Extraterritoriality in Financial Regulation: A Global Governance Challenge

「金融規制における域外適用問題：グローバル・ガバナンスにおける課題」

Presentation Material prepared for the 3rd Research Meeting, organized by the Japan Association of Global Governance

September 21, 2013

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Views expressed in the paper are those of the authors and do not necessarily reflect those of the Canon Institute for Global Studies or the Bank of Japan

Purposes and Structure of Today's Presentation

In the wake of the 2007-08 economic crisis, justification of taxpayer-backed rescue plans for poorly managed financial institutions replete with moral hazard has long been publicly discussed along with debates over a new global financial governance framework.

Like the cases of climate change, nuclear disasters, and the proliferation of weapons of mass destruction (WMD), cross-border financial activity has been one of the most important areas in the discipline of global governance. The 2007-08 crisis brought home how central the financial system is to the world economy. Despite its significance, however, discussions on better global financial governance, mainly because of the nature of its extreme complexity, have been exceptionally confined to a small community comprising policymakers, academics, and professionals working for large financial institutions.

This presentation tries to provide a broader intellectual community with a bird's eye view of the current situation of global financial governance and regulatory reform agenda from a Japanese perspective.

1. Global Financial Governance in the Wake of the 2007-08 Crisis

Brief History and Global Governance Perspectives

2. Reform Agenda: Global and National Approaches

Financial Regulatory Harmonization and Individual Reforms

3. Extraterritoriality Problems Facing Japan

Case Studies in the Field of Global Financial Governance

Who Governs Cross-border Financial Activity?

How Can We Understand the Growing Complexity of Financial Governance?

International financial integration is commonly seen as increasing economic efficiency and growth, but it may increase the probability of suffering a systemic banking crisis by transmitting international shocks via bank balance sheets. Empirical analysis finds not surprisingly strong evidence that bank balance-sheet contagion has indeed been amplified by exposure to borrowing from cross-border banks. . . .

Short-term borrowing from cross-border banks may pose additional external funding risk beyond the size of total cross-border bank debt. . . . For example, in 2008-09 a country with low cross-border bank debt (e.g. Australia) had an annual crisis probability that was roughly 5 percentage points lower than a country with high cross-border bank debt (e.g. Iceland). . . .

Ireland already had a three times larger annual risk of suffering a systemic banking crisis in 2008-09 than Poland or Mexico. These large increases in crisis probability underline the important role of cross-border bank debt, and in particular of short maturities, for spreading financial turmoil.

[OECD, "Financial Contagion in the Era of Globalised Banking," OECD Economics Department Policy Note No. 14, June 2012, pp. 6-7.]

Who Can Handle Money Safely and Adroitly?

Is It Easy to Predict Complex Financial Crises?

Catching a frisbee is difficult. . . . Yet despite this complexity, catching a frisbee is remarkably common. Casual empiricism reveals that it is not an activity only undertaken by those with a Doctorate in physics. It is a task that an average dog can master. Indeed some, such as border collies, are better

Catching a crisis, like catching a frisbee, is difficult. Doing so requires the regulator to weigh a complex array of financial and psychological factors . . . . Yet despite this complexity, efforts to catch the crisis frisbee have continued to escalate. Casual empiricism reveals an ever-growing number of regulators, some with a Doctorate in physics. Ever-larger litters have not, however, obviously improved watchdogs' Frisbee-catching abilities. No regulator had the foresight to predict the financial crisis, although some have since exhibited supernatural powers of hindsight.

So what is the secret of the watchdogs' failure? . . . Applying complex decision rules in a complex environment may be a recipe not just for a cock-up but catastrophe. . . . The general message here is that the more complex the environment, the greater the perils of complex control.

[Haldane, Andrew G., [Executive Director, Financial Stability, Bank of England] A 'Jackson Hole' Speech: "The Dog and the Frisbee," August 31, 2012]

Brief History: US Government's Strenuous Efforts amid the Crisis

Alhough Policymakers Chose Best Policies Available in the Past . . .

2007
Jul. 11: Standard and Poor's places 612 securities backed by subprime residential mortgages on credit watch
Jul. 31: Bear Stearns liquidates two hedge funds that invested in Mortgage-backed Securities (MBS)
Aug. 06: American Home Mortgage files for bankruptcy
Aug. 09: BNP Paribas halts redemptions on three investment funds
Dec. 12: Fed establishes Term Auction Facility (TAF) and FX swap lines with ECB and Swiss Nat'l Bank (SNB)

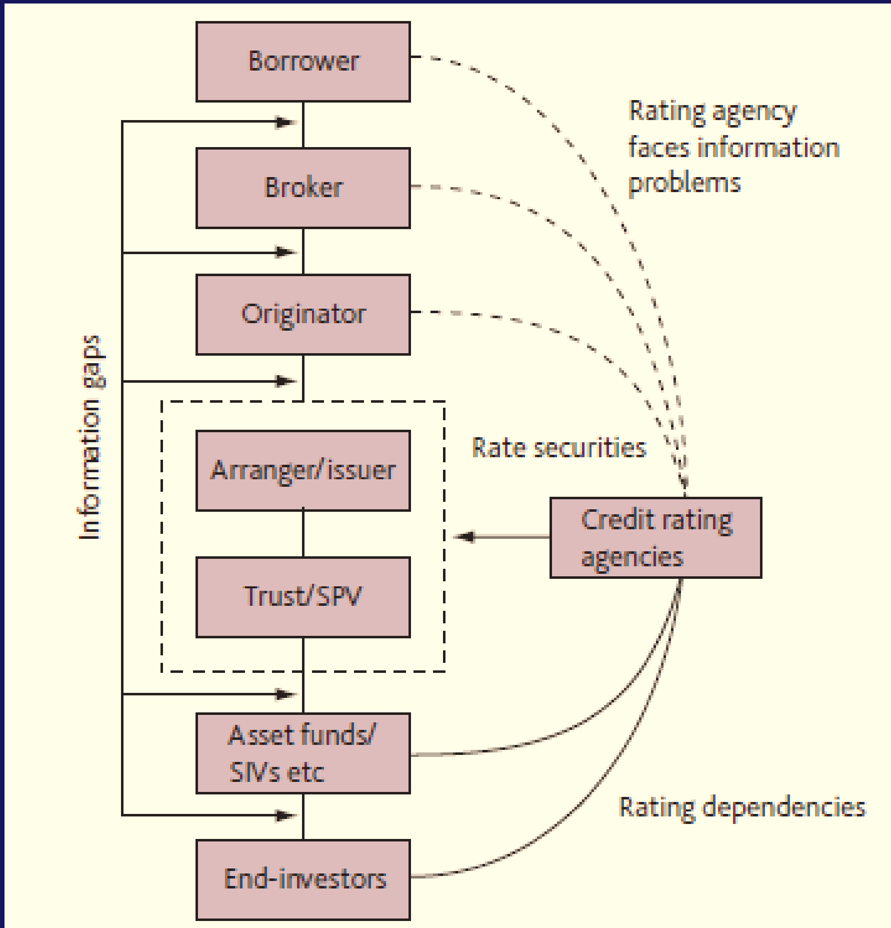
2008
Mar. 11: Fed establishes Term Securities Lending Facility (TSLF); FX swap lines with ECB and SNB increase
Mar. 14: JPMorgan Chase to acquire Bear Stearns
Jul. 11: Failure of IndyMac Bank, the largest savings and loan association in the Los Angeles
Jul. 13: Fannie and Freddie allowed access to discount window
Sep. 15: Lehman Brothers to file for bankruptcy
Sep. 16: AIG receives loan
Sep. 17: Treasury announces Supplementary Financing Program
Sep. 18: Fed establishes FX swap lines with BOJ, BOE, and BOC
Sep. 22: Goldman Sachs and Morgan Stanley become bank holding companies (BHCs)
Sep. 24: Fed establishes FX swap lines with other central banks
Sep. 25: Washington Mutual fails
Oct. 07: Fed announces Commercial Paper Funding Facility (CPFF)
Oct. 09: Wells Fargo acquires Wachovia
Oct. 14: Treasury announces Capital Purchase Program;
Federal Deposit Insurance Corporation (FDIC) announces Temporary Liquidity Guarantee Program
Oct. 21: Fed announces Money Market Investor Funding Facility (MMIFF)
Oct. 28: Fed establishes FX swap lines with Resarve Bank of New Zealand (RBNZ)
Nov. 10: AIG support restructured
Nov. 23: Citigroup receives federal support

2009
Jan. 16: Bank of America receives federal support
Feb. 23: Treasury initiates Capital Assistance Program
Feb. 27: Treasury announces participation in Citigroup exchange offering
Mar. 03: Term Asset-Backed Securities Loan Facility (TALF) launches
Mar. 04: Federal financial regulatory agencies announce support of the "Making Homes Affordable" loan modification program

Sources: Federal Reserve Bank of San Francisco, "Annual Report 2008," San Francisco, 2009, pp. 8-9

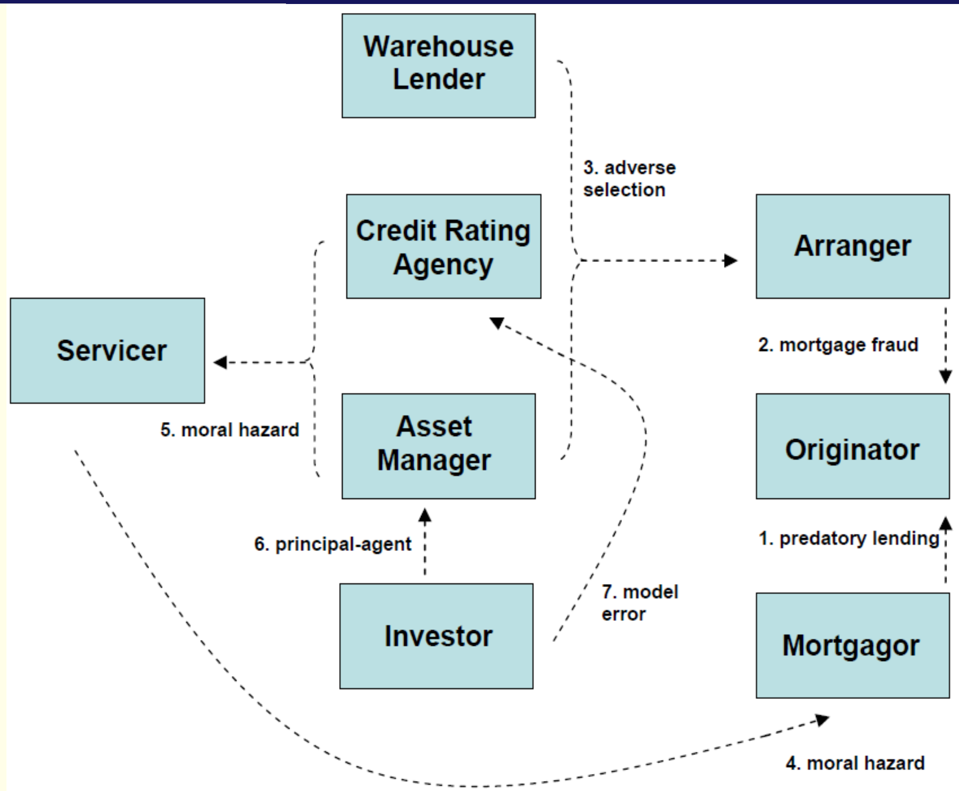
A New History: Need to Develop Innovative Approaches

In Response to the Proliferation of Mortgage-Backed Securities (MBS)



(a) For more detail on the roles of participants in structured finance markets see Committee on the Global Financial System (2005), *The role of ratings in structured finance: issues and implications*, January, available at www.bis.org/publ/cgfs23.htm.

Source: Bank of England, "Financial Stability Report," Issue No. 22, October 2007, p. 41.



Source: Ashcraft, Adam B. and Til Schuermann, "Understanding the Securitization of Subprime Mortgage Credit," Staff Report No. 318, New York: Federal Reserve Bank of New York, December 2007, p. 8.

Governance: Can We Benefit from and Defend against the Externalities of Cross-border Financial Activities?

Global Financial Issue: Why Can We Endorse Taxpayer-funded Bailout Programs When Large (Foreign) Banks Fail?

(As in the Cases of Nuclear Accidents and Climate Change)

[Mit der zunehmenden Bürokratisierung der Verwaltungen des Staates und der Gesellschaft scheinen sich die Kompetenzen hochspezialisierter Fachleute, aus der Natur der Sache, immer mehr einer Aufsicht durch räsonierende Körperschaften entziehen zu müssen. Max Weber hat bekanntlich diese Tendenz an dem, freilich immer schon prekären Verhältnis von parlament und Exekutive analysiert.]

[国家と社会の官僚制化が進展するにつれて、高度に特殊化された専門家達の知識は、事柄の性質上、論議する団体による監視からはますます隠されていかざるを得ないようにみえる。周知のようにマクス・ヴェーバーはこの傾向を、元々から不確かであった議会と行政府との関係について分析していた。]

[With the mounting bureaucratization of the administration in state and society it seems to be inherent in the nature of the case that the expertise of highly specialized experts would necessarily be removed from supervision by rationally debating bodies. Max Weber analyzed this tendency with respect to the inevitably precarious relationship between the parliament and the executive.]

[Habermas, Jürgen, *Strukturwandel der Öffentlichkeit* [『公共性の構造転換』/*The Structural Transformation of the Public Sphere*], 1990 (1960), S. 339 [p. 233]]

[E]ven the most abstruse and technical markets (as OTC may appear) are subject to social processes. . . . Politicians and regulators often find it difficult to respond coherently and this creates unevenness and uncertainty and with it the possibility of regulatory arbitrage.

[Morgan, Glenn, “Constructing Financial Markets,” in *The Consequences of the Global Financial Crisis*, edited by Wyn Grant and Graham K. Wilson, 2012, p. 85]

Alphabet Soup of Global Financial Governance Bodies

(a) Status of Lender of the Last Resort, (b) Growing Tension between International Harmonization and National Jurisdiction, and (c) Each NMR's (Dis)proportionate Representation in the Global Community

{NMR: Non-Majoritarian Regulators (cf. Coen and Thatcher (2005)}

Organizations	Japanese translation	Est.		HQ
BOE (Bank of England) (United Kingdom)	イングランド銀行	1694		London
BOJ (Bank of Japan) (Japan)	日本銀行	1882		Tokyo
Fed (Federal Reserve) (United States)	連邦準備制度理事会	1913		Washington
BIS (Bank for International Settlements)	国際決済銀行	1930	Post WWI	Basel
IMF (International Monetary Fund)	国際通貨基金	1946	Post WWII	Washington
BCBS (Basel Committee on Banking Supervision)	バーゼル銀行監督委員会	1974	Post Herstatt Crisis	(within BIS)
G7; G8 (1997~)		1975	Post Oil Shock	
IOSCO (Int'l Organization of Securities Commissions)	証券監督者国際機構	1983		Madrid
IAIS (International Association of Insurance Supervisors)	保険監督者監督機構	1994		Basel
ECB (European Central Bank)	欧州中央銀行	1998	Prior to the Euro Zone	Frankfurt
FSF (Financial Stability Forum)	金融安定化フォーラム	1999	Post Asian Fin. Crisis	(within BIS)
G20		2008	Post Lehman Crisis	
FSB (Financial Stability Board)	金融安定理事会	2009	An umbrella body	(within BIS)

Capital Requirements: Basel III: Compliance Grading

Key Components of the Basel Framework	Japanese Translation	Japan	US	EU	Swit-zerland	Singa-pore
Overall grade	総合評定	C	NYL	NYL	C	C
Capital requirements	資本					
Scope of application	適用範囲	C	C	(C)	C	C
Transitional arrangements	移行措置	C	(C)	(C)	C	C
Definition of capital	自己資本定義	(LC)	(LC)	(MNC)	LC	C
Pillar 1: Minimum capital requirements	第一の柱					
Credit risk: Standardised approach	信用リスク	C	(LC)	(LC)	C	LC
Credit risk: Internal ratings-based approach	信用リスク	C	(LC)	(MNC)	LC	LC
Credit risk: securitisation framework	信用リスク	LC	(MNC)	(C)	C	C
Counterparty credit risk rules	信用リスク	C	(LC)	(LC)	C	C
Market risk: standardised measurement method	市場リスク	LC	C	(LC)	C	C
Market risk: internal models approach	市場リスク	C	C	(C)	C	C
Operational risk: Basic Indicator Approach and Standardised Approach	オペリスク	LC	n.a.	(LC)	C	C
Operational risk: advanced measurement approaches	オペリスク	C	LC	(LC)	C	C
Capital buffers (conservation and countercyclical)	資本バッファー	NYL	(C)	(C)	C	C
G-SIB additional loss absorbency requirements	重要銀行	(1)	(1)	(1)	n.a.	n.a.
Pillar 2: Supervisory review process	第二の柱	C	C	(C)	C	C
Pillar 3: Market discipline	第三の柱	C	(C)	(C)	LC	C
Liquidity standards	流動性	(1)	(1)	(1)		
Leverage ratio	レバレッジ比率	(1)	(1)	(1)		

Notes: Compliance assessment scale: C: compliant, LC: largely compliant, MNC: materially non-compliant, and NC: non-compliant; Ratings that are based on draft or proposed rules are indicated within parentheses. Ratings based on final rules are indicated without Parentheses; NYL: Not yet released;
(1) To be assessed after the Committee concludes its review on any revisions or final adjustments of these elements of Basel III.

Source: Bank for International Settlements (BIS), "Report to G20 Finance Ministers and Central Bank Governors on Basel III Implementation," October 2012, pp. 24-26; BIS, "Regulatory Consistency Assessment Programme (RCAP) Assessment of Basel III Regulations – Singapore," March 2013, pp. 3-4.; BIS, "Regulatory Consistency Assessment Programme (RCAP) Assessment of Basel III Regulations – Switzerland," June 2013, p. 10.

Capital Requirements: Basel III: G-SIBs

(a) Avoid the Moral Hazard of G-SIBs, and
(b) Avoid the Situation of Too-big-to-Fail (TBTF)

Required Level of Additional Loss Absorbency (To Be applied from 2016)

%		Globally Systematically Important Banks (G-SIBs)
2.5	4 Banks	Citigroup (US), Deutsche Bank (DE), HSBC (UK), JP Morgan Chase (US)
2.0	2 Banks	Barclays (UK), BNP Paribas (FR)
1.5	8 Banks	Bank of America (US), Bank of New York Mellon (US) Credit Suisse (CH), Goldman Sachs (US), Mitsubishi UFJ FG (JP), Morgan Stanley (US), Royal Bank of Scotland (UK), UBS (CH)
1.0	14 Banks	Bank of China (CN), BBVA (ES), Groupe BPCE (FR), Group Crédit Agricole (FR), ING Bank (NL), Mizuho FG (JP), Nordea (SE), Santander (ES), Société Générale (FR), Standard Chartered (UK), State Street (US), Sumitomo Mitsui FG (JP), Unicredit Group (IT), Wells Fargo (US)

Notes: In addition, newly designated G-SIBs are required to implement the following: (1) Establishment of Crisis Management Group (CMG) (within 6 months); (2, 3) Development of a recovery plan and a resolution strategy and review within CMG (within 12 months); (4) Agreement of institution specific cross-border cooperation agreement (within 18 months); (5) Development of operational resolution plan (18 months); (6) Conduct of resolvability assessment by CMG and resolvability assessment process (within 24 months).

Source: Financial Stability Board (FSB), "Update of Group of Global Systemically Important Banks," November 2012, pp. 3-4.

Capital Requirements: Basel III: Japan is the Front-runner

Regulatory Consistency Assessment Programme (RCAP) Schedule

Assessment Status	Completion of Assessment Report	Country
Completed	October 2012	Japan
	March 2013	Singapore
	June 2013	Switzerland
Preliminary Assessed	October 2012	United States
	October 2012	European Union
Underway	(Tentative) September 2013	China
	(Tentative) April 2014	Australia
Initiated	(Tentative) June 2014	Canada, European Union
	(Tentative) September 2014	United States
Planned	(Tentative) December 2014	Hong Kong, Mexico
	(Tentative) March 2015	India, South Africa
	TBD (To be determined)	Argentina, Indonesia, South Korea, Russia, Saudi Arabia, Turkey

Source: Bank for International Settlements (BIS), "Report to G20 Leaders on Monitoring Implementation of Basel III Regulatory Reforms," August 2013, p. 27.

New Global Financial Governance: A Long Way to Go

The Implementation of Basel III Will Take Long Years to Come

All Dates are as of January 1

	2013	2014	2015	2016	2017	2018	2019
Capital							
Leverage Ratio	Parallel run Jan 1 2013-Jan 1 2017 Disclosure starts Jan. 1 2015					Migra-tion to Tier 1	
Minimum Common Equity Capital Ratio (%)	3.5	4.0			4.5		4.5
Capital Conservation Buffer (%)				0.625	1.25	1.875	2.5
Minimum Common Equity Plus Capital Conservation Buffer (%)	3.5	4.0	4.5	5.125	5.75	6.375	7.0
Phase-in of Deductions from Common Equity Tier 1 (CET1) (%)		20	40	60	80	100	100
Minimum Tier 1 Capital (%)	4.5				6.0		6.0
Minimum Total Capital (%)				8.0			8.0
Capital Instruments That No Longer Qualify as Non-core Tier 1 Capital or Tier 2 Capital		Phased Out Over 10 year Horizon Beginning 2013					
Liquidity							
Liquidity Coverage Ratio (LCR)—Minimum Requirement (%)			60	70	80	90	100
Net Stable Funding Ratio (NSFR)						Introduce Minimum Standard	

Source: Bank for International Settlements (BIS).

New Global Financial Governance: We Have to Do More

Basel III Is an Important but Uncompleted Part of the New Policy Framework for Global Financial Governance

Policy Options to Improve Global Financial Stability	Scope of Basel III
Price-based Regulation accompanied by Enhanced Supervision and Effective Regulation	
Enhanced Regulatory Framework	
Higher Quantity and Quality of Loss Absorbing Capital	○
Tougher Liquidity Standards	○
Systemic Risk Surcharges	○
Proactive and Intensive Supervision	○
Effective Resolution Framework	
Bail-in Resolutions	
Cross-border Arrangements	
Firm-specific Structural Measures	
Enhanced Transparency and Disclosure	
Structural Limits on the Size and Scope of the Activities of Institutions	
Proprietary Trading Operations	
Risk-taking Trading Operations including Hedge Funds	
Market Making	
Subsidiary Operations	
Market Structure Reform	
Cross-border Derivatives Markets	
SIFI (systemically important financial institution) other than the Banking Sector	

Notes: Policy options listed above is not necessarily mutually exclusive among them; several agencies including the BIS are examining every policy option designed to enhance global financial efficiency and stability.

Structural Reform: Against TBTF

Three Major Regulatory Proposals to Limit the Size and Scope of Big Banks

	United States	United Kingdom	European Union
Leader of the Reform	**Paul Volker**	**John Vickers**	**Erkki Liikanen**
Legislative Status	Yes, 2010	Scheduled, 2015	No
Regulation Implementation	Scheduled July 2014	No	No
Basic Principle	Outright Separation	Ring-fencing	Subsizization and Restriction on Intra-group Exposures
Holding companies with banking and trading subsidiaries	No	Yes	Yes
Deposit taking institution dealing in securities and derivatives	No	Only for subsidiaries	Only for subsidiaries
Deposit taking institution dealing in market making services	Yes	Only for subsidiaries	Only for subsidiaries
Non-trading exposures to other financial institutions	Yes	Restricted	Yes
Size threshold	No	Yes > £25 billion	Yes > €100 billion with a condition
Expected Benefits	Effective in risk reduction for the entire group, but no Benefits regarding resolvability	Effective in exploiting in interconnectedness	Effective in risk reduction for the bank, and Effective in exploiting interconnectedness
Expected Costs	Mis-idenficiation, Compliance burdens for both banks and regulators, higher risk migration to shadow banking system		Higher risk migration to exempt institutions

Note: As for further details regarding the benefits and costs, see Viñals (2013).

Source: As for the Volker Rule, see the Dodd–Frank Wall Street Reform and Consumer Protection Act (Pub.L. 111–203), January 21, 2010; the Vickers Report, Independent Commission on Banking (ICB), "Final Report: Recommendations," September 2011; the Liikanen Report, "Report of the European Commission's High-level Expert Group on Bank Structural Reform," October 2012.

Concluding Remarks

Extraterritoriality in Financial Regulation: A Global Governance Challenge—Regulatory Uncertainty (Is the Glass Half Full, or Half Empty? Some Experts Look to Politicization (and Sinicization) of FSB and Structural Reforms)

"The quest for consistency does not, . . . imply the eventual development of a single global rulebook that can be applied without exception to all activities of all banks in all jurisdictions at all times."

"Cross-border financial regulation . . . promotes global financial stability; it supports cross-border trade, by promoting international financial markets to match those in goods and services; it improves the efficiency of capital allocation, by allowing capital to flow more readily across national boundaries to find its most productive use; and it facilitates more competitive financial markets, allowing consumers and investors access to the greatest range of financial services at the lowest cost.

[T]here can also be reasons why complete harmonisation would be sub-optimal: national financial systems are at different stages of economic development, and may need differences in regulatory and supervisory approaches even if their financial stability objectives are the same; financial regulation does not exist in isolation, and needs to be blended with national tax, accounting and legal frameworks, . . . to achieve appropriate outcomes; and it would not provide room for macro-prudential (or micro-prudential) adjustments to regulatory requirements to deal with vulnerabilities and risks arising from the different stages of business and financial cycles in individual jurisdictions.

[Byres, Wayne [Secretary General, Basel Committee on Banking Supervision], "Global Consistency in Financial Regulation: Is the Glass Half Full, Half Empty, or Just More Transparent?" A Speech in Nice, France, September 10, 2013]

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