

Summary – ‘Understanding and Effective Responses to Explosive Growth of US Extraterritorial Enforcement’ by Paul Backer (25th September 2015)

Introduction

- According to Wall Street Journal, banks and financial institutions were fined 60 billion dollars in just 2 years by US extraterritorial enforcement.¹
- Issues of Sovereignty - FATCA
 - The subjects of US extraterritorial enforcement are often seen as ‘unlikeable’, generally are wealthy, generally good at defending themselves.
- Definition of Extraterritorial Ability: The ability of a government to project its enforcement beyond its borders (long-arm jurisdiction, cross-border jurisdiction)
 - E.g. If an American citizen or subject goes to another country, committed an act that is not constituted as a criminal act in that country but is under American laws, and by that very fact, being prosecuted by US authorities.
- Extradition – trade drugs in Columbia; they never ship them to the US, but they can be extradited and jailed for that purpose.
 - Reasonably low to suspect that they conspire in the US, but they are drug dealers.
 - International banks – not very likeable; US extraterritorial enforcement impacts just about everything.
 - We still have not had a standard language for the features of US extraterritoriality.
- Objective of this presentation: Why is it relevant to you? How does it affect you? What makes it interesting, what makes it very exciting? Historically, to be subject to Chinese enforcement?

Overview

- Enforcement of own laws and regulations outside borders. Increasingly, against parties lacking a territorial jurisdiction nexus in proceedings departing from substantive law.
 - Example (1) - Payday loan scam – the territorial jurisdiction nexus is the ‘internet’, which may have a main server in the US territory.
 - Example (2) – Credit Card – If you use credit card in Hong Kong to buy a ticket online, you are using the American Payment System, which can potentially become a territorial jurisdiction nexus.
- Regulation is the ability to impose own will to control conduct and extract penalties.
 - The penalties extracted from US extraterritoriality has brought a huge profit for the government and regulatory agencies.
 - If you use the American Payment System; it has attracted penalties – annual legal exposure on US extraterritoriality is around 100 billion dollars on legal risk. In other words, it creates 100 billion dollars-worth for agencies to sue you.
- US extraterritoriality brought blockbuster penalties in hundreds of millions and cumulatively, tens of billions of dollars against companies and to a much lesser extent physical persons with registration, HQ and primary operating locations, majority of clients, shareholders and transactions outside the US.
- FATCA - compliance costs 8-10 billion, 20 times more than the best case scenario any agency can profit from this scheme yet, it is also true that the cost for the enforcement agencies is 0.

¹ ‘Banks to Pay \$5.6 Billion in Probes: Citigroup, J.P. Morgan, Barclays, RBS and UBS to plead guilty to criminal charges’, Wall Street Journal, (20th May 2015)

- Penalties linked to extraterritoriality characterized as *one of the greatest wealth transfers in history*.
 - One article even suggests that ‘US regulatory activities are one of the greatest bank robberies in history’.
- Subjects of extraterritoriality are wealthy, unlikeable and consistently failed to mobilize to protect interests.
 - AIG was near collapse, and a senate asked AIG at a senate hearing ‘did you make that decision, and how much money did you make?’ The manager replies, ‘30 million dollars that year. I made just above the grave level’. The senate rhetorically stated, ‘Who made above the grave level? God?’
- Non-US companies unprepared for draconian enforcement.
 - Part of it is lawyer’s fault; lawyers failed to anticipate the impact. *They did not distinguish between substantive and regulatory law, courts and agencies.*
 - E.g. Part of the sanction against Russia is to prohibit exports to Russia of high pressure pumps use for fracking. Lawyers were not aware of the details of the requirement of the regulatory features, and only took it seriously when a lawsuit has already emerged.
- The failure to predict and plan for impact led to non-US companies’ failure to implement effective company policies and programs to mitigate impacts. Need to change.
 - BNP Paribus: Never believed to have fined 9 billion dollars. They never realized how popular they are.

Power of Legal Ideas

- In Law, ideas are uniquely powerful. Legal Ideas shape the world. The first to be involved, shape the ideas. Future and application of extraterritoriality is being shaped.
 - Idea of extraterritorial idea: how do you see it, what we do - *Legal ideas shape the world.*
 - E.g. Collateralized debt securities – take mortgages, bundle, strip and securitize them. Sell them to the public. This idea has helped change every piece of real estate in the world. With collateralized debt securities we could raise the price according to specific circumstances.
- Extraterritoriality will change the way banks transact.
 - E.g. If you are an American citizen you cannot have an American bank account anymore overseas, this is because one of the impacts is that foreign companies due to extraterritoriality no longer hire American because if he or she has signature right, he or she can drag the company into US regulatory jurisdiction.
- ‘One country, two systems’ – Uniqueness of Hong Kong: facilitate circulation of money and provide expertise in many different areas.

Extraterritoriality Changes Everything

- July 2014: BNP Paribus pled guilty to criminal charges² and agreed to pay almost USD 9 billion to resolve accusations it violated US sanctions against Sudan, Cuba and Iran.
 - In other words, nothing happened – there was no court case, no evidence, no prosecution. Nothing was published. Economists described the one policy as unclear what they were fined for, unclear what they pleaded guilty to it, and unclear of why this whole thing happened. Other important thing to note is that, BNP Paribus was barked from conducting

² ‘BNP Paribus Draws Record Fine for “Tour de Fraud”: BNP Admits to Filing False Business Records and Conspiracy’ (30 June, 2014)

certain US transactions, a critical part of the bank's global business, in addition to the fine which was a record for violating American sanctions.

- The ability to impose limitless fines and proceedings- if there is no clear due process, it is not clear how these banks attracted such huge fine.

The Russian Kerfuffle

- Impact of Extraterritoriality (Sanctions)
 - E.g. Sanctions collapsed Russian economy and sales except raw resources. No one is sure whether the businesses or the banking systems used by them are related to US nexus. JP Morgan Chase, at the beginning of the Ukraine invasion, did not know which was owned by Russian government, decided to freeze all payments. One of the payments was the Russian embassy in Kazakhstan paid to an insurance company (owned by the Russian government). The payment got frozen.
- *How do you view extraterritoriality?* Protects against abuse by the overprivileged and crooks or a threat to legitimate state sovereignty interests? UnionPay and CIPS as pushback?
 - The field is about two years old; a common language on extraterritoriality is yet to be set up.

Explosive Growth of Extraterritoriality

- From *Pax Americana* to *Lex Americana*. Effective pursuit of policy from non-lethal force or sovereignty?
 - Pax Americana is to send resources to a place to achieve an objective, say, to build a democratic society in Iraq.
 - One of the things about extraterritoriality sanction is that by applying sanctions, businesses were killed. – It helps the US government to impact on everything, without getting the negative effects that were once threatening when the notion of Pax Americana was dominated. More importantly, Lex Americana pays for itself.
- International law does not really exist.
 - *Westphalian Peace Conference of 1648* and 30 Years' War. Religious War - Catholics fighting for every person who was trapped in Protestant's countries and vice versa for the Protestants.
 - The agreed principle is that state sovereignty should prevail at all times.
 - US extraterritoriality revolutionizes this notion, e.g. telling other countries how their banking system should work. This is done in a subtle way, e.g. asking the regulatory agencies to make their evaluation standards equivalent to the American's standard. This of course upsets the other countries' regulatory agencies.
 - *Dodd-Frank Act – Volcker Rule*: it prohibits a bank to trade security on its own account. If I want to sell you my shares, and nobody wants to buy the shares, market makers step in to buy them. Major financial institutions worldwide buy those shares, but they cannot, and they are now starting to worry after hearing that 60 billion dollars were fined only in 2 years. So, they hope for clear guidance. But the only guidance they ever got so far is 'being reasonable'. The way of defining reasonableness is to negate what is not being reasonable – which does not help them at all, and it remains an arbitrary concept.

Purpose of Law

- Efficiency and integration – global best practices should prevail. US law, longest successful track record cost effectively governing large markets. Extraterritoriality broadly positive.
 - If you see efficiency as the primary purpose of law, you should embrace US extraterritoriality.
- Local – local history and social values. Extraterritoriality broadly negative, maybe a threat to sovereignty.
 - Embodies the local values, e.g. the Chinese Way; unique viewpoints in dealing with problems. Vast majority of national systems express national values.
- Right Answer – justice of every situation. Extraterritoriality but differently administered? Something else?
- Corporate finance and transactions are integrative.

Greatest Story Ever Told/ Substantive Elements

- It is multi-dimensional.
- *Activities covered:* US regulatory agency and court enforcement range broadly from civil litigation under the Alien Torts Act, anti-money laundering, anti-bribery, anti-tax evasion (“FATCA”), anti-terrorist financing, anti-trust, criminal prosecution (“RICO”, drug trafficking, sexual exploitation of children), data protection, derivatives swaps under Dodd-Frank Act, know your client (“KYC”), sanctions and the Volcker Rule under Dodd-Frank Act.
- *Subject Companies:* Primary impacted entities are non-US financial institutions: banks, broker/dealers, custodians, transfer agents, insurance companies, investment funds and their executives. Other targeted companies include trading companies and active non-financial foreign entities. Any quarantines company immediately loses clients, rating and market share.
- *Enforcers:* Courts no longer dominant players in terms of financial impact. Federal enforcement agencies include Commodity Futures Trading Commission, US Department of Justice, US Department of the Treasury including OFAC and FinCen, Federal Deposit Insurance Corporation and the Federal Reserve. State agencies active in extraterritorial enforcement include the New York State Department of Financial Services as the primary player and others such as the California Department of Business Oversight. Alliances (revenue sharing?) with non-US, primarily UK regulators.
- *Impact:* In May 20, 2015, six banks agreed to pay USD 5.6 billion for FX manipulation for “breathhtaking” anti-trust violations. The Economist characterized the same penalty as, “no individuals charged with any crimes and some confusion as to what exactly the banks were admitting to and [to] what effect ...” – *The dichotomy of regulatory and substantive law:* differs in quality of staff, in due process etc.
 - In May 2015, Benjamin Lawsky, NY State’s first Superintendent of Financial Services stated Barclays to pay \$2.4 billion and to fire employees for a scheme to manipulate FX markets.³
 - The fine is to be split: NYDFS \$485 million, Commodities Futures Trading Commission (CFTC) \$400 million, U.S. Department of Justice (DOJ) \$710 million, US Federal Reserve \$342 million, UK Financial Services conduct Authority (FCA) \$441 million.

³ ‘Barclays fined \$2.4bn for forex rigging’ Financial Times (20th May 2015); ‘NYDFS Announces Barclays to Pay \$2.4 Billion, Terminate Employees for Conspiring to Manipulate Spot FX Trading Market’ NYDFS, Press Release (20th May 2015).

- The link between the fine and the charge is not very clear.

Jurisdiction, Territoriality Eroded

- Becoming subject to a state's territorial jurisdiction required a voluntary act.
 - What about using emails? Court decided not. One of the arguments raised in the case was whether the internet sever located in the US is suffice to constitute jurisdiction and subsequently, redress must be sorted. Luckily, it was a criminal case, if it was an agency case, the result might not be the same.
 - We are moving from 'jurisdiction by choice' to 'jurisdiction by strict liability'. Whether providing legal services could be seen as jurisdictional? Not sure.
- How do you build a worldwide 'bitcoin system'? To build a 'worldwide' application of the US criminal law. Yet, this seems to make unrealistic because it is useless to have laws that you cannot enforce. Moreover, why would we want a legal system that benefits other countries' citizens and not targeted for the US citizens themselves. However, *regulatory laws are different*. It is a good way to make profit for the country.
- US Supreme Court, "*United States law governs domestically, but does not rule the world*". In 1985, the NY Southern District Court, "We start with the proposition that the laws of any jurisdiction apply only to activities within its borders unless there is some indication to the contrary." In 2013, Second Circuit Court, "absent specific authority from Congress, the federal government cannot prosecute foreign activity".

Enforcement Standards

- Enforcement of financial regulations falls closer to the middle of the spectrum between strict liability and full due process.
- Regulatory law and agencies differ materially from courts and substantive law.
- Destabilizing, limited due process, limited instructional value.
- No published opinion, administrative officers do not have good legal background.

Drivers of Increased Application

- Bloodlessly achieves state policy objectives.
- Popular outcomes against unpopular, defenseless targets, e.g. banks.
- Standardization of process; integration, efficiency – dictate to all banks about FATCA; *transacting in one language*. It becomes profitable, thus more regulatory laws.
- It generates billions of dollars for federal and state budgets.
- Regulators not concerned with compliance costs. Compare est. \$600-800 million estimated annual revenue for FATCA with costs of more than 10 times that amount. (Forbes)
 - More sanctions would allow government to cease bad actors without bringing dead people and emotional crowd, with monetary profits.

Expected Evolution

- Dodd-Frank Act (Whistleblowers Programs): expanded offer of rewards for whistleblowers, protection of whistleblowers. Ratio of offer to use = 1000:1. Of the 6000 offers, only 6 were used.
- Continued shift away from the courts toward agency enforcement. *Faster, more revenue, more predictable*.

- Banks don't care what the standard is – as long as it is one standardized system; but there are significant regional blocs, such as SWAP transactions, e.g. one side must report, how many sides report? US says they only want one side reporting, EU says two.
 - Chinese PRC government – how do they adopt policies?

Responses

- Public – greater regulatory cooperation through IOSCO and toher groups and at government level. Promote regulatory substitution. Recognition.
 - You can't keep hitting with 9 billion fines, need to mitigate and governments must work together. We need definitions for a standardized language.
- Academic - HKU and other compliance programs, establish centers, coordinate with other academic institutions.
- Private – lobby, influence formulation, education, implement company programs.

Conclusion

- Lex Americana from convergence to coercion.
- Surprised how easy it was. NYDFS.
- Devolution of enforcement from courts to agencies with different staff, policies, procedures and incentives.
- Substantive legal arguments, appeals to international law not effective in regulatory agency/law environment.
- Normative or cost arguments not effective against multi-billion dollar revenue streams not shared with victims.

Q&A Session

Q1. (*Question is omitted from the recording*)

PB: Russia has been telling us about the riding West ... the West has been riding for so long and yet the problem is that transacting is convergence, transaction is integration. The argument that somebody would abandon the working or cost-effective, regulatory-effective model in favor of something ideologically driven transaction is ridiculous. It is a good political argument that Indonesia, as I worked there in Jakarta that I have heard of the independence requires the rupee, is not going to happen. So waiting for the dollars at forty-eight, I don't have the time for that. I don't think it will happen in our life time.

The problem is that like, one of my favorite stories, we are dealing with 16 billion finance dollars in Russia for the American government. In a room, that was in 1994, an elderly Russian law professor who said to an elderly American law firm partner, 'I don't understand, I have written books on project finance, I have taught project finance, and I made 400 dollars a month. You made 400 dollars an hour, why?' The American partner said, 'it is like a marital relation that I do it you write me ...' The problem with transacting is that it is very hard to imagine.

Q2. (*Question is omitted from the recording*)



PB: ... Not at all ... If I was fighting for US extraterritoriality, I would fight tooth and nail for territorial laws and fight tooth and nail for the movement of having close room no record regulatory proceedings to court proceedings. I would tell Paribus, take a chance to court, not going to do much worse for billions of dollars. It may take five years in court proceedings.

According to statistics, 10% of world transaction is in RMB, out of which 0.4% processes in RMB. You could build the model, because it is not right to just have lex Americana model. But statically, if you are 0.4% of 10%, then you are going to be unlikely to be dominating. it may happen sometime in the future.

Q2. Would the US regulatory agencies breach the US Constitution relating to due process proceedings?

PB: They don't care. They are not interested. For the courts to do something, you have to have a case, I am not clear what the Constitution violation would be, but again you are talking about an administrative agency, imagine you are a Chinese administrative agency, imagine they get twice the order bills you suppose to get and you come and say the Constitution damns it. They will tell you, they have a job.

As a very young lawyer, used to work in Republican politics, we have a case in very democratic district where our personal signature were verified standing 15 feet away from the signature to verify it. I called up the clerk, and say this is not how it is supposed to be done, and I quoted, 'I ain't got time for law, I am running an election'. They don't have time for you and me. They don't have time for the constitution. They are not interested. Because there is no individual employee administering gas bills in Hong Kong to comply with the Constitution. They are not rewarded for it, they are not punished for it, and they don't care. And besides that short of a court ruling, you don't have a violation.

What do you feel it violates? ... Fair enough, what part of the US Constitution applies to a United Bank of Switzerland. They are not US nationals. They are also not people. ... The BNP Paribus is not in the US, it is not a US legal entity. ... To violate the constitution, you have to have somebody whose rights are violated as I disagree with all my heart, I think, Antonimos is a disgrace, our system should have held on other things. But as recent history proves, American can take people keep them without proceedings and no Constitution violations. As an analogy, you go to Hong Kong Utilities Board and you say to them you have violated the US Constitution.

For there to be a constitutional claim, you need a constitutional violation. There is no settled ruling that you are entitled to court due process. I very much doubt New York Department of Financial Services violated its own rigs. They apply rigs as the 'honesty belief to be applied', to somebody the honesty to belief to be 'bad actor' who agreed to be entered into some of them. They won't be trialed, I don't know how some of the banks persuaded their own employees to go plead guilty and go to jail in New York, but they did come to New York court to plead guilty. What will be your standing?