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Platform Responsibility Reforms: Lessons from International Financial Regulation

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Platform Responsibility Reforms: Lessons from International Financial Regulation

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This research paper aims to offer some insights into platform responsibility reforms by relying on forty years of experience in regulating cross-border financial institutions. Internet platforms and cross-border banks have much in common from a regulatory perspective. They both operate in an interconnected global market that lacks a supranational regulatory framework. And they also tend to generate cross-border spillovers that are difficult to control. Harmful content and systemic risks – the two key regulatory challenges for platforms and banks, respectively - can be conceptualised as negative externalities.

One of the main lessons learned in regulating cross-border banks is that, under certain conditions, international regulatory cooperation is possible. We have witnessed that in the successful design and implementation of the Basel Accord – the global banking standard that regulates banks' solvency and liquidity risks. In this paper, I will analyse the conditions under which cooperation can ensue and what the history of the Basel Accord can teach to platform responsibility reforms. In the last part, I will discuss what can be done when cooperation is more challenging.

1. The Rationale for Regulatory Action

Before we venture into the complex discussion on the international regulation of global banks and internet platforms, which will occupy a large part of this essay, we need to explain what these two regimes have in common from a regulatory perspective. In this regard, they share two critical regulatory problems. First, both banks and internet platforms exist and operate in a network. Second, they both generate harmful effects from their activities. In this section, I will explain the concept of negative externality, the core regulatory problem that platforms and banks share. In the last part of the section, I will explain how financial regulation has tackled the negative externalities of banks' activities and draw a parallel with the regulation of platforms.

i.Understanding Banking and Platform Networks

Banks and platforms operate in an ecosystem – the financial system and the internet, respectively - where they are forced to interact with third parties to provide their services. Both organisations are structurally connected to a broad network of users, suppliers, clients, and other entities without which they cannot function.

Bank balance sheets give an excellent idea of how interconnectedness operates in banking.[1] On the liability side, banks borrow in many ways from various parties. They take deposits from retail customers. They issue multiple forms of debt securities such as secured or loss-absorbing ("total loss-absorbing capacity," or TLAC) bonds from institutional and retail investors. They borrow short-term from repo lenders (a service sometimes offered by other banks) and money market funds. They assume potential derivatives liabilities with various traders. In addition, they receive financing in the form of equity from their shareholders, which take the enterprise risks of investing in the bank and the rewards if the bank makes profits. On the asset side, banks invest their money (which originates from the various sources described above) in many ways. They lend to retail and commercial customers by issuing loans and mortgages. They pledge debt securities as collateral for other operations (including short-term financing for other financial institutions). Before the 2008 crisis, banks also heavily invested in markets by purchasing various financial instruments or gold. Finally, they also hold some deposits at the central bank.

Internet platforms also operate in a network – the internet – and rely on interconnectedness, albeit very differently. Indeed, platforms rely on

[1] JOHN ARMOUR ET AL, PRINCIPLES OF FINANCIAL REGULATION 284-287 (2016)

third-party app developers or influencers to create the content that is, in turn, offered to end-users. In most cases, including Twitter, Instagram or Facebook, end users are at the same time active generators of content as well as passive consumers of content. In addition, platforms are often connected to maximise their users' network effects. For instance, Instagram feeds can be shared through WhatsApp, Twitter, Pinterest and other platforms. This particular business model is facilitated by a specific regulatory approach that favours interconnectivity and interoperability as the dominant norms.[2]

ii.Externalities

Being part of a network would not be a problem if it wasn't because both banks and platforms are structurally prone to generate harmful effects through their activities. This creates a regulatory problem as these harmful effects negatively impact the entire network where the firm operates. In other words, without regulation, the business models of banks and platforms would make them inherently unable to perform their functions in a socially efficient way. In economics, this problem is described as an externality. This concept defines the indirect costs (negative externalities) or benefits (positive externalities) that a third party receives due to another party's particular activity.[3]

When it comes to banking, the main problem has always been to tame the excessive proclivity of banks to take risks and, on a broader level, to ensure that financial losses are not transferred across the financial system.[4] Unfortunately, banks cannot avoid taking risks. Indeed, their funding and operational model is based on borrowing short-term and investing long-term. While banks try to minimise financial losses by adopting internal models which calculate their various credit, market, and operational risks,

[2] Niels ten Oever, *The Metagovernance of Internet Governance*, in POWER AND AUTHORITY IN INTERNET GOVERNANCE RETURN OF THE STATE? (Blayne Haggart, Natasha Tusikov, Jan Aart Scholte eds.)

[3] STEVEN SHAVELL, FOUNDATIONS OF ECONOMIC ANALYSIS OF LAW 77-101 (2004)

[4] ARMOUR ET AL, *supra* note 1, at 57-59

they cannot eliminate them. Risk is a necessary part of finance that banks have to live with.[5]

Crucially, despite taking risks, banks do not fully internalise the financial costs of their activities. Indeed, the accounting mechanic of bank balance sheets means that a financial loss on the asset side (the bank's investments) is inevitably met by a loss from the liabilities side. In other words, the loss would be taken by one of the bank's various creditors. When financial losses are too high, the insolvency of a bank would create a cascade of negative spillovers to all the bank's creditors and, progressively, to the entire financial system. We define this as "systemic risk".[6]

Platforms' activities can also produce externalities, both positive and negative.[7] Depending on whether they are open access or on subscription, platforms' network effects enhance the platform's value for every additional user they attract. This means that platforms are incentivised to attract users and content producers to expand their networks. Yet, the more a platform successfully expands its user ship and increases the audience, the higher the chance that harmful content will be drawn due to the platform's increased ability to disseminate content. Sometimes, the same content can become viral thanks to particular algorithms and recommendation systems. Harmful content can be considered a negative externality of platforms' activities as it negatively affects some users.

Ultimately, much like banks have an incentive to take on more significant risks to improve profitability, platforms have an incentive not to police content to protect their network. Harmful content for platforms is much like market or credit risk for banks. It is a by-product of the firm's activities and business model that cannot be easily eliminated. In the case

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[5] Id. At 289

[6] Viral V. Acharya, *A Theory of Systemic Risk and Design of Prudential Bank Regulation* 5 Journal of Financial Stability 245 (2009); Douglas W. Diamond and Philip H. Dybvig, *Bank Runs, Deposit Insurance, and Liquidity, 91 Journal of Political Economy* 401 (1983); Jean-Charles Rochet and Jean Tirole, *Interbank Lending and Systemic Risk*, 28 Journal of Money, Credit and Banking 733–4 (1996); Franklin Allen and Douglas Gale, *Financial Contagion* 1–2 (C.V. Starr Center for Applied Econ., Research Report No. 98-33, 1998).

[7] Yassine Lefouili and Leonardo Madio, *The Economics of Platform Liability*, 53 Eur. J. of Law & Econ. 319, 324 (2022), at 324

of platforms, harmful content is a structural element of the platforms' business model, which relies on network effects as its primary driver of profit. Given platforms' inherent need to attract users and producers, policing content is arguably a barrier to growth. It would limit the potential expansion of the platform to new users and producers.

iii.Regulating Externalities

Regulating externalities requires striking a trade-off between the need to guarantee the maximum profitability for the firm, on the one hand, and the protection of third parties' interests.

In banking, regulating negative externalities has been achieved through various policies. First, banks are screened before being given a licence to operate – thus, before being admitted into the financial system - and monitored by supervisory agencies through various means. Second, banks must finance their operations through loss-absorbing instruments, including capital and subordinated bonds that can be converted into equity if the bank's losses pass a certain threshold. In addition, they must keep a portion of their funds liquid to meet a sudden surge in creditors' withdrawals. Third, banks must restrict their investment choices by not concentrating on a few assets. All these tools reduce the freedom of manoeuvre of banks and, with that, their profitability to a certain extent.[8]

Regulating platforms' externalities is perhaps more challenging as the regulation of internet platforms has been historically based on two fundamental pillars: openness and freedom. Notwithstanding, if demand for a more interventionist approach arises, liability rules could be used to restrain the harmful effects of free speech. According to Lefouili and Madio, liability rules may be socially desirable when the interests of the platform to police itself and the interests of the society are not aligned.[9]

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[8] Whether capital reduces banks' profitability is an old debate in economics. For an argument in support of capital as the primary source of funding see, ANAT ADMATI AND MARTIN HELLWIG, THE BANKERS' NEW CLOTHES: WHAT'S WRONG WITH BANKING AND WHAT TO DO ABOUT IT (2013)

[9] Lefouili & Madio, *supra* note 7 at 323

This could be because of externalities and excessive market power arising from the quasi-monopolistic nature of some platforms.[10]

The decision is not straightforward, as liability rules might also reduce platforms' profitability and innovation. This largely depends on how they are designed. The rules on platform liability can be intended as a spectrum from lenient (no-liability) to strict (strict liability). Each choice will have a cost on the firm and the consumers. From a regulatory perspective, a strict liability regime might reduce the attractiveness of platforms – very much like adopting very high capital adequacy standards for banks might reduce the bank's profitability. There are different potential explanations for this. First, a strict liability regime would inevitably lead to higher litigation costs and increased fines. The threat of litigation would then translate into over-policing by platforms eager to avoid penalties and prolonged court battles. Second, the increased need for platforms to divert financial and human resources to police content would increase firms' operating costs and reduce their profitability. This will then increase the costs of using the platform for consumers.[11]

2. The Challenges of Regulating Firms in Global Markets

The regulation of externalities in banks and platforms is made astonishingly more complicated by the global nature of their networks. Regulating firms operating in a global market presents unique challenges. Regulators need to factor in two additional elements when designing rules: the presence of foreign firms and users and the challenge of foreign regulators with different regulatory objectives.

i.Global Markets in Banking and Internet Platforms

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[10] Xinyue Hua & Kathryn Spier, *Product safety, contracts, and liability*, 51 The RAND Journal of Economics)2020)

[11] Lefouili & Madio, *supra* note 7 at 324

Since the 1970s, banks and capital markets have progressively internationalised.[12] Many Western and Asian banks now operate regionally or, in some cases, globally through branches and subsidiaries. Those local entities are themselves very connected with the local market. They raise debt and, sometimes, capital locally and invest in the local economy. Capital markets also operate globally. Corporations can list in foreign stock exchanges and issue foreign-denominated debt. Investment funds and global banks also sell various instruments to clients abroad with minimal regulatory barriers.[13]

Global financial interconnectedness brings many benefits, but it also means that a problem in one part of the global financial system can quickly spill out beyond national boundaries. We define it as "global systemic risk".[14] The first manifestation of global systemic risk was during the string of banking crises in the 1980s and early 1990s. Still, it was during the 2008 global financial crisis – at the very height of financial globalisation - that we witnessed how global systemic risk truly operates. The collapse of several financial institutions in the US triggered a chain reaction that immediately impacted European banking and capital markets.[15]

The structure of the internet is somehow very similar, as it developed over the years as a fundamentally global network. Interconnectivity brings substantial benefits as it allows platforms to reach economies of scale, increase network effects, and spur innovation. Platforms or apps developed in one country can be immediately launched and made accessible to users across the globe. This is possible due to the inherently stateless nature of the internet, where the technical specifications in

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[12] EMILIOS AVGOULEAS, GOVERNANCE OF GLOBAL FINANCIAL MARKETS: THE LAW, THE ECONOMICS, THE POLITICS, 35-54(2012); RAWI ABDELAL, CAPITAL RULES: THE CONSTRUCTION OF GLOBAL FINANCE (2007).
[13] IMF, UNDERSTANDING FINANCIAL INTERCONNECTEDNESS (2011)
[14] DOUGLASS EVANOFF ET AL (EDS.) GLOBALIZATION AND SYSTEMIC RISK (2009); ROGER W. FERGUSON JR., INTERNATIONAL FINANCIAL STABILITY (2007)
[15] The collapse of Lehman Brothers in August 2008 – which was back then most international US financial institution – almost immediately sent a funding shock to all its European subsidiaries. As these were connected to the local markets, they created a contagion across the local financial system. In turn, the financial crises in various European countries created a systemic shock into the real economy, which ultimately affected the fiscal balance of a few European countries.

systems like iOS or Android are often more important than the local regulatory requirements. While firewalls and other barriers to access specific platforms exist and are often applied to censor content, these barriers are an exception to the norm. Yet, global interconnectivity dramatically increases the reach of negative externalities sometimes produced by platforms as many more users – often with different cultural and political sensitivities to content - can be impacted.

ii.Regulatory Trilemma

The next question is how to approach regulating globally active and interconnected firms. The section below discusses the main theoretical approaches in the financial regulation literature.

Much like the internet, the global financial system is built upon a dangerous asymmetry between the global scope of financial markets and the national scope of economic policies.[16] Unlike other areas of international economic policy that rely on an international organisation to set binding rules and solve interstate disputes,[17] international finance has historically operated through non-binding agreements. Without an international organisation competent to develop a common rulebook, each country is free to regulate and police firms operating in its jurisdiction. In an interconnected market, national control over financial policies creates two main challenges.

First, globally active firms can practice regulatory arbitrage and force national regulators to compete in designing rules that appeal to firms as opposed to regulations tailored to the need of the local market. If the cross-border provision of services is possible, firms would exploit regulatory loopholes and relocate to jurisdictions with minimal regulatory or business constraints. This would place regulators between a rock and a hard place, as they have to strike a delicate balance between the need to design rules that respond to local economic needs or attitudes – be these

[16] FEDERICO LUPO-PASINI, THE LOGIC OF FINANCIAL NATIONALISM (2017)
[17] The classical example is international trade, where rules are set and adjudicated at the World Trade Organization.

stringent prudential rules or very lenient free speech laws – and the need to maintain the competitiveness of national firms against foreign firms.

If regulations are too rigid, regulators risk that firms relocate to a different jurisdiction where the regulatory compliance costs are lower, thus putting the remaining firms at a competitive disadvantage. Conversely, if regulations are too lenient, regulators might not respond to the local regulatory needs. As I will explain in the next section, this was the main problem that banks faced with regard to capital adequacy regulation in the 1980s. The regulatory dichotomy between competitiveness and national interest is made more complicated by the option of a third choice: autarchy. In other words, if regulators are unwilling to tailor their rules to the demand of the global market, they adopt a protectionist stance and close their market to foreign-based firms.

Second, when foreign firms conduct business on a cross-border basis while regulated by their home rules,[18] host regulators cannot address the negative externalities those firms produce in the host regulator's market.[19] For example, imagine a bank headquartered in Country A (subject to Country A's rulebook) with substantial operations in Country B through a network of branches. Country B's supervisor (the host) will not be able to control the bank's solvency and risk position, which might create risks for local creditors. The same example could be easily used for an internet platform subject to its home country's rule. If the home rules allow for harmful speech that has a detrimental impact on host users, there is little the host regulator can do other than adopt a protectionist stance that blocks the platform. In both cases, the only option for the host regulator is to prevent the foreign firm from operating in the host territory.

Several political science, economics, and legal scholars have successfully analysed the challenges of global regulation. The most important contributions are regulatory race theories, transnational

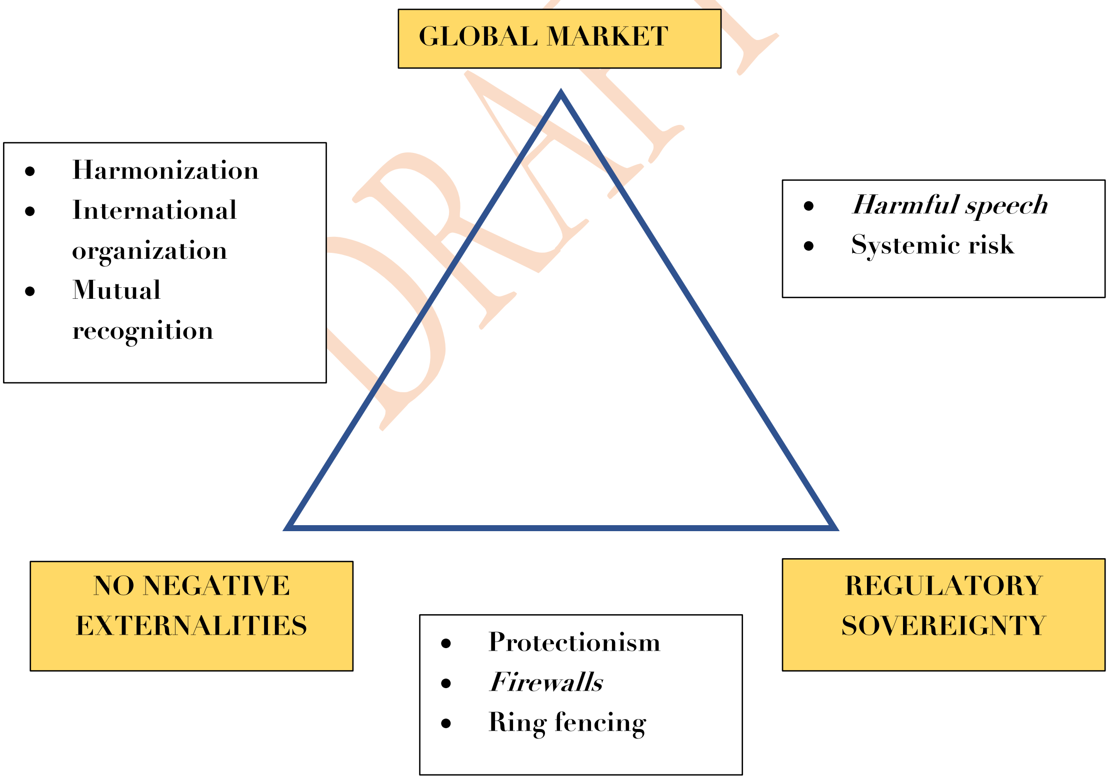
[18] In banking, this would occur when the bank operates abroad through branches or subsidiaries. Internet platforms operate cross-border by simply offering their services and products to customers located in foreign jurisdictions.

[19] In international banking, the "home supervisor" is the supervisor/regulator where the bank is headquartered. In contrast, the "host supervisor" is the supervisor/regulator in the foreign jurisdiction where the bank operates through branches or subsidiaries.

regulatory network theories, and dominance theories.[20] In finance, the complexity of international regulatory design was very well illustrated by Schoenmaker's *Financial Trilemma*.[21] He argued that an interconnected financial system can't achieve at the same time: (1) national sovereignty over financial policies, (2) an optimum level of global financial stability (essentially, the absence of cross-border externalities), and (3) meaningful financial integration. States have to give up one of them.

DIRK SCHOENMAKER'S *FINANCIAL TRILEMMA*

(Adapted for internet platforms)



[20] I will discuss some of those theories in the next section.
[21] DIRK SCHOENMAKER, GOVERNANCE OF INTERNATIONAL BANKING: THE FINANCIAL TRILEMMA (2013)

According to Schoenmaker's theory, if countries maintain financial integration and national control over financial policies, they will inevitably suffer instability as foreign regulators refuse to cooperate. Alternatively, if they want to achieve a globally stable financial system, they have two options. One option is to relinquish the power to set financial policies. This can be done in many ways, from regulatory harmonisation to mutual recognition or even creating a global institution tasked with setting international rules. The opposite option is the reduction of financial integration. This alternative can also take many shapes and forms. The easiest option is to ask foreign banks to incorporate locally through subsidiaries, thus giving up their freedom to move assets across the consolidated global banking group. The most drastic option is a return to Bretton Woods-like financial system in which there is no capital mobility, and financial systems operate only within national lines.

The problem of cross-border negative externalities plays out slightly differently with internet platforms. The policing of platforms allows for a higher margin of control and flexibility by national regulators compared to what we see with banking. For instance, a national regulator might opt to restrict speech that is destabilising internally but to allow speech that is destabilising externally. Notwithstanding, it is useful to use the trilemma analogy as it give a sense of the broader cooperation trafeoffs internet regulators have to grapple with.

Regulators unwilling to sacrifice their regulatory freedom and eager to protect local users against harmful speech originated by foreign-based internet platforms will have no option but to react. They can do so in many ways. One drastic option would be to erect firewalls or other protectionist measures that reduce local access to foreign platforms. This, however, would hurt consumers not affected by harmful content. A milder option would entail the regulation of foreign platforms according to the local liability regime. Thus, foreign platforms would be required to comply with local platform content rules requiring the takedown of harmful content or the imposition of penalties for breaches of content policy. Foreign platforms would face the choice of either adapting to the host country's regulatory and legal requirements or else renouncing to entering the host country's market if the cost of compliance is deemed too high. At the same time, regulators must assess the risks of harmful speech from foreign platforms if they want to maintain an open internet and regulatory sovereignty. The best solution is to agree on a common global framework, which reduces regulatory competition and, at the same time, maintains the benefits of interconnectivity and openness.

After illustrating the choice regulators need to confront, the next step is to assess how cooperation can be achieved. International cooperation in financial regulation has been through various ups and downs in the last four decades. While cooperation in certain areas of financial regulation was successful, for instance, in the prudential regulation of banks, in others, it failed dramatically. In the next section, I will look at the most successful experience in regulatory cooperation in finance: the harmonisation of bank prudential rules in the Basel Accord.

3. Regulatory Harmonization

When banking integration took off in the 1980s, regulators in the UK and the US were confronted with the problem of how to maintain the competitiveness of their local banks against Japanese banks, which were subject to more lenient prudential rules. The critical issue was the application of capital adequacy requirements.

i. The Basel Accord

Bank regulators in the United Kingdom and the United States, the two most globally active banking systems in the 1980s, adopted capital adequacy rules as part of their prudential rulebook.[22] They required locally supervised banks to fund their assets with a minimum amount of 3% to 5% of capital.[23] The rules were eventually harmonised between the two jurisdictions through a bilateral supervisory agreement. When global bank

22 The banking sector highly contested capital adequacy rules as they allegedly increased banks' funding costs and reduced profitability. See ADMATI & HELLWIG, *supra* note 8

23 Rules varied according to jurisdiction, type of bank, and calculation methods. For the US, see Joseph Haubrich, *A Brief History of Bank Capital Requirements in the United States*, Economic Commentary 2020-05 - Federal Reserve Bank of Cleveland (2020)

activity took off in the 1980s, US and UK banks found themselves at a disadvantage against foreign competitors – especially Japanese banks – which did not apply the same prudential standard. In a few years, cheaper funding costs allowed Japanese banks to acquire a substantial market share in the US.

The issue for Western regulators was how to strike a balance between the need to protect the stability of their financial systems while at the same time maintaining the competitiveness of local firms. Regulators were caught between a rock and a hard place as they were confronted with a choice between the risks and the benefits of financial globalisation. The option of withdrawing licences to foreign banks was not feasible, as the economy was booming, and local industries needed fresh cash from foreign banks. US and UK regulators had a binary option: either to lower their capital requirements to align them with Japanese banks' or convince the Japanese regulator to accept a common regulatory standard. Negotiations took place within the Basel Committee on Banking Supervision (BCBS), a regulatory network for bank regulators from G10 countries.[24] Ultimately, under the peer pressure from BCBS members and the open threats by the US to withdraw the licence to Japanese banks, Japanese regulators caved in.

The agreement to implement a common capital adequacy standard for banks was finalised in 1988 and adopted no long after that. It was enshrined in a supervisory agreement, the Basel Accord – also known as Basel I. The Basel Accord went through substantial iterations, especially after the 2008 global financial crisis, and it is now in its third version.[25] Unlike international treaties, the Basel Accord is a soft agreement. Thus, the agreement is voluntary, and it only offers a template, albeit a very detailed one, that national regulators are free to adapt and tweak to the specificities of their financial system. The agreement sets a minimum standard that national regulators can improve, as some did.[26] While there

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24 CHARLES GOODHART, THE BASEL COMMITTEE ON BANKING SUPERVISION: A HISTORY OF THE EARLY YEARS 1974-1997

25 DANIEL K. TARULLO, BANKING ON BASEL: THE FUTURE OF INTERNATIONAL FINANCIAL REGULATION (2008);

26 For instance, Switzerland has historically adopted a regulatory capital ratio that is higher than that required by the Basel Accord.

were problems in implementing Basel I and II, the latest version has been widely adopted by BCBS members with a reasonable degree of uniformity. At present, Basel III is the industry standard for bank prudential regulation.[27]

ii. Explaining Cooperation

The Basel Accord has been widely studied in the legal, political science, and economics literature.[28] Two questions, in particular, are essential for the comparative analysis of the international regulation of platform responsibility: why was harmonisation obtained? And how was compliance with the agreement achieved?

The binary option between harmonisation and regulatory competition has been subject to extensive scholarly analysis.[29] In the earlier literature on international finance, a debate ensued about whether regulatory differences would lead to a race to the bottom or the top in financial regulation. Political scientists such as Cerny argued that the push from the financial sector to maintain competitiveness would lead to a dangerous de-regulatory drive.[30] Conversely, Romano argues that regulatory harmonisation forces firms to adopt similar strategies, which might increase systemic risk if they do not work.[31] Regulatory diversity would boost innovation and force regulators to compete for the best regulatory

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27 SIMON GLEESON, THE INTERNATIONAL REGULATION OF BANKING (2013)

28 DAVID ANDREW SINGER, REGULATING CAPITAL: SETTING STANDARDS FOR THE INTERNATIONAL FINANCIAL SYSTEM (2007); BRYCE QULLIN, INTERNATIONAL FINANCIAL COOPERATION: POLITICAL ECONOMY OF COMPLIANCE WITH THE 1988 BASEL ACCORD (2008); DANIEL TARULLO, BANKING ON BASEL (2008)

29 Daniel W. Drezner, *Globalization, Harmonization, and Competition: The Different Pathways to Policy Convergence*, Journal of European Public Policy 841 (2005); JUNJI NAKAGAWA, INTERNATIONAL HARMONIZATION OF ECONOMIC REGULATION (2012); Andrew T. Guzman, *International Regulatory Harmonization*, 3 Chicago J. of Int.l Law 271, 278 (2003)

30 Philip Cerny, *Globalization and the Changing Logic of Collective Action*, 49 Int. Org (595) (1995)

31 Roberta Romano, *Empowering Investors: A Market Approach to Securities Regulation,* 107 Yale L. J. 2359 (1998); Roberta Romano, *For Diversity in the International Regulation of Financial Institutions: Critiquing and Recalibrating the Basel Architecture*, 31 Yale J. of Reg. 1 (2014); Roberta Romano, Against Financial Regulation Harmonization: A Comment (November 20, 2010). Yale Law & Economics Research Paper No. 414, Available at SSRN: https://ssrn.com/abstract=1697348

framework. Ultimately, the Basel Accord showed that harmonisation could be achieved, although only in Basel III the regulatory playing field was levelled up to a stringent standard.

As a subordinate question, it is interesting to see why an agreement was reached on the prudential standards adopted by Western regulators and not on the Japanese prudential rules. Political economy scholars such as Keohane and Kapstein argued that cooperation could be achieved because all national regulators agreed that low capital requirements would put their financial systems at risk of instability.[32] In his analysis of the Basel Accord, Singer similarly argues that national regulators had little choice but to strike an international deal due to the severe risks of financial instability that lax capital requirements would bring.[33]

Hence, cooperation was the easiest choice. Other scholars, including Simmons and Drezner, have tried to explain this outcome as a result of market dominance by the United States and the United Kingdom.[34] According to their theories, the dominance of big financial centres would act as a magnet for smaller centres, which are compelled to align their rules if they want to access foreign markets. While dominance theories cannot be extended to the entire set of financial regulations, they help explain the Basel Accord.[35] Indeed, Japan was practically coerced into agreeing to the standard under the threat of its banks being denied market access in the US- back then, the most lucrative market for international banks.

A more recent stream of scholarship looks at why cooperation is maintained given the non-binding nature of the Basel Accord.

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32 ETHAN B. KAPSTEIN, GOVERNING THE GLOBAL ECONOMY: INTERNATIONAL FINANCE AND THE STATE (1994); Ethan B. Kapstein, *Resolving the Regulator's Dilemma: International Coordination of Banking Regulation*, 55 INT'L ORG. 323 (1989)

33 Singer looks at the incentives of regulators to level up the standards and proposes a model based on the domestic pressure faced by regulators in light of exogenous shocks to financial stability or international competitiveness. See, DAVID ANDREW SINGER, REGULATING CAPITAL: SETTING STANDARDS FOR THE INTERNATIONAL FINANCIAL SYSTEM (2007)

34 DANIEL W. DREZNER, ALL POLITICS IS GLOBAL: EXPLAINING INTERNATIONAL REGULATORY REGIMES 135–37 (2008); Beth A. Simmons, *The International Politics of Harmonization: The Case of Capital Market Regulation*, 55 INT'L ORG. 589, 601–05 (2001)

35 Stavros Gadinis, *The Politics of Competition in Financial Regulation*, 49 Harvard Int.l L. J. (2008)

Transnational Regulatory Network (TRN) theories explain cooperation by examining the institutional structures underpinning the design and implementation of financial standards.[36] According to these theories, regulators participating in the network are compelled to comply with the standards due to pressure from different sources, including fellow regulators, the industry, and international organisations. In this regard, it is interesting to see how the IMF and the World Bank have consistently monitored compliance with the Basel Accord in their periodical financial sector assessment reports.

4. Lessons for Platform Responsibility from the Basel Accord

The experience with negotiating the Basel Accord and its subsequent implementation can offer some insights into what is needed to achieve an international agreement that is sustainable in the long term.

i. The Importance of Regulatory Networks

Firstly, the Basel Accord benefited from an already existing and well-functioning Transnational Regulatory Network, the BCBS, which was set up precisely to discuss and address common regulatory issues. Banking regulators from G10 countries had already cooperated successfully within that network to address the supervision of cross-border banks, an issue that caused various banking crises in the 1970s and early 1980s.[37] It is without a doubt that the positive experience in successful cooperation with the Basel Concordat and the familiarity between national regulators helped to get another agreement on the ground.

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[36] Andrew Moravcsik, *A New Statecraft? Supranational Entrepreneurs and International Cooperation*, 53 INT'L ORG. 267, 269–70 (1999); Kal Raustiala, *The Architecture of International Cooperation: Transgovernmental Networks and the Future of International Law*, 43 VA. J. INT'L L. 1, 5 (2002); Pierre-Hugues Verdier, *Transnational Regulatory Networks and Their Limits*, 34 Yale J. Int'l L. 113 (2009); CHRIS BRUMMER, SOFT LAW AND THE GLOBAL FINANCIAL SYSTEM: RULEMAKING IN THE 21ST CENTURY 63–67 (2012); ANNE-MARIE SLAUGHTER, A NEW WORLD ORDER 36–61 (2004);

[37] The Basel Committee on Banking Supervision was created in 1974 to address the allocation of supervisory powers of cross-border banks between home and host supervisors. The first supervisory standard issued by the BCBS was the Basel Concordat.

Moreover, as correctly argued by network and institutional theories, national regulators faced heavy peer pressure to find a common standard that would work for the global banking industry. Putting up a fight to resist an agreement that most members saw as a positive advancement to safeguard financial stability would have put Japanese regulators in a very awkward position within the BCBS. Given the widespread consensus among regulators that capital adequacy rules were fundamental for guaranteeing financial stability, national regulators were under heavy pressure to adopt the standard as they did not want their banking system to be perceived as risky and unstable.[38]

Internet platforms, unfortunately, do not benefit from the presence of an established regulatory network like the BCBS. Internet governance is split across a few different organisations, such as the Internet Governance Forum or the Internet & Jurisdiction Policy Network, and a few other private sector organisations, such as the Internet Corporation for Assigned Names and Numbers (ICANN) or the Internet Society. The absence of a single catalyst of regulatory debate could make cooperation more difficult, as regulators might not feel the institutional and peer pressure they would otherwise experience if all regulatory actions on internet governance converged into one single regulatory network.

ii. Dominant Markets

Secondly, there was an apparent power asymmetry between those financial regulators that wanted an agreement, the US and the UK (eventually followed by European G10 regulators), and those who resisted it, Japan.[39] In the 1980s, the US was the most significant banking market in size and business opportunities. The UK was not as big, but its capital market was well developed, and its banks were active globally. On the other hand, the

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[38] Beth A. Simmons, The International Politics of Harmonization: The Case of Capital Market Regulation, 55 INT'L ORG. 589, 602 (2001)

[39] Also, some European G10 countries (Germany and France) initially opposed the agreement. Still, they immediately agreed once they feared that they would be perceived as somehow inferior by the broader banking industry. See, Ethan Kapstein, "Resolving the Regulators' Dilemma: International Coordination of Banking Regulations", International Organization 323 (1989), 340-341

Japanese market was very attractive but difficult to penetrate for foreign banks. Japanese banks needed market access to Europe and the US more than European and US banks needed access to the Japanese market. Thus, the threat by the United States to suspend the licence of Japanese banks that were not subjected to adequate prudential standards was seen as a clear danger by the burgeoning Japanese banking industry.

In this light, a global deal on the regulation of harmful speech could probably be pushed if enough pressure was coming from US regulators and the European Commission, as they oversee the two biggest markets for platforms. Both jurisdictions, in different ways, play a prominent role in regulating the digital economy. The United States, as a host of the biggest internet companies in the world and a massive market in itself, is centrally placed to regulate digital platforms. The European Union, while less central in developing successful startups, has nonetheless acquired a major role as a global regulator due to its uncompromising stance in levelling up the regulatory playing field in data privacy and hate speech.[40] Following Simmons and Drezner's theories of regulatory dominance, once the two regulatory powers agree to a common standard, it would be difficult for smaller markets not to adjust to it.[41]

On the contrary, a division between US and EU regulators would probably make harmonisation impossible. Unfortunately, this outcome might be inconceivable given the different interests at stake. One player, the US, has a clear incentive to promote innovation and guaranteeing a fertile ground for the development of new startups. This might lead to a softer stance on platform responsibility. On the other hand, the EU is historically more sensitive to the protection of consumers, which might push it towards a stricter approach to harmful content. Predicting whether such divisions can be healed as they were in banking regulation is challenging. Much depends on the economic development of the two markets over time and the degree of global integration achieved by platforms. Yet, as I show in the next section, adopting a more flexible

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40 See, ANU BRADFORD, THE BRUSSELS EFFECT (2012)
41 Simmons, *supra* note 35; DREZNER, *supra* note 35

approach in the initial regulatory standard might help to get the two regulators progressively closer.

iii. The Flexibility of Soft Law

Thirdly, the history of the Basel Accord clearly shows that regulatory standards have become increasingly stringent and more detailed. Basel I was only 30 pages long and was very basic in its approach. If we compare it with the latest version, Basel III, which extends to hundreds of pages if we also include the annexes, we can see an apparent trajectory towards increased precision and detail. The initial vagueness and flexibility of the standard allowed national regulators to accommodate the agreement to the specificities of their banking system. It also helped regulators sell the deal to local politicians and the local banking industry.

Notwithstanding, it is essential to remember that Basel I, and especially Basel II, were considered one of the reasons for the regulatory failures that led to the global financial crisis in 2008. The excessive flexibility in calculating banks' risk-weighted assets allowed banks to bypass the capital ratio set as the agreement's primary objective, enabling them to increase their leverage. This element is widely recognised as the key reason for banks' excessive risk appetite and fragility during the 2008 financial crisis.

In this light, it would be recommendable to work on a platform responsibility framework that is flexible enough to entice reluctant regulators to join in while progressively working to strengthen it once regulators and the industry have become used to it. For instance, the EU, US and other national regulators could agree to work on an outcome-based framework that simply sets the basic principles and the final regulatory targets while maintaining flexibility in achieving them. This would allow national regulators to tweak the standards to the local needs and legal framework. It would arguably make the negotiation easier and faster. Over time, the framework could be improved and more detailed in its prescriptions.

iv. Compliance

From a cooperation perspective, complying with international regulatory standards is much easier than in other areas of regulation, like cross-border banking resolution, where the incentives to defect are very high. Thus, the main hurdle is to reach a common position. Regulatory convergence confronts regulators with a very challenging initial task of accommodating different regulatory preferences and goals. Sometimes states want to achieve regulatory coordination with other states because they know this will bring more significant individual benefits than unilateralism. Still, they might fight over which alternative is best. Yet, states have few incentives to change once a common position is reached.[42] This explains why there has been no public attempt by national regulatory authorities to exit the Basel Accord. Two reasons explain why compliance with the Basel Accord worked.

First, the Basel Accord was immediately perceived as a fundamental regulatory tool by international financial organisations and the broader regulatory community. Backed by a widespread consensus among economists, no regulator raised doubt as to the effectiveness of capital adequacy measures in preventing financial instability. The IMF, the World Bank, and the OECD list the Basel Accord as one of the essential elements in the prudential regulatory framework and look for its adoption as part of their engagement with their members. The institutional pressure coming from international organisations helped to extend its adoption beyond G10 countries.

Secondly, it is essential to highlight that once the agreement was reached, there was pressure from the broader financial industry to implement the standards. Hedge funds, banks, investment funds, rating agencies, and other market players shared the common belief that capital adequacy rules were necessary to guarantee financial stability. Therefore,

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[42] See Pierre-Hugues Verdier, "Transnational Regulatory Networks and Their Limits" (2009) 34 Yale Journal of International Law 113; Chris Brummer, *How International Financial Law Works (and How It Doesn't)*, 99 Georgetown L J. 257 (2011); Chris Brummer, *Why Soft Law Dominates International Finance and Not Trade,* 13 J. of Int.l Econ. L. 623. (2010)

regulators faced much market pressure to adopt the standards as part of their prudential toolbox if they wanted to attract foreign capital.

5. When Cooperation is More Difficult

The experience with the Basel Accord is somehow an unmatched success in international financial cooperation. As I explained earlier, various factors conspired to make cooperation easier. However, many other critical regulatory problems in international finance did not lead to optimal cooperation solutions, despite causing substantial negative externalities. Historically, cooperation has been challenging in many areas, including money laundering, securities regulation, over-the-counter (OTC) derivatives, central counterparties, and resolution and insolvency of cross-border financial institutions. More recently, national regulators are struggling to cooperate on cryptocurrencies and sustainable finance, the two key regulatory areas of contemporary finance.

Despite its allure and simplicity, harmonisation is perhaps the most challenging cooperation solution. However, there are other regulatory options besides harmonisation. In the section below, I will briefly discuss two of them, extraterritoriality and mutual recognition. I will do so by looking at the regulation and clearing of OTC derivatives.

i. OTC Derivatives

Markets, like banks, are also very susceptible to creating negative externalities. One problem, for instance, is the use of non-centrally cleared OTC derivatives. Without proper regulation, OTC derivatives can expose traders to substantial losses.[43] Without central clearing, traders cannot gauge the actual trading position of their counterparty, thus taking excessive risks. In a global market where derivatives trading often has a cross-border dimension, achieving a regulatory playing field is fundamental. Managing derivatives risks would prevent globally active foreign firms from creating global systemic spillovers. Not surprisingly,

[43] See, Dan Awrey, *Split Derivatives: Inside the World's Most Misunderstood Contract*, 2 Yale J. on Reg. 495 (2019)

given OTC derivatives' havoc created during the 2008 global financial crisis, the 2009 Pittsburgh G20 put their regulation at the forefront of the regulatory agenda.[44]

The regulation of OTC derivatives is quite complex. Derivatives markets involve multiple actors other than the trading parties involved in the bilateral deal, including trade repositories, clearing agencies, and trading platforms. It also requires a vast array of regulatory interventions, from margin requirements to trade reporting requirements or the supervision of central counterparties, just to mention a few. Despite the push from national regulators, the Financial Stability Board ("FSB"), the International Organization of Securities Commissions ("IOSCO"), and other organisations, regulatory coordination has not been achieved on many critical regulatory issues. This does not mean that cooperation did not work at all. In many areas, there have been substantial improvements compared to 2008. Yet, we are far from seeing the same regulatory playing field we achieved with capital adequacy regulation, where rules were substantially harmonised.[45] Instead, regulatory cooperation takes place through bilateral agreement on mutual recognition and the extraterritorial application of local laws.

ii. Mutual Recognition

Mutual recognition is a possible solution to coordination problems that cannot be solved through harmonisation. In a Mutual Recognition Agreement ("MRA"), two national regulators agree to determine each other's regulatory frameworks as substantially similar. Through the MRA, each national authority permits the partner's firms to access the domestic market without complying with local regulatory requirements. Firms must

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[44] At the 2009 Pittsburgh summit, G20 leaders agreed to tackle the question of OTC derivatives and proposed that "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". G20 Leaders' Statement: The Pittsburgh Summit (Pittsburgh: 24–25 September 2009).

[45] IOSCO, MARKET FRAGMENTATION & CROSS-BORDER REGULATION (2019); John Kiff et al., "Applying the Central Clearing Mandate: Different Options for Different Markets", IMF Working Paper 22/14 (2022)

only comply with their home regulatory framework and can operate in a foreign market subject to home rules. In securities regulation, a mutual recognition agreement allows firms authorised and supervised in a foreign country to operate or transact in the host-country jurisdiction without the host country's approval, provided that the home country does the same with the host country's firms.[46] Some regulatory challenges with OTC derivatives were solved through MRAs, including the regulatory spat between the US Commodity Futures Trading Commission ("CFTC") and the European Securities and Markets Authority ("ESMA") over the recognition of foreign derivatives clearing regimes.[47]

Mutual Recognition was one of the driving forces behind the creation of the European Single Financial Market in the 1980s/1990s through its ability to promote financial integration without intruding on states' regulatory sovereignty.[48] This quality explains why recognition is considered an excellent approach to solving regulatory cooperation problems. In a world where policy coordination can only be achieved through lengthy multilateral negotiations, assigning the burden of regulating a financial institution or individual transaction to a single authority is the easiest way to promote efficient financial integration. The simple fact that countries do not need to engage in lengthy negotiations to agree on an identical regulatory regime, as is the case with harmonisation, speeds up negotiations and arguably favours the signing of new agreements.

In this light, mutual recognition could be a useful tool for international cooperation on platform regulation if the main regulatory objective is to integrate the market. First, mutual recognition agreements can be structured as bilateral deals but later expanded to plurilateral agreements. This would allow two regulators with similar, but not identical, approaches to free speech or data sharing to mutually allow the partner's platforms to

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[46] Pierre-Hugues Verdier, *Mutual Recognition in International Finance*, 52 Harvard Int.l L. J. 55 (2008)
[47] European Commission Press Release, "European Commission and the United States Commodity Futures Commission: Common approach for transatlantic CCPs" (Brussels, 10 February 2016).
[48] Matteo Ortino, *The Role and Functioning of Mutual Recognition in the European Market of Financial Services*, 56 The Int.l and Comp. L. Quarterly 309 (2007)

access their market without changing domestic law. Platforms would also be incentivised to expand across borders as they would not be subject to two regulatory compliance requirements.

Yet, if not properly arranged, mutual recognition might entail substantial risks if the home regime is not up to the host country's standards, does not share the same regulatory goals, or has an incentive to externalise risks to the host country. This is why TRNs such as the FSB or the BCBS exert a vital role in setting minimum regulatory standards. In securities regulation, regulators are often more wary of the risks of giving access to firms authorised under a weak regulatory regime. In a mutual recognition agreement, regulators provide recognition to a foreign regime only after having conducted a compatibility test that ensures the similarity of regulations. Thus, in cross-border securities regulation, recognition usually levels up the regulatory playing field and operates only between partners with similar regimes. This ensures that no "firm can escape regulation" and no "dangerous" transactions can occur in a shared market.

The main risk associated with a mutual recognition solution in platform regulation is lowering consumer protection standards. If the host country's laws on free speech and harmful content were more rigid than the home's, the host country's users would be less protected against harmful content originating from the foreign platform as rules on content would follow the platform's home country's standards. Given that the regulation of harmful content is much closer to consumer protection than listing rules, it is more difficult to imagine that mutual recognition could be a solution for the regulation of harmful content. Very rarely do countries regulate consumer protection standards through mutual recognition. In conflict of laws, the law applicable to consumer protection issues is typically the laws of the consumer's jurisdiction, not the company's. This is because, in many jurisdictions, the European Union, above all, consumer protection is given primacy over other objectives.

iii. Extraterritorial Regulation

The last possible option, albeit the most disruptive, is to extend the reach of local laws to conducts taking place in another jurisdiction. This protects the jurisdiction that adopts this approach against the negative externalities from foreign firms. Extraterritoriality is a well-known regulatory instrument in finance, which has been used by US, UK, and EU regulators to address the risks in capital markets.[49] It is also used extensively by many jurisdictions for financial crime -such as corruption and money laundering - as it tackles actions that are often committed abroad but impact the local market.

Extraterritoriality is not a single clear-cut approach as it can be tailored according to the specific conditions of the market. The most common use of extraterritorial jurisdiction in finance is by linking the application of domestic law to local contact points. These contact points could be local firms or individuals affected by the foreign action or firms and national citizens operating abroad. The US Dodd-Frank Act, for instance, puts under the reach of US law any financial entity that (1) has transacted with a US counterparty, or (2) enjoyed a financial guarantee provided by a US entity, or (3) has entered into a derivatives transaction with a counterparty that was guaranteed by a US entity. In the European Union, the European Market Infrastructure Regulation (EMIR) requires that clearinghouses authorised in a third country "comply with legally binding requirements which are equivalent to the requirements set out in EU law to be used by European firms.[50] Sometimes, the jurisdiction of securities regulators is extended to all activities that "have a direct and significant connection with activities in, or effect on, commerce in the United States", as in the Dodd-Frank Act.[51]

If protecting content users is the main regulatory objective, extraterritoriality is, undoubtedly, the best option. The extraterritorial reach of local content rules would protect local users against harmful content disseminated by a foreign platform. This would be the case if

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[49] When capital markets integration took off in the 1980s, regulators in key financial centres – especially the US – had to grapple with the issue of how to treat a foreign company seeking access to the local markets. The SEC answered by requiring foreign firms listing in the US to comply with local rules, subject to a few exemptions. Howell E. Jackson, *Substituted Compliance: The Emergence, Challenge, and Evolution of a New Regulatory Paradigm*, 1 J. Fin Reg. 169 (2015), at 172

[50] EMIR, Article 25(6).

[51] Dodd-Frank Wall Street Reform and Consumer Protection Act §722(d)

'users' were the contact point for applying local laws. Thus, in this case, it would be sufficient that specific content reached users for the foreign platform to be subject to the final users' laws. This approach would be much closer to current regulatory practice when the main objective is to protect consumers.

Yet, the regulatory tradeoffs associated with extraterritoriality are opposite to those related to mutual recognition. While extraterritoriality is better for protecting local consumers, it is much worse for market integration. Indeed, platforms located in countries with more liberal harmful content rules might be deterred from entering a market whose content rules would subject the platform to substantial litigation costs. Ultimately, firms are the primary victims of this situation as extraterritoriality increases market fragmentation. Indeed, firms must comply with multiple regulatory requirements for every jurisdiction they are linked to. We saw this with the regulation of OTC derivatives which is still subject to numerous national regulatory requirements.[52] Moreover, extraterritoriality is perceived as an undiplomatic way to regulate commercial affairs. While it protects the jurisdiction that adopts it, it also reduces the regulatory sovereignty in the jurisdiction whose firms are targeted.

[52] IOSCO, MARKET FRAGMENTATION & CROSS-BORDER REGULATION (2019)