openly defending the banks' efforts to do so. While the G.O.P. had just taken control of the House in the November 2011 mid-terms with the Senate and Executive branch still firmly in Democratic control, they were unable to overturn Dodd-Frank directly.

[225] NYSE/Euronext chief executive at the time Duncan Niederauer's stated that the US reform effort and its focus on central clearing represented a business opportunity for the the firm as it sought to establish two new clearing houses in 2012. His initial assessment of reform was that "the Dodd-Frank Act will bolster our growth in derivatives". See: Mackenzie, Michael (2010) "NYSE Euronext surpasses second-quarter expectations" *Financial Times,* 4 Aug. 2010, P.16.

However the political shifts occurring in Washington that fall saw Republicans utilizing their newfound power in the House to impede the law's implementation in several ways. First, through their control of the House appropriations committee, they sought to undermine the regulatory capacity of the agencies tasked with creating rules for OTC reform by starving them of funds. This would have significant implications for the newly ascendant but already under-funded CFTC, now tasked with overseeing the bulk of the OTC market. Secondly, Republicans in the House committees directly contested regulators' efforts to draft rules for derivatives while challenging ideas about the appropriate tempo of reform during rule-making, an argument echoed by pro-industry groups as well. Finally, Republican legislators used the courts as an institutional resource to veto reform by legally challenging the CFTC's authority arguing that regulators went beyond their mandate as delegated by Dodd-Frank.

What follows is illustrative of how the tempo of reform was a key point of contention as actors on both sides of reform utilized competing ideas about how the process should proceed during rule-making. For ascendant regulators and their supporters in Congress, time was of the essence in light of looming deadlines and the need to make haste given the public's waning salience for financial reform. Moreover, the political contestation that occurred during this time period was largely a function of Dodd-Frank's residual ambiguity in prescribing how the process should ensue. This ambiguity gave marginalized actors institutional opportunities to engage in a process of deliberate incrementalism to create friction. Despite their inability to directly veto specific reform initiatives, in the low salience world of technocratic rule-making, they could still challenge the trajectory of policy reform.

From the outset, actors in the US intent on delaying the rule-making process, employed a multi-pronged attack that utilized institutions to stymie the efforts of regulators and delay the trajectory of OTC reform**.** The first prong consisted of Republicans legislators starving the regulatory agencies of funding in early 2011. As we saw above, the disparities between the annual budgets of the two primary agencies overseeing financial reform were considerable from the outset. The prospects this had for the CFTC's regulatory capacity were all the more so given that it would now oversee the lion's share of the formerly unregulated OTC market. Moreover, unlike federal bank regulators, the SEC and CFTC both lack an independent source of funding leaving them limited to levying fines and fees to cover their costs.

As rule-making began, regulators were inundated with public commentary by firms-from both the buy-side and sell-side whose use of derivatives would be affected by any rules they promulgated. This overtaxed the CFTC's already meager resources.[226] Republicans then sought to impede the process by voting successfully in the House to reduce both agencies funding in the proposed 2012 budget, cutting the CFTC's funding by 1/3 and stripping $25 million from the SEC.[227] They justify the proposed cuts on ideological grounds citing that the proposed increases would contribute to the deficit (that increased in the wake of the crisis), and which they contended would sink the economic recovery underway. This argument was a consistent thread Republicans would return to time and time again in their efforts to veto the implementation of reform. It also had the

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[226] For the Wall ST. banks, flooding the rule-making process with thousands of letters was a relatively low-cost way of slowing down the regulatory process and one that allowed them to maintain a low public profile in light of the populist sentiment that had crept into Washington policy debates.

[227] Editorial (2011).“Funding regulators” *Financial Times,* 25 Feb. 2011, P.10.

added benefit of giving them ideational cover from having to defend directly Wall St and financial institutions by citing what they pointed to as Democrats' poorly designed reform effort at the expense of the broader economy.

For their part, Democrats in the House pushed back against veto efforts to starve the agencies of funds. Democratic Representative and cosponsor of the Dodd-Frank Act-Barney Frank refuted the Republican argument that bolstering the agencies' budgets would impede the economic recovery, noting that the sums requested by the agencies were marginal relative to the overall budget and that there would be a significant 'traffic jam' for regulators if they didn't get additional funding. Frank, also called out Wall ST. banks who were indirectly utilizing the legitimacy of ascendant non-financial firms as cover for their plans to affect implementation stating, "A major attack is coming from the financial institutions who are trying to roll back the derivatives legislation," he said. "They are using the end users as stalking horses*"*[228].

From the outset, competing ideas about the tempo of implementing Title VII of the Dodd-Frank Act in the U.S. also contributed to the political contestation laying out the terms of engagement for actors during the rule-making process. For their part, the Democrats in Congress sought expediency as too many delays would inevitably result in

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[228] Braithwaite, Tom (2011). "Frank set for fight to defend regulatory overhaul" *Financial Times.* 07 Jan 2011:5. This intersection between the large financial institutions of Wall ST. and end-users of derivatives, has been identified in the literature on OTC reform as having significantly influenced the implementation of OTC reform in the U.S. See: Pagliari, S. & Young, K. (2013) 'The Wall-Street-Main Street Nexus in Financial Regulation: Business Coalitions Inside and Outside the Financial Sector in the Regulation of OTC Derivatives'. *Great Expectations, Slow Transformations: Incremental change in post-crisis regulation. Manuela Moschella dn Eleni Tsingou (Eds.)*Ch.6 pp. 125-48. Colchester, UK ECPR Studies Press.

the decreased political will to hold Wall St. accountable.[229] This expediency was fairly unambiguous in the Dodd-Frank Act which set out a clear timeline mandating that regulators should complete the rule-making process within a year's time. However, Republicans and the financial industry firms challenged their ability to do so by inserting friction into the rule-making process. In December 2010, eleven bank and financial industry groups asked the CFTC and SEC to reshuffle the rule-making sequence. In doing so, they expressing their preference for regulation that would be phased in over time and asking that the deadlines be extended.[230] Even at this early stage of OTC reform, pro-industry groups sought to veto the rule-making process, criticizing that its rapidity came at the expense of its fairness and quality.[231] They also added that the increased tempo of reform would hinder the US economic recovery and that such hastily crafted rules would risk lengthy court challenges with the latter proving particularly prescient (see below). Ultimately, they suggested that Congress should hold hearings to deliberate the tempo of the rule-making process.

The political dynamics between legislators and regulators in the oversight hearings that resulted, portrays the particularly active role that Republican members in the House took in trying to veto the Title VII rule-making process. In doing so, they continued to echo the industry's concerns about the rapidity of the rule-making process. That spring, with the July 21 deadline looming for the agencies to complete their rule-making, Scott Garrett (R-NJ) chairman of the House Financial Services Subcommittee

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[229] Braithwaite, Tom; & Aline van Duyn. (2011).“Dodd-Frank one year on: why regulators are likely to miss July deadline” *Financial Times,* 4 May 2011, P.30.

[230] Meyer, Gregory. (2010). “Busy bureaucrats 'inundate' traders” *Financial Times,* 22 Dec. 2010, P.28.

[231] The Committee on Capital Markets Regulation, a research group cited by Meyer.

sent CFTC chair Gensler a letter. In it, he rebuked the speed with which the CFTC was drafting its rules; as by this point it had already drafted more than 50 derivatives rules, despite efforts to diminish its capacity. The letter also served as a proxy for industry concerns, posing a series of detailed questions that asked Gensler to clarify the CFTC's position on a series of technical matters. Garret ultimately criticized the commission's sequencing for drafting rules.[232] In doing so, he chided the commission's public commentary process as insufficient, given that it only gave the public 60 days to respond to complex proposals which in some cases ran over 100 pages in length.

By this point, the CFTC had held over 500 meetings with Wall ST. executives, their lobbyists, and consumer advocates, even accepting late comments when it deemed appropriate. Furthermore, at a subcommittee hearing in February, Spencer Bachus (R-AL) now the chairman of the full House Financial Services Committee, had held the public record period open for an additional 30 days extending the deadline for firms to voice their concerns with the Commission's proposals.[233] Rules for entity and product definitions, the end-user exemption, margin requirements, and position limits were all particularly controversial and contributed to the political impasse. Unsatisfied with the

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[232] For example Garrett was critical of the CFTC's drafting of standards for swaps dealers before identifying which firms would qualify as such. See: US House of Representatives (2011). "ASSESSING THE REGULATORY, ECONOMIC, AND MARKET IMPLICATIONS OF THE DODD-FRANK DERIVATIVES TITLE" *HEARING BEFORE THE COMMITTEE ON FINANCIAL SERIVCES.* U.S. HOUSE OF REPRESENTATIVES, one hundred twelfth Congress First Session, 2 Feb. 2011. <https://financialservices.house.gov/uploadedfiles/112-5.pdf> Accessed 21 Apr. 2020. Also: Waddell, Melanie (2011)"Rep. Garrett Prods CFTC's Gensler on Dodd-Frank Derivatives Rules" *Think Advisor* 3 Jun. 2011. <https://www.thinkadvisor.com/2011/06/03/rep-garrett-prods-cftcs-gensler-on-dodd-frank-deri/?slreturn=20190824162207> Accessed 21 April 2020.

[233] Protess, Ben. (2011)."Republicans Seek to Slow Agency's Work on Derivatives Regulation" *New York Times.* 8, March 2011. <https://dealbook.nytimes.com/2011/03/08/republicans-seek-to-slow-c-f-t-c-rule-writing> Accessed 21 April, 2020.

rapid pace of reform and Gensler's response to Garrett's request (by June 3 Gensler still had not responded), Republicans actors in the House Financial Services Committee passed legislation which would mandate a delay in the implementation of derivatives regulations as prescribed by Dodd-Frank. However, Democratic control of the Senate precluded a broader legislative initiative to impede the rule-making process, making this Republican effort in the House, largely symbolic.

It should be noted that not all of the delays associated with rule-making and the implementation of Dodd-Frank were the deliberate efforts actors trying to veto OTC reform. Some of the temporal issues *were* attributable to the complexity of doing so under the U.S.' fragmented regulatory system for OTCs. For example, the CFTC and SEC both had different approaches to drafting rules, differences which would ultimately have to be reconciled before a rule could be finalized, then implemented.[234] These differences, as well as some of the latent ambiguity within Dodd-Frank itself contributed to turf wars over which agency had discretion to draft a given rule. In short, the preservation of the bifurcated financial regulatory system had unintended consequences downstream during the implementation stage of rule-making.

Moreover, not all efforts to delay the rule-making process fell along partisan lines. For example, a CFTC inspector general's report concluded that the CFTC had moved too

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[234] Both agencies had recently set out which products would constitute a swap and which would fall under the designation of security-based swap, falling under the CFTC and SEC respectively. For example, both the SEC & CFTC had different approaches to drafting the rules for swap-exchange facilities. This contributed to the perception that the main source of delay was attributable to disagreements between legislators and the agencies. According to Kevin McPartland, director of fixed-income research at the Tabb Group (the US capital markets consultancy)"From our studies, the industry says it's as ready as it can be…So to me, the delay is politics". This contributes to the idea that the veto effort to delay rule-making was spearheaded by financial institutions and not the buy-side of which the fixed-income side of the industry is representative of. See: Demos, Telis & Michael Mackenzie (2011). "Trading reform 'will take years to complete" *Financial Times* 14 Nov. 2011, P.22.

quickly without conducting adequate cost/benefit analyses on the impact of their proposed rules, resulting in a one-size-fits-all approach. There was enough bipartisan support from Democrats to facilitate the successful passage of H.R. 1840, which would require the CFTC to conduct such an analysis before promulgating any regulations or rules.[235] This would eventually prove beneficial to actors trying to impede implementation through the courts, the second prong of attack that we focus on below.

Meanwhile, NFCs continued to be a source of legitimacy and coalitional support for congressional legislators on both sides of the aisle. A bipartisan coalition of Chairs from the House and Senate Agriculture, House Financial Services, and Senate Banking Committees wrote to the regulatory agencies expressing concerns that end-users should not be swept up in the new regulatory regime under Title VII.[236] Some Democrats had agreed with Republicans and industry commentators that end-users shouldn't bear the brunt of the costs associated with derivatives reform. As a result, they joined them in arguing to regulators that they should be exempt from the clearing requirement. The CFTC responded that even if they were exempt, NFCs would likely face higher costs for hedging passed on to them by swap dealers.[237] Regardless, this bipartisan effort by the

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[235] Joining Congressmen Mike Conaway (R-TX) & Patrick McHenry (R-NC) in drafting the House proposal were Democrats Mike Quigley (D-IL) & Leonard Boswell (D-IA) See: US House of Representatives H.R. 1840 [Report No. 112-482]-To improve consideration by the Commodity Futures Trading Commission of the costs and benefits of its regulations and orders. 112th Congress 2d Session. <https://www.congress.gov/congressional-report/112th-congress/house-report/482/1>.

[236] Frank Lucas R-OK) and Spencer Bachus (R-AL) and U.S. Senators Debbie Stabenow (D-MI) and Tim Johnson (D-SD) See: US Senate Committee on Agriculture, Nutrition, & Forestry (2011) "Stabenow, Johnson, Lucas, Bachus Send Bicameral, Bipartisan Letter" 07, April 2011. <https://www.agriculture.senate.gov/newsroom/press/release/stabenow-johnson-lucas-bachus-send-bicameral-bipartisan-letter>.

[237] CFTC commissioner Scott O' Malia (R-) responding to the agencies proposed rules on capital requirements: "Either the swap dealer will require commercial end users to post margin to avoid taking a capital charge or they will point to the regulation as a reason to increase the bid-ask spread. "Either way the

influential committee chairs lent legitimacy to Republican efforts in the House and Senate at the time to codify the end-user exemption from margin requirements.[238] In light of such bipartisan support, and with the looming deadline for rule-making under Dodd-Frank fast approaching in the summer of 2011, the SEC and CFTC both issued orders providing exemptive relief to market participants.[239] Non-financial companies however, spent the next year continuing their furious lobbying effort in opposition to the increased costs and margin requirements that forced clearing would eventually entail.

We saw above how actors in Congress sought to exert their veto over OTC reform by defunding the CFTC/SEC to impede their regulatory capacity. We also saw how an aggressive lobbying campaign by Wall ST. firms contributed to overriding the populist-driven bipartisan consensus for OTC reform in the wake of the crisis, giving the discredited financial institutions a presence in Congress to defend their interests. Like the ascendant Democrats during the legislative debates (see last section), Republicans opposed to reform used their new position in the committees to directly oversee the rule-making efforts of regulators. Finally, we saw how the legitimacy granted to ascendant end-users of derivatives in policy-reform debates gave the Republicans ideational cover to launch a broader attack in trying to delay reform. This legitimacy also translated into

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cost of hedging commercial risk for end-users is going up." See: O'Malia, Scott D. (2011). "NOT ALL END-USERS ARE CREATED EQUAL". *Commodities Futures Trading Commission Remarks of Commissioner, Reval Annual Client Conference,* 11 May 2011. <https://www.cftc.gov/PressRoom/SpeechesTestimony/opaomalia-6>.

[238] The companion legislation H.R. 1610 and S. 947 were proffered by Michael Grim (R-NY) and Senator Mike Johanns (R-NE).

[239] Bollen, Brian (2011). "Industry welcomes reform deadline change" *Financial Times* 1 Aug 2011 P.16. Some aspects of Dodd-Frank were to automatically come into effect regardless of the state of rulemaking, hence the exemptive relief by both agencies. However, the disparity in the time allotted to firms were notable in that the CFTC set a sunset clause provision for Dec. 2011, while the SEC's relief could proceed indefinitely until rule-making was completed.

some bipartisan agreement as it related to end-users as well.[240] These efforts were successful in creating pressure for the regulators to delay rule-making, giving firms more time to prepare for the implementation of the new regulations. However, where these methods failed actors had other institutional options; in this case, the US legal system and the courts.

Wall St. Firms, Trade Associations and The Courts

In the last section we saw actors' multi-pronged veto effort towards regulators efforts to implement OTC reform during rule-making. Despite the effect that the crisis had on delimiting their role in the policy process, the large investment banks on Wall St. were still able to affect the rulemaking process by using their considerable material resources to flood the agencies with suggestions during public commentary. In turn, their Republican interlocutors in the House appropriations Committee sought to affect their capacity by starving them of funds. They then framed reform as a broader attack on the American recovery during an economic downturn by pointing to ascendant NFCs to justify their position. These veto efforts were driven primarily by a combination of partisan and ideological reasons.[241] When these mutually reinforcing tactics were unsuccessful, reform opponents turned to the courts to have their preferences realized. As Former House member Barney Frank (D-MA) put it:

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[240] This last factor was especially relevant given that the rulemaking for determining which actors would be subject to the new regulatory regime had not been completed. An argument could thus be made that the significant uncertainty up until this point had contributed to an aggregation of both the buyside and the sell-side due to such ambiguity in rulemaking.

[241] Barney, Frank (2013). "Don't panic -financial reform is coming to America" *Financial Times Op-ed* 4 April 2013 P.7.

> This is where the DC courts come in. Not only do these agencies have to go through comments, the court then grades their work with a strictness that belies conservatives' professed opposition to "judicial activism". On several occasions, DC courts have struck down SEC and CFTC rules, not because of any constitutional problem, but because the conservative judges think the agencies have given too little deference to the financial industry's arguments.[242]

Consistent with Frank's assessment, private market actors had used their relevant trade associations to petition the courts to delimit regulators' rulemaking authority. For example, the International Swaps and Derivatives Association (ISDA) and Securities and Financial Markets Association (SIFMA) initiated a lawsuit against the CFTC in late 2011. Their complaint alleged that the commission had exceeded its legislative mandate by promulgating a rule that would establish position limits in commodity markets. The rule implicit in Dodd-Frank, had been a response by lawmakers to high gasoline prices that were part of a comprehensive surge in the costs of commodities during the crisis. Officials at the time had suspected that these increases were attributable to speculation occurring in commodity futures and swap markets. More importantly, the financial institutions on Wall ST. and their attendant trade associations had spent considerable time and money opposing the proposal by flooding the CFTC with thousands of comment letters. When the commission rejected their arguments on anti-competition grounds, these actors then turned to the bipartisan legislative initiative H.R. 1840 (see above) embedded within Dodd-Frank to sue the agency, arguing that it had exceeded its Congressional mandate.

The effort by private market actors to delimit regulators' authority through the courts proved successful. A US district court judge in Washington sided with Wall ST.

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[242] Barney, Frank (2013). "Don't panic -financial reform is coming to America" *Financial Times Op-ed* 4 April 2013 P.7.

firms in the suit brought by the ISDA and SIFM against the CFTC over its position limits rule. In the ruling, the judge said that the CFTC had failed to heed the Congressional requirement that it first conduct a detailed cost/benefit analysis to establish that the rule was necessary to diminish, eliminate, or prevent excessive speculation.[243] The CFTC's argument to the court was that through Dodd-Frank, Congress had not asked the agency to determine first whether or not a rule was necessary before its promulgation. As noted above, H.R. 1840 was a bipartisan legislative initiative that amended this particular aspect of rule-making for the agencies. Whether or not the CFTC failed to take this into consideration when making its counterarguments in court is unclear. In light of actors various efforts to veto regulators' ability to facilitate rule-making so far, the CFTC's actions nonetheless forced the financial firms to spend its time and money contesting this one rule in the courts. As we shall see below, this would not be the last time a rule issued by the CFTC would be challenged by private market participants on Wall St. acting to veto its rules though the courts.

The courts' ruling in favor of private market actors had induced some friction into the productive conditions experienced by the CFTC as it came on the heels of the close of the first significant phase of rulemaking for OTCs in the U.S. Two months prior to the judicial decision, the CFTC had voted to finalize the definition of a swap. Despite a 4-1 vote among the commissioners for the swap definition rule, the CFTC voted unanimously to exempt from central clearing large NFCs in manufacturing and energy production as

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[243] CFTC chair Gensler defended the rule stating: "The rule addresses Congress' concern that that no single trader is permitted to obtain too large a share of the market, and that derivatives markets remain fair and competitive. I believe it is critically important that these position limits be established as Congress required." Nasiripour, Shahien (2012). "US court rejects 'position limits' proposal" *Financial Times* 29 Sept. 2012 P.19.

well as some small banks and credit co-operatives. Lawmakers had continued calling for such an exemption from Dodd-Frank given that the ambiguity over the issue in the two years since the law was passed was an ongoing source of uncertainty for firms. These votes set the stage for a string of rules by the CFTC pointing to the productive conditions it was now operating within. These included new conduct standards for swap dealers, real-time reporting of swap prices and volumes as well as those for any firm designated as a dealer.[244] Therefore, the court ruling against the CFTC's authority can be construed as delimiting some of the productive conditions the commission was experiencing at the time.

There were two primary ideas that eventually contributed to the end-users success in facilitating an exemption from the more onerous regulatory burdens of central clearing: First, that end-users shouldn't suffer the punitive effects of the new regulatory regime as the Wall St./Main St . nexus was firmly ensconced within the OTC policy community. And secondly, that derivatives used for hedging served a legitimate function for firms in an increasingly globalized world. Recall from the last chapter that the changes to the structure of the global economy induced by the U.S. hegemonic effort to forego a global economic system based on trade in favor of the promotion of a system built on global finance. The long arc of history had now come to the point that the institutional changes transpiring with OTC reform for end-users helped contribute to their efforts in facilitating regulatory exemptions with the CFTC. As we shall see in the next section, the extraterritorial guidance embedded within the CFTC's swaps rules would have negative effects on its role as *de facto* global regulator. This would ultimately impact the efficacy

[244] Nasiripour, Shahien (2012). "US swaps vote triggers reform of global derivatives trading" *Financial Times* 11 July 2012 P.20.

of the US first-mover effort and its attempts to get other regulatory regimes to follow its lead.

Cross-Border Guidance and Fragmentation

The last section highlighted the domestic sequencing associated with implementing the G20 OTC agenda vis-à-vis its attendant politics in the US. In contrast, the next section focuses on the international sequencing effects associated with the US first-mover effort in global OTC regulatory reform. This occurred as a result of a temporal disparity between US OTC reform and other regulatory regimes' efforts, which were moving at a decidedly slower pace. However, this sequencing was also affected by contingent events occurring in the global financial system-namely a series of ongoing scandals linked to cross-border derivatives some four years after the initial crisis began. These contributed to the perception of US officials that the US financial system still remained vulnerable to speculative activity conducted by its globally active investment banks abroad. This in turn, contributed to the permissive conditions that ultimately led US regulators to the conclusion that they needed to promulgate a rule for cross-border swaps. However, this triggered opposition from their regulatory counterparts in Europe and Asia who vehemently resisted the US' extraterritorial rules which in turn, threw off the sequencing of global OTC reform.

Here we start to see the true limitations of the G20's OTC agenda, in that it afforded national authorities significant discretion to implement global OTC reform in line with their own national interests. This discretion eventually began to undermine coordination efforts across regulatory regimes. The result was fragmented markets and regulatory overreach as regulators sought to capture transnational financial activity

conducted in foreign markets that could potentially impact domestic taxpayers at home. Moreover, as we will see below the US' extraterritorial rules largely discredited the idea of regulatory arbitrage, which up to this point had been the lynchpin in global policy deliberations that kept domestic regulators focused on international coordination and the harmonization of OTC reform policy across regulatory regimes. These factors contributed to a transatlantic effort to reset the sequencing of global OC reform through a hastily drafted coordination pact between the US and the EU.

Why Timing and Sequence Matter: The US as First-Mover

The issue of how swaps would be defined would be the most important aspect of rule-making undertaken by the CFTC during OTC reform. As we saw above, how swaps were defined would affect who was considered a major participant in the market and would thus be subject to the more onerous regulatory obligations under Dodd-Frank. However as I address here, the long historic arc of cross-border contracting hadn't simply disappeared with the G20 agreement. Because the CFTC's delegated authority to develop the rule played out in the context of contingent events surrounding cross-border swaps, it would also have significant effects on the international coordination over global OTC reform going forward.

Even before the CFTC's swap rule was finalized, it became apparent that certain elements of the Dodd-Frank Act would have significant extraterritorial implications. These implications would undermine the transparency that the legislation had originally sought to bolster, in line with the G20 OTC reform agenda. For example, a clause in the act required US-based swap data repositories to obtain indemnification from foreign

regulators, as a pretext for sharing market data.[245] This process of shielding US firms from any anticipated losses from foreign counterparties as a result, had the effect of hindering international regulators' efforts to monitor risk in the global financial system. Moreover, the clause was pushed through at the last minute before the Dodd-Frank was signed without any recourse to the committee process in Congress. This eventually undermined the legislation's intended aim of increasing transparency, particularly as it related to cross-border contracting in derivatives.[246]

During the earliest stages of rule-making by the CFTC, there was the perception that that the US' status as first-mover in OTC reform would leave Wall ST. banks at a significant disadvantage competitively. This was because the US effort was significantly outpacing other regulatory regimes. In turn, this affected US firms relative to their European and Asian peers who wouldn't have to comply with rule for central clearing until at least 2012.[247] For example, EMIR-the European OTC draft legislation (see next chapter) wouldn't be passed until July 2012 a full two years after the passage of Dodd-Frank. By this point, the CFTC was finalizing its swaps definition, which would codify the broad contours of the new US regulatory regime for swaps (see next chapter). This temporal disparity in the global sequencing of reform eventually contributed to an incongruity between the global competitiveness of Wall ST. firms as well as the ability of US regulators to act as first-movers in OTC reform. They also go a long way in

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[245] Indemnification is security from legal liability for one's actions.
[246] Macbeth, Stewart (2011). "Dodd-Frank may add to opacity in derivatives market " *Financial Times* 7 Nov. 2011, P.10.

[247] Masters, Brooke. (2011). "Banks and regulators at odds" *Financial Times* 3 Nov. 2011, P.3.

explaining the preferences of investment banks towards inducing institutional friction in the rule-making process, that we saw occurring in the last section.

The CFTC's finalizing of the swaps definition rule in the summer of 2012 triggered an international backlash by other national regulators towards the US first-mover reform effort. For example, as part of its rules on swaps-the CFTC in July of that year had issued proposed rules that would require foreign firms trading with any US institution or overseas affiliate to register with it first. This move would have the effect of extending American oversight to swaps markets beyond US borders.[248] In October, British, French and Japanese finance ministers along with the EU's internal market commissioner sent a letter to CFTC chair Gensler warning him of the negative impact to the global economy of applying its rules extraterritorially. Their fear was that this would fragment the markets as global firms, in lieu of accepting US regulation would likely retreat to their home markets. This confrontation-much like the internal regulatory debates in the US-also focused on the requisite tempo of OTC reform. Despite the CFTC's new global focus, foreign finance ministers pushed the US for more time to implement reform while also defending their current efforts to introduce their own swaps rules. The letter impressed upon the CFTC chair, "We would urge you before finalizing any rules, or enforcing any deadlines, to take the time to ensure that US rulemaking works not just domestically but also globally"[249]. In sum, these international regulatory developments lend credence to the idea that the CFTC's rule-making efforts as *defacto*

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[248] Foley, Stephen (2012) "EU and Japan warn US on swaps" *Financial Times,* 19 Oct. 2012, P.25.

[249] Cited by Foley, P.25.

global regulator, contributed to the intransigence of other national regulators to see it as such.

The international opposition to the CFTC's extraterritorial rule-making encapsulated what had already been mounting evidence about regulatory regimes' different approaches to regulating derivatives. In early 2012, finance ministers and regulators in Asia had begun protesting that the US extraterritorial first-mover efforts in Dodd-Frank conflicted directly with some Asian countries existing laws precluding counterparty disclosure. This threatened to choke off nascent derivatives markets in the region, seen as a new market opportunity for western investment banks. Even prior to the CFTC's swaps definition however, there had been a growing recognition of the different approaches to developing post-crisis OTC reform on both sides of the Atlantic. For example, up until this point the development of the European Markets in Financial Instruments Directive (MiFId-see next chapter) started with a broad set of principles and then proceeded to work down in terms of specificity, with increasing layers of detail. In contrast, the US approach was more reactionary as regulators often promulgated rules in response to particular issues.[250] In short, as global OTC reform was being implemented, the differences between regulatory regimes were becoming clear. The competitive implications of which would eventually threaten to unseat international coordination efforts at global reform.

Extraterritoriality: US gamblers in the City

The reactionary nature of the US approach to regulating OTCs through cross-border rule-making, points directly to the role of contingent events and the extent to

[250] These distinctions were noted by former regulator and international lawyer Richard Frase See: Davis, Phil (2012). "Global standards are still a far-off goal" *Financial Times* 9 April, 2012 P.3.

which these contributed to the permissive conditions actors faced to move with deliberate haste in what was still a largely unregulated market. Recall that in the second chapter, that AIG's role in the crisis had contributed to the idea that any US reform effort for derivatives should include an extraterritorial measure intended to close the 'London Loophole' which challenged the ability of US regulators to oversee American firms operating in foreign markets like the City.

A series of ongoing scandals several years later, pointed to the unfinished nature of global reform. These scandals at the time were related to American and British financial firms whose speculative use of derivatives saw them gambling for outsized profits or by simply engaging in outright manipulation of the OTC markets. In the fall of 2011, the collapse of MF Global was attributed to a futures broker that had placed large speculative bets on the debt of distressed European countries that had been caught up in the EU's sovereign debt crisis.[251] Much as the SEC's reputation had suffered from scandals affecting firms under its remit during the crisis (see above), this event had the effect of subjecting the CFTC-which had oversight for MF Global-for failing to identify problems at the firm. Additionally, the LIBOR scandal in the summer of 2012 also contributed to previously undiscussed issues surrounding OTCs, as the open

[251] It could be argued that OTC reform in Europe was gradually subsumed by the European preoccupation with the sovereign debt crisis of which sovereign CDS played a leading role. This however, would refute the idea that Europe was less reactionary towards OTC reform as the contingencies associated with derivatives linked to sovereign debt created policy initiatives unique to the European case (see next chapter).

manipulation of existing benchmarks used to price derivatives by traders, sent shockwaves through the global financial system.[252]

But it was the scandal that engulfed the American/global investment bank JP Morgan in May 2012 that' signaled to US officials of the continued harm presaged by the main focusing events for OTCs. The London Whale scandal was attributed to a risky derivatives bet made by a trader at Morgan's London desk that resulted in a $6.2bn loss for the firm, reinforcing the perception by public officials in the US of the continued risk to the US' financial system. As a result, it also contributed to increasing the permissive conditions legislators needed to task the CFTC to close the existing loophole. This in turn, facilitated the productive conditions through which the commission was able to promulgate its extraterritorial rule for swaps traders operating abroad to reign in US market actors in the City.[253] The contingent, real world effects of unregulated cross-border derivatives were occurring long after the crisis had started.

The disparity in the tempo and sequencing between the US and EU in implementing their own visions of reform up to this point, had resulted in a continued vulnerability. All of the events above shared a similar feature, namely transnational banks operating across national boundaries with unregulated derivatives contracts. Despite incomplete global reform, the persistence of cross-border OTC contracting led to a series of smaller scandals that affected the perceptions of public authorities in the US that OTC

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[252] The LIBOR scandal brought to light the tampering of benchmark that interest rate derivatives were priced with by a few traders working in conjunction with interdealer brokers. The scandal triggered a response by international regulators led by the CFTC in the US & The FSA in the UK both of which began looking into whether other benchmarks for energy, precious metals and other financial derivatives were similarly susceptible to manipulation. See: Grant, Jeremy (2012). "Singapore caught in the Libor web" *Financial Times* 24 Oct. 2012, P.19.

[253] Ironically, JP Morgan would try to use legitimate hedging in its arguments to regulators the following year during deliberations over the Volcker rule (see below).

reform was a moving target. The London Whale scandal in particular, renewed officials commitment to the US' first mover effort. It also contributed to the permissive conditions that led to the idea that the promulgation of extraterritorial rules was necessary to bring its own gamblers under regulatory oversight. Despite the ascendancy of extraterritoriality as an idea within the US OTC policy community at the time, it was also out of step with the established sequencing of global OTC reform vis-à-vis the G20 agreement. Moreover, its application through cross-border rules for swaps also boldly underscored the seeming incongruity between the international consensus for OTC reform and the pragmatic realities of doing so in the context of the re-assertion of national authority. As we shall see, it continued to hinder US officials in international OTC deliberations with their European and Asian counterparts.

Undermining the G20 OTC Reform Agenda

The sequencing associated with the US first-mover effort to establish extraterritorial authority for OTCs, had the unintended effect of undermining the G20's emphasis on coordination. At a November, 2012 meeting at the CFTC in Washington, regulators from Japan, Europe and Hong Kong voiced concerns to the CFTC that its territorial overreach threatened to introduce considerable uncertainty in financial markets, adding to the threat that transactions could shift to other jurisdictions. Since the initial onset of the crisis, this threat of regulatory arbitrage-whereby market actors seek out the most lax regulatory regime-was, and would continue to be the lynchpin in international policy deliberations for OTC reform. As soon as officials were aware of the inevitability of reform, different actors began to invoke the idea of regulatory arbitrage as a means of

underscoring the risks to coordinated reform if countries and regimes acted unilaterally in implementing their own version of the G20 agenda.

The US' role in facilitating the international consensus that led to the G20 Pittsburgh summit (see last chapter) was a means of legitimating its authority relations with other wealthy countries in light of the crisis. However, through its actions as regulatory first-mover to bring its gamblers under its regulatory ambit, the US began undermining any good will that it had engendered with other industrialized countries in the G20. Its unilateral moves to regulate transnational OTC activity had created opposition by other governments and their regulators seeking to "defend their own patch"[254]. Therefore by extension, the US extraterritorial rule-making had also undermined the sequencing of global reform that it had carefully sought to establish.

What made the US first mover effort at extraterritoriality especially problematic; was that its broad regulatory umbra for OTC activity would now render the threat of regulatory arbitrage as moot. US rules would follow US financial firms, regardless of the home country's regulation where they contracted. For example, a US based firm operating a foreign branch in London could engage in a derivatives contract with two different counterparties in both Europe and Asia. Traditionally, the derivatives trade association ISDA's master contract had resolution provisions in the event of a counterparty default for a cross-border contract. However, these were developed by the private sector in a relatively frictionless pre-crisis world of OTCs. While the intent of the new clearing, trading and reporting requirements of the G20 agenda was to bring transparency to derivatives contracting, it also had the unintended effect of making cross-

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[254] Davis, Phil "Global standards are still a far-off goal " *Financial Times* 9 April 2012, P.3.

border contracting significantly more complex as the discretion afforded to national regulators was now producing a piecemeal of overlapping regulations, helping to fragment the global market. In short the threat of regulatory arbitrage that had been the lynchpin in facilitating harmonized global OTC reform, was now being undermined by the US first-mover effort.

The international sequencing thrown off by the US first mover effort not only rendered regulatory arbitrage moot, it also impacted the viability of US firms as counterparties. Any American company, engaged in a derivatives contract as a counterparty-were now seen as *persona non grata* in the global OTC market. For example, CFTC rules in Asia had come online mandating that Asian firms doing business with US counterparties must first register with the CFTC. At a CFTC sponsored meeting, the Japanese commissioner for international affairs at its Financial Services Agency Masamichi Kono, expressed to chairman Gensler anecdotal evidence that non-US firms were starting to refuse to conduct swaps transactions with US counterparties.[255] The senior officer of post-trading for the European Securities and Markets Authority, Fabriizio Planta underscored how U.S. efforts to regulate overseas derivatives transactions were increasing compliance costs for financial firms. He also complained that duplicative regulation across the two regulatory regimes was making it nearly impossible for actors to enter into swaps contracts. Dutch firms were some of the first to eschew business with U.S. firms. These sentiments were echoed by the private sector as banks at industry gatherings in Asia began to declare their decision not to do business

[255] Nasiripour, Shahien. (2012). "Foreign regulators warn CFTC over wider derivatives reform" *Financial Times* 8 Nov. 2012, P.34.

with US-based banks and other institutions, noting that they would still trade with the US arms of European companies which were exempt from central clearing. Trade associations chimed in as well noting that U.S. rules were beginning to impact the likelihood of who was willing to engage in cross-border trades with U.S. entities.[256] CFTC chair Gensler, in spite of the unified international opposition to its cross-border guidance maintained that it was necessary to do so, citing the persistent threat of cross-border financial activity to the stability of the U.S. financial system-and by extension the American taxpayer. In short, the U.S. first mover-effort and the subsequent focus on extraterritoriality in the form of the CFTC's cross-border guidance threatened to swamp not only the global OTC reform effort, but also the economic viability of U.S.-based firms through their newfound pariah status in global markets.

The Common Path Forward

It was the CFTC's passage of its cross-border guidance, that set off the most contestation with EU officials who sought to create friction as they sought to check US preferences. The CFTC had sought to finalize its rule-making for cross-border OTCs right before an exemption from transaction rules for foreign swap dealers like Deutsche Bank and foreign branches of US banks was set to expire in July 2013. Again actors' ideas about the requisite tempo of reform again proved critical. In April, the chair of the European Securities & Markets Authority (ESMA) in conjunction with the head of the European Commission's department of financial services wrote a letter to CFTC chair Gensler. In it, they urged the CFTC to extend the exemption, citing the G20 pillars lack of international principles for the rules addressing cross-border swaps. EU commissioner

[256] Davies, Paul J. (2013). "UniCredit not trading in OTC with US groups" *Financial Times* 29 April 2013, P. 16.

at the time Michel Barnier, also re-emphasized to Washington the danger of unilaterally imposing US rules on the rest of the world.[257]

The perception of European officials at the time had been that the CFTC's cross-border guidance was a power grab. This occurred despite Gensler's insistence that such strict oversight of foreign trading was necessary to insulate the American taxpayer. The Europeans however, had been pressing for substituted compliance whereby national regulators would see other regulatory regimes' rules for OTCs as functionally equivalent. This particular mode of transatlantic regulatory accommodation had been customary in the immediate years leading up to the crisis, and was now something that officials in Brussels were attempting to revive. However, the EU's efforts to persuade the US to take this effort up so far had proven insufficient, with the CFTC seeking to maintain its position on applying US rules to entities abroad.[258] In light of the CFTC's looming deadlines, the regulatory impasse now threatened to check US preferences by throwing off its sequencing of global OTC reform.

On July 12, 2013 officials from the US and EU reached a last-minute accord that established a 'Common Path Forward' between the two sides. This placed OTC reform on a trajectory in which both would recognize the other's rules as functionally equivalent. European and American regulators made a joint statement announcing that the agreement would allow domestic regulators to defer to each other in the application and enforcement of each other's rules. As a reflection of the rapid tempo with which global policy-making

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[257] Barker, Alex & Gregory Meyer. (2013). "Regulators clash over derivatives reforms" *Financial Times,* 30 May 2013, P.13.

[258] Meyer, Gregory. (2013). "Talks on US derivatives rules set to run to the last minute" *Financial Times* 9 July 2013, P.18.

was occurring, the accord was reached on the same day that the US' foreign bank exemption would have expired, potentially triggering legal jeopardy concerns for banks engaging in cross-border derivatives activity.

There was more than just the threat to the sequencing of global OTC reform however, that led to the agreement namely; the successful veto efforts of an unlikely transatlantic coalition opposed to the CFTC's extraterritorial agenda. For example, after failing to persuade Gensler to abandon the US' new extraterritorial policy orientation, EU officials took the tact of shifting forums, using the regulatory impasse over OTCs as justification to demand that the US include financial services regulation in the transatlantic trade talks which were occurring around the same time. The Obama administration however, was worried that the European efforts to develop a mechanism for mutual cross-border derivatives recognition through the transatlantic trade talks would also allow the Europeans to justify delaying their own reforms. In turn, this would simultaneously bring the broader post-crisis financial reform effort to a halt on both sides of the Atlantic. The administration was also worried that this would allow US banks to circumvent Dodd-Frank as well. For their part, the Wall ST. banks were now in the strange position of backing Brussel's efforts. This left the US Treasury- representing the White House's position in the trade talks at a disadvantage against the Europeans who were unified over the proposal considering it a top reform priority.[259] That May, the Treasury Dept. had sought to defend the US first-mover effort to establish the sequencing and tempo of global financial reform by noting that it didn't want to give the Europeans an excuse to delay their implementation in issue areas like bank capital, clearing and

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[259] Barker, Alex & Gregory Meyer. (2013)."US and EU seal landmark derivatives deal" *Financial Times* 12 July 2013 P.1.

cross-border derivatives. In doing so, the Treasury also sought to reassure the Wall St. banks that they would benefit competitively from the administration's cross-border guidance efforts. Additionally, there was at least one dissenting commissioner in the CFTC who sided with the Wall St. banks and EU officials in pushing for mutual recognition. Ultimately, the Obama administration successfully resisted European officials' preference to include financial services regulation in transatlantic trade talks. A disparate coalition of public/private actors on both sides of the Atlantic however, were successful in pressuring Gensler and the CFTC to accept the idea of mutual recognition between the two regulatory regimes for OTC reform.

The accord quickly proved epiphenomenal, as private market participants continued with their veto efforts to portray US banks as *persona non grata* on European trading platforms. An obscure rule that would force any overseas platform to follow US rules if it traded with a US counterparty, saw the CFTC's recommitting itself to its preferences on cross-border guidance. However, this threatened to once again throw off the US' sequence of reform by derailing the commission's plans to shift the murky derivatives market towards SEFs by October 2. At a meeting at the US embassy in London, market participants sought to veto this proposal by suggesting to CFTC chair Gensler that US banks operating in the City could be kicked off British platforms. Interdealer brokers like ICAP-a globally oriented firm in the UK were now fearful of being tainted by the presence of US firms. ICAP also wanted to escape the CFTC's cross-border rules in light of its being fined by the US agency that same week for playing a role in manipulating LIBOR. It went so far as explicitly telling US banks to clear out by the CFTC's October 2 deadline for SEFs.

The SEFs rule was part of the US effort to bring transparency to the opaque world of derivatives, which had long been conducted on a bilateral basis by brokers over the phone. Unlike bilateral trading, the intention was that trading on exchanges would allow for price discovery in the bidding process for contracts as well as allowing access for a wider array of potential counterparties. However, the rift with European market actors over the CFTC's cross-border guidance for SEF's now threatened to push trading away from electronic platforms and back towards phone trading. International trade associations like the ISDA one of the biggest proponents for harmonized rules, chimed in on the policy debate noting that in light of the growing schism between the US and the EU, bilateral trading still remained a viable option.[260] These veto efforts found support once again from internal dissent at the CFTC with commissioner Scott O'Malia, accusing chairman Gensler of engaging in imperialist regulation. This argument was based on the logic that the CFTC's new cross-border rule was inconsistent with EU-US deal reached only several months before.[261]

Back in the US: More Veto Efforts

Continued Use of the Courts

Private market actors continued their veto efforts challenging the CFTC's authority using the US court system to introduce institutional friction into the policy process. A common thread in each of the lawsuits was Wall St. firms' continued use of H.R.1840, the bipartisan legislative initiative developed in Congress in 2011. As we saw

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[260] Recall that the move by US regulators to bring more OTCs onto exchanges would undermine the long-standing market dominance of the broker/dealer divisions of the large investment banks who are also the ISDA's charter members.

[261] Barker, Alex; Braithwaite, Tom; Chon, Gina; Mackenzie, Michael; Stafford, Philip (2013). "US rules endanger derivatives reforms" *Financial Times* 27 Sept. 2013 P.1.

above, despite their marginalized status in the US OTC policy community, the banks' veto efforts through the courts had been successful by arguing that the CFTC had exceeded its original Congressional mandate in Dodd-Frank. As a result, a series of lawsuits by business and trade associations ensued against the CFTC. Some of these veto efforts also challenged the commission's s rule-making authority by arguing that a specific rule that it promulgated would make swaps-trading more expensive and that it was done without the requisite cost-benefit analysis.[262] However, some of these market participants also attempted to expand H.R. 1840's legal scope towards their own interests in challenging the CFTC. As a result, some of these veto efforts were unsuccessful.

Mid-2013 marked the return of the DTCC; the post-trade transaction group controlled by investment banks that had preempted the push towards public oversight of derivatives in the earliest stages of the crisis (see last chapter). The DTCC also sued the CFTC, arguing that the commission didn't follow H.R.1840's cost/benefit analysis before promulgating its rule. The suit also pointed to what the DTCC suggested was the CFTC's failure to consider the anti-competitive effects of its rules. A decision by the CFTC had given the CME and Intercontinental exchange (ICE)-both industry rivals to the DTCC-a competitive edge in compiling lucrative swaps trading data. Any swaps subjected to central clearing would have to be reported to Swap Data repositories (SDRs). While each of these firms operated their own SDRs, CME and ICE both also had their own clearing services. Therefore, this put the DTCC-which was reliant on LCH.Clearnet for its central clearing-at a significant disadvantage in that it had to receive post-trade data through its

[262] A number of lawsuits were brought by business associations against the CFTC citing H.R. 1840 on legal grounds. The Investment Company Institute, US Chamber of Commerce and Bloomsberg LP are some examples of organizations representing market participants that brought suits against the CFTC's rule-making for OTCs.

SDR. Additionally, both of these lawsuits point to the existing geographical rift between Wall ST. and Chicago (see above) in a spat to see whose commodity traders would dominate the swaps data business.[263] The CFTC ultimately won a dismissal on 3 of the 5 counts in the suit brought by the DTCC.

Another lawsuit in late 2013, saw three industry associations directly challenging the CFTC's cross-border rules in court. The International Swaps and Derivatives Association (ISDA), the Securities Industry and Financial Markets (SIFMA) and the Institute of International Bankers (IIB) also sued the CFTC, citing H.R. 1840's cost/benefit analysis provision adding that its rules ran contrary to the international cooperation expressed via the G20 agenda. The court was unconvinced and instead ruled in the CFTC's favor in the cross-border swaps case.

What these lawsuits have in common is that they demonstrate how the investment banks that had been discredited by the crisis used indirect methods to affect OTC policy-making. The large investment banks, many of whom held influential seats in multiple trade associations were able to use the groups simultaneously in a coordinated effort to indirectly challenge the CFTC's authority to implement OTC reform vis-à-vis Dodd-Frank. Much as the banks had used the legitimacy afforded to NFCs as ideational cover to further their interests during reform, the role of trade associations afforded the banks an institutional resource that allowed them to continue contesting the CFTC's rule-making initiatives in spite of their diminished standing with regulators in a post-crisis environment. However, because their veto efforts also sought to expand the legal scope

[263] Miedema, Douwe. (2013). "DTCC sues regulator CFTC in swaps data spat" *Reuters* 2 May, 2013. <https://www.reuters.com/article/us-swaps-lawsuit/dtcc-sues-regulator-cftc-in-swaps-data-spat-idUSBRE9410SL20130502> Accessed 23 April 2020.

of H.R. 1840 towards the CFTC's authority-and perhaps because their institutional strategy had now become apparent to judges-the banks were less successful in doing so.

Domestic Politics and the Volcker Rule

We now turn back towards US regulatory policy debates in considering the way in which market actors continued to use the legitimacy granted to NFCs via hedging in an attempt to veto reform. Named after former Federal Reserve chairman Paul Volcker, the Volcker rule was initially proposed in the immediate aftermath of the crisis in 2009. It was intended to prohibit banks from engaging in risky speculation by attempting to re-establish the wall between commercial and investment banking that had been torn down with the partial repeal of the Glass-Steagel Act, some ten years earlier. The rule would allow banks to continue their market-making activities like underwriting, offering hedge and private equity funds, hedging and other insurance-like actions. However, the caveat was that they could not do so if their profit-generating efforts created a material conflict of interest, or created exposure to high-risk assets or trading strategies that could then impose instability on the institution or the broader financial system. Although Volcker's proposal was not part of the Obama administration's initial agenda for financial reform, its perceived causal relevance to the crisis and increasing salience among legislators led to its inclusion by Congress in the Dodd-Frank drafts in early 2010.[264]

Investment banks on Wall St. sought to veto elements of the Volcker rule by continuing to hide their speculative activity behind legitimate hedging. In December 2013, both the CFTC and SEC along with the Board of Governors of the Federal Reserve

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[264] Chen, James. (2019). "The Volcker Rule" *Investopedia,* Laws & regulations 9 Dec. 2019, <https://www.investopedia.com/terms/v/volcker-rule.asp>Accessed 24 Aril, 2020.

system, the Federal Deposit Insurance Corporation (FDIC) and the Office of the Comptroller of the Currency were in the final deliberations on rulemaking for the Volcker rule. CFTC chair Gensler and SEC commissioner Kara Stein, had been strong proponents for strengthening the measure by closing a loophole that would end speculative trading masquerading as hedging. However, Bart Chilton a democrat on the CFTC board of commissioners held out, abstaining from a final vote on the rule. In doing so, he pointed to the investigation into JP Morgan's role in the London Whale scandal. This had led the firm to suggest that it had been engaged in a legitimate hedge as opposed to proprietary trading which would have been prohibited under the Volcker rule. At issue, was the closure of an existing loophole in the rule that would have allowed banks to declare any accidental or collateral effect of the trade to be classified as a valid hedge. The CFTC/SEC's joint effort was successful in that it strengthened the draft's final language. It now required the banks' hedges to be designed in such a way as to reduce and mitigate actual risk, not through an unintended side effect of the transaction.[265]

What this brief discussion on the Volcker rule demonstrates at least anecdotally, is that Wall St. banks were continuing to use the newfound legitimacy associated with hedging as a foil to cover their role in large-scale speculative derivatives bets.[266] As we saw, the validity of hedging with contracts had been demonstrated in early policy deliberations in the US (see above). However, this eventually provided cover for the discredited investment banks to validate their risky speculation, something that the

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[265] Chon, Gina. (2013). "Wall Street critic declares himself won over after rule's loopholes closed" *Financial Times* 11 Dec. 2013 P.17.

[266] Chon, Gina. (2013). "Federal Reserve eyes delay for compliance with Volcker rule " *Financial Times* 18 Nov. 2013 P.19.

focusing event in the US had demonstrated had the potential to destabilize the broader financial system. However, this once again points to the significant ambiguity associated with rule-making-as hedging isn't always easy to distinguish from speculation. This is why the-CFTC ultimately pushed back against JP Morgan's arguments in asserting that a firm's position has to be correlated with risk. The final stages of developing the Volcker rule vis-à-vis the London Whale scandal also revealed an existing pathology in the broader claims made by market actors, of hedging as a legitimate activity.

Swaps Push-Out Rule Repealed

The final aspect considered in this chapter addresses actors' successful attempt to veto OTC reform through their repeal of the Swaps Push-Out law in Nov. 2014. Recall that the Republicans' ability to repeal Dodd-Frank after its passage was stymied by a unified Democratic government in power at the time. Despite their inability to do so however, it remained somewhat common knowledge within the OTC policy community that their long-term strategy was focused on Dodd-Frank's eventual repeal. Although Republicans were successful in picking up the House in the 112th Congress of 2011-2013, the Senate and White House still remained firmly in Democratic control. However, there had also been a changing of the regulatory guard in Jan. 2014 as Gary Gensler stepped down from his position at the CFTC.[267] I pick up this thread in the next chapter by arguing that this constituted a regulatory reset in the form of his successor Timothy Massad, who was eventually instrumental in facilitating the transatlantic agreement between the US and EU. For his part, Gensler had been the primary agent driving OTC

[267] Patterson, Scott & Jamila Trindle (2013)."Gensler to Step Down as CFTC Chairman" *Wall St. Journal* 3 Oct. 2013. <https://www.wsj.com/articles/SB10001424052702304906704579113472232135630 Accessed 24 April 2020.>

reform which were largely consistent with US preferences at the time. As a result, he had borne the brunt of the criticism from actors seeking to veto OTC reform who argued that he had overstepped his legislative mandate from Congress in implementing Title VII of Dodd-Frank. The large investment banks were eventually successful in gaining enough bipartisan support to repeal the Swaps-push out rule which as we saw above had been included in Dodd-Frank through the Lincoln Amendment (see above). However, it was the way in which they were successful in doing so, that I focus on here.

The repeal of the swaps push-out rule was slipped quietly into a budget bill in December 2014, where it passed into law. The rule had originally been intended to protect taxpayers from risky derivatives trades by decoupling investment banks' swap desks from the implicit FDIC backing of the federal government. This sort of end-run around the Volcker rule (see last section) sought to address the moral hazard problem, as large financial institutions would engage in proprietary trading backed by federally insured retail deposits. Its repeal triggered the ire of Democratic firebrand Elizabeth Warren who railed that the rule's repeal had now left federally insured banks-and by extension US taxpayers-exposed to the potential contagion of risky swaps trades. But it was the way in which the bill was repealed that illustrates the way in which market actors were successful in facilitating its repeal marking the return of 'quiet politics' in OTC policy-making in the US.[268] Former FDIC chair Sheila Bair remarked that the swaps repeal was a, "classic backroom deal […] there's no way this would have passed muster

[268] Quiet politics, according to Culpepper, occurs when officials and market participants draft legislation and regulation away from the view of the general public largely due to its complex technocratic nature. See: Culpepper, Pepper D. (2011). *Quiet Politics and Business Power* Cambridge University Press.

if people had openly debated it. [The banks] didn't want to go that route, so they had to sneak it on to a must-pass funding bill"[269].

Conclusion

This chapter focused on the US' effort to implement the G20 OTC reform agenda. In doing so, we saw how the crisis contributed to the ascendancy of some actors and the marginalization of others. From the outset, the institutional developments of OTCs suggested that there would be winners and losers from reform. The role of the large exchanges, whose challenge to the large Wall St. investment banks a decade earlier had been unsuccessful (see last chapter) was reversed, as they would now be the primary beneficiaries of reform. Furthermore, the political contentiousness surrounding OTCs started chipping away at the bipartisan consensus for reform produced by the focusing event in light of the public's negative response to the crisis. The Democrats, given their unified control of the federal govt at the time were ascendant. This gave the exchanges an institutional resource to have their preferences realized through their historical reservoir of support in Congress through the committee that controlled their respective regulator the CFTC. Contingent events surrounding the crisis also diminished the likelihood of regulatory turf battles with the SEC, making the CFTC ascendant as well. Dodd-Frank's passage ultimately saw the US embedding the G20's main OTC pillars, in its domestic legislative initiative. The manner in which it did so however, was consistent with its preferences for the preservation of the US' functional regulatory system's bifurcation of securities and futures along distinct product lines.

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[269] Jopson, Barney and Ben McLannahan. (2015). "Warren attacks Dodd-Frank rollback: Wall Street" *Financial Times,* 11 Nov 2015: 4.

The rule-making process that followed saw the ascendant but otherwise middling and underfunded regulatory agency the CFTC as the focal point for actors' efforts to veto reform. For their part, the marginalized Wall St. firms benefitted from Republicans' ascendant control of the House appropriations committee in the mid-terms. Together, these actors engaged on a multi-pronged attack to impede the fledgling regulators capacity by starving it of funds while simultaneously flooding the commission with public commentary on its proposed rules. The commission's authority was also challenged by ascendant NFCs who had utilized OTCs to hedge their economic exposure. While not directly benefitting from reform, these firms would nonetheless be shielded from its most punitive measures. The idea of punitive reform was picked up by Wall St. firms who tied their fate to the NFCs as well as by Republican legislators who framed OTC reform as an effort that would hobble an economically distressed US during a crisis as they challenged regulators over its sequencing and tempo.

A series of contingent events associated with scandals from unregulated cross-border OTCs highlighted for officials the shortcomings in global OTC reform that had come about through the G20 reform agenda. The London Whale Scandal served as the impetus for US officials to address its decades-old vulnerability from American firms operating in the City of London. This contributed to the permissive conditions by expanding the agency of these officials to address this problem through extraterritorial legal means. The productive conditions that facilitated the CFTC's resultant cross-border guidance however, affected the sequencing of global OTC reform as it was largely inconsistent with the spirit of the G20 OTC reform agenda. The US' cross-border guidance also triggered a series of lawsuits brought by trade associations challenging the

CFTC's delegated authority by relying on a bipartisan provision embedded within Dodd-Frank that had mandated that the commission conduct a rigorous cost/benefit analysis before it promulgated a rule.

The US extraterritorial rule-making as a *defacto* global regulator triggered international opposition. This saw the newly ascendant EU officials trying unsuccessfully to exert its lone market power to curb the US unilateral effort. However, coalitional politics were at play internationally as well with Asian regulators joining the Europeans in casting US market actors as *persona non grata* in the global OTC market. EU institutional efforts to attach OTC reform to international trade talks proved unsuccessful however, as they sought to reach a mutual accommodation with the US to see each other's regulatory regimes as functionally equivalent. In conjunction with a series of looming deadlines created by the US established sequencing, these developments led the two sides to a tentative agreement. The good intentions were short-lived however, in light of further sequencing effects from US rule-making. Fixing the problem would be several years away.

Back in the US, Wall St. firms and their attendant trade associations continued their ongoing veto efforts through the courts. Enough time has passed however that some of the legal ambiguity over what constituted a legitimate hedge became clearer. Moreover, market actors' veto efforts to expand the legal applicability of the bipartisan provision in Dodd-Frank were now seen by judges as attempts to impede reform and they began siding with the CFTC. Deliberations during the joint rule-making process by the CFTC/SEC on the Volcker rule, illustrated how the idea of legitimate hedging had developed over the process of OTC reform. A final look at the formal repeal of the Swaps

push-out rule from Dodd-Frank by ascendant Republicans in 2014, shows how it took place largely behind closed doors. This marked the return of quiet politics in the US as public salience had waned by this time. It also demonstrated why introducing institutional friction was such a viable veto strategy for actors opposed to reform as they played the long-game over reform.

4. POST-CRISIS OTC REGULATORY REFORM: EU

Introduction and Plan of the Chapter

Our second case study focuses on the regulatory reform developments for OTCs in the EU after the G20's pronouncement at the Pittsburgh Summit. It's worth noting that its most prominent member states; the UK, Germany, and France, as well as the EU itself were all relevant stakeholders in the G20. As such, they shared an interest in implementing its recommendations for structural financial reform within their own domestic financial systems as well as that of the common European market. It's also worth qualifying once again, that OTCs and derivatives were just one of a number of issues associated with post-crises financial services reform. As we shall see however, their ability to transmit financial cross-border contagion well after the start of the crisis in the US, placed the issue upfront in European crisis reform policy deliberations. Moreover, for officials in Brussels the contingent events surrounding their role in what would eventually become the Eurozone crisis represented the EU's own unique focusing event for OTCs and as such, reflected the endogenous institutional characteristics of the its approach to global finance.

As we saw in the second chapter, the G20 reform deliberations during the crisis saw the continental countries of Europe ascendant in challenging both the US and UK's preferences for global reform. This process saw Germany and France benefitting from their membership in the G20 as individual nation states, as well as leading European countries representing the EU. Their defense of the sovereignty of the Euro also contributed to their ability to veto US preferences for a global central counterparty for

clearing OTCs. Also, the support of other G20 members enabled them to limit the UK's influence in the proceedings, as its calls for a new international regime for global finance akin to the Bretton Woods system were largely ignored. Their ascendant influence eventually followed them back to the continent, where they were able to continue successfully delimiting the influence of the UK-who was not a member of the eurozone-in central clearing debates in Brussels. Therefore, German and French officials' ascendant position in the G20 vis-à-vis the EU ultimately contributed to their ability to act effectively in vetoing American and British attempts to set the global OTC regulatory reform agenda.

This chapter's case study on the European implementation of the G20's main OTC pillars, sees a continuation of these trends in the context of the EU. French and German officials were now ascendant and thus in a position to have their preferences realized in OTC reform in the EU. France's unique institutional policy orientation in the pre-crisis era towards the historical development of capital liberalization through multilateral institutions as well as the substantive fairness of its civil code's approach to business contracting (see second chapter) would contribute to its ascendancy in early OTC deliberations during the crisis. Germany's ascension in European financial reform and its ability to see it preferences realized with OTC reform however, represents more of an intermediate case. As the case study below demonstrates, its regulatory authority for European financial reform was ultimately contingent upon the ability of German officials to reconcile the disparity between its preferences for closer European coordination and the speculative behavior of its globally-oriented banks. More so than the French, Germany had benefitted historically from the informal nature of cross-border contracting

in Europe as it was able to preserve its distinct national regulatory framework while simultaneously allowing its more speculative firms to gamble in the city of London.

As we will see, the trajectory of OTC reform in the EU was largely a function of the authority relations among its primary member states. Up until the crisis, the informal institutional arrangement that had allowed for the preservation of national regulatory models to coexist with greater regional integration, had so far delimited any initiatives that might have brought OTCs under greater regulatory oversight in the EU. Historically, this had contributed to bolstering the UK's market power in countering any Pan-European proposals for OTCs. However, the crisis' focus on financial reform and OTCs in particular contributed to the issue's salience, spurring ascendant French and German officials to reconcile these disparities through greater regional regulatory integration. These developments are also consistent with pre-crisis trends towards a transfer of greater financial regulatory authority to the EU-level. This would eventually result in institutional impediments for UK regulators to act as first-movers in OTC reform to the same extent that the US did. It also contributed to the perception of British officials and market participants in the City that the shift in regulatory authority for OTCs would inevitably jeopardize London's competitiveness in financial services. Therefore, if French and German officials were the primary actors leading OTC reform, it was the UK that was most likely to attempt to veto their efforts. As we shall see however, British officials were only successful in vetoing the shift in regulatory authority to the EU when one of two conditions obtained: when they had the support of a coalition of member states opposed to these reform initiatives, or when they were able to portray reform

efforts as French and German attempts to gain a competitive advantage in monopolistic terms, at the expense of the EU's efforts to foster greater competition .

The EU case study is also consistent with what we've seen so far considering the tempo of OTC reform. Namely, that the preferences of reform-oriented actors are towards more rapid reactionary policy change whereas actors whose preferences favor the existing status quo seek to induce institutional friction into the policy process. This leads to a key argument in the first section, namely that the Greek Sovereign Debt Crisis was a significant focusing event in European OTC reform. Even after signing on to the G20 Pittsburgh Summit's recommendations, the EU was lagging their transatlantic counterparts in the US considerably. This slower pace I argue, is attributable to the origins of the global financial crisis in the American subprime mortgage market and the authority relations between the institutions of the European Union and its member states. The UK in particular, was in a particularly tough position vis-à-vis the continental countries due to the many financial interconnections created through complex contracting between banks operating in New York and the City. The transatlantic financial contagion in Europe for the most part, landed on England's shores first (see Chapter 3). Moreover, the increasing recognition that the transatlantic casino must be policed at all costs was beginning its reign in EU policy circles.

Seen in this light, the Greek Sovereign debt crisis represented a unique European focusing event for derivatives reform in the EU. By signaling to European policy-makers of the continued threat posed by the financial interdependence created through derivatives contracting it also highlighted the continuing costs of policy inaction. In turn, this contributed to the permissive conditions experienced by ascendant French and

German officials to bring OTCs under EU regulatory oversight. Much as had occurred in the US with AIG (see last chapter) the Greek crisis also lent considerable weight to their calls to pick up the pace of reform. As noted at the outset of this study, the implementation of reform often takes years to complete. Despite the G20's pronouncement and the subsequent US first-mover effort, when the Greek crisis began in the EU, derivatives were for the most part still largely unregulated as comprehensive global implementation was years away. In the case study on the EU, the focusing event for OTCs had the effect of renewing the sense of urgency for completing implementation. This also had the effect of expanding the agency of ascendant reform-oriented actors to bring this about.

The Greek crisis triggered a process similar to what occurred to the spread of counterparty risk in the US. It wasn't until Greece began defaulting on its sovereign debt that this began affecting the debt profiles of other European sovereigns leading to more calls for an increase in the tempo of OTC reform. This leads us to also consider the prospect that EU-level officials may have thought that the worst of the crisis would be limited to the UK. The implication for our analysis is that French and German officials may have up until this point misread the extent of the financial interdependence which the US' focusing event for OTCs represented. Instead of a series of interconnected linkages across countries through complex derivatives contracting, there may have been the perception that their own domestic financial systems as well as that of the EU writ large, were largely shielded from the market behavior of the casino in London. Therefore, given the primary focus on central clearing that resulted from the initial G20 consensus, the early threat to the sovereignty of the Euro that came out of these discussions not only

structured the nature of authority relations between key member states in the EU, but it also affected the nature of European OTC regulatory reform as well.

This leads us to another key argument of this chapter: that negative ideas about the speculative nature of derivatives contracts were successfully politicized by EU officials to increase the pace of OTC reform. This framing is a key source of cross-case variation in this study, as officials in the US never openly derided speculative finance to the same extent. In contrast, the sovereign debt crisis saw French and German authorities in the EU successfully politicizing the speculative side of derivatives contracting in an attempt to make speculation synonymous with the causes of the crisis. This was done despite the functional neoliberal protestations by national regulators attempting to veto these efforts. Another key source of variation from the US case was the ability of EU-level officials to delimit the large global investment banks' ability to influence OTC reform policy-making during implementation. We see this in the degree to which the ascendant French regulator ESMA sought to limit the number of banks in a key OTC policy-making committees for technical standards during its rule-making effort. The framing of hedging in the context of European OTC reform also opened a rift between EU member states with the more merchant oriented French and German officials on one side and the more speculative UK and some of its coalitional supporters opposed to particular reform initiatives, on the other. Once negative ideas about speculation were embedded within EU OTC reform, this established the terms of institutional engagement going forward and had significant effects further downstream in the policy process.

The next aspect addressed in this chapter is an analysis of the domestic and European developments leading to Germany's unilateral naked swaps ban. The Greek

sovereign debt crisis and its focus on the negative effects of speculation saw German officials caught in a tough position in EC deliberations. No sooner had they positioned themselves as ascendant actors on the right side of the OTC debate, then it was brought to light that German speculators may have contributed to the crisis as well. This could have potentially delegitimized Germany's position as an EU reformer during the crisis. This section addresses the actions of domestic actors within Germany whose preferences were to rectify this incongruency by acting as Europe's first-mover in regulating OTCs. As we will see, it did so by going farther than any other country was willing to go in terms of an outright regulatory ban on a specific type of swaps. In this regard, the German unilateralism vis-à-vis the naked swaps ban sees German officials acting successfully to re-positioning the country in European deliberations by targeting the most speculative aspect of the sovereign debt crisis.

The chapter then focuses on the European System of Financial Supervision (ESFS), which helped to preserve the consolidated approach to regulate derivatives along with traditional securities. Unlike the historical development of bifurcated financial regulation in the US which we saw in the last chapter, most European countries had pursued a consolidated regulatory approach. This in turn, eventually influenced the trajectory of EU financial regulation which would adopt a similar approach. Moreover, as it pertains to OTC reform, France's multilateral history with financial globalization and its cautious legal approach to contracting gave it a legitimacy during reform proceedings, to the extent that it obtained regulatory oversight over derivatives and traditional securities under the EU's consolidated regulatory system. Therefore, the institutional process in developing the ESFS, saw the French regulator as ascendant actor for OTC

reform while simultaneously preserving the historical consolidation of financial products in the EU.

There were also institutional processes associated with the ESFS that embedded OTC reform in existing institutions while simultaneously preserving the autonomy of key member states. This discretion was carved out largely along the lines of the primary rift between the UK, Germany and France with specific regulatory niches carved out for the EU's dominant members. France's new financial regulator ESMA was like the CFTC, a middling regulator that was now on the forefront of regulatory rule-making that would have significant implications for the global OTC markets. While not subject to the same attacks on its regulatory capacity as occurred with the CFTC in the US, the ascendant French regulator was still the focal point of actors efforts-namely the UK-to veto the shift to EU-level authority coming at London's expense. ESMA's discretionary powers were also delimited by the institutional parameters within the proposed European counterparts to Dodd-Frank: EMIR, and MiFiD II an agreement from the early 2000s that structured the extent of EU-level authority relative to member states. Therefore, what we see occurring with OTC reform in the EU reflects the historical bifurcation between pan-European authority and the autonomy of key member states.

We then focus on the continuing development of the draft legislation for EMIR as delays to implement OTC reform were subsumed within an increasing recognition by EU-level officials of slippage from the G20 agenda. The explicit focus on central clearing within the G20 remit had also led to a wave of consolidations and proposed mergers in the industry which elevated the status of large multinational exchanges which now stood to profit from OTC reform. EMIR's successful passage would eventually underscore that

ESMA (like the CFTC in the U.S.) was severely understaffed, and ill prepared to address the flood of proposals from the industry during rule-making. The rift among member states served as the continuing backdrop for these developments as ESMA's delegated authority to oversee central clearing houses is continually challenged by the veto efforts of British officials. Moreover, the development of European legislation for OTCs also brought signs of significant transatlantic ambiguities between the EU and US implementation efforts that threatened to fragment the global market.

The chapter then hones in on the international effects of European rule-making. Due to the successful marginalization of the UK in European policy deliberation in the context of the European Commission (EC), we see the UK attempting to forum-shop its regulatory response to the LIBOR scandal through its traditional Anglo-American alliance in IOSCO. These efforts however, are unsuccessful in helping the UK's effort to act as a successful regulatory first-mover and re-establish itself as a primary actor in OTC reform.

I then turn to the competitive opportunities for the western exchanges in Asia represented by derivatives reform. Analytically, this section is a compendium to what transpired in the last chapter between the EU's veto efforts towards the US as regulatory first-mover for OTC reform. Ironically, in a move reminiscent of US cross-border swaps rules (see last chapter) the EU also sought to exert its market power over Asian firms through extraterritorial regulation in a bid to bring European market participants activity in the region under its remit. This move backfired as Asian regulators and firms successfully vetoed European efforts at cross-border rule-making by making European firms *persona non grata* in Asian derivatives markets. This in turn, leads European

officials to the conclusion that they must reconcile the regulatory disparities with their American regulatory counterparts.

The last section in the chapter deals with the policy developments between the EU and the US in reaching a mutual recognition accord for derivatives. This would entail that both sides see their regimes as functionally equivalent for the purposes of letting multinational firms continue to be active within each other's regulatory regime. However, lingering ideas of the crisis and regulatory sovereignty taint the initial proceedings as the EC paints CFTC rules as insufficiently stringent. However, the established sequencing of global reform continues to influence the process. Looming institutional deadlines imposed at earlier stages of the implementation process lend weight to actors arguments that an accommodation must be reached between the two sides. This is set against the backdrop of significant market fragmentation for OTCs as well as the ongoing threat of legal uncertainty for counterparties exposed through existing contracts.

Before EU officials could reconcile the obstacles to coordination with the US, there was significant pressure occurring within Europe as well. As implementation began to crystallize in Europe, market executives from several prominent exchanges pushed officials in the EC to continue with open access for CCPs in the EU's regulatory regime. Without central clearing divisions of their own, they successfully mobilized by linking the idea of open access to the broader pro-competitive liberalization push moving through the EU at the time. This ultimately undermined arguments proffered by the large entrenched multinational exchanges that sought to preserve their own vertical silos. The increasing implications of the UK leaving the union start to materialize as the rift

between European member states now metastasizes into talk of Brexit in Euro OTC deliberations.

The chapter closes with the late stage dynamics between the EU and US towards the accord that was reached for OTCs in Feb. 2016. Despite significant technical obstacles to be overcome, both sides are able to facilitate a regulatory reset marked by a changing of the regulators overseeing the proceedings on both sides of the Atlantic. I then frame the US' efforts to reach an agreement in terms of a good cop/bad cop dichotomy, as the US regulator eventually reaches a more conciliatory tone with its EU counterparts than its predecessor. An ongoing American narrative couched in the US' market power gives way to the broader idea of financial interdependence as well as an increasing recognition of the inevitable variation in regimes' regulatory reform. This more conciliatory tone struck by the US finds purchase with the EU officials, as both sides make significant concessions towards reaching the mutual accommodation accord for OTCs.

A Focusing Event for OTCs: The Greek Sovereign Debt Crisis

In the summer of 2009, with several months to go before the G20 Pittsburgh Summit, the trajectory of OTC reform in the EU lagged its transatlantic counterpart considerably. With US legislators in the House already engaged in developing draft legislation to reform OTC derivatives, the European Commission had only just published a working paper adopting communication on OTCs from relevant industry actors. Similar to what had occurred in the US, this preliminary public commentary phase in Europe had triggered significant opposition from NFCs, who as end-users were most likely to utilize derivatives to hedge their exposure to financial uncertainty and risk. Despite the

decidedly slower European response to OTC reform, NFCs challenged the perceived speed with which EU bureaucrats and lawmakers were proceeding.[270] In the second chapter, I laid out the political dynamics between the US, the EU, and its influential member states in facilitating the international consensus that produced the statement by G20 leaders at the Pittsburgh summit in Sept. 2009. The trajectory of European OTC reform that fall had remained consistent with the preferences of these market actors and even some EU officials for its slow deliberate pace.

It wasn't until January 2010, that the sell-off in Greek markets served as the focusing event for European officials to increase the tempo of European OTC reform effort. As the following section lays out, the Greek sovereign debt crisis helped serve as the European equivalent of AIG in the US, some 15 mos. earlier. The comparison with the US is an apt one. In the early stages of the crisis in the US, credit-default swaps (CDS) had been identified during the AIG melt-down, in part because of their ability to spread the financial contagion from the US sub-prime mortgage markets across the Atlantic.[271] Once again, CDS contracts were identified by public officials as the culprit spreading financial contagion throughout Europe. This time however, the source of the financial contagion were the contracts used to insure government bonds against default in the European sovereign CDS market.

As a focusing event, the Greek sovereign debt crisis helped crystallize the necessity of OTC reform for EU officials who began to strengthen their calls to increase the tempo of the policy process. A week after the Greek market sell-off, at a hearing in

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[270] Grant, Jeremy (2009). "Euro summit to review the architecture of finance" *Financial Times*. 24 Sep. 2009 p.28.

[271] (See Chapter 3)

front of the European Parliament (EP), the commissioner designate for financial services Michel Barnier was asked by ministers to lay out the scope of European financial reform. Barnier suggested that in light of recent events, Europe was indeed going to engage in financial reform despite some policy-makers' doubts to the contrary. Furthermore, problems coming out of the markets for sovereign CDS had led Barnier to note the scandalous nature of speculation in commodity-related derivatives. As this section lays out, one of the key variations between the EU and the US cases was the extent to which public officials in Europe successfully politicized the idea of speculation as the root cause of the crisis to an extent not present in reform deliberations in the US.

These political developments also exposed a rift between EU member states. British MEPs sought to veto reform challenging its inevitability while trying to insert friction into the process. They were concerned that the amplified calls for financial reform in light of Greece's recent default would result in an excessively zealous approach to regulating finance. This represented a potential threat to the economic prosperity of the City, while also posing a threat to millions of EU jobs linked to the financial sector.[272] The British veto effort was directed primarily at ascendant French officials, whose preferences for stricter financial regulation was driven by a crisis that had exposed taxpayers in European countries to risk created by bankers operating in London. Moreover, the success of French president Nicolas Sarkozy in securing a Frenchman (Barnier) to his post also played into UK fears that calls for reform might lead to a single pan-European financial regulator. For his part, Barnier was forced to reassure both sides

[272] Tait, Nikki.(2010) "Barnier displays reforming zeal on plans for Europe" *Financial Times.* 14 Jan. 2010 p.10.

that he would remain independent. However, by this point the rift between the two influential EU member states had already been exposed, foreshadowing the trajectory of European OTC reform.

The focusing event of the Greek crisis spreading throughout Europe and its origins in the sovereign CDS market contributed to the sense of urgency felt by EU officials as the new permissive conditions gave them a way to frame their arguments in favor of increasing the tempo of OTC reform. An EC meeting in early March 2010 with banks and regulators saw Germany joining France in pressing the EU for urgent action to limit the extent of financial speculation in sovereign debt markets. [273] At the time, both countries were in the process of drafting a letter to EC president Jose Manuel Barroso urging him to do so. However, there was some disagreement between the two continental countries on how exactly to proceed. French preferences favored giving regulators discretion to temporarily suspend such trading in the event that a sovereign default seemed imminent while Germany favored an outright ban on some instruments. At the meeting, German Chancellor Angela Merkel took aim at the more speculative elements of derivatives trading, calling for haste in adopting rules that would ban naked swaps transactions despite the reservations from other national regulators.[274]

At the heart of these policy debates was the idea that speculation in sovereign CDS was exacerbating the crisis. For example, Greek politicians had recently railed against speculative hedge funds who were causing panic among investors from their

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[273] Hall, Ben; et al. (2010) “Call for action on speculation” *Financial Times.* 10 Mar. 2010 p.19.

[274] When asked about the feasibility of Merkel’s proposed ban on naked swaps transactions, CFTC chair Gensler remarked, "I'm not sure I know how an outright ban would work technically." Tait, Nikki. (2010) “Commission to back curbs on credit default swaps” *Financial Times.* 18 Mar. 2010 p.6.

efforts to drive up the price of Greek CDS.[275] This was also starting to affect investor sentiment in the broader stock market, with hedge funds increasingly being pointed to as the villains in the story. Despite the disparities between French and German preferences for OTC reform however, Angela Merkel announced that, "We are all agreed that we must put a stop to financial speculation" [276]. Barroso ultimately pre-empted the French/German policy initiative by announcing that the EC would examine effects that the purely speculative naked swaps were having on the market for sovereign debt. In short, speculation had become the pejorative *dejour* in the European financial policy-making community as credit default swaps had now become a political lightning rod in Europe.

Due to the cross-border structure of the sovereign CDS market, any proposed bans on speculation in Europe would be subject to international policy deliberation. Barroso cautioned that any further policy discussions on the matter needed to be done in conjunction with Europe's international partners in the G20, given the cross-border, opaque nature of the sovereign CDS markets[277]. The ongoing problems with the sovereign CDS market were serving as the focusing event for EU officials to respond more quickly to the developing crisis. This in turn, contributed to the permissive conditions that followed as they were able to successfully embark on building a European

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[275] Like OTCs, the EC around this time was also in the process of drafting rules for hedge or alternative funds operating across the European block. In addition to OTCs, London also houses the bulk of the European hedge fund industry and British officials cited the threat to European competitiveness that a stringent clampdown would represent. In doing so, they also voiced concerns about the implementation of any regulation that would emerge. France was worried about whether or not new rules for depositories-which safeguard funds-were adequate. See: Mallet, Victor; Parker, George; Tait, Nikki. (2010). "Hopes rise of compromise deal on hedge fund rules" *Financial Times.* 16 Mar. 2010. p.2

[276] Hall, Ben; et al. (2010) "Call for action on speculation" *Financial Times.* 10 Mar. 2010 p.19.

[277] Cited by Hall et al.

consensus for OTC reform. Before they could do so however, the cross-border nature of those same markets again threatened to undermine the G20 OTC reform agenda. This last point would prove particularly prescient, given that any subsequent increase in the tempo of EU OTC reform could-like the US first mover effort-potentially contribute to international friction as unilateral proposals were often inconsistent with the cooperative spirit of its recommendations on OTC reform. In sum, these developments point to the fundamental tension associated with the multi-level governance in the EU between its national member states and the EU's broader international commitments towards OTC reform.

Despite the sense of urgency by EU officials to hasten the pace of OTC reform, national regulators used functional arguments about the CDS market to justify their slower, albeit deliberate pace. In light of the increasing calls for more transparency in the CDS market, the regulator overseeing the world's leading market for sovereign CDS (the UK's Financial Services Authority (FSA) began to track trades and price levels. This had the intended effect of increasing their monitoring of the CDS segment of the financial market. However, despite the broader calls for a clampdown on the market, the FSA declined to issue any public statements on the matter because of their refusal to see it as a problem.[278] Additionally, Germany's financial services regulator BaFin also announced publicly that they found no evidence that Greece's woes were the result of manipulation by speculators.[279] Arguments emanating from the broader policy community also suggested that banks' efforts to buy protection against sovereign defaults constituted the

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[278] Oakley, David Tett, Gillian Hughes, Jennifer (2010) "Sovereign CDS become Europe's new bogeyman" *Financial Times.* 2 Mar. 2010. p.19.

[279] Lex Column (2010) "Short-changing the euro" *Financial Times.* 20 May 2010. p.12.

majority of activity in sovereign CDS and that the market for Greek sovereign CDS was too small to pose a systemic threat. In other words, functional arguments were being made that the sovereign CDS market was working as it was intended to: as a source of legitimate hedging for banks. Some hedge funds had used CDS contracts speculatively to bet on the likelihood of countries going into default. However, these instances were treated by national regulators as exceptions to the rule rather than as examples of rampant speculation run amok the narrative proffered EU officials. What this suggests is that the rift between the UK and Germany in particular was subject to a cross-cutting cleavage at the national level as regulators in both countries were in agreement about policy evaluations that sovereign CDS markets were working as they should.[280]

Market participants used their time honored strategy to veto increasing European calls for public oversight by engaging in efforts at self-regulation. In doing so, it exposed the transatlantic rift that had come to light earlier in the G20.The DTCC made a concerted effort to bring transparency to the opaque CDS markets in Europe. It did so by publishing data on the size of outstanding trades for sovereign CDS. However, the preferences of German national regulators in Berlin were for a European equivalent of the DTCC which would force buyers of credit derivatives to register their trades with the envisioned SRO. Also, recall in chapter 2 that there was significant discord between the US and EU during the initial deliberations in the G20 that emanated from the perceived threat to European sovereignty posed by an American-based global clearer operating in Europe. With central clearing as a central plank of participating nations commitment to the G20 agreement in Pittsburgh, the self-regulatory efforts of an American post-trade

[280] This also suggests that there was some internal incongruity in Germany as its national regulators policy evaluations were inconsistent with the Merkel's anti-speculation fervor in the context of EC deliberations.

financial services company to now head-off more stringent calls for reform didn't sit well with European officials embroiled in the ensuing sovereign debt crisis. The self-regulatory veto effort by the DTCC had inadvertently exacerbated the perceived threat to European sovereignty.

The discussion above laid out the political dynamics associated with the Greek sovereign debt crisis and the extent to which this affected the trajectory of European OTC reform. In a similar vein to what transpired in the U.S. in Sept. 2008, credit default swaps were once again at the center of the crisis. It was their unique role in the European market for sovereign debt that however, that served as the EU's own focusing event to hasten the pace of OTC reform. It also revealed deep fissures among member states in European policy deliberations on how reform should proceed. The broad strokes of this cleavage saw Germany and France as the primary actors pushing to increase the tempo of reform with UK regulators trying to veto these efforts. Furthermore, the continental countries were successful in politicizing CDS in EC deliberations by painting a portrait of OTCs as inherently subject to rampant speculation. This put the UK on the back foot with a large majority of EU member states during the initial talks. As the home to the vast bulk of sovereign CDS in the City of London, British officials feared of being put at a competitive disadvantage due to the increasingly amplified calls for EU-wide reform. But the ongoing deliberations also revealed a more nuanced picture of the rift. Disagreement between Germany and France over the prospects of an outright ban on naked CDS swaps, gave way to deliberations about the role played by speculation in destabilizing the sovereign CDS market. Here we saw a cross-cutting cleavage among national regulators from the UK's FSA and Germany's BaFin. Both made functional arguments that pushed

back against the political fervor taking over Europe, suggesting that the markets were working as they should in allowing actors to hedge against uncertainty in a time of crisis. As we will see below, the political contestation in the EU between its influential member states would not only threaten to unseat the European consensus for reform, but the prospects of international coordination for the G20 OTC reform agenda as well.

The German Naked Swaps Ban: Europe's Furthest Mover

As we saw above, the Greek sovereign debt crisis served as a focusing event for EU officials to increase the tempo of reform. Furthermore, the permissive conditions that it fostered saw ascendant French and German officials successfully politicizing the sovereign CDS markets operating out of London. In doing so, they painted speculation as all that was wrong with the European financial system in order to build a consensus within the EU to promptly address the problem with OTCs. However, as the following discussion on the German Naked Swaps ban demonstrates, Germany's initial ascendancy as a reformer within the EU during this time was tentative at best. In keeping with a theme of this study, it was once again contingent events associated with OTCs that called this into question. When these developments directly implicated German banks, German officials attempted an end run around the EU to address its problems closer to home and re-establish its reform credentials. This would eventually affect the trajectory of OTC reform in the EU.

In the discussion that follows, I unpack the contextual factors that contributed to German unilateralism as part of the broader OTC reform effort and its relevance for European financial reform in general. In the process, I argue that Germany's unilateral ban on naked swaps was an attempt by domestic officials to reestablish Germany' reform

credentials within the European financial services policy community in Europe. In doing so, they sought to save face in light of the role played by German banks operating out of London, whose speculative behavior contributed to the crisis. The German electorate, whose preferences were generally consistent with the European trajectory of reform was nonetheless unsatisfied with the slow deliberate pace of the European effort-pushing for an increase in the tempo of the reform process. The culpability of German banks combined with BaFin's policy alignment with the UK's FSA over problems in the CDS market for sovereign debt (see last section). In doing so, German officials sought to address the role played by German banks in contributing to the sovereign debt crisis. But by acting as an extreme case of regulatory first-mover, they also sought to establish Germany's own national autonomy in its relations with other EU member states. Consistent with Barroso's earlier fears that unilateral bans could prove inconsistent with the G20's OTC reform agenda (see above), Germany's unilateral strategy exacerbated officials ongoing fear of regulatory arbitrage, a trait that it shared with the US first mover effort. Like the American regulatory scenario, the move by Germany also threatened to undermine the prospect of international/transatlantic coordination in the face of continuing national bail-outs.

The most immediate effect of German unilateralism was the extent to which it took the rest of the EU by surprise. European deliberations on the most contentiously speculative aspect of the Greek crisis (naked short-selling) were on track for a planned June 2010 consultation on draft rules. As the new internal market commissioner Barnier promised an EU proposal by October. However, on May 18 Germany's chancellor Angela Merkel announced publicly a ban by its national regulator BaFin on naked short-

selling of eurozone sovereign bonds as well as 10 other financial stocks.[281] The German ban on sovereign bonds had originally been planned to coincide with the EC's consultation on draft rules. Furthermore, it would apply to shorting the bonds both through CDS or selling them directly. However, the ban caused significant controversy with some EU partner countries who were angry that they had not been briefed about Germany's plans to go it alone. This had occurred despite Berlin's insistence at the time that other member states be kept in the loop. Moreover, the German unilateral ban was seemingly at odds with the European consensus driven by the Greek debt crisis only a month before.

Observers of the German ban on naked swaps had noted that it was hard to see the ban as anything other than as a response to domestic political pressure.[282] Only several weeks before, Merkel's Christian Democratic Union of Germany (CDU) had suffered a severe blow in regional elections that cost her party control of the Bundesrat, the federal upper house of parliament. The measures proposed in the ban were already part of a larger bill to be enacted in autumn, consistent with the European timeline for comprehensive financial reform. However, Merkel and finance minister Wolfgang Schauble came under increasing pressure from fellow members of the Christian Democrats to regulate the markets that were seen by many as precipitating the eurozone crisis, despite BaFin's pronouncements to the contrary. Thus, at a time of relative

[281] AAREAL BANK AG, ALLIANZ SE, COMMERZBANK AG, DEUTSCHE BANK AG, DEUTSCHE BÖRSE AG, DEUTSCHE POSTBANK AG, GENERALI Deutschland HOLDING AG, HANNOVER, RÜCKVERSICHERUNG AG, MLP AG, MÜNCHENER RÜCKVERSICHERUNGS-GESELLSCHAFT AG. According to BaFin, these bans would apply from 19 May 2010, 00:00, until 31 March 2011, 24:00, and would be subject to review. See: Ishmael, Stacie Marie. (2010)."BaFin statement on Germany's naked short selling ban" *Financial Times.* 18 May 2010.

[282] Heaney, Vince. (2010). "Politically motivated reform is no help". 31 May 2010. p.24.

consensus among European member states towards financial reform, the German electorate emerged unsatisfied with the decidedly slower pace established by officials in the EC. The pressure that they exerted eventually forced the German government to accelerate the tempo of national financial reform.

The conventional wisdom at the time was that the pressure on German officials was rooted in the German electorate's resentment as taxpayers for having to bail-out profligate Greeks. However, this view misses the context in which these contingent events were transpiring in light of the increasingly negative perception of speculation in the continental countries at the time. Europeans experiencing rising food prices which feared a repeat of 2007-8, when the prices of agricultural commodities like rice and wheat skyrocketed. A Harris poll in 2010 showed that respondents in France and Germany were more likely than those in the UK or US to blame speculators for having more of an effect on markets than droughts, rains or even government policies.[283] These responses echoed the negative perception of speculation voiced by EU officials earlier in the year, which was now feeding back into EC reform discussions.[284] Therefore, it was thought that popular opinion would bolster the position of reformers in the EU looking to overhaul regulation for commodities derivatives. Like the use of CDS in sovereign debt markets, commodities derivatives had become another political football for European

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[283] 49% of French respondents said that speculators were the principal factor associated with rising food prices while 35% of German respondents said the same. Contrast these numbers with 11% & 9% in the US & UK respectively. Cited in Blas, Javier. (2010) "Speculators at fault for food prices, says poll" *Financial Times.* 11 Oct. 2010.p.3.

[284] Schmidt found similar feedback processes at work in her analysis of the sovereign debt crisis in Europe. Schmidt, Vivien A. (2014) "Speaking to the Markets or to the People? A Discursive Institutionalist Analysis of the EU's Sovereign Debt Crisis" *British Journal of Politics and International Relations* vol. 16, no1.pp.188-209.

OTC reform. France's finance minister Christine Lagarde voiced her concerns to the EC in Sept. 2010 by stressing that the French considered, "European regulation of trading in commodity derivatives to be insufficient"[285].

German resentment of the Greeks also misses the contingent role played by German banks in the crisis. German banks had been much more active in CDS trading than their French counterparts, who mainly used the OTC markets to hedge the exposure of French multinationals to interest and exchange rate fluctuations. For example, several high profile German bank had been instrumental in the sell-side for sovereign CDS and were listed among the financial stocks listed in the BaFin ban. This suggests that there were some perceived threats to the stability of the German financial system created by risky speculative bets German banks had made in the market for sovereign CDS. As the eurozone crisis spread, the idea emerged that German speculation may have contributed to the spread of financial contagion. This would have ultimately left German taxpayers on the hook for bailing out other member states. Furthermore, it was inconsistent with the harsh line that German officials had taken towards speculation in early EC deliberations (see above). Moreover, BaFin's earlier pronouncement in March that sovereign debt markets were functioning as expected, was at marked odds with the financial contagion that people in Germany and the rest of Europe were witnessing firsthand as a result of the integrated financialization of European countries. Therefore, the relatively successful politicization of speculation and CDS in the EC by ascendant EU reformers that spring had ultimately found a receptive ear in Germany's national electorate, who then voted the CDU out of the Budesrat. The German naked swaps ban also played into the rift between

[285] Cited in Hall, Ben (2010). "France steps up tougher rules campaign: Call for comprehensive regulation of raw materials markets" *Financial Times.* 31 August, 2010.

European member states. Recall above, that in EC deliberations, German reform proposals targeting speculation had been even more stringent than their French counterparts in their regulatory ambit. Given this, BaFin's declaration that speculation was not responsible for the meltdown in the sovereign CDS markets, painted a picture of policy incoherence and internal fragmentation within German domestic politics. However, it also created tension across member states as Germany's national regulator was now acting alongside its British regulatory peers in the FSA to veto OTC reform in the EU. This threatened Germany's ascendancy as a reformer in ongoing European policy deliberations. Thus BaFin's turnaround from this veto effort vis-à-vis its pronouncement on the naked swaps ban is instructive. Therefore, the German unilateral ban on naked swaps that may be thought of as an attempt to reconcile its domestic policy position on reform with the EU's larger project for OTCs. This allowed it to act as furthest mover for financial reform and reestablished its regulatory bona fides in ongoing EU deliberations.[286]

The response to the German ban from the broader financial services policy community-in Europe saw opponents of reform again pushing back along functional lines. Some observers posited that the German unilateral ban was not based on sound economic arguments-citing IMF data that the magnitude of investors sovereign CDS

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[286] Hall's now classic formulation of varying levels of policy change sees first-order change (routine adjustments to existing policies), second-order (changes in the policy instruments used to achieve shared goals), and third-order change (shifts in the goals themselves). Relative to the initial financial crisis, it could be argued that third-order change had already occurred (formerly unregulated OTCs were now subject to public oversight) so policy change in Europe policy deliberations was occurring somewhere between first and second order change. Therefore, an argument could be made that the German naked swaps ban was an effort to push the bounds of proposed reforms back towards third order change at least in Germany, signaling to other member states that it was willing to use its national discretion to change the terms of engagement for policy change debates. See Hall, Peter A.(1993). "Policy Paradigms, Social Learning, and the State: The Case of Economic Policymaking in Britain". *Comparative Politics* Vol.25, No.3 (April), pp.275-296.

exposures were negligible-but was instead was the result of policy-makers swinging at a straw man in an effort to win support for a EUR750 rescue package for the eurozone.[287] Additionally, the policy position that accompanied these arguments pointed to the notion that while naked short selling can often be speculative, it can also be used by banks seeking to protect their loan exposure to companies in troubled countries on the verge of default. In other words, naked short selling can be a legitimate form of hedging. In sum, when the increased politicization of CDS and in particular naked swaps in Europe resulted in an outright ban by a national regulator, opponents of the ban once again attempted to veto this effort by using functional arguments to bolster their position in ongoing reform policy deliberations. More importantly, these arguments relied on the newfound legitimacy associated with hedging in derivatives trading picked up by the OTC policy community. Empirical research eventually determined that German banks in the sovereign CDS markets acted as gamblers using these swaps to *extend* rather than hedge their exposure to risky bets. [288]

The German ban also pointed to a growing trend in financial reform towards unilateral- rather than multilateral-action that threatened to derail the G20 OTC reform agenda.[289] The effect that the Greek sovereign debt crisis on the subsequent politicization of CDS and the extent to which it served as a focusing event for OTCs underscored for European policy-makers the interconnectedness of their financial markets vis-à-vis the sovereign market for CDS. This helped contribute to the permissive conditions for

[287] Lex Column. “Short-changing the euro” *Financial Times.* 20 May 2010, p.12.

[288] Viral V. Acharya, Yalin Gündüz , Timothy C. Johnson. (2018) “Bank use of sovereign CDS in the eurozone crisis: hedging and risk incentive” *Discussion Paper Deutsche Bundesbank* No 26/2018.

[289] Heaney, Vince. (2010). Politically motivated reform is no help” *Financial Times* 31 May 2010. P.24.

reformers to increase the tempo of reform. However, these developments served as a focusing event with unique implications in the German context relative to its role in the EU. Therefore, much like the U.S.' own first mover effort, (see last chapter) Germany's unilateral ban on naked swaps pointed to the inherent problem with regulatory arbitrage within Europe as well. There's a truism in financial regulatory debates that, banks are global in life and national in death.[290] As a test case, the German unilateral ban supports the significant discretion afforded to national regulators to circumscribe the behavior of global financial market actors as counterparties. However, it also points to the fundamental tensions associated with regulating cross-border contracts with national rules.

Given the parameters sketched out in the discussion above, we can see the extent to which the tempo and magnitude of the European consensus for OTC reform was both increased and amplified by domestic actors in Germany. The backdrop for this was national bail outs that threatened to derail both coordination among European members states as well as within the G20. It may have been the case that before the crisis, public officials in the continental countries of Europe saw their domestic financial systems as relatively insulated from the speculative activity of global banks, which operated largely within the cities of London and New York. It may also have been the case that these same officials perceived the initial financial crisis as having stopped at their doorstep but still largely confined to the casino of London. As a result, it kickstarted a more assertive stage of the policy process giving European reformers leverage in calling for an increase in the tempo of OTC reform. Seen in this context, Germany's unilateral ban served two

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[290] Commonly attributed to former Governor of the Bank of England Mervyn King.

purposes. First, it re-established the legitimacy of Germany's ascendancy in the financial services policy community due to the reputational blow it took at the hands of German speculators. Secondly, it also asserted Germany's national autonomy in the face of increasing European integration and global financialization.

The German ban is also instructive in that it explicates the nature of the shifting authority relations within Europe at the time, and the extent to which first-mover attempts are deemed as legitimate. For example, internal OTC policy-making in the UK up until now had gone the furthest, the fastest with regards to financial reform. This would seem to be prima facie evidence of its preferences to be the first-mover in Europe. Like the US, it also demonstrates that those countries responsible for the crisis sought to send signals to other nation states that they would get their houses in order with regard to financial services regulation. British financial services policy-making (like the US) however, had largely been discredited by the crisis and domestic regulators within the UK scrambled to address structural problems with their regulatory regime. In contrast, Germany's unilateralism points to the both the contested nature of authority relations within Europe at the time. It also points to the recognition by German officials of the inconsistency between their rhetoric in Brussels as reformers and the effects that German speculation was having on the crisis. This disparity threatened German ascendancy within the EU to the extent that they sought to send a signal to other member states. A signal that they were willing to go farther with reform by prompting a ban that no other European actor in the policy community had proposed. Thus the German naked swaps ban was of a considerably higher order of magnitude in terms of the European proposals being bandied about in Brussels. The German ban also seems like an effort by German

officials to reestablish some semblance of its historical pre-crisis era legislative restrictions on contracts of differences (see chapter 2). This suggests that the Greek crisis associated with sovereign CDS had represented a unique focusing event in OTC reform for the Germans as well. As an affirmation of the German ascendancy in crisis-induced financial reform, the European Parliament in November 2011 would mirror the German ban by passing a regulation banning naked CDS on sovereign debt.

ESMA: The Little French Regulator That Could?

The preceding section laid out the broad parameters of the policy debates among European member states in the wake of the Greek crisis. As I've argued, the role played by CDS in the market for sovereign debt was successful as a focusing event for EU officials to increase the tempo of OTC reform, which was on a slower more deliberate pace than its transatlantic counterpart. As we will see below, similar to what transpired in the US the perception of hedging as legitimate within the OTC policy community would assist the veto efforts of NFCs to introduce friction into the reform process. While the success of reform oriented officials within the EU was attributable to their earlier effort to portray CDS as synonymous with the perils of rampant speculation.

The following section sketches out the politics associated with the institutional development of The European System of Financial Supervision (ESFS). Its development is consistent with the historical institutionalist framework proposed in this study in that once again we see a formerly middling, yet now ascendant French regulator tasked with a central role on OTC reform. In this regard, the newfound oversight powers delegated to the European Securities and Markets Authority (ESMA) as a focal regulator for OTCs bears some resemblance to the ascendancy of the CFTC in the US. However, the CFTC's

ascendancy was rooted in the preferences of domestic actors to preserve the bifurcated structure of financial regulation in the US. In contrast the EU's approach to financial regulation in light of the crisis saw a continuation of its consolidated approach as derivatives were brought under the authority of its securities regulator now rebranded for a new era. Furthermore, the institutional bifurcation in the EU and ESMA's ascendancy vis-à-vis the ESFS is associated with European authority relations wherein an increase in EU-level authority coexists with the preservation of national discretion for its member states in distinct issue areas.

The decision by officials in Brussels to delegate authority over OTC reform, was informed by historical ideas about member states approach to regulating finance relative to European integration in the pre-crisis era. As we will see, due to the crisis the UK's diminished status continued to hinder the efforts of its national regulator to act as first-mover in European financial services policy-making, particularly as it pertained to OTCS. Germany's mixed status actually delimited its ability to act-hence its symbolic moves to ban naked swaps (see above). In contrast, France was the country whose experience with global finance and derivatives was mostly closely aligned with European integration and multilateralism. This ultimately contributed to its ascendancy in EU proceedings. OTC reform in the context of creating the ESFS was a reflection of the historical authority relations among the three primary member states in the EU.

In September 2010, the European Parliament backed a deal among EU member states to create an institutional framework of shared authority. This move would consolidate integrative European supervisory discretion to regional bodies while also embedding significant discretion for key member states in specific issue areas. The

European System of Financial Supervision (ESFS) that resulted would consist of the European Supervisory Authorities (ESAs), three watchdogs responsible for micro-prudential oversight at the EU-level; the European Systemic Risk Board tasked with macroprudential supervision across the EU, the Joint Committee of the European Supervisory Authorities as well as the national supervisory regulators of the individual member states. The authority delegated to the three watchdog agencies was also split among the three member states with the largest financial centers in Europe, where the agencies would be headquartered across three distinct issue areas. Banking issues would be under the remit of The European Banking Authority (EBA) headquartered in London, while Insurance concerns would be the province of The European Insurance and Occupational Pensions Authority (EIOPA) in Frankfurt with securities oversight delegated to the newly formed European Securities and Markets Authority (ESMA) residing in Paris, respectively.[291] For its part, ESMA would fulfill CESR's traditional oversight role as a securities regulator. This helped to preserve Europe's consolidated approach to regulating financial products, as the ascendant agency would be granted broad oversight over derivatives as well.

For the sake of brevity, I eschew a deeper examination of the structure of the ESFS in favor of looking at the agency tasked with oversight for OTCS. Specifically, I sketch out the some of the implications of the policy debates emanating out of the EC in the months leading up to the adoption of the ESFS and how these affected the authority

[291] European Union (2010) Regulation No 1093/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Banking Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/78/EC. <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:32010R1093>

that was delegated to ESMA. The broad thrust of what follows is similar to what occurred in the US in the lead-up to Dodd-Frank: the permissive conditions created by the Eurozone crisis, opened up new institutional opportunities for formerly marginalized actors-in this case France which had been somewhat sidelined historically in global regulatory financial policy-making-to suddenly punch above its weight in European financial regulatory policy debates.[292] Also like the CFTC in the U.S., French preferences for reform would now be embedded within ESMA, an agency with little experience but which would now be responsible for rule-making regarding for the most important plank of the G20 agenda: central clearing.

The import of implementing the G20's central clearing recommendations featured prominently in early EU deliberations. A European consultation paper from the EC in Spring 2010, suggested that a new pan-European supervisory agency would be given oversight over which OTC contracts should be subject to central clearing. In lieu of creating a new agency however, European officials instead proposed a revamp of the Committee of European Securities Regulators (CESR) which would now become the European Securities and Markets Authority (ESMA). Originally created by the EC as part of the Lamfalussy process in June 2001, CESR had-until then-been an independent committee of national securities regulators in Europe that served as an advisory group to the EC. It had been tasked to improve coordination among national regulators while working to implement community legislation among member states. However, no sooner

[292] Germany was ascendant during this time as well however to a lesser degree due to the culpability of German banks that were exposed to credit default swaps during the Greek crisis. This challenge to the legitimacy of German officials acting as reformers informs the analysis of Germany's unilateral ban on naked swaps as a means of restoring its tarnished reputation vis-à-vis the crisis (see above).

that this proposal was floated by European officials to revamp CESR, that some began challenging the idea of delegating significant cross-border authority for clearing to ESMA " an institution with no track record and arguably little relevant experience to deliver" [293].

European officials in Brussels at this time, proposed a bifurcated two-tier approach for CCPs with the proposed agency sharing delegated authority with national regulators. In this envisioned plan a domestic clearing house would first have to consult with its national regulator over whether it could clear a contract. Once this had occurred, ESMA would then rule on the applicability of any clearing obligation. For situations in which an OTC contract could potentially be subject to the clearing obligation but for which no clearing facility yet existed, ESMA would then work in conjunction with a new eurozone body tasked with overseeing systemic risk issues: the European Systemic Risk Board to make a determination.

The EU's development of the bifurcated approach to fulfilling its central clearing commitment was rife with political conflict. Recall that the sequencing of OTC reform vis-à-vis the G20 had already seen the issue as a focal point of transatlantic contestation.[294] Officials in the EC at the time were also highly cognizant of the financial services industry's early European attempts at self-policing initiatives (see above). These factors contributed to the fears of EU officials of leaving the development of central clearing in Europe solely up to the industry. Additionally, the threat of regulatory arbitrage elucidated by the unilateral German swaps ban (see above), had also weighed

[293] Quotation from Damian Carolan-then partner at Allen & Ovary. See: Grant, Jeremy & Nikki Tait. (2010). "Europe-wide body to oversee OTC clearing." *Financial Times* 8 June 2010.

[294] See Chapter 2.

heavy on the minds of European officials. They had been wary that allowing member states to decide on which contracts were required to be cleared could "lead to 27 different clearing obligations for market participants"[295]. Some officials sought to veto this effort, citing that a national approach would be insufficient in mitigating systemic risk and would only contribute to legal uncertainty. As a result, they emphasized the need for a single list of eligible contracts in Europe. In sum, the bifurcated supervisory approach for CCPs was informed by historically informed ideas about the negative aspects of self-regulation in conjunction with ascendant ideas about the need for pan-European coherence in the face of diverging national responses to crisis reform.

With officials in Brussels deliberating comprehensive financial reform and the transformation to ESMA still forthcoming, CESR efforts to further OTC reform would have lasting institutional effects. In July 2010, the Committee issued advice to the EC on by updating the Markets in Financial Instruments Directive (MiFID), a pre-crisis set of technical standards which officials in Brussels were set to review in 2011. One of CESR's main recommendations to the EC at this time had focused on improving post-trade transparency by establishing a mandatory common consolidated tape. This would address an existing problem under the original MiFID that had allowed high-frequency traders (HFT) to profit from differentials across a number of alternative trading venues that had proliferated in recent years. A strategy that was unlikely to occur with traditional stock exchanges. There was a perception at the time that CESR had not gone far enough in address HFT in the lead up to the crisis. Furthermore, the permissive conditions in the financial services policy community in Europe at the time lent weight to the regulator's

[295] Quotation from Damian Carolan-then partner at Allen & Ovary. See: Grant, Jeremy & Nikki Tait. (2010). "Europe-wide body to oversee OTC clearing." *Financial Times* 8 June 2010.

attempts to rectify this.[296] However, the conditions surrounding the controversy over CDS and the policy misfire in the Greek crisis also contributed to the committee widening CESR's regulatory ambit. Subsequently, it began voicing its desire to extend the transparency requirements for equities markets to bonds, derivatives and other structured products. This would see an expansion of CESR's original supervisory oversight as ESMA's new mandate was grafted onto the original MiFiD.

The deal among the primary member states to create the ESFS, reflected some of the characteristics of the rift that had opened during earlier EC deliberations (see above). As noted, the authority delegated to the three new watchdog ESAs was divided among the three most influential EU member states the UK, France and Germany. However, the deliberations among these countries also reflected some of the latent tension between the autonomy of national regulators and deeper European integration. Under the proposed ESFS, ESMA would not supervise markets or individual companies directly, but instead would be responsible for drawing common technical rules and standards. This would leave direct supervisory oversight to the discretion of national regulators. However, there was enough latent ambiguity in the deal that passed through the EP that officials from these countries still had reservations. The fears of market actors in the City of London, were that further EU legislative proposals would see Brussels seeking to expand the watchdogs' oversight. This was despite British officials suggesting that the deal had resulted in a favorable outcome for the UK after months of negotiations. France, whose banks had come through the Greek crisis relatively unscathed, had also emerged during the EC's initial deliberations as the actor pushing most strongly for centralized pan-EU

[296] Anonymous (2010) "Miffed markets" *Financial Times. Opinion, 30 July 2010.* P.6.

powers. With the deal splitting authority relations between EU-level authorities and national regulators falling short of their ambitious preferences, French officials nonetheless still voiced their support. Germany, took a more moderate tone trying to reassure national regulators. German finance policy expert Leo Dautzenberg, a member of Chancellor Merkel's CDU hailed the agreement noting that it had closed an important gap in financial market regulation. He also cautioned the three new EU-Level watchdogs to exercise care in using their powers over national institutions and securities market sectors.[297]

Drafting EMIR

With the ESFS agreed to in principle, the European Commission set out to fully address the clearing aspect of OTC reform. This process that would pit public officials against the veto efforts by market actors on the derivatives buyside. As the policy process of developing the draft legislation began to proceed however, there was (like in the US) significant uncertainty as to exactly whom EMIR's clearing obligation would apply to. For example, property firms that used swaps to hedge against risk, were concerned that they would be swept up by the new European clearing rules. Rules that might have demanded cash as security for collateral as opposed to the traditional means of using a firms' physical assets to do so. A study conducted by Chatham Financial estimated at the time, suggested that the loss of working capital could be as high as EUR64.9bn in Europe's property sector. This could in turn, have significant knock-on effects for European development projects and the jobs related to them.[298] In response, officials in

[297] Tait, Nikki. (2010). "States back EU finance overhaul" *Financial Times.* 4 Sept. 2010. P.6.

[298] Tait,Nikki. (2010). "Property groups warn on swaps" *Financial Times.*24 Nov. 2010. P.23.

the EC echoed the CFTC in stressing the need for a level playing field free from regulatory exemptions that could potentially contribute to loopholes that firms could then use to evade regulation.[299] The Commission had already stated that it was willing to grant exemptions for non-financial firms using derivatives as a legitimate hedge, but was seemingly unprepared for the flood of firms seeking exemptions that ensued. As a result, the response from Brussels was that European officials were also ready to take into account any valid concerns that market participants may have.[300]

Like the US, issues regarding the tempo of OTC reform also plagued European policy deliberations as actors tried to create institutional friction. Jean Baptiste de Franssu of the European Fund and Asset Management Association whose members managed EUR 14,000bn in assets, expressed concern that officials in the EC were moving too far, and too fast. He also added that the quality of European regulation was deviating from historical standards. European investors also feared that their voices were being drowned out by policy actors who were more concerned with moving quickly through the process. The response from European reform oriented officials was consistent with what we've seen so far in that they preferred to move with haste on OTC reform. To this end, Michel Barnier voiced his concerns that the regulatory reform agenda could lose its urgency as the financial crisis receded.[301]

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[299] This response from the EC tracks almost verbatim to Gary Gensler's early CFTC statements on OTC reform in the U.S. See: Braithwaite, Tom (2010). "Republicans urged to protect funding for futures watchdog" *Financial Times* 22 Nov. 2010: P.2.

[300] Braithwaite, Tom (2010). "Republicans urged to protect funding for futures watchdog" *Financial Times* 22 Nov. 2010: P.2.

[301] Milne, Richard. (2011). "Investors voice concern at impact of changes" *Financial Times* 21 March 2011 P.18.

European integration was an important component lending weight to asset managers' arguments on the legitimacy of financial reform. The asset management sector at the time was quite critical of EC officials hewing too closely to global initiatives like the G20 agenda on OTC reform. This was seen as coming at the expense of building Europe up as a financial center in its own right. From their perspective, Europe's strength was its large savings pool on the continent, which British fund managers had long capitalized on by exporting management services to other European member states. For example, foreign funds consisted of only 10% of the asset base in France, while UK managers looked after almost the same amount of funds based in Luxembourg and Dublin as they did in London. In terms of Europe as a whole, this contributes to the idea of a relatively bifurcated European financial system with most of the speculative activity occurring in the UK tapping into a large continental savings pool. This contributed to the increasing status of asset managers as ascendant policy actors in reform deliberations on two grounds: One, that they oversaw the vast savings of European investors that British fund managers were reliant upon to keep the European financial system liquid. And two: that they were in favor of more European integration, not less. This made their overall regulatory preferences consistent with reform oriented EU officials despite the existing issues over the requisite tempo of reform.[302]

From MiFID To MiFID II

As noted above, the regulatory regime for OTCs that emerged from the sovereign debt crisis in Europe was bifurcated along institutional lines that reflected the shifting

[302] Skypala, Pauline. (2010).“Regulators trailing cross-border trends” *Financial Times* 27 Sept.2010 P.14. Jean Baptiste de Franssu, chairman of EFAMA, the European Fund and Asset Management Association. Franssu's efforts were seen at the time as pushing “for the integrated regulation that was resisted by previous European Commission personnel”.

nature of authority relations among member states in the EU. Also, the European derivatives regime that emerged from the crises saw the EU's commitment to the G20's pillar on clearing embedded within the regulation: EMIR. This process that saw the introduction of a new rule making clearing mandatory for eligible participants. More importantly, because under EU rules a regulation has binding force within each member state (unlike a directive which doesn't) this means that any subsequent legislation would not require implementation. Therefore, the least ambiguous element of the G20 reform agenda-central clearing-was embedded within European legislation that left little room in the way of discretion for member states. Trading rules however, were more ambiguous under the G20 recommendations. In the EU these were addressed under MiFID II, an update to the original MiFID, although there are enough significant overlaps to render even this delineation somewhat problematic. The original MiFID I was a financial services policy initiative introduced by the EC in 2004. It intent was to liberalize share trading by breaking up the monopolies of national stock exchanges and fostering competition in share trading. This in turn, would allow for the proliferation of new trading platforms going into effect in 2007 right before the crisis began in the US. Moreover as an EU directive, MiFID II must be enacted into law by national member states, giving national regulators within the EU significant discretion in interpretation during implementation. In sum, while the US regimes is bifurcated along product lines, the derivatives regulatory regime in Europe is bifurcated along institutional lines that reflect authority relations between the autonomy of individual member states and EU-level initiatives.

In the spring of 2010, as European officials and policy makers began developing the draft legislation for EMIR, it was apparent that the two institutional facets of the European regime for OTCs were progressing differently along varying timetables. The initial view of EMIR was that it largely mirrored the requirement in Dodd-Frank that OTCs be processed through clearinghouses consistent with the transatlantic commitment to the G20 reform agenda. However, the early draft review of MiFID II suggested that the European model for trading would likely diverge from the US approach. For example, in proposing a structure for its Swap Execution Facilities (SEFs) the CFTC in the US had displaced the opaque pre-crisis trading model where dealers negotiated with private counterparties outside the public domain. Instead, the new model in the US would foster greater transparency by allowing market participants to view prices directly in view of the public. This would ultimately contribute to significant price discovery in the OTC markets. In contrast, MiFID's model for Europe saw greater flexibility for their trading requirements. Under their version: Organized Trading Facilities (OTFs), a small number of broker dealers would still be able to quote prices over the phone to potential buyers and sellers. Dealers active in Europe took this as a positive sign that their existing model might survive the reform process more or less intact.[303]

There was also another significant difference with the US in the way that the revision of MiFID would proceed: the extent to which the big banks would be allowed to influence rule-making. Many of the large globally active banks were already engaged in pushing back against US exterritorial rules which would have forced their EU arms to

[303] Grant, Jeremy. (2011). "Governments wary about boosting monopolies" *Financial Times*. 31 May 2011. P.6.

collect collateral from their counterparties.[304] Additionally, many of these banks were implicated in two sweeping European anti-trust investigations by the EC. One involved Markit, a British firm that provided pricing and financial information for the CDS market. The other centered around the European clearing business of Intercontinental Exchange a US firm.[305] As ESMA was starting its work as Europe's new securities regulator in January 2011, it set out to establish the Securities and Markets Stakeholder Group (SMSG) a deliberative body that would advise the regulator on implementing financial market reform. Most of the large global banks had already submitted their names to be considered for inclusion in the 29-member body. However, they now found themselves largely shut out of the process by the European regulator. Only one of the major global banks-JP Morgan-was appointed to the group- to represent financial market participants (the only other bank appointed was EFG of Greece). Also, exchanges (like in the US) were ascendant during the Eurozone crisis with the Federation of European Exchanges and three of Europe's largest exchanges-LSE, NYSE Euronext and Deutsche Bank's Eurex obtaining seats with the advisory group.[306] In sum, like the US first mover effort in deliberating with the EU, the global banks were considered *persona non grata* in

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[304] Braithwaite, Tom (2011). "JPMorgan urges Congress to halt new capital rules " *Financial Times.* 16 June 2011. P.6

[305] In the case of Markit, the firms was accused of colluding with the banks in order to block market entry to potential competitors while ICE Clear Europe was accused of engaging in a profit-sharing with the banks, as well as granting them preferential tariffs, in effect precluding their ability to use competing CCPs. Some of the banks cited in reporting on the two investigations were some of the largest financial institutions in the world including: Bank of America Corporation, Barclays Bank, Citigroup, Credit Suisse Group, Deutsche Bank, Goldman Sachs Group, JP Morgan Chase, Morgan Stanley and UBS. Authorities in the US had begun a similar probe in 2010. See: Chaffin, Joshua; Jeremy Grant. (2011) "Brussels to probe big CDS operators" *Financial Times.* 30 April 2011. P.1.

[306] Grant, Jeremy. (2011). "Derivatives rules body excludes industry " *Financial Times.* 19 May 2011. P.6.

ESMA's new advisory group. Under normal circumstances, the banks-whose expertise in derivatives would guarantee them a key role in helping to develop technical standards for trading contracts. However, the decision by ESMA to exclude the large global financial institutions from a key European deliberative body, left the banks at a significant disadvantage. This would eventually hamper their veto efforts as they sought to impede reform during the development of MiFID II for trading European derivatives.

The subsequent MiFID review saw EU reformers updating the directive. Of primary concern were the issues highlighted by the focusing event for OTCs as well as changes to the market that had occurred since the original directive. For example, the EC's unveiling of MiFID II in early October 2011 saw the scope of the original MiFID widened considerably. While its predecessor focused largely on securities trading of equities and bonds, the new version-in light of the crisis-would now focus on the derivatives of commodities, currencies and credit products as well. Moreover, MiFID's original liberalization of share trading (see above) had also led to the proliferation of trading platforms that in the ensuing years had resulted in a fragmentation across multiple trading venues creating potentially risky market structures falling beyond the scope of the initial directive. As a result, MiFID II would also focus on trading venues in addition to its new wider scope of trade reporting. This would also expand the definition of an OTF along with rules for their supervision. In sum MiFID II would oversee the changes to financial markets affected by its institutional predecessor as well as issues brought to light by the crisis.

The MiFID review, also displayed a key difference in the European regulatory philosophy from their US counterparts. As noted above, MiFID II's rules for defining

what constituted a trading venue (OTFs) were significantly more flexible than the US' for SEFs. When it comes to developing financial sector regulation, there is an argument that a broad principles-based approach produces better policy-oriented results than a prescriptive approach. This is because the ability of market actors to evade regulation increases in tandem with the requisite level of details in a given rule. There is some evidence to suggest that this regulatory philosophy was a consideration for EU officials during the MiFiD review. For example at the time of MiFiD II's unveiling, reform oriented authorities in Brussels preferred leaving considerable ambiguity in defining what constituted an OTF, precisely because it would make it difficult for firms to develop creative ways to circumvent the rules.[307]

The revisions to MiFiD also demonstrated some bifurcated institutional elements mirroring the authority relations in EU financial services reform. For example, while MiFiD II defined OTFs, OTF rules and reporting requirements would be addressed by MiFiR, which was passed on its own but is usually referred to in conjunction with MiFID II. In contrast to MiFiD II which is a directive, MiFiR was passed as EU level regulation and thus has binding force over member states leaving them little to no discretion in its application. Some of MiFiR's standards included promoting trade venue transparency by mandating that they publish rules related to volume allowances (position limits) of its trading members as well as what products needed to be traded on the venue. Investment firms would face a stringent requirement to report the basic details of trades in near real time. Transaction reporting which is more of an in-depth measure than trade reporting-however, would include details of both the buyer and seller as well as how the trade was

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[307] Barker, Alex; Jeremy Grant. (2011). "Mifid's net cast wide to overhaul Europe trading " *Financial Times*. 21 Oct. 2011. P.31.

executed. In contrast, post-trade transaction reporting to an Approved Reporting Mechanism (ARM) was more flexible for end-users and the sell-side alike, in that its temporal requirement allowed for a T+1 approach to accommodate Europe's dual reporting regime which was more onerous than its US equivalent.[308] The complexities of the MiFID review, led the European Parliament to postpone (like the CFTC had done the year before) the finalization of EMIR in July 2011.

Intense politicking around derivatives and the clearing aspects of EMIR/MiFID also played a role in postponing EMIR's finalization. The historical legacy of longstanding relationships between clearing-houses (CCPs) and national stock exchanges had left Europe with a highly fragmented landscape for central clearing.[309] Despite the recent emergence of new clearing houses spurred by the proliferation of alternative trading venues from the first MiFID (see above), the cost of central clearing in Europe was up to 8x higher than in the US, with up to 40% of a trade's costs devoted solely to clearing. Therefore, the financial reforms implicit in EMIR/MiFID represented a new wave of business opportunities for exchanges and clearing-houses as a result. Market participants on the buyside however, favored reduced clearing costs, calling for more competition in clearing. This was opposed by the large banks, who favored the consolidation of CCP clearing voicing their concerns through the Association for

[308] T+1 denotes a temporal threshold for reporting of the time of the initial transaction plus one day. This aspect of MiFIR, focusing on a time allowance for trade reporting seems like a political compromise in light of the more stringent reporting requirements in the European regulatory regime given the real time requirements for speculative investment firms and the looser reporting time for end-users.

[309] Stafford, Philip. (2010). "Stock exchanges muscle in as clearing-houses prepare for shake-up " *Financial Times.* 3 Nov. 2010. Vertical silos in this instance refers to when a stock exchange has its own clearing house allowing it to benefit competitively from vertically oriented economies of scale.

Financial Markets in Europe (AFME).[310] There were however some points of agreement: a coalition of banks, CCPS and regulators were pushing for greater interoperability.[311] Generally speaking though, buyside actors wanted greater competition in clearing to reduce costs with the banks as the ascendant CCPs stood to benefit from any new changes to the status quo that would result from consolidation in the clearing sector.

The political dynamics of the European clearing sector inevitably pointed to underlying transatlantic competitive concerns as the implications of financial reform threatened to unseat Europe's dominant CCP. Prior to the crisis, the vertical silo that existed in the US had helped the CME Group in Chicago secure its dominant position in US futures markets.[312] Across the Atlantic, Germany's Deutsche Börse shared largely the same distinction for futures in Europe. However, the newfound opportunities in clearing fostered by regulatory reform, saw Anglo-American firms now planning to develop their own clearing houses in Europe. This represented a competitive threat to the German exchange's favored status in Europe. This competitive threat is why in October 2011, Deutsche Börse sought to veto a MiFIR requirement that would open up exchange traded derivatives to greater competition in Europe as soon as it was announced. These

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[310] A spokesperson from AFME argued that the consolidation (of CCPS) "allows users to gather and offset their positions in a single portfolio" Presumably, their argument rested on the higher costs and inefficiencies that would result from having multiple portfolio positions to offset. See: Stafford, Philip. (2010). "Stock exchanges muscle in as clearing-houses prepare for shake-up " *Financial Times.* 3 Nov. 2010.

[311] Interoperability addresses the connections between 2 or more clearing houses and trading venues, allowing the CCP to clear its members trades regardless of the platform that executed the trade.

[312] Tellingly, federal antitrust regulators in the US in 2007 approved a merger between CME and CBOT holdings allowing the CME group to basically corner the market in futures clearing in the US. US Dept. of Justice (2007). STATEMENT OF THE DEPARTMENT OF JUSTICE ANTITRUST DIVISION ON ITS DECISION TO CLOSE ITS INVESTIGATION OF CHICAGO MERCANTILE EXCHANGE'S ACQUISTION OF CBOT HOLDINGS INC. Monday June 11, 2007. <https://www.justice.gov/archive/atr/public/press_releases/2007/223853.htm>

preferences for consolidation in the clearing sector also undoubtedly played a part in Deutsche's proposed merger with NYSE Euronext, which was opposed by European officials on anti-competitive grounds the following year.[313]

The UK used the German exchange's preferences for consolidation to successfully veto an expansion of EU-level authority. In European policy deliberations, the British had pushed vehemently for the inclusion of exchange-traded derivatives (in addition to the focus on OTCs) which would have widened the scope of EMIR's draft legislation considerably. The UK also feared that London's predominance in derivatives would be undermined by the proposed EU-level regulation, which would force clearing houses to relocate to the continent. In an effort to veto this initiative, the UK used the threat of expanding EMIR's scope (which would result in higher costs and potentially unseat Deutsche's vertical silo in clearing) into obtaining concessions. The UK eventually removed its request that exchange-traded derivatives be included in EMIR. However, this was contingent upon obtaining a significant concession from Brussels (despite being outnumbered at one point 26-1 in EU negotiations over derivatives rules that would affect the City primarily). This concession from the allow ESMA's to overrule UK regulators decision to authorize a clearing house only if there was near unanimity to

[313] European Commission 2012. Case No COMP/.6166 - DEUTSCHE BÖRSE / NYSE EURONEXT REGULATION (EC) No 139/2004 MERGER PROCEDURE Article 8 (3) Date: 01/02/2012 <https://ec.europa.eu/competition/mergers/cases/decisions/m6166_20120201_20610_2711467_EN.pdfAccessed> Accessed April 12, 2021.

do so in the Agency's relevant committee. George Osbourne, the British financial minister at the time said that the changes, in effect "remove a eurozone veto" against the city.[314]

More EU Dynamics

The political dynamics of the EU deliberations over derivatives rules and the competition among member states fed into the broader narrative in the split over European integration. British prime minister, David Cameron suggested that the UK's veto efforts towards beefing up European market supervisors like ESMA were an attempt to resist Germans moves to relocate the financial services industry to Frankfurt at the expense of the City. These efforts by the British prime minister to protect the UK's national interests were supported domestically by the largely Eurosceptic Conservative party. The main point of contention for the continental countries of Europe was rooted in the original argument that was proffered in early debates about a Euro clearing house in chapter 3, namely whether or not it was legitimate for London to "dominate the market for euro-dominated instruments without accepting European supervision"[315]. This had contributed to calls by the ascendant French and Germans for greater European integration in financial services reform in general and OTCs in particular.

The continuing spread of the eurozone crisis served as an ongoing focusing event for officials in Brussels to address the lingering concerns with problems in the European market for sovereign CDS. Its implications for the central banks in European member states in particular was a significant source of concern. In November 2011, the EC

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[314] Barker, Alex. (2011)."UK wins ground on derivatives regulation " *Financial Times.* 5 Oct. 2011. P.2.

[315] Barker, Alex "Barniers vs the Brits " *Financial Times. 9* Nov. 2011. P.7.

followed the German-led model putting forth a Euro ban on naked sovereign CDS which stopped investors trading CDS unless they owned the underlying bonds.[316] This occurred, despite earlier concerns by actors in Brussels that doing so would trigger regulatory arbitrage as the trades would then migrate to New York.[317] It's worth noting that the euro ban was initiated by the EC, despite an earlier proposal which would have exempted central banks in the initial draft legislation for EMIR. The ongoing eurozone crisis however, had contributed to the permissive conditions for officials in the EC to expand their remit for reform. As a result, the exemption was no longer politically tenable given fears of systemic vulnerability to contagion originating in the market for sovereign CDS in Europe from banks' large exposures to German and Italian debt.[318]

Despite the sense of urgency created by the ongoing eurozone crisis, actors veto efforts in Brussels were successful in introducing friction into the process of drafting EMIR. With their sights set on finalizing the draft legislation by the end of 2011, a trialogue of the European Parliament, Council of Ministers and European Commission officials, met in Brussels in November. The trialogue however, failed to reach agreement on several key points as member states sought to veto the greater pan-European authority that OTC reform represented. First, the British resistance to French authority over central clearing continued, as the issue of whether or not to expand ESMA's oversight to authorize CCPs was resisted by a small coalition of regulators from countries aligned with the UK. Also, there were disagreements over whether the EU could give unfettered

[316] Barker, Alex "EU ban on 'naked' CDS to become permanent" *Financial Times*. 18 October 2011.

[317] Hall, Ben; Oakley, David & Nikki Tait (2010). "Policing of CDS trading poses dilemma" *Financial Times.* 10 March 2010. P.4.

[318] Bowles, Sharon. (2011). "It is time for the sovereigns to swallow their medicine" *Financial Times.* 24 Nov. 2011. P.20.

access to EU markets for central clearing to non-EU market participants, and whether the EU could also tie-in recognition of non-EU CCPs. On the other side of the Atlantic the CFTC at the time was issuing a 6 mos. extension for market participants in the US to adhere to the commission's newly promulgated swaps rules.[319] Therefore, policy-makers on both sides of the pond were just starting to come to grips with the disparity between the international consensus for global OTC reform and its implementation. As a result, the European trialogue pushed off EMIR's finalization into the New Year.

The successful efforts to delay the implementation of derivatives reform on both sides of the EU-US, signaled the potential slippage of the G20's timetable. Olivier Guersent, the EC internal markets official (and Michael Barnier's second in command at the time) recognized that eliminating ambiguities between the transatlantic approaches as well as doing away with regulatory overlaps between the two regulatory regimes, was particularly significant for derivatives. Moreover, he hinted at some of the problems brough to light by the recent German unilateral swaps ban that represented an ongoing challenge for the EU's regulatory development. In doing so, he cited its origins as a system of national networks that made coordination at the EU-level particularly difficult but one that was necessary given the transnational nature of the market.[320]

Opportunistic Reform: The Global Exchanges

As deliberations over EMIR proceeded, the EC set its sights on a proposed merger that would have vast implications for the global market for central clearing in Europe.

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[319] Grant, Jeremy. (2011). "Over-the-counter derivatives reform faces delay in Europe" *Financial Times.* 21 Dec. 2011. P.24.

[320] Woolfe, Jeremy. (2011). "EU prepares to battle for a stronger system: Interview". *Financial Times.* 19 December 2011: 8.

Deutsche Börse and NYSE Euronext were engaged in lobbying the Commission to approve a merger between the Bourse's derivatives exchange with Liffe, a derivatives exchange operated out of the UK by NYSE. Officials in Brussels had been skeptical of the merger suggesting that it would create barriers to entry as the Commission was already focused on forcing more competition into exchange-traded futures. The argument proffered by the exchanges was that because the different products offered by Eurex and Liffe were at different ends of the interest rate yield curve, they were not in direct competition with one another. When this argument proved unpersuasive to European officials, the ascendant exchanges tapped into the existential crisis plaguing the EU's sovereignty *vis-à-vis* its lack of a continental CCP for the large market of Euro-denominated derivatives. They argued that the EC should approve the deal in order to create a European counterpart to the CME in the US, suggesting that the large regional market needed a European champion in central clearing.[321] EC officials however, opposed the merger suggesting that both firms already enjoyed significant benefits from their siloed structures (see above) and that approving the merger would have in effect created a single vertical silo in European clearing.

Finalizing Emir

The detailed framework for EMIR began with the Level 1 phase of legal documentation in early 2012. The European Council agreed to a general set of principles for EMIR in Feb. the same month that ESMA began to develop technical standards for OTCs, CCPs and trade repositories. At the time, there was considerable uncertainty about

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[321] Anonymous. (2012)"Q&A: Are Europe's antitrust authorities right in trying to block the biggest exchange merger ever attempted?" *Financial Times.*12 Jan 2012. P.24. As noted above, the CME merger in the US before the crisis had contributed to the CME's monopoly on clearing.

whether ESMA would be able to function in line with its new regulatory remit. The agency only had 75 employees overseeing the reporting of millions of OTC trades leading to the conclusion that the middling agency was significantly overworked and understaffed. Lawmakers in the EP signed off on the new rules the following month in accordance with its standard co-decision procedure with the European Council. After public commentary discussions that spring in Paris, the Level 2 phase of the regulation saw ESMA releasing a consultation paper that June. EMIR was published into the Official Journal of the EU on July 27, 2012 and entered into force of August 16, 2012. Its application however, was ultimately contingent upon the finalization of the regulations technical standards, which weren't adopted by the EC until that December.

The finalization of EMIR in 2012 reflected the shifting dynamics of regulatory authority in Europe. An openly contentious debate among finance ministers in Brussels had revolved around a proposed transaction tax that would cover all bond, share and all derivative transactions.[322] The levy once again had been driven by ascendant French and German officials who planned on mimicking the UK's existing stamp duty. They pushed for the tax despite the growing recognition that there wasn't the requisite unanimity in the eurozone to further the proposal. Sweden and the Netherlands joined the UK's veto efforts towards the EU-level initiative as they voiced reservations about the proposed tax. The following month saw Sweden again aligning itself with the UK rallying other countries to veto the EC's plan that would preclude another unilateral ban like the one Germany passed on naked swaps (see above). The Commission had sought to prevent

[322] Barker, Alex. (2012). "EU looks at stamp duty to settle tax impasse" *Financial Times.* 14 Mar. 2012. P.7.

member states from out-regulating the EC by adopting rules more stringent than EU standards.[323] However, races to the top were not the only consideration as some of the continental countries sought to gain a competitive advantage challenging the regulatory authority of a pan-EU regulatory body based in Great Britain. For example a coalition of France, Germany and Spain pushed for changes to make it easier for their national banks to meet stringent standards promulgated by the new pan-EU banking regulator the European Banking Authority based in London. In sum, the development and passage of EMIR took place in the context of a number of financial regulatory reform issues that saw opposing coalitions of EU member states acting to veto the preferences of ascendant actors. The bifurcation of European OTC reform had preserved autonomy for its member states to veto the centralizing aspects of pan-European authority when it best served their national competitive interests.

The UK: Forum Shopping for Regulatory Authority

The discussion that follows demonstrates at least anecdotally, the extent to which the UK sought to re-assert its regulatory authority in financial services policy-making for OTCs. London's role in transmitting the financial contagion across the Atlantic from the US sub-prime mortgage market via OTC contracts had the effect of diminishing the influence of British officials in the context of the G20's subsequent efforts to build an international consensus for global financial reform (see chapter 2). Additionally, this process saw the ascendant continental countries of France and Germany benefitting from this institutional setting due to their dual roles as individual members of the rich club of countries as well as influential members of the EU which was also a member.

[323] Barker, Alex & Brooke Masters. (2012)."Conflicting signals" *Financial Times.* 2 April 2012. P.7.

Furthermore, as the Greek sovereign debt crisis triggered the start of the eurozone crisis, London's status as home to much of the world's market for sovereign CDS saw a continuation of these trends.[324] Therefore, the efforts of the French to levy a transaction tax on derivatives as well as a whole host of financial transactions, demonstrates not only the degree to which the crises had diminished the influence of the British in European OTC reform deliberations, but also the extent to which the French and Germans sought to utilize their newfound influence in EU deliberations to gain a competitive advantage for their firms and financial centers. Consistent with much of what has been addressed so far in this chapter, is the idea that the crisis had triggered a significant shift in institutional regulatory authority in the EU. Despite their diminished status in the European financial services policy community, British officials and regulators were still able to successfully check French and German preferences for EU-level regulatory proposals. However as we saw above, these veto efforts succeeded only in two instances: 1) Where the UK was able to secure a supporting coalition of other EU member states opposed to these measures or 2) When British officials were able to portray these national attempts to gain a competitive advantage as monopolistic coming at the expense of the EU's efforts to foster greater competition in financial markets.

The shifting nature of European regulatory authority also saw British regulators attempting to reassert their influence through their shared historical regulatory authority for OTC policy-making with the US. Recall in the last chapter, that the LIBOR scandal had contributed to tensions between the US and UK, much as a market power thesis

[324] See beginning of the chapter.

would predict. Additionally, the American extraterritorial effort to reign in US banks in London saw British interdealer broker ICAP threaten to kick American firms from its platform in light of the hefty fine it had incurred from the CFTC. However, the LIBOR scandal also saw the Anglo-American alliance working together to levy a large fine on British bank Barclay's, given that the firm had been implicated in the manipulation of the benchmark rates for a host of derivatives linked to energy and other financial products (like mortgage rates) on both side of the Atlantic. The ensuing scandal, and the considerable attention it attracted regulators from the CFTC in the US and the FSA in the UK to start paying greater attention to regulating speculation within the physical oil market. Although the exchanges in New York and London linked to physical commodities like oil were regulated in both countries, the global market for oil-like OTCs in the pre-crisis era, was still totally unregulated.[325] Therefore, the increased focus on benchmarks saw the US and UK using its historical influence in IOSCO (see chapter 2), an international umbrella group of financial regulators in an attempt to affect the trajectory of policy-making for benchmarks. After initial proposals for an increased regulatory response to the benchmark scandal, IOSCO backtracked in light of intense opposition from major oil producing firms in the OPEC cartel and international bodies like the International Energy Agency.[326] However, the ongoing probes into the role played by price reporting agencies in setting benchmarks, ensnared 20 of the world's

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[325] Blas, Javier; Guy Chazan, and Ajay Makan. (2013). "Price probe ripples across oil world" *Financial Times.* 18 May 2013. P.12

[326] Anonymous. (2012)."Misconduct in oil pricing is not mere conjecture" *Market Pulse-Financial Services: The Beat of Global Market.* Industry blog 25, Sept. 2012 <https://www.marketpulse.com/20120925/misconduct-in-oil-pricing-is-not-mere-conjecture-iosco/> accessed 6 April 2020.

biggest financial institutions forcing American and British regulators to lean more heavily into their own investigations[327]. This eventually undermined the Anglo-American led initiative through IOSCO. In sum, the response by the UK to the LIBOR sees the UK-despite its waning influence in European financial deliberations-trying to re-assert itself in international OTC policy-making, potentially establishing itself as regulatory first-mover.

Another attempt by the UK to re-assert itself in European OTC reform policy deliberations was through the Vickers reform debate in mid-2012. A domestic British commission initially led by Sir John Vickers in 2011, had proposed that all derivatives products-even plain vanilla instruments-should be kept separate from the retail operations of lender banks. A such, the proposal bore some resemblance to the swaps push-out rule in the US which the Republicans fought fervently to repeal (see last chapter). Like its US counterpart, the British plan would ringfence more complex derivatives like interest rate and currency swaps on a bank's balance sheet. This would effectively shield retail customers from any potential losses incurred from these contracts, which were riskier than traditional retail banking However, when this initiative migrated upward to EU-level deliberations, banks veto efforts saw them arguing that these were core functions of small and medium bank's business. For example, a bank with a significant portion of its business in foreign currencies might have a legitimate reason to hedge its exposure to such risk. Moreover, given that ESMA was still engaged with defining standardized swaps in the European context, attempts to define which products should fall inside the ringfence would not only be difficult, but may also create new opportunities for banks to

[327] Blas Javier. (2012). "Regulators to probe unusual gas trades" *Financial Times.* 13 Nov. 2012. P.17.

exploit any loopholes that would result from the regulation. The EC eventually agreed with the banks arguments that they should be allowed to sell simple derivatives inside the ringfence.[328] In short, the Vickers reform debate saw UK regulators as unsuccessful in asserting their regulatory authority by recasting themselves as regulatory first mover in Europe through domestic level initiatives. The process also saw the banks-whose influence had been delimited in European policy deliberations after the Greek sovereign debt crisis (see above) now successfully vetoing the British regulatory move in EU-level debates.

What we glean from the discussion of UK involvement in the LIBOR scandal and Vickers reform debate, is the way in which the British regulators sought to re-assert the UK as a regulatory first-mover in global OTC reform. There are a number of factors-institutional as well as structural-that could have factored into the regulatory calculus of British officials at this time. First, British regulators sought to forum shop in two institutional areas where they may have believed they still had considerable influence in affecting regulatory debates: 1) operating in conjunction with the US to set benchmarks via IOSCO as it had been an historical forum for Anglo-American financial services policy-making influence in the pre-crisis era, and 2) in the Vickers reform commission, a domestic institutional arena where its preferences would have been insulated from other EU member states. Moreover, both issues revolved around regulating the behavior of banks, an institutional pan-European regulatory function that the UK had gained through the political development of the ESFS in the wake of the Greek Sovereign debt crisis (see above this chapter). Secondly, UK's structural position in the global derivatives market

[328] Thompson, Jennifer. (2013).“Defining the trigger for ultimate sanction will be next step” *Financial Times.* 5 Feb. 2013. P.3.

was bolstered by the consolidation of the UK in global derivatives trading, to the extent that by 2013, 40-50% of all global trades were now going through London.[329] Therefore, British officials may have come to believe that this combination of institutional and structural factors would have strengthened its position in these institutional forums.

The results of the British effort to re-establish the UK within OTC policy-making were consistent across both cases. The US/UK's joint coordination as potential reformers saw both countries intent on setting global benchmarks through IOSCO as a response to the LIBOR scandal. However, the issue of benchmarks-and their attendant derivatives-overlapped with the broader global energy policy-making community. Therefore the Anglo-American regulatory initiative was ultimately stymied by the petroleum industry (OPEC) as well as international organizations like the International Energy Agency (IEA), who were able to successfully veto these efforts. The role played by both US and UK global banks in the scandal may have also delegitimized this Anglo-American global regulatory initiative in the eyes of the other actors in this policy community.

Additionally, the UK's joint efforts with the US to make an end-run around the European Commission in an issue area regarding derivatives may have also undermined its legitimacy even further with officials in Brussels. A unique aspect of the Greek sovereign debt crisis as a focusing event for OTCs had been that EU officials now saw them as potentially threatening the stability of the European financial system. Therefore, its unsurprising that the EC overrode Anglo-American preferences again by granting

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[329] Jenkins, Patrick; Michael Mackenzie, Daniel Schafer, Philip Stafford. (2013). "Banks suffer as derivatives trade shifts to the 'shadows' " *Financial Times.* 12 Sept. 2013.

ESMA oversight of benchmarks the following year.[330] In short, attempts by officials in the UK to reassert its authority in global OTC policy-making through its traditional position in IOSCO, fell quite short. Despite their diminished post-crises reputation (see above), banks operating in London were also able to successfully veto the most extreme regulatory proposals of British regulators in the Vickers reform debate. Their newfound success with officials in Brussels, was predicated largely on arguments based on the legitimate use of hedging with derivatives.

EU Rules, German Firms, and Asian Regulators

The next section picks up the thread of international dynamics set forth in the last chapter that occurred as a response to the CFTC's first mover regulatory effort during rule-making. Recall that the CFTC's first-mover efforts in 2012 at promulgating extraterritorial rules over derivatives had the effect of triggering a blowback from not only the EU but also from regulators in Asia as well. This effort was largely perceived as illegitimate by other countries/regions given its inconsistency with the G20 OTC reform agenda as well as its incongruency with domestic legislation for derivatives in other regulatory regimes (see last chapter). Extraterritorial rule-making by the US also undermined the threat of regulatory arbitrage which up to this point, had guided international deliberations towards harmonized OTC reform. As regulators and firms in Europe and Asia were set to implement central clearing by the end of 2012, the effect was such that in some cases, duplicative regulations were in place across regulatory regimes. This created even greater uncertainty for firms using derivatives and began

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[330] Anonymous. (2013).“Phoney turf war” *Financial Times.* 7 June 2013. P.8.

contributing to an increasingly fragmented global derivatives mark that threatened to undermine the G20 global OTC reform agenda.

The global OTC reform agenda and its attendant coordination problems, also took place within an international context in which new competitive opportunities were to be found in the nascent derivatives markets in Asia. Continued Chinese demand at the time had spurred greater use of hedging strategies by Asian firms, increasing the growth prospects of energy and commodity derivatives in the region.[331] This, therefore represented an opportunity for western firms seeking to profit from the increasing use of derivatives, by firms in leading Asian financial centers. For example, the global OTC reform effort's focus on central clearing had led to a wave of consolidation in the industry that triggered a race between large European exchanges like Deutsche Börse, ICE as well as US rival CME, to develop the necessary clearing infrastructure in order to capture more business in the region. More importantly, the eagerness of markets in Hong Kong, Japan and Singapore to build their own OTC clearing infrastructure in light of the G20 OTC reform agenda, created not only new opportunities for exchanges to profit, but also underscored the need for national regulators to succeed at coordinating the harmonization effort.[332]

Transnational market dynamics also signaled an opportunity for any regulatory regime best placed to offer its services for Asian firms contracting with western counterparties. Additionally, the standoff over the extraterritorial nature of the CFTC's

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[331] Grant, Jeremy; Hornby, Lucy. (2013). "Fast-growing commodity and energy markets lure exchanges to Singapore." *Financial Times,* 17 January, 2013; P.16.

[332] Grant, Jeremy. (2011). "Central counterparties eye a wave of opportunities" *Financial Times.* 22 March 2011; P. 3.

rule-making had represented a unique opportunity for European firms to profit from the international resentment from the US' unilateral extraterritorial effort. In this regard, the City of London already stood to benefit temporally from its closer geographical time-zone proximity to Asia over New York making it well-placed to benefit from new opportunities in the newly burgeoning derivatives markets in Asia. However, London's geographical proximity over NY was less significant to Germany's leading financial center Frankfurt, which also sought to raise its status as a leading global financial center. German globally-oriented firms had begun targeting Asian derivatives clearing business, in a marked shift away from the Anglo-American capital markets they had pursued for the past decade.[333] In the race to establish a foothold in central clearing for Asian derivatives, the multi-national exchanges would have to distinguish themselves from their peers.

German financial market participants courting business in Asia also sought to distinguish their regulatory approach from that of their Anglo-American peers. For example, in 2013 Europe's largest exchange operator Deutsche Börse had already begun pursuing a number of ventures in the region, with China's derivatives business standing out as a particularly attractive prize. Chief executive at the time, Reto Francioni suggested that the reason the firm was pivoting towards Asia was due to the cultural affinity that both countries shared towards the perceived social obligation that market economies were expected to fill. At the company's annual reception he told the group,

[333]Deutsche Börse sought to merge with the London Stock Exchange in 2016, but was blocked from doing so by officials in Brussels on anti-competitive grounds in 2017. See: European Commission (2017). "Mergers: Commission blocks proposed merger between Deutsche Bourse and London Stock Exchange" EC Press Release. 29, March 2017.

"We share the same basic belief […] that the 'Rhine capitalism' model of an economy buffered by corporations and focused on the long term, with strictly regulated markets […] is fundamentally superior to the Anglo-American capitalism model of deregulation"[334]. Francioni was suggesting that given Germany's newfound clout in European crisis deliberations as well as Germany's status as the largest economy in Europe that it should also host Europe's leading financial center as well. Then and only then, would Germany be able to play its leading role in Europe. Additionally, all future regulation at the EU-level should also take this issue into account. These suggestions were proffered-despite criticisms from bankers at the time-suggesting that what Franfkfurt needed to become a truly global financial center was what it sorely lacked relative to the Anglo-Americans: namely more hedge funds and private equity houses.[335] This demonstrates the extent to which market actors at the time were willing to use the idea of Germany's ascendant national profile in EU financial services policy-making, to further their own interests abroad. By linking its British and American competitors regulatory preferences to the causes of the crisis, Deutsche Börse also sought to burnish its credentials with prospective Asian clients, through appeals to a shared identity. The implication for Asia's fledgling derivatives markets however, was clear: the promoters of speculation shouldn't hold the keys to the casino.

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[334] Quoted by Stafford, Phillip. (2014). "Deutsche Börse calls for Frankfurt to take European lead in Chinese trading" *Financial Times.* 21 Jan. 2014. P.18.

[335] Ross, Alice. (2014). "Business coups help raise profile" *Financial* Times. 17 April 2014. P.6. Multinational banks like Goldman Sachs, JP Morgan and Morgan Stanley had already been drawn to Frankfurt based on the strength of Germany's Mittlestand-small and middle sized firms largely private and family owned-and had teams in Frankfurt advising large German companies on financing and mergers and acquisitions.

The interactive effects of transnational rulemaking not only had significant implications for who would benefit from the new derivatives business in Asia, but also helped to determine the region's engagement with the west over the G20 reform agenda. There were some who feared at the time that antitrust and nationalist imperatives would create barriers to the global wave of consolidation for the multinational exchanges, given that earlier attempts by national regulators to put in place harmonized standards for CCPs had been less than fruitful[336]. More importantly, in light of the ongoing efforts of European member states to implement MiFID, the cross-border implications of EMIR were becoming clearer. In late 2012, Asian regulators began voicing concerns that they needed to engage the global reform effort more fully. In response, Ashley Alder chief executive of the Securities and Futures Commission (SFC) in the region called on Asian regulators to work closely together stating, "If Asia does not get properly involved in the global regulatory agenda, we will find that the US and the EU rules will be extended to us whether we like it or not"[337].

Transnational rulemaking for OTCs also saw Asian market actors exploiting variations between the US and EU's regulatory regimes for derivatives. For example, a regulatory loophole in the transatlantic relationship between the US and EU, permitted Asian firms to trade with the US arms of European companies who were exempt from the central clearing requirement.[338] The implications of this loophole were significant in

[336] Grant, Jeremy. (2011). "Exchanges may have to dent national pride to be effective " *Financial* Times. 11 Feb. 2011 P.17.

[337] Davies, Paul J. (2012). "Calls for Asia to take own route" *Financial Times*, 28 November, 2012. P.22.

[338] Davies, Paul J. (2013). "UniCredit not trading in OTC with US groups " *Financial Times.* 29 April 2013. P.16.

creating synergies in derivatives contracting between European and Asian firms, as their financial outcomes were now linked more closely to the fate of European regulatory developments. As we see below, this would eventually ultimately contribute to the influence of Asian regulators' ability to veto EU officials' OTC rule-making efforts.

In late 2013, the coalition of European and Asian regulators that had successfully vetoed US extraterritorial rule-making the year before, proved to be short-lived. Asian regulators now became significant actors in vetoing the EU's own extraterritorial rules. In a move that echoed that of the US, the EU had mandated that under EMIR's rules, any clearing house in Asia hoping to offer services to EU financial institutions would first have to register with ESMA in Europe. However, Asian regulators were concerned that the rules being promulgated by Brussels and ESMA (which at the time was assessing whether or not Asian CCPS were operating under equivalent standards to those in Europe), were being written at the expense of Asian clearing houses whose primary focus was on local currencies and domestic bankruptcy laws. In response, 23 regulators from Asia wrote a letter to the EU's internal market commissioner Michel Barnier, warning of the significant impact that European extraterritorial rules would have on the viability of EU financial institutions doing business in the Asia-Pacific region. Moreover, this impact would be compounded if the EU imposed "conditions and standards that are not relevant, appropriate or even feasible*"* for clearing houses in Asia.[339] The inherent irony in this scenario is that it replicates almost verbatim, the arguments proffered by the same Asian and European regulators towards the US' own extraterritorial rule-making in 2012 (see

[339] Grant, Jeremy "Asia regulators attack Europe over clearing house standards " *Financial Times.* 4 Dec. 2013 P.20.

last chapter). The only difference now was that the EU was now trying to exert its own market power over Asian regulators.

US Accommodation and Mutual Recognition

The following section focuses on how the EU and the US ultimately sought to overcome its coordination problems in light of the international fragmentation of the global OTC market. The last section laid out how the varying challenges of implementation made a mutual recognition pact-whereby each regime saw each other's as functionally equivalent-between the two, imperative. Recall in the last chapter, that the intent of the Common Path Forward for derivatives, the bilateral agreement reached by the US and EU in the Summer of 2013 was to help contribute to harmonization efforts between the two regulatory regimes. Also recall, that the agreement itself had been the successful result of EU officials in Brussels (with the support of their Asian regulatory counterparts) acting to veto US cross-border rulemaking. That regulatory officials on both sides of the Atlantic could reach such an agreement, demonstrates the extent to which both sides were committed to moving forward together towards harmonized OTC reform. In keeping with the thrust of this empirical examination, the disparity between the international commitment towards OTC reform by public officials, and the regulatory reality of its implementation vis-à-vis complex cross-border contracting suggested that the Common Path forward would be short-lived and that a mutual recognition pact was absolutely necessary.

There were a number of international and transnational factors that ultimately threatened to undo the newly signed Common Path Forward. The last chapter saw this cooperation between US and EU officials quickly undermined by the efforts of European

market participants in the financial services industry, who pushed back against the CFTC's extraterritorial rules- by portraying US firms as *persona non grata* in London and the rest of Europe. This led the G20 in early September 2013, to recommit itself to finishing the job it started with the original Pittsburgh summit.[340] However, in keeping with this study's assertion that the G20's efforts beyond the original 2009 summit were largely epiphenomenal, no sooner had this pronouncement been made that the EC accused the US' CFTC of reneging on the transatlantic deal that both sides had agreed to that summer. This led to some authorities suggesting that mutual coordination for OTC reform might never occur, given divergent national implementation in lieu of a stronger international regime mechanism.[341]

Two other factors in late 2013 contributed to the perception that the G20's aspirations of harmonized global OTC reform were divorced from reality. The first was Asian regulators' successful veto efforts towards the EU's own extraterritorial rules, that we saw occurring in the last section. The second, was associated with the continued legal efforts of transnational market participants in the derivative trade associations to veto the CFTC's cross-border swaps rule-making. Once again, these actors argued that the CFTC was legally remiss in not conducting a cost benefit-analysis according to procedural rules

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[340] Carney, Mark. (2013). "A plan to finish fixing the global financial system " *Financial Times.* 10 Sept. 2013 P.9.

[341] Fleming, Sam. (2013) "Regulator warns of cross-border risk to markets " *Financial Times.* 25 Nov. 2013 P.18. The secretary general of IOSCO at the time David Wright, suggested repeatedly that the only way to overcome the fragmented global market created by varying national regulatory interpretations was for global bodies with the authority to sanction violators, to adjudicate between the differing regulations across countries. However, he also acknowledged that this potential solution was unlikely given that international treaties containing bindings mechanisms would have to be signed.

laid about by the US Congress.[342] However, this time they took aim at the CFTC's cross-border swaps rules for explicitly for imposing rules contrary to the framework of international cooperation established by the G20 OTC pronouncement.[343] These international and transnational factors represented a perfect storm of global regulatory dynamics that ultimately pushed EU/US officials back to the drawing board.

Given that varying interpretations of the G20 reform agenda were creating an increasingly fragmented global derivatives market, what the transatlantic relationship desperately needed was a reset. In January 2014, the US saw Gary Gensler stepping down as the chairman of the CFTC. This was significant to the extent that his position as the point man for US OTC foreign regulatory policy-making had cast him in a negative light due to the US' non-compromising unilateral approach to extraterritorial rule-making for cross-border swaps. Now that the US' the rule-making phase of implementation was largely complete, all that remained was to ensure that the EU's rule-making efforts in implementing EMIR/MiFID II didn't veer too far away from US regulatory standards.

By this stage of implementing OTC reform, the structure of transnational rulemaking earlier in the process had reinforced officials preferences to make haste by creating powerful incentives for financial market participants to increase the tempo of the reform effort. Time was of the essence, due to transnational rule-making as London's OTC markets were set to come under US rules. ICAP in particular, was set to begin trading of US dollar denominated swaps in the City's own Swap Exchange Facility (SEF)

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[342] See last chapter.

[343] Chon, Gina. (2013). "Wall Street eyes potential legal challenge to Volcker rule " *Financial Times* 9 Dec. 2013 P.21.

that spring.[344] In Europe, the EC had also been pressing forward with implementation after overruling ESMA's own veto efforts to delay rule-making which in turn, would have allowed the agency and firms more time to adequately prepare.[345] Moreover, the EU's deadline of December 2014 for equivalency determinations sharpened European firms' outlook to start being ready by the fall.[346]

The job of reaching a more accommodative tone with the Europeans was left to Gensler's successor at the CFTC. In June 2014 the US Senate had confirmed Timothy Massad, who took over the helm at the CFTC. This occurred just as transatlantic tensions had begun to increase over the EU's refusal to recognize the world's other largest derivatives market despite its recognition of 4 smaller regulatory regimes. Also, the international impasse was threatening to derail cooperation between the two just as the CFTC was considering an exemption for overseas CCPs from its rules. Massad stepped into the position by maintaining the US' commitment to protecting US customers (part of the original impetus for the US cross-border rules). However, he also took a new tact in professing that the US was willing to give appropriate deference to other countries in harmonizing their regulatory approaches through mutual recognition, stressing the requisite need for an international framework for over the counter derivatives.[347]

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[344] Stafford, Philip. (2014). "ICAP opts for US swaps switch " *Financial Times* 21 April 2014. P.19.

[345] By this point, the EC had already approved several of ESMA's delay requests. See: Stafford, Philip. (2013) "Deadline set for derivatives dealers " *Financial Times* 8 Nov. 2013 P.20.

[346] Chon, Gina "'There are signs of cracks developing in the system" *Financial Times* 27 Aug. 2014 P.7.

[347] Chon, Gina. (2014). "Derivatives regulator sees end to US-EU clearing dispute" *Financial Times,* 01 August: 18.

Despite the US' more accommodative tone, the issue of benchmarks continued to be an obstacle to international OTC coordination. Recall that the issue had come to the fore with the LIBOR scandal and Anglo-American attempts to reassert their regulatory authority through IOSCO(see above). Given that there were already varying interpretations to the G20 focus on central clearing, financial regulatory supervisors in the EU were engaged in resisting US or Asian benchmark setting, arguing that these were less stringent by comparison. The UK had already taken a similar line ceding its authority over standard setting for LIBOR benchmarks the year before to ESMA, which had contributed to British perceptions that the EC was engaged in another regulatory land-grab over UK-based financial activity.[348]

With EU officials once again poised to veto US preferences in bilateral deliberations over the benchmark obstacle, US regulators adopted a more conciliatory position based on mutual recognition. What was unique about this regulatory reset was the language utilized by the Americans. For example, the CFTC's new chair Tim Massad pointed to structural differences in regulatory regimes as driving the need for an accord of mutual recognition. Not only was this consistent with earlier EU proposals, but it was now in stark contrast to the CFTC's extraterritorial market power-based approach that had initially sought to flatten these distinctions between the two. Massad explained to officials in Brussels, that the US' regulatory system was based on a non-supervisory model and therefore lacked the binding powers of the EU. Therefore, it needed a formal

[348] Anonymous (2013). "Phoney turf war " *Financial Times* 7 Jun. 2013 P.8.

agreement for third country equivalency.[349] He also stressed that Congressional legislators would soon be hearing retaliatory calls from firms like CME to consider shutting out European firms' access to the US. Moreover this situation was set to persist, despite the EC lack of recognition for the US as having equivalent rules for CCPs.[350] Massad suggested that unless an agreement was reached, banks and asset managers under EU supervision would be locked out from hedging derivatives traded on US futures exchanges and SEFs. The CFTC regulator then chose a different tack and couched this threat in terms of European firms' own self-interest; that they would lose the ability to successfully hedge against market volatility. This accommodative change in tone was distinctive, given that US-led reform efforts up until this point had been driven largely by projections of US market power.

This time however, the US' first-mover sequencing began paying off. The completion of rule-making by the CFTC, now gave the US some leverage in weakening the veto power of European regulators who still had much to contemplate in terms of the effects of their rulemaking efforts. These developments coincided with the more persuasive language of mutual interdependence utilized by the Americans at this juncture. Mutual recognition of the US market was in the EU's best interest, so that European firms could continue having access to US capital markets (and ironically, its requisite degree of speculative market participants). If an accommodation could not be reached however, this would prevent EU firms from accessing the ability to hedge against the inherent volatility of global markets. In turn, this would result in a significant increase in

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[349] Stafford, Philip. (2014). "US warns on European benchmark plans" *Financial Times* 21 Nov. 2014. P.22.

[350] See last chapter.

the cost of doing business for European banks and hedge funds who would be faced with onerous capital charges for their trades. In some instances, this constituted a premium of over 30x current levels at the time. This cast domestic US firms like the CME as unlikely bedfellows with European banks and hedge funds in supporting an eventual accord, given that many of these same banks relied on the CME's Eurodollar interest futures contract to hedge their risks.[351]

Before the EU could consider reaching a mutual recognition accord with the US, officials in Brussels still faced considerable pressure from European market participants who were pushing for increased competition in central clearing. For example, senior market executives from firms looking to compete with the larger exchanges applied pressure to the EC that it maintains its position on opening up clearing houses (CCPs) to other trading venues.[352] Financial firms in Europe were already on the defensive, after having recently been forced by the EU to accept position limits on over 1900 commodities traded on European exchanges. More importantly, recall that the EC's position on open access was couched in terms of liberalizing competitiveness and the view that its OTC reform effort should not contribute to the monopolies in central clearing that had entrenched certain interests (see above). The negative implications of this consensus in Europe towards greater competition, were most strongly felt by the ascendant exchanges (Deutsche Börse, ICE and CME) who had benefitted from the G20's OTC reform's focus on central clearing, as well as the subsequent wave of consolidation that occurred on both sides of the Atlantic (see last chapter). This was

[351] Stafford, Philip. (2015). "US told to get tough on Europe clearers" *Financial Times* 26 Mar. 2015.

[352] Stafford, Philip. (2015). "Europe urged to safeguard derivative reforms" *Financial Times* 1 April 2015. P.18.

especially evident given the number of prominent banks that had shuttered their clearing businesses in the past 18 months. However, the exchanges had also continued benefitting from the vertical silos from the pre-crisis era that shielded them from potential competitors. This incongruity lent weight to European calls for bringing more competition to the financial services industry on the continent. This had the effect of casting the large exchanges as standing in opposition to the liberalization-through-competition initiative, given that the implementation of MiFID II-set to come into effect in 2017-was now set to go further than other regulatory regimes.[353]

In addition to pressure from market participants, officials in Europe had to address the existing EU regulatory rift with the UK, which had now metastasized into stronger calls to leave the EU. While the Brexit referendum was still well over a year away, firms in the UK were already contemplating the effects that a British exit from the EU would have on their existing business models. At issue were their large volumes of euro-denominated swaps that were being cleared through British clearing houses. The fear was that if Britain left the EU, the European Bank- in line with the EU's financial regulatory model-would then increase pressure for more direct supervision of these swaps. This move would force UK-based firms like LCH.Clearnet and ICE Clear Europe to shift their businesses to euro-zone based entities. This had significant implications for London's continued standing in the global financial system and contributed to tensions between the UK and the rest of the continent.

[353] Royal Bank of Scotland, Bank of NY Mellon, and Nomura had all exited from the central clearing business during this time. See: Rennison, Joe. (2015). "Derivatives rules squeeze building societies" *Financial Times* 29 May 2015. P.18.

The UK's Financial Conduct Authority (FCA) continued working in conjunction with ESMA and the EC, in an ongoing dialogue with industry firms. In March 2015, the FCA issued its own discussion paper on the implications of the EU on the implementation measures for MiFID II which were set to be adopted with the formal approval process for OTFs in Europe by October. This effort was made more complicated by the complex thicket of delegated acts, regulatory standards, guidelines and national laws under the directive, potentially resulting in 28 different interpretations in Europe. The Level 2 texts under MiFID II under development at the time however, would still have to be adopted by the EC and published. Moreover, this would be followed by the Level 3 texts, that would provide the necessary guidance for implementation. In short, despite the rift with the UK over OTCs and the threat of potential Brexit being discussed in Brussels, the deadlines created by earlier stages of the rule-making process had resulted in an institutional momentum that created strong incentives for cooperation between regulators and market participants.

Despite the looming deadlines for European implementation, disparities in the technical rules for central clearing continued to be an obstacle in the common transatlantic recognition of clearing houses. At the heart of the dispute was the EU's continued mistrust of speculation by the investment banks. The ongoing talks between the US and the EU, had led some to suggest that a deal was forthcoming by early summer 2015, despite the EU suggesting publicly to the contrary. Meanwhile, the EC had also recently undergone a regulatory reset of their own. A Brit, Jonathan Hill had succeeded the outgoing Michel Barnier in late 2014 and had been working with the CFTC's Massad in a full-court press to reach an accommodation between the two sides. However, the

EC's position was that the CFTCs rules for CCPs were less stringent towards the investment banks that backed clearing-houses than the EU's, which had higher capital standards for banks as clearing house members. A draft deal at the time, saw the US willing to accept the EU's longer two-day liquidation period on net futures contracts positions despite publicly voicing its opposition to the significant changes in its rules.[354] In instances of extreme market volatility, exchanges and clearing houses might need to liquidate open futures positions on highly leveraged traders. As a result, the EU rules were more stringent to the extent that they favored CCPs' ability to do so. Additionally, the US would also accept the EU's more stringent capital rules. These had come about during early post-crisis reform deliberations as a potential bulwark against procyclicality. This occurs as interactions between the financial system and the real economy are mutually reinforcing, thus contributing to financial instability. Although still yet to be implemented, the EU's rules for initial margins on futures positions were expected to be more conservatives than the US' one-day margin period as well. Moreover, the key concession offered by the US was that it would permit substituted compliance for EU CCPs. This was significant, in that it would allow EU clearing-houses in the US to comply with EU rules, a key requirement of EMIR. In return, the EU would allow for a one-day liquidation period on gross futures positions for clearing members. In general, the EU rules favored a more conservative approach to central clearing, giving more tools to CCPs to ward off the procyclical effects of a financial downturn. In contrast, the US rules favored more flexibility towards traders and counterparties, who in times of

[354] Stafford, Philip. (2015). "EU and US aim for May derivatives deal" *Financial Times* 2 April 2015 P. 11.

financial stress might have difficulty in finding stable assets and would in turn, benefit from lower margins and flexibility during a downturn.

By this point, the more ambitious European regulatory approach wasn't a new obstacle in coordination between the two sides. In Feb. 2014, trade-reporting rules had come into force under MiFiD II's initial rulemaking. In trade reporting, each trade is issued a unique trade identifier to distinguish it from the myriad of transactions being reported. Additionally, every legal identity using derivatives also needs a unique code to identify them from other counterparties. When trade repositories first began to register, European regulators had given derivatives users 90 days to begin reporting trades. Additionally, European rules mandated that both counterparties must report the trade while the US' required only one. The more onerous EU rules also meant that European trades had to be reconciled through a discrete matching process. As US regulators had argued at the time, the confusion from the resulting complexity for firms was so excessive that it resulted in only 3% of exchange traded derivatives and only a third of swaps in Europe to be matched initially across repositories.[355] As negotiations continued between the EC and the CFTC, this prior experience that European regulators had fundamentally misjudged the complexity of their rulings had assisted to some degree in undermining the perception that US rules were needlessly lax. Another instance came in 2015, when European regulators admitted that some of the plans drafted by ESMA addressing exemptions for intragroup transactions with non-EU entities had put market participants' right to the legal certainty of their contracts at risk. This had already caused significant delays with implementing OTC reform in Europe. Moreover, the EU wouldn't

[355] Rennison, Joe. (2015). "Policymakers left with problem in the wake of London whale" *Financial Times* 13 Oct. 2015 P.4.

begin enforcing mandatory clearing for swaps until 2016, four years after the US and Japan had already done so. In sum, the disparity between European regulatory ambitions for OTC reform and actually turning these policies into practicable laws, may have also negatively affected to their ability to coordinate with the US.

In August 2015-with implementation deadlines looming-came the increasing realization that both the US and EU must give way, or the end result would be a permanently fragmented global derivatives market. Both sides of the transatlantic dispute continued to maintain that their rules were better suited to guard against systemic risk, while simultaneously preserving enough capital for banks to make their own trades. However, there was still significant variation in the nature of the banks themselves across the two regulatory regimes (and their requisite propensity to speculate), a qualitative difference which remained somewhat unspoken in deliberations. The main sticking point revolved around the initial margin collateral required by counterparties to post in the event of a default.

EU regulators engaged with the reform effort, now saw market participants willing to make significant concessions to move forward. ESMA had been engaged in the process of consulting market participants about their willingness to accept the proposed draft deal with the US. The results of ESMA's public commentary also showed that European firms were willing to accept the US-style one-day liquidation period for clients, with the proviso that the initial margin must be put into an Omnibus Segregated Account (OSA), a move that would help avoid any pro-cyclical effects from the clearing

process.[356] Surprisingly, the EU was also willing to accept a significant hit to its competitiveness, given that its system would still require clients of European CCPs to post a 41% margin premium over US clearing houses. To Europeans, the costs of using derivatives would ultimately be borne by its market participants.

On February 10, 2016; the European Commission and the US' CFTC reached a mutual accord on OTCs. This ended a particularly contentious three year period of difficult talks between the two sides over regulatory gaps to agree on common standards for derivatives reform. These gaps, which had threatened to fracture the global market were now overcome just as the initial rules for EU clearing houses were set to come on line. As a result, the EU and US would now continue to control up to 90% of the $700 trn market going forward. At the last minute, the threat of decreased economic competitiveness in Europe had led the EC to concede to formally changing its rules on the amount of margin for clients at CCPs. This concession would bring EU rules closer to the US, thus making it cheaper for EU firms as a result. However, the EC also received a significant concession from the CFTC, in that the US would changes to its rules as well to increase the margins held by banks at clearing houses. This moved the US system closer to the EU's more stringent regulatory treatment of banks using derivatives. The deal was also seen as benefitting big derivatives dealers, who would now not have to post as much collateral to insure their trades. Banks hedging their dollar swap interest rate exposure on CME's future market indicated privately that they would probably discontinue their use of the CME. In general terms however, the accord was beneficial for CCPs as well as NFCs on both sides of the pond. Jonathan Hill, the European

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[356] Stafford, Philip. (2015). "EU clears way to end derivatives spat with US" *Financial Times* 15, December 2015. P.22.

Commissioner for financial stability, financial services and capital markets union laid out the transatlantic implications of an equivalence agreement for mutual recognition of each other's rules. This would allow American CCPS to continue servicing EU firms while also making it easier for European CCPs to do business in the US.[357] While some coordination obstacles like the prospect of similar equivalence decisions for trading platforms and margin rules remained, the mutual accord nonetheless marked a significant juncture in OTC coordination between the largest, and now most influential rule-making regulatory regimes for derivatives.

Conclusion

The case study above on the implementation of OTC reform in the EU demonstrated a continuation of the trends that began in the context of the earlier G20 global financial reform deliberations that we saw occurring in chapter 2. These trends were marked by the ascension of the continental countries Germany and France in financial services policymaking. This ascension was a function their dual role as both individual members of the G20 as well as leading member states in the EU.

As I argued, the Greek sovereign debt crisis served as a focusing event for OTC reform for EU officials. The role in the crisis played by CDS in the European market for the sovereign debt issued by its member states, highlighted for these officials of the need to increase the tempo of its OTC reform effort which had lagged significantly behind the Americans. The problem occurring within the sovereign CDS market had brought to light the existing problems of OTC contracting in Europe as the majority of these contracts were conducted exclusively in the City of London outside of the eurozone. It also opened

[357] Brunsden, Jim & Philip Stafford. (2016). "EU and US seal derivatives agreement" *Financial Times* 11 Feb 2016. P.22.

a rift among the three leading member states as the continental countries continued to check the regulatory preferences of discredited British regulators and officials in EU reform deliberations. These developments created permissive conditions for officials to bring OTCs under EU-level authority as they successfully politicized the inherent speculation involved with derivatives as a threat to the EU's financial system. Therefore France and Germany's earlier defense of the sovereignty of the Euro in the context of the G20-which saw them checking Anglo-American regulatory reform preferences-had also left them in an influential position to influence its subsequent implementation in the EU.

However, contingent events associated with the crisis helped determine who would oversee OTCs going forward. The role played by a number of German banks in exacerbating the crisis represented a potential obstacle to the country's ascendancy in EU regulatory reform. The examination of German naked swaps ban demonstrated the policy incongruity between the aspirations of German EU-level officials for greater European coordination and its national regulators who sided with their British counterparts in defending the CDS markets on neoliberal grounds. From a purely comparative standpoint, the German swaps ban is instructive because it largely breaks with an historic institutionalist prediction that would have predicted more regulatory stringency for swaps from its French counterparts. German regulatory efforts are best viewed as an attempt by German officials to reestablish its legitimacy as an ascendant reformer during the ensuing eurozone crisis. Therefore, the development of the German naked swaps ban is still consistent with an HI approach provided that ample consideration of its position within the EU as a leading member state are first taken into consideration.

The political development of the ESFS saw elements of OTC reform consistent with an HI explanation as well. These elements reflected the historical bifurcation of authority relations between EU-level authority and the national discretion of its member states. The division of labor among its three leading member states the UK, Germany and France for the three primary regulatory agencies in distinct issue areas reflects an extension of this underlying logic. As it relates specifically to OTCs, the delegation of authority to the French regulator ESMA sees the preservation of the historical consolidated approach to regulating derivatives alongside securities common in many European countries. However, the strong role for the French regulator to oversee the large EU market for OTCs also reflects both the problems with German ascendancy noted above. As such, the ascendancy of France's regulatory authority for OTCs in the context of the EU also reflects its historical multilateral preferences for overseeing the proliferation of global finance as well as the relatively low degree to which its banks had contributed to the crisis that we also saw in the second chapter.

As we also saw, the ascendancy of French regulatory authority for OTCs vis-à-vis the EU came largely at the UK's expense. Fearing that greater EU-level regulatory coordination would come at the expense of the City's profitability, British officials tried pushing back against the continental countries' efforts to consolidate OTC reform in the EU. However it was only successful doing so in instances where it could build a supporting coalition of member states to veto these efforts. The support for the British from mainly Scandinavian countries is surprising given that generally more closely aligned with CMEs under the VOC approach relative to the UK which is considered an LME. However, once again HI helps us refine this approach when we consider that the

actions of these countries to support the UK's veto efforts towards EU-level OTC reform suggests that the EU-level investments by these countries was as important as the preservation of their existing domestic regulatory models. In contrast, in instances where the UK did not enjoy support from other member states its efforts to assert its regulatory authority over OTCs was unsuccessful. We saw this both in that its failed attempts to utilize IOSCO, its historical reservoir for global policy-making in the pre-crisis era as well as through domestic fora like the Vickers commission.

It's the period after the Common Path Forward was agreed to that we see the full implications for the theoretical propositions laid out in the first chapter. We saw in the chapter on the US case how the EU was able to counter US regulatory preferences by successfully challenging its extraterritorial cross-border swaps rules with the help of Asian regulators. After the sequencing of the US first-mover effort caused the G20 agreement to quickly break down, in an ironic turn the EU also sought unsuccessfully to exert its own newfound market power over Asian regulators by promulgating its own extraterritorial rules. This taps into the interaction between market power and institutions in that Asian regulators were well aware of crisis-induced shifts in the regulatory authority for OTCs between the UK and the EU. Therefore, there seems to be a miscalculation on the part of EU officials at the time who mistakenly equated the increased institutional development of regulatory authority over OTCs in the EU as somehow synonymous with European market power. However, the fragmented nature of contracting in Europe would also suggest that the material capacity for the OTC market still resided within the City of London despite the UK being trapped institutionally within an expanding EU.

Another miscalculation by officials about the relationship between market power and institutions can be seen in the failed effort of the efforts by German exchange Deutsche Börse. The firms efforts to translate Germany's ascendancy in EU financial services reform policy-making into securing their own competitive advantages in the nascent derivatives markets in Asia. The issues over regulatory harmonization problems between East Asian countries and the West also demonstrates how global OTC reform wouldn't truly be comprehensive without effective coordination between the two biggest actors in the global market. This is also consistent with an HI prediction if we consider that the US first-mover effort actually began with the initial sequencing of global reform through the G20.

Ultimately, the transatlantic accord for OTCs that eventually materialized between the EU and US saw the US regulators taking a more conciliatory tone with their European counterparts. A changing of the regulatory guard on both sides saw the US now adopting the mutual accommodation initiative originally proposed by the Europeans prior to the Common Path Forward. This occurred in light of looming regulatory deadlines that the US had established with the sequencing of its first-mover effort. Both sides also made significant concessions in accepting specific elements of the other's regulatory regimes. This helped curb the prospect of continued fragmentation of the global OTC market.

5. CONCLUSION

Introduction and Plan for the Chapter

What explains the changes we see occurring over time in the nature and construction of the regulatory authority for OTC derivatives, the contracts behind the largest market in the world? The role of OTCs in exacerbating and spreading the global financial crisis that began in 2008 served as a focusing event for public officials in advanced market economies. The spread of counterparty risk inherent in complex over-the-counter contracting brought to bear just how interdependent their financial systems truly were. This interdependence had grown in the decades before the crisis in conjunction with the rise of a global market that was largely unregulated. Therefore, the global spread of the crisis and the subsequent costs to taxpayers in these countries led their leaders towards an international consensus vis-à-vis the club of wealthy nations in the G20 to bring these financial contracts under greater public oversight. These changes also entailed a significant shift away from the US' and UK's market-led self-regulatory preferences for OTCs that prevailed in the pre-crisis era. In the post-crisis era, it would now be both the US' and EU's preferences that would determine the regulatory trajectory of implementing the G20's OTC reform agenda.

As I've argued, the regulatory traditions for pre-crisis OTCs in light of these focusing events helped to determine whose regulatory preferences were seen as authoritative during the development and implementation of post-crisis reform. Existing materialist theories posit that the degree of convergence around the preferences of one actor should be directly proportional to the degree of market power imbalance between the two. This imbalance, defined by actors' relative material capacity in a given

economic sector, often plays out as the dominant regulatory actor threatens to withhold access to its internal markets in a bid to force the other towards convergence with its preferences. However, these theories shed little light on how institutions mediate or circumscribe these material disparities, particularly when they're subject to change in the context of a crisis. More importantly, while the EU's economic heft in other issue areas like trade often justifies its counterweight position to the US, it was precisely because Europe's material capacity for financial services had resided primarily in the UK for so long that the shift towards EU-level preferences for OTCs is especially intriguing. Therefore, I've also argued the market thesis alone is insufficient in explaining post-crisis OTC reform without an institutional complement that can explain national regulatory traditions and how they explain the preferences of diverse capitalist countries towards specific international institutional configurations. This study found support for an agent-centered historical institutionalist approach to explain the shifting nature of authority relations both within and across the US and EU.

Regulatory Preferences in the Pre-Crisis Era

In the chapter on their historical development, we saw how financial derivatives were developed in part to hedge as well as profit from the increasing vulnerability of international investors to cross-border risk in the post-war global environment of capital mobility and financial volatility. In the world before the 2008 global financial crisis, these contracts were touted by advocates for their ability to diffuse risk within financial systems. However, the proliferation of purely speculative or 'naked' OTC contracts in the years before the crisis did much to credibly undermine this view.

We also saw how different countries pursued the development of global finance in the post-war era to varying degrees. Of the four main countries in this study, the US went the furthest and the fastest in pursuing a vision of hegemony based on global finance and complex cross-border contracting. In turn, the UK and Germany represent more intermediate cases of financial globalization. Like the US, both countries unilaterally pursued capital account liberalization as they prepared their economies for the inevitable volatility that would accompany a world of floating exchange rates. Policymakers in both countries altered their legal frameworks for contracting, allowing them to pursue US-style financial innovation to varying degrees. The UK chose to court the interests of global finance by allowing for naked speculation to occur with OTC contracts. In contrast, Germany only went so far in its adjustments to its regulatory framework to the extent that it contributed to the development of its exchange-traded (and publicly monitored) futures markets. At the far end of the continuum, the US never created legal certainty for derivatives, preferring instead to let its legal framework for contracts to drift significantly over time. At the opposite end of the spectrum, France was the only country analyzed that pursued a multilateral approach to financial globalization. We saw this in its distinctive policy orientation to capital account liberalization through its coordinated overtures to the European community as well as larger international organizations. The French domestic legal orientation to contracting was also unique in the extent to which its civil code represented a substantive fairness that often benefitted domestic counterparties at the expense of global finance. Thus the variation in the French experience with financial globalization and contracting eventually contributed to the scope of agency experienced by its securities regulator during post-crisis reform.

The domestic deregulatory adjustments favoring global finance contributed to an increasingly permissive regulatory environment that enabled OTC markets to grow over time. These developments occurred in conjunction with the Anglo-American promotion of a market driven self-regulatory paradigm as the US and UK utilized both small club-like international financial institutions as well as a transnational policy network of experts to promote their preferences for OTCs. However, a series of highly publicized swaps-related scandals in the 1990s found OTCs on the radar of many regulators, particularly in the US. The driving force behind this effort to bring more of the derivatives markets onto their publicly monitored platforms were the futures exchanges that had been losing out to the OTC broker/dealer divisions of the large global investment banks. The banks' veto efforts to oppose this initiative were successful thanks to the support of American officials who defended them by advocating for the diffusion of risk that derivatives represented. They also successfully resisted an alternative proposal to mitigate the counterparty risk inherent in OTCs by subjecting them to central clearing. This proposal too went nowhere, a sign of the banks recent ascendancy as well as the self-regulatory paradigm that reigned at the time.

An analysis of the major developments surrounding OTCs during the sub-prime crisis shows that US officials were slow to acknowledge the extent to which credit derivatives were contributing to the crisis through counterparty risk. In contrast, the rift between the exchanges and the broker dealers threatened to derail the veto efforts of the derivatives industry which moved at a considerably faster pace to head off the growing regulatory impulse for OTCs. We saw this during the year-long collapse of Bear Stearns as the industry pursued its time-tested self-regulatory initiatives that were still vocally

supported by most public officials at the time. One example that ran counter to this was then Treasury secretary Paulson' proposal to consolidate the American financial regulatory system which had long been criticized in international circles for its relative fragmentation. US proposals at the time were myopic to the extent that they failed to consider the potential international dimensions of counterparty risk as international regulators resisted the idea of global solution to the failing CDS market. The subsequent transatlantic tensions that ensued between Anglo-American regulators therefore seemed to confirm the market thesis' prediction of this initial cleavage between the countries hosting the majority of the world's OTCs.

As I've argued, it was the collapse of the large-scale monoline insurer AIG whose large positions in the global CDS market, that served as the focusing OTC event for public officials in the US. While the problems with Lehman Brothers in September 2008 caused US officials to consider the latent threat this posed to the American financial system, it was ultimately what was occurring with AIG that forced them to recognize the exponential effects of counterparty risk as it exposed the rest of the global financial system to the contagion coming from the US' sub-prime market. The inevitable public oversight that would accompany derivatives regulation saw US officials shepherding the derivatives industry through the process in turn helping to institutionalize their influence during its subsequent reform. However, the cross-border implications of this focusing event for the global OTC market would also contribute to the subsequent institutional considerations that would override the Anglo-American cleavage based on mere material capacity.

The spread of counterparty risk and cross-border contagion brought the G20 into the picture in its first meeting since its initial expansion at end of the Asian financial crisis a decade earlier. This process saw the continental countries of Germany and France ascendant, given their dual member roles as both influential individual nations as well as leading member states of the EU. This influence and their ability to check the two leading market powers (US/UK) was bolstered by the lack of coherent Anglo-American regulatory preferences. The British had been proposing an international regulatory regime for global finance similar to the one that had occurred for global trade some sixty years before. In contrast, the US maintained its commitment to market-led self-regulation through its promotion of a global CCP for CDS. The alignment of preferences between the US and the continental countries, was sufficient in curtailing the UK's relative influence during the proceedings. Germany and France's sovereign defense of the euro also helped them successfully veto US preferences for a global market clearing solution, given that the bulk of global OTCs traded in London were derived from the currency.

Taken in toto, the developments with the G20 over OTC reform are largely consistent with an historical institutionalist prediction as we start to see how the UK's market power was subsumed through the EU's increasing influence in the OTC policy community. In the pre-crisis era, Germany and France's efforts to bring financial services under greater EU-level authority had been delimited by the ascendancy of US/UK regulatory preferences and the dominant self-regulatory paradigm that was occurring. However, the continental countries were now in a position to have their preferences realized as the institutional engagement with the G20 allowed them to check not only the UK's market power but also the US' as well. Despite this, the US was still able to

successfully embed its preferences in the G20 OTC reform agenda through the inclusion of central clearing which would remain its most important pillar during implementation. This also ensured that the actors that had lost out a decade earlier in US regulatory debates-the exchanges and the merchants they serviced-would now be the direct beneficiaries of OTC reform. Internationally, the G20 OTC reform agenda reflected countries' long-standing historical preference for global regulatory initiatives that allow for the preservation of their existing regulatory models.

Post-Crisis Reform Preferences: Merchants and Gamblers

The implementation of the main pillars of the G20's OTC reform agenda in both the post-crisis empirical chapters also bear out the predictions of the historical institutionalism approach. In both cases, actors that were institutionally marginalized in the pre-crisis era OTC policy community were now ascendant and in a position to have their regulatory preferences realized. Additionally, in both the US and EU implementing global reform into their own respective regulatory regimes saw these dynamics play out in bifurcated institutional contexts that structured authority relations between competing actors. This in turn, saw the incorporation of the new global regulatory initiatives for OTCs taking place alongside the preservation of their existing regulatory models.

In the US, the preservation of its existing regulatory system for finance meant that implementation occurred along product lines that reflected the historical bifurcation between securities and futures there. This structured the authority relations between the ascendant exchanges and the diminished investment banks during the drafting of Dodd-Frank in which the G20's OTC pillars were embedded, consistent with US regulatory preferences. These actors found institutional support during the legislative process in

their respective congressional committees while the rule-making process was driven by the discretion these committees delegated to the regulators they oversaw. In contrast, OTC reform in the EU saw the preservation of its consolidated regulatory system covering both securities and futures under a single regulator. Moreover, implementation in the EU instead reflected the historical bifurcation between pan-European authority and the relative autonomy of its leading member states. We saw how this structured authority relations in the EU through the development of Dodd-Frank's European regulatory counterpart EMIR/MiFiD II, which also mirrored this bifurcation as well. In general terms, the development of MiFiD II as a directive afforded member states significant discretion to implement the G20 OTCs pillars for trading, and post-trade reporting in line with their own regulatory models. In contrast, EMIR focuses solely on central clearing and as an EU-level regulation was legally binding on all member states.

I also unpacked the downstream effects of the established sequencing of global OTC reform that began in the G20. For the US, we saw the relative importance of its success in embedding its preferences for central clearing within the G20 reform agenda. This now translated into a windfall for the ascendant exchanges who would now be the direct beneficiaries of reform. However, the existing vertical silos for central clearing in both regulatory contexts had different effects. In the US, this had contributed to the dominant position of its dominant futures exchange (CME) which enabled it to consolidate its position going forward with OTC reform. Its European counterpart (Deutsche Bourse) however, was never able to use its vertical silo to consolidate its position in the post-crisis era given the legacy of the historically fragmented central clearing sector of CCPs and national stock exchanges in the EU.

In the broader context of global financial reform, OTCs were a particularly problematic issue that contributed to the ongoing political contestation along the institutionally structured lines of authority relations in each. In the US, the issues surrounding derivatives reform contributed to the breakdown of the bipartisan consensus triggered by the crisis as implementing OTC reform began proceeding upon largely partisan lines. In the EU, OTC reform exposed the rift between its leading member states. This represented the continuance of a trend that began in the G2O deliberations as the ascendant countries of France and Germany continued to marginalize the ability of the UK to see its regulatory preferences realized. In both cases, formerly middling regulatory agencies would now be granted significant discretion over rule-making and the development of standards for the world's largest market. Both were also focal points for political contestation as status quo actors sought to challenge their legitimacy in the context of global reform. In the US, the large Wall St. banks and their congressional interlocutors mounted attacks on its capacity to regulate by overwhelming the commission with public commentary while simultaneously denying it funds through the appropriation process. In the EU, French regulator ESMA saw its authority continuously challenged by officials from the UK who sought to prevent any expansion of EU-level authority to come at the expense of the City's profitability. Given their diminished status in the financial services policy community at the time, the UK's veto efforts towards these French-led initiatives were only successful when they were able to build an opposing coalition with the support of several Scandinavian countries. This in itself is an important finding in line with one of my ancillary hypotheses: that the informal institutional nature of OTCs in Europe saw coordinated market economies

simultaneously benefitting from the ability to preserve their own national regulatory models while allowing their hedge-seeking merchants were able to access the UK's more speculative markets. Another important finding highlighting variation in the two cases is the degree to which the ascendant French regulator ESMA used its authority to limit the influence that the large investment banks would have during the EU's rule-making process. In contrast, the marginalized banks' challenges to the ascendant CFTC reflects the US' more pluralist approach to regulatory rulemaking. ESMA's allowance of only one bank on its advisory panel for OTC seems to suggest a more corporatist approach to rule-making in the EU.

The transatlantic cleavage that occurred over OTC reform reflected the institutional disparities between the global OTC reform agenda and the way in which OTCs were traded historically. The informal arrangements in the EU that had allowed for gamblers and merchants to engage in complex contracting in London would prove particularly difficult to reconcile. We see this in the degree to which contingent events associated with the crisis pushed US authorities to suddenly pursue extraterritorial cross-border swaps rules to address the long-standing vulnerability of its financial system to American investment banks contracting in London. Therefore, the US also had a vested interest in the preservation of the existing informal international system for OTCs. This is why it found its preferences aligned with the ascendant continental countries in the G20 to resist the new British proposal for a Bretton Woods-style international regulatory regime for global finance. Its also why the implementation of OTC conflicted with the established sequencing established by the G20 and the US' first-mover effort. For the UK, which arguably didn't go as far as the US in actually causing the crisis, it was

nonetheless left holding the bag. Moreover, its lone preference for a new international regulatory regime for finance wasn't merely a function of the preferences of its domestic firms alone. Rather it also reflected its only way of escaping its prior institutional commitments to the rest of the member states of the EU.

Implications for The Literature and The Direction of Future Research

A thoughtful analysis of the politics of global finance and its attendant regulation necessitates being able to analyze these dynamics across multiple levels of analysis over time. While the historical institutionalist framework in this study sheds light on changes between the pre and post crisis nature of global regulatory authority for OTCs, it also has some broader implications for the literature on the politics of international financial regulation and our understanding of how different capitalist countries engage in preserving their existing regulatory systems in conjunction with these international initiatives.

HI, the Transatlantic Focus and VOC

This project has taken its main analytical cues from the general IPE postcrisis reform literature that emerged in the years following the global financial crisis As such, its informed by the early work done after the crisis that noted the shift away from the Anglo-American preferences towards those of the EU.[358] However, much of that work took these changes in regulatory authority largely as given. In the years that followed, the challenges facing the US and EU over their competing visions of implementing global

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[358] Helleiner, Eric & Stefano Pagliari. (2010) "Crisis and the reform of international financial regulation" *Global Finance in Crisis: The Politics of International Regulatory Change.* Eric Helleiner, Stefano Pagliari and Hubert Zimmerman (*eds). Ch1.*New York: Routledge. Also: Helleiner, Eric and Stefano Pagliari (2011) "The End of an Era in International Financial Regulation? A Postcrisis Research Agenda" *International Organization* 65, Winter 2011, pp. 169-200.

OTC reform gave rise to a specialized postcrisis research agenda focusing on the transatlantic relationship between its two largest markets and their attendant regulatory regimes.[359]

This study expands on this transatlantic work, to include how EU-level preferences reflect those of its leading member states. Recent work on the coordination problems experienced between the US and the EU over the implementation of OTC reform like this study, has utilized a temporally focused HI approach to analyze the sequencing issues that threw off this process.[360] However this work like other transatlantic studies, treats the EU as a unitary actor treating EU-level preferences largely as given in explaining its interactions with the US. The institutional theory posited by this study also builds on existing historical institutionalist-informed work that explains EU-level regulatory preferences as reflecting those of its leading member states.[361] In contrast, this work usually limits its analysis to the EU without considering transatlantic

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[359] Mügge, Daniel (2014). *Europe and the Governance of Global Finance.* Oxford University Press. Also: Knaack, Peter. (2015). "Innovation and Deadlock in Global Financial Governance: Transatlantic Coordination Failure in OTC Derivatives Regulation" *Review of International Political Economy*, 22(6), 1217-1248. As well as: Posner, Eliot (2018). "Financial Regulatory Cooperation: Coordination of Derivatives Markets. in *Governing the World's Largest Market: The Politics of Derivatives Regulation after the 2008 Crisis.* Eric Helleiner, Stefano Pagliari & Irene Spagna *eds. Ch2 p. 54;* Oxford University Press.

[360] Posner, Eliot (2018). "Financial Regulatory Cooperation: Coordination of Derivatives Markets. in *Governing the World's Largest Market: The Politics of Derivatives Regulation after the 2008 Crisis.* Eric Helleiner, Stefano Pagliari & Irene Spagna *eds. Ch2 p. 54;* Oxford University Press.

[361] Fioretos, Orfeo (2010) 'Capitalist Diversity and the International Regulation of Hedge Funds' *Review of International Political Economy.* 17(4) pp.696-723. Also see: Fioretos, Orfeo (2011a). "Historical Institutionalism in International Relations" *International Organization* 65 (2). Fioretos, Orfeo (2016) "Retrofitting Financial Globalization: The Politics of Intense Incrementalism after 2008" in *Historical Institutionalism and International Relations: Explaining Institutional Development in World Politics.* Oxford University Press. See as well: Zimmerman, Hubert (2010). "Varieties of global financial governance? British and German approaches to financial market regulation" *in Global Finance in Crisis: The Politics of International Regulatory Change.* Eric Helleiner, Stefano Pagliari, and Hubert Zimmerman. New York; Routledge. Ch.8 pp.121-136.

regulatory interactions with the US. To the best of my knowledge, this is the first study in postcrisis financial reform that incorporates an HI-based/VOC approach while simultaneously addressing transatlantic dynamics between the US and EU beyond the context of the G20.

This study also builds on work that utilizes a varieties of capitalism approach to explain EU-level developments as well.[362] The conceptual development of the HI research program was such that scholars began extending some of VOC's core insights into HI. For example, both approaches share an underlying logic: that international regulatory outcomes will reflect countries' preferences for the preservation of their existing regulatory models. One of the products of this institutional line of inquiry is that it focuses on the interactions between coordinated and liberal market economies in constructing international institutional arrangements that are conducive to both in the context of increasing global financial interdependence.

Therefore, the extension of VOC related insights into the HI research program also represents an integrative approach for considering the analytical interaction between the Comparative and IR subfields in political science. Again however, much of this work focuses on the EU and as such addresses the interaction between CMEs and LMEs in the European context. In line with this, one of the ancillary findings of this study is the degree to which CMEs in the Scandinavian countries supported the UK as an LME in EC deliberations. While early postcrisis financial reform work in the HI tradition first brought this to light, this study takes these empirical development one step further

[362] A similar argument could be made regarding the support of German regulators in BaFin for the UK's FSA leading up to the naked swaps rule. See chapter 4.

through a theoretically informed HI/VOC approach. [363] Given the effect of the crisis on its diminished status, the UK could only see its preferences realized by developing a coalition of support from several Scandinavian countries. Similar dynamics played out with the German regulator BaFin siding with the UK's FSA in the developments leading up to the naked swaps ban (See chapter 4). This suggests that firms in these CME's had an interest in preserving these EU-level institutional market arrangements that they had long benefitted from as it allowed them access to more speculative profit seeking in London that they couldn't access in the context of their national regulatory models. Consequently, this study has built on the advice of HI scholars who have suggested that studies of European financial integration should look to using HI's analytical framework to examine empirical examples of instances where member states preferences were the result of earlier EU-level decisions.[364]

Additionally, the support of the Scandinavian CMEs for the UK/LMEs approach to global reform, coupled with the contingent events of the naked swaps ban that threatened Germany's regulatory policy-making credentials, suggests that the EU's regulatory regime may come to reflect national preferences beyond the LME/CME types laid out by VOC. We saw how it was the support of a majority of EU member states-many of which lie outside of these typologies-for the French *dirigiste*-statist model that

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[363] Quaglia, Lucia (2013) "Financial Services Governance in the European Union after the Global Financial Crisis: Incremental Changes or Path-Breaking Reform?" in *Great Expectations, Slow Transformation: Incremental Change in Post-Crisis Regulation.* Manuella Moschella and Eleni Tsingou eds. Colchester, UK ECPR Press, Ch.3 pp.57-75.

[364] Deeg, Richard and Elliot Posner. (2016). "Durability and Change in Financial Systems" in *The Oxford Handbook of Historical Institutionalism*. Orfeo Fioretos, Tulia G. Falleti & Adam Sheingate eds.pp.438-452.

ultimately contributed to the ascendancy of their securities regulator. These developments therefore, have interesting theoretical implications for the empirical direction of financial services policy-making in the EU in the future.

By extending some of these insights into transatlantic studies, future research should also avail itself of the HI toolbox and its implications for comparative capitalisms in the context of future international financial regulatory outcomes vis-à-vis US/EU coordination. This study has demonstrated how the US too had a vested interest in the preservation of the existing transatlantic institutional arrangements that had facilitated cross-border contracting given the long-standing market activity of its globally oriented banks in London. As Posner has suggested, one of the consistent themes of the postcrisis financial reform research program has been how market-friendly subsequent reform was despite the populist backlash towards complex speculative finance on both sides of the Atlantic[365]. The historical institutionalist development of the global OTC market laid out in this analysis helps explain why this is so, given that it benefitted both CMEs and LMEs alike as well as their merchants and gamblers respectively.

Focusing Events And The Salience Problem

This study has also built on existing postcrisis financial reform literature that points to domestic level political developments for their explanatory power in explaining international regulatory outcomes. I've chosen to integrate the concept of focusing events from the public policy literature to explain how crises bring to light dormant issues forcing local officials to respond with policy initiatives. This shares a conceptual link

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[365] Posner, Eliot (2018). "Financial Regulatory Cooperation: Coordination of Derivatives Markets. in *Governing the World's Largest Market: The Politics of Derivatives Regulation after the 2008 Crisis.* Eric Helleiner, Stefano Pagliari & Irene Spagna *eds. Ch2 p. 54;* Oxford University Press.

with IPE work on crisis-induced financial services reform that points to peaks in salience by the general public as determinative in bringing issues like OTCs, hedge funds and credit-rating agencies under more public oversight on both sides of the Atlantic.[366] Subsequent empirical work uncovered that the postcrisis lobbying space in the US for OTCs in particular was dominated primarily by the actors that are actual counterparties to OTC contracts or in other words, merchants and gamblers.[367] One of the main implications of this finding is that despite the large scale effect that the global financial crises had on citizens in participating market countries, organizations and groups representing the broader public interest were largely excluded from the process. This idea is linked conceptually to two different contributions from comparative scholars. William Coleman's early comparative public policy work in financial services reform pointed to the relatively insular nature of the relevant policy communities that drive the process. This informed some of my decisions for data selection in the introductory chapter, and is noteworthy because of his work's decidedly non-democratic implications for citizens living in participating market economies. Another similar conceptual strain was Culpepper's work, that suggested that complex technocratic fields like finance are the domain of 'Quiet Politics'. In the absence of crises, politicians, policy-makers and regulators often work in close conjunction with regulated firms whose technical expertise they're dependent upon to develop regulation. As a result most of this type of regulatory

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[366] Pagliari, Stefano (2013). "Public Salience and International Financial Regulation: Explaining the International Regulation of OTC Derivatives, Rating Agencies, and Hedge Funds". Ph.D Thesis: University of Waterloo. Ontario, Canada.

[367] Pagliari, Stefano. (2018). "The Second Half: Interest Group Conflicts and Coalitions in the Implementation of the Dodd-Frank Act Derivatives Rules." in *Governing the World's Biggest Market.* Eric Helleiner, Stefano Pagliari and Irene Spagna eds. Ch.5 P.137; Oxford University Press.

policy-making and standard-setting occurs away from the attention of the general public. In instances where these decisions generate externalities at a later point in time, this often comes at their expense. Therefore, how can broad measures of salience impact regulatory policy outcomes if they're inherently fleeting and eventually circumscribed by the very policy communities that generate policy outcomes?

Conceptually, more work should be done to connect the links between complex technocratic issue areas like financial services and what drives public officials to respond. Here the focus in the broader literature on critical junctures as well as the connections I've made between historical institutionalism and focusing events is instructive. This project's case studies reveals that as it pertained to OTCs, the financial crisis that began in 2008 consisted of two focusing events and related scandals that not only forced officials to respond but also opened up new permissive conditions that significantly increased their agency to do so. However, we should be careful not to conflate the productive conditions following these developments with normatively positive policy outcomes. The expanded agency that US authorities experienced in the wake of the OTC-driven London whale scandal in 2012 which created the conditions for its extraterritorial rule-making bears this out, as it was largely inconsistent with the spirit of the G20 OTC reform agenda. This in turn, suggests that students of public policy could also benefit from a more fruitful engagement with HI's analytical tools like sequencing. Complex regulatory reform is a process that develops over time and HI's temporal focus helps explain how contingent events that play out during an ongoing crisis can negatively impact the sequencing of regulatory developments resulting in less than optimal policy outcomes.

Another implication of this study's temporal focus is on time as a political resource that actors compete over. I've derived this idea from HI-informed postcrisis work that sees revisionist status quo-oriented actors using institutionally generated friction in an effort to veto the efforts of reformers.[368] However, I've also expanded on this idea to suggest that reformers use institutions as well to override these veto efforts. Given the discussion above about the waning salience of the general public in highly technocratic issue areas like complex financial services, for these reformers time is of the essence. Focusing events are therefore inherently fleeting and the public's attention quickly moves on to something else removing the impetus felt by public authorities. Therefore local regulatory actors have to move quickly in proceeding with the development of standards. The goal is to institutionally embed enough of the essential regulatory elements of their reform mandate into rules with clear deadlines. This forces the hand of revisionist actors to forego their veto efforts at creating institutional friction as they come to the table to facilitate a compromise. Naturally HI's focus is well suited for more theoretically driven empirical work in this regard. While I've used the idea of the politically contested tempo of reform as a crude proxy for this idea of time as a political resource, more empirical work should be done to expand on this idea on how it plays out in the context of different types of policy reform beyond finance.

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[368] Moschella, Manuela and Eleni Tsingou. (2013) "introduction: the financial crisis and the politics of reform: explaining incremental change." In *great expectations slow transformations.* Manuella Moschella and Eleni Tsingu eds. UK, ECPR Press Ch. 1 pp.1-33.

This study has also built on recent postcrisis work pointing to the relevance of regulatory actors in impacting the developments we see occurring with OTC reform.[369] This is attributed to the expanded discretion that these actors were granted to enact extraterritorial rules, in light of the new prudential mandate in the G20 countries to consider systemic level threats to the stability of their home financial systems. This occurred, despite the fact that regulators on both sides of the Atlantic had clauses baked into their legislative mandates that would have allowed for mutual recognition of each other's regulatory regimes as being functionally equivalent. Therefore, the problems that arose with transatlantic coordination were rooted in the inconsistencies between a new institutional approach to reform vis-à-vis this prudential mandate and the highly internationalized nature of cross-border derivatives markets. The agent-centered HI approach utilized in this study also gets at the expanded agency of these local regulatory actors. However, by focusing on the changes in regulatory authority over time this study expands on this work by explaining exactly how this new discretion occurs. By linking these actors to the institutional contexts in which they operate future HI-based work in IPE can tap into which domestic regulators see their discretion expanded during reform and why.

Market Power And Institutions

The case studies in this project were developed to test the theoretical predictions of the market power thesis relative to the institutional theory, which I proposed goes further in explaining the developments we see occurring with global OTC reform. In

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[369] Gravelle, Matthew and Stefano Pagliari. (2018). "Global Markets, National Toolkits: Extraterritorial Derivatives Rule-Making in Response to the Global Financial Crisis" in *Governing the World's Biggest Market.* Eric Helleiner, Stefano Pagliari and Irene Spagna eds. Ch.3 P.82; Oxford University Press.

doing so, I've built on earlier work which found a similar complementary relationship between the two in the context of the EU, its member states and the issue of regulating hedge funds.[370] However, as this earlier work suggested and as I noted in the first chapter, historical institutionalism isn't meant to replace theories based on material capacity, but rather serves as a useful complement that captures much of the nuance that the market power thesis is missing a theory driving institutional preferences for specific international regulatory outcomes. Therefore, the last section of this study will be devoted to a discussion about what some of its empirical findings suggest for furthering our theoretical understanding of how institutions and market power interact.

I've framed the analysis in this study according to the changes we see occurring in the regulatory authority for OTCs over time from those of the United States and United Kingdom to those of the US and the European Union. Therefore, the implication is that the institutional ascension of the EU's regulatory authority for OTCs was accompanied by a diminishment of the US' and UK's market power. Additionally, it's important to consider that much of the OTC story in the pre-crisis era is one of the US' and UK's attempts to utilize their joint regulatory market power to influence other countries consistent with the interests of global finance. At times, this consisted of concrete regulatory policy proposals to induce harmonization with their regulatory preferences for given which in turn were then promulgated by international institutions. At other times, this consisted of efforts simply to get market participants in these countries to pursue

[370] Fioretos, Orfeo (2010) 'Capitalist Diversity and the International Regulation of Hedge Funds' *Review of International Political Economy.* 17(4) pp.696-723.

complex contracting to varying degrees. However, despite the EU's rise to now include OTCs under its regulatory remit, the US' and UK's material capacity in financial services didn't simply disappear overnight. Both countries are still home to some of -if not- the deepest and most extensive capital markets in the world. Rather the events surrounding OTCs and its causal role in exacerbating the crisis gave rise to a new international consensus that American and British market power should be subsumed through new institutional arrangements governing global markets.

However, there is also an important theoretical corollary to this logic that is worth considering. To what extent might have European officials in Brussels misread the transfer of regulatory authority for OTCs to the EU as being synonymous with a s transfer of market power for OTCs as well? How else might we explain the efforts by the EU to emulate the US unilateral strategy in its attempts to enforce its preferred extraterritorial regulatory standard on Asian regulators? If anything, the disparities in relative capacity between Asian markets and the EU were considerable. Even countries in the region with fairly deep capital markets like Japan, Singapore and Hong Kong have only recently begun using derivatives. As Li has laid out, these countries used their "power as autonomy" to resist both the US' and EU's heavy handed attempts at exerting their market power over the region. Moreover, as he notes they never pushed back to obtain their own concessions from the west preferring instead to cherry pick standards that they deemed consistent with their own local regulatory orientation. This points directly back to HI's related thesis that countries look to pursue international coordination that allows for the preservation of their own often diverse regulatory models. Empirical scholars looking to explain the development of regulations in Asian market economies

should avail themselves of HI's insights in explaining how their unique historical paths to capitalist financial development create new forms of interaction with international financial regulatory outcomes.

The developments in Asia referenced above are particularly telling. In global finance as in most capitalist endeavors new markets are everything, and the expansion of capital is a never ending story for its adherents. We saw this in chapter 4 in the degree to which German exchanges that were boxed in competitively by new EU-level rules nonetheless sought to build on the EU's new regulatory authority by developing its own competitiveness in the region. In their interactions with Asian regulators, they didn't point to the material capacity of Europe's capital markets but rather to the extent to which EU and German institutions could oversee some of the externalities generated by the speculative vagaries of global finance. As you'll recall these efforts were unsuccessful as well. Therefore, neither market power nor institutions were determinative in fostering closer harmonization with western institutions or allowing for western firms to gain competitively at their own expense. This speaks to the caution with which public officials in these countries allow domestic firms to interact with gamblers from the west. However, the proliferation of nascent derivatives markets in Asia reinforces that what occurred with OTC reform, like much of postcrisis financial reform did not represent the wholesale abandonment of global finance. It still has its uses and the extent to which the legitimacy of international hedging came to light throughout the process demonstrates how this is the case for many Asian firms.

It seems as though market power is more determinative in weakly institutionalized regulatory environments. It arguably held more sway in the pre-crisis era

for OTCS which were subject to very little in the way of public oversight. This is why it represented a unique opportunity to test the predictions of the market thesis relative to the wave of institutionalization engendered by the crisis. Recent HI-inspired work focusing on the transatlantic coordination problems has suggested that these were attributable to the weakly institutionalized transnational environment that carried over into the postcrisis era causing headaches for local regulators in their interactions with their counterparts across the pond. Analytically speaking however, I've tried to control for this precisely because the weak transnational institutional environment that preceded the crisis was pointed to by public officials in different countries at the time as contributing to the crisis' global nature. Therefore ceteris paribus, the institutionalization of the global derivatives market was the whole point of the G20 OTC reform agenda. While this recent work also uses HI sequencing-based arguments, it doesn't address the changes in regulatory authority and market power preferring instead to focus on the post-crisis coordination issues between the US and EU which drives most of the literature. Future empirical work should use real world examples of crises-driven reform in formerly weak institutionalized environments to tease out how these things might change in conjunction with one another over time.

I'd now like to focus the discussion on both the theoretical and empirical implications of this study and what they represent for the UK going forward. It's worthy of consideration here because the political developments associated with OTC reform meant that it potentially had the most to lose. As such, the process of reforming the global OTC market saw the UK losing out institutionally within the context of the EU, which in turn negated the impact of its market power during postcrisis reform. Also, as I

mentioned above, Asian regulators were well aware of the international developments in the EU occurring with financial services reform in general and OTCs in particular. Because the majority of the world's OTCs are still traded In London, this may have contributed to their resistance to EU-level cross-border rules. However, the conditions surrounding Brexit and the UK's process of beginning to extricate itself from the EU, which coincided with the early stages of this project are particularly intriguing. Especially when we consider how this may impact future developments in global finance.

While the complex process of Brexit is ongoing and has taken years to develop, the conditions are ripe for a return of the UK's market power. While the size of the British financial sector relative to the rest of its economy was by no means the sole determinant of its leaving the EU, it was however a contributing factor. This is particularly relevant for the new financial products that will inevitably emerge and in which prior institutional arrangements with the EU no longer apply. Therefore, as it unwinds itself from EU-level institutions, an HI-related comparative hypothesis going forward is that this newfound autonomy in financial services should spur its financial sector to go further than they have in the past decade in pursuing financial innovation, one of their core competencies as an LME.

The international implications beyond the European context are significant as well. While the US is still relatively hegemonic in its promotion of global finance, things could see the UK's relative status rising. Also recall from chapter 2 that the development of the global OTC market and the heady days of its robust growth occurred in conjunction with a commensurate push towards greater European integration. Because this is no longer the case, the UK's role in the ongoing development of global finance

should increase. Therefore we should also expect to see a commensurate rise in the UK's market power in determining international regulatory outcomes in the future as its institutional autonomy help it counter the US more directly. These and related developments in the coming years should be a topic of focus for scholars working in the research program on international financial regulatory outcomes.

Despite the persistence of market-friendly postcrisis reform, the institutional effects on the OTC markets have been considerable. The efforts by participating countries in implementing the G20's OTC reform agenda constituted an example whereby segments of the derivatives industry would now come to resemble traditional futures in the degree to which they were now able to be traded on monitored exchanges and subjected to central clearing. Therefore in broad terms, the subsequent institutionalization of OTCs caused by the crisis came to be associated with what some in the derivatives industry have come to refer to as the "futurization of swaps"[371]. This effort was successful to some extent in curtailing the growth of the global CDS market which has flattened in the ensuing years.[372]

As I've pointed to at various points in this analysis, the growth of the global OTC market over time has represented an instance of financial globalization that many citizens in market economies were unaware of up until the crisis. Moreover, the longitudinal scope of this study suggests that the US hegemonic promotion of global finance that originally created the demand for OTCs was in turn successful in the extent to which

[371] Attributed anonymously to an interview with a former CFTC regulator.

[372] See also Aldasoro, Iñaki & Torsten Ehlers 2018. "The credit default swaps market: what a difference a decade makes" *BIS Quarterly Review.* Bank of International Settlements, June 2018. <https://www.bis.org/publ/qtrpdf/r_qt1806b.htm>

many globally oriented firms in various countries now used derivatives to hedge their exposure to fluctuating market conditions in the global economy. The process of implementing global OTC reform and the ascendancy of merchants or end-users during this period also underscores how influential these trends were over time. It also speaks to a corrective to former trends in the scholarship on financialization which posited an increase in the size and influence of financial institutions and their attendant markets particularly in the US. [373] More recent comparative work has also suggested similar empirical developments occurring in Europe as well.[374] This particular research program has expanded in recent years, to consider how these trends are playing out in the global economy as it also takes into consideration the broader effects of similar trends in emerging economies and China as well.[375] While the predictions of HI suggest that countries will pursue this mode of financial development in a manner consistent with their existing regulatory models, this study has hopefully contributed to work in this vein by suggesting that this will inevitably feedback into international regulatory outcomes as well. One of the takeaways from the global financial crisis was that the trends contributing to unchecked financial globalization constituted not merely an economic market failure, but also a political one as well. Therefore, IPE scholars are well placed to

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[373] Krippner, Greta. (2005). "The Financialization of the American Economy" *Socio-Economic Review 3, 173-208.*

[374] Stolbova, Veronika; et al (2017) "Financialization of Europe: a comparative perspective" *ISI Growth Working Paper.* EU Horisin 2020 Research, 22/2017 July. < http://www.isigrowth.eu/wp-content/uploads/2017/07/working_paper_2017_22.pdf>

[375] Epstein, Gerald (2005). *Financialization and the World Economy.* Cheltenham, Elgar Publishing. See also: Ramos, Raquel A. (2017). "Financialization at the international level: evidence from emerging market economies" *Economia e Sociedade,* Campinas, v.26 Número Especial, p. 959-990; 2017.Also Dünhaupt, Petra (2016) "Financialization and the Crises of Capitalism" *Working Paper No. 67/2016* Institution for International Political Economy Berlin. Petry, Johanes (2020) "Financialization with Chinese characteristics? Exchanges, control and capital markets in authoritarian capitalism" *Economy and Society*. Volume 49, p.213-238.

engage with this literature to address the political determinants of how financial globalization proceeds apace.

The agent-centered approach has also allowed us consider how one of Historical Institutionalism's main advantages over rival approaches is that it allows us to consider the interaction between the agents engaged in the regulatory process as they compete over the politics of ideas vis-à-vis existing institutional arrangements. Here, the potential dynamics surrounding the UK are instructive. It may well be the case that its subsequent departure from the EU in conjunction with the US' continued promotion of global finance may contribute to a revival of Anglo-American joint market power. It is therefore likely that the future political contestation over new neoliberal-inspired ideas about the direction of the global economy is likely to play out in this context. Some neoliberal ideas about the positive contributions of the CDS market to liquidity, the diffusion of risk, and price discovery still persist. However, the long arc of the last global financial crisis suggests that these have now been limited primarily to academics working in finance and business studies. Whether or not new ideas find purchase with policy-makers in the future will be subject to a complex array of political, economic and social factors associated with the global economy and its attendant markets rendering such predictions difficult, if not impossible. By staying abreast of these developments, IPE scholars working in the HI tradition are well poised to contribute to this discussion. This is especially relevant given that some European CMEs no longer have a proponent for global finance to side with inside fortress Europe. Moreover, the EU now has two LMEs with considerable material capacity in financial services to contend with, going forward. These future interactions will undoubtedly determine the path of future international financial regulatory outcomes.

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“I’m afraid we’re moving towards a partisan process,[…] I think that’s where we’re headed.”
Braithwaite, Tom. “US Senate to introduce draft financial bill” *Financial Times* 1, November 2009.

“A major tenet of US politics is that if politicians wait long enough, public attention wanders
Reich, Robert. “Why Obama must take on Wall St.” *Financial Times.* 13, Jan. 2010 P.1.

“bring the derivatives market out of the dark”
Geithner, Timothy. “How to prevent America’s next financial crisis” *Washington Post* 13 April, 2010.

“a strong mechanism to regulate derivatives. [...] We need to get that [market] into daylight”.
Fifield, Anna. (2010)“Republicans dismiss Obama's plan for crackdown on derivatives” *Financial Times* 15 April 2010 P.3.

"A major attack is coming from the financial institutions who are trying to roll back the derivatives legislation," he said. "They are using the end users as stalking horses"
Braithwaite, Tom. “Frank set for fight to defend regulatory overhaul” *Financial Times* 7, Jan. 2011, P.5.

“On several occasions, DC courts have struck down SEC and CFTC rules, not because of any constitutional problem, but because the conservative judges think the agencies have given too little deference to the financial industry's arguments”
Barney, Frank. “Don't panic -financial reform is coming to America” *Financial Times* 4, April 2013 P.7.

“There's no way this would have passed muster if people had openly debated it. So [the banks] had to sneak it on to a must-pass funding bill.″ Jopson, Barney and Ben McLannahan. “Warren attacks Dodd-Frank rollback: Wall Street” *Financial Times,* 11, November 2015 p.4.

“We are all agreed that we must put a stop to financial speculation.” Hall, Ben; et al. (2010) “Call for action on speculation” *Financial Times.* 10, Mar. 2010 p.19.

"We share the same basic belief […] that the 'Rhine capitalism' model of an economy buffered by corporations and focused on the long term, with strictly regulated markets […] is fundamentally superior to the Anglo-American capitalism model of deregulation” Stafford, Phillip. “Deutsche Börse calls for Frankfurt to take European lead in Chinese trading” *Financial Times.* 21, Jan. 2014. P.18

Moreover, this impact would be compounded if the EU imposed “conditions and standards that are not relevant, appropriate or even feasible*”* for clearing houses in Asia. Grant, Jeremy “Asia regulators attack Europe over clearing house standards “ *Financial Times.* 4, December 2013 P.20

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