How International Financial Law Works (and How It Doesn’t)

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The “Great Recession” has given way to a dizzying array of international agreements aimed at strengthening the prudential oversight and supervision of market participants. How these international financial rules operate is, however, deeply misunderstood. Theorists of international law view international financial rules as merely coordinating mechanisms in light of their informal “soft law” quality. Yet these scholars ignore the often steep distributional implications of financial rules and thus fail to explain why soft law would ever be employed where parties can defect from costly commitments. Meanwhile, political scientists, though aware of the distributional dynamics of financial rule-making, rarely examine international law as a category distinct from international politics. Law is instead cast as an inert, dependent variable of power, as opposed to an independent factor that can inform the behavior of regulators and market participants.

This Article presents an alternative theory for understanding the purpose, operation, and limitations of international financial law. It posits that international financial regulation, though formally “soft,” is a unique species of cross-border cooperation bolstered by reputational, market, and institutional mechanisms that have been largely overlooked by theorists. As a result, it is more coercive than classical theories of international law predict. The Article notes, however, that these disciplinary mechanisms are hampered by a range of structural flaws that erode the “compliance pull” of global financial standards. In response to these shortcomings, the Article proposes a modest blueprint for regulatory reform that eschews more drastic (and impractical) calls for a global financial regulator and instead aims to leverage transparency in ways that more effectively force national authorities to internalize the costs of their regulatory decision making.

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INTRODUCTION

Few developments in the wake of the financial crisis have been more stunning—or significant—than the coming of age of the international financial system. In the wake of failures by national and international regulatory regimes to prevent the global financial crisis, the governance of the world economy is being transformed from the top down. Not only have once obscure international organizations like the G-20 and the Financial Stability Board come to bear new responsibilities for economic cooperation, but regulators, too, are entering into a dizzying array of international agreements aimed at introducing standards for supervisory and macro-prudential oversight. To revive credibility in securities
markets, international standard setters are in the process of proposing new standards for executive compensation and the regulation and oversight of credit rating agencies. Meanwhile, banking authorities are evaluating new international capital adequacy standards for national and multinational financial institutions in the hope that these standards will bolster institutions’ ability to weather future financial crises. Indeed, even insurance authorities are currently working to craft new standards for “solvency and investment, risk management, corporate governance and compensation.” Together, these activities have elevated the “private” law governing international finance to rival public international law — those global rules governing the behavior of countries and governments — as the most high-profile and visible instrument of transnational coordination.

Nevertheless, this complex set of regulatory rules, standards, and best practices — which I will collectively refer to as “international financial law” — remains unchartered territory in international law literature. To the extent that some of the most notable legal academics have taken note of cross-border financial regulation, many have incorrectly assumed that international financial standards are born almost entirely out of shared interest and sense of purpose among regulators. Although this assumption is understandable as scholars confront the global nature and repercussions of “systemic” financial risk, it overlooks the deep distributional implications of rule making in a world of competitive and globally integrated financial markets. As a result, the


dominant legal literature lacks a comprehensive account of the coordination challenges underlying cross-border regulation and the function and role of international financial law in the global financial system.

Instead, it has been international relations scholars who have consistently proffered the most compelling and high-profile theories of global financial rule making. More sensitive to the competitive pressures unleashed by global financial markets, scholars in the field have with growing intensity emphasized the distributional consequences inherent in international financial rule making, and in the process identified various means by which states pursue their own national interests and governance standards. These academics have, as a result, found considerable success in underscoring the coordination challenges cross-border regulation presents, as well as some of the tactics employed to secure cooperation.

Yet as Jack Goldsmith and Eric Posner point out, even international relations theorists rarely, if ever, examine international law as a category distinct from international politics. Political scientists do not, in short, generally talk about the prospect of international financial regulation as law. Instead, law is viewed as the product of power relations between countries. It is, as a consequence, almost always cast as a dependent variable or signpost of power positions, as opposed to an independent variable informing the behavior of a host of regulatory and financial actors.

In many ways, this stance is not surprising, especially in light of the “soft law” character of international financial regulation. In contrast to areas like international trade, financial agreements do not take the form of legally binding treaties. Instead, international financial rules are promulgated mainly through nonbinding agreements. This informal quality helps spur agreement between countries by limiting the risks of often uncertain costs and benefits accompanying the adoption of any regulatory standard. Nevertheless, the absence of any formal obligation enables cheap exit from commitments and potentially opportunism by countries, as defection carries no reputational consequences. Consequently, many theorists do not accept soft law—including international financial law—as “law” at all. In the absence of a forceful legal regime, it is economic and military power, not law, which promotes the promulgation of soft interna-


6. Jack L. Goldsmith & Eric A. Posner, The Limits of International Law 16–17 (2005) (noting that theorists have only recently considered international law to be “distinct from institutions embodied by international law”).
This realist posture of international relations scholarship is useful in helping to highlight the advantages of international financial regulation as a tool for coordination, though it is still far from a robust explanatory theory. Above all, it fails to explain why soft law should exist at all where deep distributional conflicts are at stake, as is often the case with cross-border financial regulations. Assuming that countries ultimately follow their own national interests, soft financial law should provide little if any credibility insofar as international legal theory predicts that parties to soft legal agreements will defect from their commitments where they begin to resemble zero-sum games, and not win-win collaborations. Existing accounts of international financial regulation are, as a result, ill-equipped to explain why soft law would ever be relied on to communicate commitments with regard to financial regulation, even in light of their front-end coordinating benefits.

The literature’s dismissal of international financial rules on the basis of their legal informality also overlooks the context in which the rules operate. Specifically, existing theories of international financial regulation are often blind to the role of market participants and international organizations in promulgating global standards. Markets and firms are, for their part, frequently framed by theorists as the means by which state policy is exerted and are rarely, if ever, viewed as independent variables that can inform the strength of international financial standards. This omission stands apart from insights in the law and finance literature that have long argued that even where rules are not legally binding they may influence the behavior of market participants seeking to signal efficiency, value, and strong corporate governance. Meanwhile, although some scholars have identified some of the key institutions governing international finance, few have comprehensively explored how these institutions operate both endogenously and as part of a larger organizational ecosystem. As a result, theorists have failed to pinpoint the micro- and macro-institutional design features that can at times bolster, as well as reduce, the effectiveness of the global regulatory system.

This Article broadens the optics used to examine international financial regulation and offers a more comprehensive theory of the field. It posits that international financial regulation, although formally a species of “soft law,” is a unique species of cross-border cooperation bolstered by a variety of disciplining mechanisms that, under certain circumstances, render it more coercive than

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8. See, e.g., John C. Coffee, Jr., The Future as History: The Prospects for Global Convergence in Corporate Governance and Its Implications, 93 Nw. U. L. Rev. 641, 673–74 (1999) (advancing the thesis that many firms migrate to U.S. securities markets as a form of “bonding” in which commitments to disclosure are signaled to investors); Roberta Romano, Empowering Investors: A Market Approach to Securities Regulation, 107 Yale L.J. 2359, 2361 (1998) (arguing that the market serves as a discipline in informing the choices of promoters choosing states of incorporation).
traditional theories of international law predict. It argues that as a matter of first-order principles, reputational constraints inform the decision making of regulators in the same way that reputation disciplines heads of state who commit to international agreements. Furthermore, even where rules are not legally binding, they may still influence the behavior of regulators and market participants seeking to make credible commitments of efficiency, value, and strong corporate governance to investors. Compliance decisions can be taken into account by market intermediaries and as such affect the cost of capital for firms operating in noncomplying jurisdictions. They can also subject nonconforming regulators to institutional sanctions and shaming.

These relatively straightforward arguments harbor a few theoretical complexities. For one, why would reputation, a disciplining force usually associated with formal (and thus more “solemn”) commitments like treaties, ever discipline actors where obligations are not legally binding? I argue that the literature overstates the importance of legal obligation, and that context is important to understanding how reputation operates. Although international financial agreements are informal, they are generally quite solemn and often taken seriously by signatories. Because regulators do not enjoy the authority to enter into treaties like heads of state, informal agreements are the only means available to express commitments. Furthermore, agreements frequently memorialize consensus on issues with important domestic import for parties. As a result, defection from even informal agreements can have reputational costs that hamper a regulator’s ability to promote its policies abroad.

This Article’s descriptive claim also raises central questions regarding the efficiency of international regulation, particularly where market actors are sources of discipline. Simply put, what use does law serve where markets are an important sources of discipline—can markets not effectively self-regulate in the absence of (even informal) governmental intervention? The Article points to the latest insights from the behavioralist law and economics literature and argues that soft law is not only an instrument for communicating policy intentions among regulators, but that it can also help “nudge” actors into accounting for the negative macroeconomic externalities of certain forms of business conduct. They may also serve as a focal point of action among market participants in a world of imperfect and limited information.

Notwithstanding its explanatory focus, this Article is not a full-throttled endorsement of the existing international financial architecture. In unpacking the functional logic and operation of international financial law, the Article demonstrates that disciplinary constraints have been hampered by a range of institutional flaws that, in practice, limit the “compliance pull” of global financial standards. For one, monitoring has been far from a comprehensive exercise, because participation in some of the most important surveillance programs is voluntary and the process depends on self-reporting by national regulators and firms. The Article also argues that the information generated through monitoring has not always been shared with the broader international regulatory community.
or market participants—and even where it is, it often goes unused due to the complex format through which it is disseminated. As a result, the risk-adjusted cost of defection is lowered, heightening the likelihood of noncompliance where significant distributional tradeoffs arise.

In response to these shortcomings, the Article presents a modest blueprint for regulatory reform. It argues that, although international legal theory presumes that greater legalization is required to discourage defection in the face of compliance problems, other less drastic means of reform are in fact possible. Specifically, the Article argues for changes to the institutional architecture supporting monitoring and information sharing such that greater transparency with regard to rules compliance is made possible, especially for market participants. In this way, key institutions helping to ensure financial stability and efficiency can be more effectively leveraged to speak to and confront increasingly global forms of risk emanating from the international financial system. That said, the Article recognizes that international financial law can be prone, like any legislation, to regulatory error, and acknowledges the democratic deficit in some international standard-setting processes. As a result, the Article calls for structural reforms that do not extend to poorer countries that pose little systemic risk to the global financial system, and provides a space for all regulators subject to surveillance to deviate from international standards where authorities find it most prudent to do so, but to do so transparently.

Collectively, the revisionist model and reforms presented in this Article make contributions to two distinct, but increasingly connected literatures. First, the Article contributes to corporate law and law and finance literatures by identifying international financial regulation as not simply an inert normative phenomenon, but also as a force in the global economic system that can, under certain circumstances, influence the behaviors of regulators and market participants. It also contributes to the international law and international relations literatures by rethinking the strategic implications of soft law as well as its normative consequences.

Part I of the Article makes the case for a new theoretical paradigm by demonstrating how public international law fails to account for the use of soft law in international finance. Part II addresses the uniqueness of international financial regulation and identifies its three distinguishing features. Part III assesses how international financial regulation can affect the behavior of its multiple beneficiaries. In doing so, it presents a new reputational theory of law that encompasses not only governments, but also market participants. It also demonstrates how international financial regulation acts as a kind of epistemic signpost for evaluating firms where information as to best practices is incomplete. Part IV then incorporates insights from the law and finance literature, as well as microeconomic theory, to evaluate the potential impediments to international financial regulation. Part V provides case studies illustrating how different institutional design dynamics, along with varying adjustment costs for regulatory stakeholders, will lead to disparate outcomes with regard to coordina-
tion. Part VI examines how international financial law forces a rethinking of classical conceptions of soft law and then examines how this particular species of rule making relates to the three core values of legality—namely efficiency, accountability, and legitimacy. Part VII ends with proposals for improving the international regulatory system.

I. THE PUZZLE OF INTERNATIONAL FINANCIAL REGULATION

A. GLOBALIZATION AND FINANCIAL RISK

The deeply international nature of the ongoing financial crisis has emphasized, if nothing else, that capital markets are more global than ever before. “Toxic” mortgage securities bundled and synthesized in the United States were sold across the Atlantic and led to bankruptcies of large financial institutions.9 AIG’s inability to honor commitments made to insure counterparties under derivatives contracts risked sparking bankruptcies among Europe’s most important banks.10 And foreign investors, not Americans, have been among the primary victims of the largest frauds perpetrated in the United States.11

These developments can in many ways be viewed as a negative externality of a larger and more significant world economic development—that after nearly seventy-five years of relatively low capital movements following the First World War, finance has come to flow more easily across borders than goods and services. In short, individuals, companies, and financial institutions around the world have engaged in cross-border money transactions—like real estate acquisitions, financing arrangements, and stock purchases and trades—at unprecedented levels, with “gross capital flows between industrial countries [rising] by 300 percent, while trade flows increased by 63 percent and real GDP by a comparatively modest 26 percent.”12

Driving this resurgence of cross-border capital flows have been three key

10. See David Henry, Matthew Goldstein & Carol Matlack, A Lethal Loophole at Europe's Banks, BUS. Wk., Oct. 27, 2008, at 32 (explaining that, because European banks had used credit default swaps issued by AIG to avoid capital requirements, an AIG bankruptcy posed a significant risk to the European banking system); Mary Williams Walsh, A.I.G. Lists Firms to Which It Paid Taxpayer Money, N.Y. TIMES, Mar. 15, 2009, at AI, available at http://www.nytimes.com/2009/03/16/business/16rescue.html (noting that, as counterparties to AIG-issued financial instruments, European banks received over $20 billion in U.S. bailout funds).
developments: deregulation, technology, and financial innovation. The first development, deregulation, involves the easing of governmental regulations over both capital and financial products. Specifically, throughout the 1990s most countries sought to increase foreign investment within their borders. To do so, many countries introduced a range of deregulatory measures that allowed “sophisticated” investors, ranging from foreign private issuers to wealthy individuals and hedge funds, to raise capital or transact free of stiff governmental interference and oversight. Moreover, rules on currency convertibility were eased, facilitating the ability to repatriate capital and in the process lowering the risk of investing inside their borders.13

Advances in information and computer technologies have also spurred capital mobility by heightening investor participation in foreign markets. Whereas just five years ago most stock exchanges were physical facilities and a financial firm might employ a bank of telephones to conduct just a single cross-border transaction, today stock exchanges are increasingly virtual facilities and can be accessed via trading screens located in any number of broker-dealers’ offices. Consequently, money can flow anywhere, instantly, regardless of national origin and boundaries, and once-exotic foreign markets have been able to dramatically increase their attractiveness as destinations for capital.14

Finally, financial innovation has served to enhance cross-border capital flows. “New instruments have emerged which make it possible to transfer risk of all kinds on a far larger scale” and to every part of the globe.15 With techniques like securitization, otherwise illiquid loans and local assets like real estate mortgages can be pooled and then sliced into new securities to be sold to investors anywhere in the world: a (piece of) a bank loan made in Boise can, in short, end up on the balance sheet of a bank in Berlin.16 Similarly, innovations in derivatives instruments also spurred greater cross-border finance by allowing institutions to contract with one another through swap and option agreements that are themselves commonly traded on electronic derivatives exchanges all over the world.

The globalization of financial markets has generated new and previously unimagined risks, many of which resulted from the breakdown in the regulatory integrity of markets. For the most part, governmental oversight has traditionally been what can be understood as the “territorial” approach to regulation, where regulation was exercised within a country’s geographic boundaries.17 In the

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13. However, such liberalization also increased incentives for speculation with rising tides of “hot money” into countries. JOSEPH E. STIGLITZ, GLOBALIZATION AND ITS DISCONTENTS 65–66 (2002).
case of banks and insurance regulation, this has meant the imposition of a country’s capital adequacy and truth-in-lending requirements on firms that operate within its borders. Meanwhile, in the case of securities law, this means that any securities either sold to the “public” investors of a country (usually meaning nationals located inside the relevant country’s geographic boundaries) or traded on an exchange domiciled or located physically inside the country must be registered with the country’s national securities regulator or, in the absence of a national regulator, with the relevant stock exchange authorities.\(^\text{18}\)

By applying to most transactions in a jurisdiction, financial authorities have long been viewed as enjoying a comprehensive regulatory “monopoly” over the transactions arising in their countries.\(^\text{19}\)

Globalization, however, seriously undermines the authority and control of regulators, at times with disastrous consequences. Three concerns have garnered particular concern among theoreticians and policymakers.

1. **Arbitrage**

   First, financial institutions dissatisfied with one jurisdiction’s rules can increasingly move to another with weaker and potentially suboptimal oversight to raise capital or engage in complex financial transactions.\(^\text{20}\) Moreover, as investors have also become more mobile and themselves participate in foreign markets, firms may nonetheless be able to transact with or tap investment capital from investors domiciled in jurisdictions subject to more stringent or effective oversight.\(^\text{21}\) In such cases, market integrity and regulatory oversight are undermined by offshore arbitrage by savvy, mobile firms.\(^\text{22}\)

2. **Inefficient Regulatory Competition**

   Globalization also increases pressure on regulators to compete with one another to attract capital. As I have previously argued,

   virtually all regulators want to increase the size of their respective capital markets, even where such activity is not a part of a regulator’s formal mandate. The success of domestic markets is generally viewed as a proxy for the success of a regulator. Furthermore, regulators are subject to enormous

\(^{18}\) See id. at 1090–91.

\(^{19}\) Id.

\(^{20}\) See Ethiopis Tafara & Robert J. Peterson, *A Blueprint for Cross-Border Access to U.S. Investors: A New International Framework*, 48 Harv. Int’l L.J. 31, 50–51 (2007); see also Brummer, supra note 17 (showing how the development of international capital markets allows for the evasion of national laws that were historically viewed as “preemptive”).

\(^{21}\) See Tafara & Peterson, supra note 20, at 51.

\(^{22}\) Id. For an in-depth discussion of the evolutionary changes in exchanges that are making these developments possible, see Chris Brummer, *Stock Exchanges and the New Markets for Securities Law*, 75 U. Chi. L. Rev. 1435 (2008).
pressure from a variety of powerful interest groups that have a direct stake in the robustness of domestic capital markets.\textsuperscript{23}

This competition can, however, take on a deleterious quality where regulators dismantle even efficient regulations in hopes of attracting certain kinds of firms to their borders. In such situations, a “race to the bottom” can ensue, endangering not only investors but the health of the international financial system.

3. “Global” Systemic Risk

Finally, and equally important, regulatory heterogeneity also generates forms of systemic risk that were once deemed entirely domestic in nature. Intervention in financial markets rests in large part on the assumption that investors—either due to hubris, cognitive bias or “irrational exuberance”—are naturally inclined to take on unwarranted investment risks, especially in economically prosperous times.\textsuperscript{24} Banks may make bad loans without proper regard of the likelihood of repayment (or the wider costs to society of its failure), and investors may make uninformed decisions without proper information.\textsuperscript{25} The current regulatory apparatus thus acts as a kind of check to these developments by regulating disclosure and systemically important financial institutions. Where, however, market participants are mobile, and participate in jurisdictions without key or suitable protections or supervision, these controls break down. Investors, for example, may make poor investment decisions where companies can provide them with faulty or deficient information. Or banks may enter into derivatives with insolvent counterparts due to poor capital adequacy requirements governing local transactions.

B. FINANCIAL REGULATION AS A COORDINATION PROBLEM

Increasingly, policymakers and scholars have called for better coordination among financial market authorities to meet the challenges of globalized financial risk.\textsuperscript{26} By working in concert, it is believed that regulators can address

\begin{footnotes}
\item 23. Brummer, \textit{supra} note 4, at 352 (footnote omitted).
\end{footnotes}
systemic risk problems while at the same time thwarting inefficient regulatory competition.

Given the systemic nature of these challenges, it is perhaps not surprising that academics, particularly experts in public international law, have often assumed that coordination is a relatively simple activity. In more extreme moments, some scholars imply that it comprises a pure “coordination problem” where regulators share the same basic preferences for regulatory standards, though the best policies must be collectively analyzed and assessed.27 At other times, scholars imply that cross-border financial regulation is an “assurance game,”28 where regulators must be convinced that others will act in accordance with that regime—otherwise many of the efforts of those regulators that adopt the optimal rule (that is, their own domestic reforms) would have been effectively wasted. Driving these portrayals is the idea that the primary obstacles to agreement are trust and information—not antithetical policy preferences. As a result, information-sharing and persuasion are considered the primary and most efficacious means of achieving coordination. That is, where there is high information sharing, there will be high levels of commitment, and high compliance.

These early forays into cross-border regulation have been useful in identifying the usefulness of information sharing in cross-border regulatory activities. Nevertheless, they misunderstand the kind of coordination problem posed by financial regulation. Regulators, in short, do not always share the same policy preferences. Some policy options will, for example, cost more for some countries than others. Because of history, culture, and custom, countries have vastly different starting points as far as what kinds of regulations are already in place.29 Effective compliance with a new international norm may as a consequence require greater adjustments for some countries than others.30 In some instances, for example, a country may have to revise its regulatory framework overseeing a particular sector of the economy, and with it the way in which market participants are governed.31 This can be difficult to achieve insofar as regulatory agencies and lawmakers, accustomed to the status quo, may resist

28. This is due in part to the view shared by many that international finance is an area of “low politics.” See, e.g., Kal Raustiala, The Architecture of International Cooperation: Transgovernmental Networks and the Future of International Law, 43 VA. J. INT’L L. 1, 5, 28–29 (2002).
30. DREZNER, supra note 5, at 123.
such reform from above. For some countries (especially developing countries) the resources and human capital may not be available to effectuate a transition. Their firms, meanwhile, may suffer more than others due to the difficulty of meeting compliance requirements.

Similarly, national authorities may have different perceptions of the effect that moving to a particular standard will have on the competitiveness of their relevant markets. Some regulators may find stringent rules and regulations an effective means of attracting firms by allowing them to signal their commitment to sound corporate governance; other regulators may find it more appealing to adopt lower regulatory standards in order to appeal to small firms and managers seeking to avoid high regulatory costs.

Indeed, even with regard to systemic risk, the costs and benefits associated across jurisdictions may differ. Some countries may, for example, be net exporters of “bad” financial products—whether stocks, bonds, credit default obligations, or other exotic instruments—to foreign investors. In such instances, countries will have few incentives to cooperate and adopt more stringent regulatory standards. Similarly, some smaller, capital-poor countries may have few other means than weak regulations to attract capital. Without a better alternative for attracting financial transactions, they may be incentivized to hope for the best and maintain weaker standards, because they have “nothing to lose” with regard to the rules they adopt.

These often significant asymmetric benefits can cause coordination to be much more complex—and difficult—than has traditionally been acknowledged in the literature. There may be, in short, no coordination due to an antagonistic distribution of preferences. Furthermore, coordination may fail even where parties have incentives to cooperate. In game theory terms, coordination may have, as between any set of two regulators, two equilibrium outcomes and compromise. In situations like these, which comprise variations of “Battle of the Sexes” games long theorized in the game-theoretic literature, actors may recognize that they would be worse off without reaching some joint accord, but disagree as to the specific terms on which agreement should be based due to an asymmetric distribution of interests. Each equilibrium outcome is, in short, unambiguously superior for one of the players, which creates a dilemma for coordination. Neither actor is sufficiently incentivized to accept the other’s regime where both act simultaneously.

32. See, e.g., Drezner, supra note 5, at 142–45 (describing the process by which international regulators have attempted to enforce standards on countries with lax money laundering protection).
36. See Brummer, supra note 4, at 354 & n.115.
C. THE CASE FOR A NEW THEORETICAL FRAMEWORK

The implications of such coordination dilemmas generate practical and theoretical difficulties for dominant descriptive theories of international financial regulation. As a matter of first order principles, the distributive undercurrent to cross-border financial regulation undermines, perhaps fatally, the utility of international financial law. Although soft financial regulations help governments coordinate, they have little if any durability. Assuming countries follow policies that promote the interests of their domestic firms, soft law should provide little utility as a means of making credible commitments. Wherever collaboration results in a win for some parties and a loss for others, international legal theory predicts that parties will defect from their commitments because they are informal. Existing theories of international financial regulation are, as a result, ill-equipped to explain why soft law is relied on to communicate commitments. At best it can be understood as an instrument with which regulators can signal their intent to carry out a specific action or promote burgeoning norms, though even here other less costly and indeed unilateral mechanisms would seem to be better suited as mechanisms of expressing the policy direction of a particular jurisdiction.

This theoretical dilemma stems in large measure from a very narrow understanding of the context in which international financial law operates. Most legal theorists understand soft law almost entirely from the perspective of hard law. According to Article 26 of the Vienna Convention, treaties are “binding upon the parties” and “must be performed by them in good faith.” Thus where a country decides not to honor treaty obligations, the cost to its reputation will be high, and other states will be less willing to enter into agreements with it in the future. On the other hand, soft law, by intent and design, is not codified in treaties or formally agreed upon by heads of state, and thus does not express any special solemnity of commitment. As a result, scholars predict that soft law, devoid of any legal obligation, imposes few defection costs and enables what can be described as “cheap” exit from commitments. Insofar as regulatory choices and compliance with particular standards begin to resemble zero-sum games, as opposed to win-win collaborations, dominant theoretical paradigms predict that soft law will be unable to achieve deep and lasting agreement if a party discovers that defection serves its interests.

37. See Robert E. Scott & Paul B. Stephan, The Limits of Leviathan 79–83 (2006) (applying contract theory to international law and noting the hold-up and moral-hazard problems that arise where a party who is obligated to perform under an incomplete contract will be tempted to reduce its “investment in the contract”).


40. Simply put, if country X enters into a nonbinding agreement with Y and agrees to do something, but then defects from this commitment, it may not incur any significant costs because it was not a
The focus on the formal legal quality of international rules is important, but if it is relied upon exclusively to understand international financial regulation, it will ignore the dynamic quality of reputation in circumstances where treaties may be absent. Although legalization may describe one element helping to underscore the degree of seriousness and solemnity with which a party undertakes a commitment, it does not necessarily follow that all soft legal regulations lack a sense of commitment or reputational repercussions if a party chooses not to follow through with its commitments. Even where formal treaties are not promulgated, parties may still expect that the commitments articulated in an agreement will be undertaken. And the failure of a party to deliver may have important repercussions for that party’s ability to secure cooperation in the future.

An excessive privileging of formal legalization also overlooks the potential roles played by nongovernmental actors, especially firms and international organizations, in the enforcement of international financial agreements. Like the law, markets and firms are often overlooked in dominant accounts of international financial regulation. Both markets and firms are, like law, generally framed as objects of state policy, but are rarely viewed as independent factors that can inform the strength of international financial standards. Theories of international financial regulation are often put forth by international relations theorists for whom these factors are often secondary to the ultimate distributive struggle arising between countries. However, it stands quite apart from insights in law and finance literature that have long argued that even where rules are not legally binding they may influence the behavior of market participants (and, as public choice theory would suggest, their regulators) that may seek to signal efficiency, value, and strong corporate governance to investors. Similarly, by neglecting the issue of international institutions, little time has been invested into how international financial rules are mediated and, even more basically, how institutional forums operate in conjunction with one another to produce global legal standards. As a result, theorists ignore the design features that may help discipline—or encourage—defection from international regulatory commitments. By extension, they also likely miss how international financial rules can promote or undermine the international economic system.

This suggests that a broader, more contextually grounded examination of international financial law is required in order to excavate the conditions under which international regulatory agreements are articulated as well as to better understand the interplay of organizational and market factors that inform the regulatory process. Only at that point, when examining the full panoply of factors driving globalized financial rule making, is a robust systemic critique possible. Part II of this Article takes a first step towards providing such a

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legally binding instrument. On the other hand, if the agreement is legally binding, country X may incur some kind of retaliatory sanction or reputational cost from defection. These costs can thus change the payoffs of that country and make compliance more likely.
descriptive theory by identifying the institutional, market, and legal features that compose the international financial regulation. In doing so, it provides a basis for understanding the constituent parts of the international system and assessing their effectiveness as sources of international financial law.

II. THE THREE KEY FEATURES OF INTERNATIONAL FINANCIAL LAW

Three central features characterize international financial law and are important in understanding its effectiveness and limits. First, international financial law is characterized by a global division of regulatory labor. That is, diverse regulatory actors—along a spectrum of different institutional forms of governmental authority—participate in its formulation, both cooperatively and competitively. Second, it is “generally applicable,” with both regulators and market participants as its intended consumers. Finally, although its rules are nonbinding, international financial law is envisioned to be “enabling” (in the corporate law sense of the term) and to promote common approaches and capacity building through the provision of persuasive model standards.

A. SEPARATION OF POWERS

International financial law is the product of a regulatory division of labor through which authorities across a spectrum of domestic and international institutions interact with one another both cooperatively and competitively to promulgate global rules and standards. In this decentralized regulatory space, the national–international dichotomies associated with public international law do not apply.41 National regulators are responsible for devising rules and participating in international standard-setting bodies. International standard-setting bodies serve as inter-agency forums; they are run by consensus and their members (national regulators) are responsible for implementing legislative products. International financial institutions are meanwhile the primary actors tasked with monitoring and evaluating compliance with international standards and best practices by governments.

1. National Financial Authorities

At the most local level of the global regulatory polity are national financial authorities—a broad and diverse group of actors that includes regulatory supervisors and agencies, finance ministers, and central bank governors. As mentioned above, the ambit of their activities has traditionally been local. Their activities have, as such, centered on administering monetary policy, issuing domestic guidelines for financial markets, and providing supervisory oversight over large, systemically important institutions like investment banks and brokerages operat-

ing under their jurisdiction. Increasingly, however, national regulators are operating on an international basis as actors transact across borders. Regulators may, for example, craft bilateral or even regional instruments under which firms in one another’s countries can transact free of domestic oversight, assuming certain conditions are met or reforms made. They also interact through international institutions to generate global best practices and to commit to common regulatory approaches. After committing to international practices, regulators are then responsible for both translating and implementing international standards locally.

That regulators engage in such activities demonstrates a significant departure from traditional public international law models of diplomacy, where political elites and heads of state participate. It injects technocratic skill at the highest level of the rulemaking process. As a result, some scholars have surmised that participation by regulators additionally tempers politics in the rulemaking process—especially because in many countries, regulatory agencies and commissions are designed to enjoy some degree of independence from the executive and legislative branches.

Still, political elites (and domestic politics and interest groups) can inform the decision making of regulatory agencies. In most countries, legislatures write the statutes that regulatory agencies apply and abide with in the course of their rulemaking activities, and heads of state participate periodically alongside financial ministers at leading economic summits to set agendas for domestic regulatory agencies. Heads of state are also responsible for the appointment of leaders to agencies, and in some constitutional systems, the legislature’s approval is required. As a result, politicians will require or seek out representatives concerned with promoting the economic welfare of the country and,

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42. Consider, for example, the Multijurisdictional Disclosure System (MJDS) program, a mutual recognition scheme adopted between the United States and Canada. See Securities Act Release No. 33-6902, 56 Fed. Reg. 30,036 (June 21, 1991) (adopting and describing the MJDS). “Under the MJDS, Canadian foreign private issuers that meet eligibility criteria qualifying them as large, established companies are viewed as meeting certain of the SEC’s securities registration and reporting requirements if they provide disclosure documents prepared according to the requirements of the relevant Canadian securities authorities.” Roel C. Campos, Comm’r, Sec. & Exch. Comm’n, The Global Marketplace and a Regulatory Overview (Sept. 17, 2004), in Commission Speeches and Public Statements Archive: 2004, U.S. SECURITIES AND EXCHANGE COMMISSION, http://www.sec.gov/news/speech/spch091704rcc.htm. By using a Canadian prospectus, issuers could avoid a range of administrative costs associated with U.S. documents. Furthermore, the SEC does not review prospectuses prepared under the MJDS, which results in considerable time savings. Because the arrangement is “mutual,” U.S. issuers also enjoy expedited access to Canadian markets, though only a fraction have chosen to do so, given the immediate advantages of U.S. markets. The program is thus viewed as a boon to Canadian issuers seeking to raise capital in the United States.

43. For examples, see infra notes 54, 65 and accompanying text.

44. This particular idea has had a long lineage, dating back to the New Deal. At that time, many thought that “the social and economic problems confronting the nation could not be solved, and might be made worse, by politics. Rather, such problems required the sort of dispassionate professional judgment that only a cadre of experts could supply.” Lisa Schultz Bressman & Robert B. Thompson, The Future of Agency Independence, 63 VAND. L. REV. 599, 612 (2010).
possibly, specific interest groups. Finally, many regulators often seek work in
the private sector after their careers in policymaking, making them more prone
to promote rules that may enhance their own marketability. In such cases,
their rule making will be, for better or worse, highly responsive to the interests
of local regulated industries.46

The presence of politics, along with natural instincts to promote local firms,
underscores that, all else being equal, where proposed or contemplated interna-
tional arrangements have distributional consequences that could negatively
affect or competitively disadvantage their home economies, regulators will
likely oppose them. On the other hand, where bilateral or multilateral rules
promote domestic economies, either by “leveling the playing field” or enhanc-
ing the reputation, stability, or attractiveness of a jurisdiction as a destination for
capital, the rules will promote those international standards. Consequently,
interactions between regulators are characterized by both rivalry and coopera-
tion—at times simultaneously—depending on the issue area under negotiation.

2. International “Agenda” and “Standard” Setters

Even more central to the international financial infrastructure are the interna-
tional standard-setting bodies themselves—that is, the global institutions in
which national authorities meet regularly to coordinate and articulate common
policy approaches.

Conceptually, these bodies can be organized along the lines of what I will
describe as “agenda” and “standard” setters, though the line between them is not
always easy to demarcate in practice. By agenda setters, I mean those institu-
tions that are geared towards large organizations with broad and diverse regula-
tory memberships that define broad strategic objectives for the international
system. Two are especially central to international financial regulation: the G-20
and the newly constituted Financial Stability Board.

Recently designated the “premier” organization for international economic
cooperation,47 the Group of Twenty Finance Ministers and Central Bank Gover-
nors (G-20) provides a forum for banking and finance ministers from the
nineteen largest and fastest-developing economies to meet, at times along with
heads of state from member countries, to discuss financial, economic, and
monetary policy.48 Furthermore, to facilitate global coordination, the Managing

45. See Adam J. Levitin, Hydraulic Regulation: Regulating Credit Markets Upstream, 26 YALE J. ON
REG. 143, 159 (2009).
46. See id.
47. See Press Release, White House Office of the Press Sec’y, Fact Sheet: Creating a 21st Century
Int’l Econ. Architecture (Sept. 24, 2009), http://www.whitehouse.gov/the_press_office/Fact-Sheet-
48. The G-20 provides this concise overview of the organization’s background:

Prior to the G-20 creation, similar groupings [designed] to promote dialogue and analysis had
been established at the initiative of the G-7. The G-22 met at Washington D.C. in April and
October 1998. Its aim was to involve non-G-7 countries in the resolution of global aspects of
Director of the International Monetary Fund (IMF) and the President of the World Bank, plus the chairs of the International Monetary and Financial Committee and the Development Committee of the IMF and World Bank, also participate in G-20 meetings on an ex officio basis. Together, member countries represent around 90% of global gross domestic product, 80% of world trade (including trade between EU members), and 64% of the world’s population.49

The legislative products of the G-20 include “communiqués” and “declarations,” usually published at the end of summits that inform the public about agreements reached by G-20 members.50 In these public declarations, the G-20 leaders as a group articulate shared viewpoints with regard to economic policies, causes, and solutions to microeconomic and macroeconomic challenges. As such, they have touched on a diverse array of topics: raising the quality of capital held by banks, restructuring the IMF’s early warning system, and coordinating with standard setters for better financial regulation, especially with regard to derivatives and credit rating agencies. Communiqués also inform the public about future initiatives and frequently task other international bodies to implement agreed-upon priorities. In order to lend more heft and credibility to these communications, they can be reinforced with other kinds of instruments. Working groups comprised of representatives from all of the G-20 countries have, especially in the wake of the crisis, been tasked to develop reports and recommendations to strengthen international standards in areas like accounting, disclosure, and prudential management.51 Similarly, on at least one occasion a progress report was published as a self-assessment, where the group evaluated success on following through with previous commitments.52

Alongside the G-20 is the Financial Stability Board. Originally christened the “Financial Stability Forum” in 1999 and tasked by what was then the G-7 with promoting international financial stability through better information exchange during the financial crisis then affecting emerging-market countries. Two subsequent meetings comprising a larger group of participants (G-33) held in March and April 1999 discussed reforms of the global economy and the international financial system. The proposals made by the G-22 and the G-33 to reduce the world economy’s susceptibility to crises showed the potential benefits of a regular international consultative forum embracing the emerging-market countries. Such a regular dialogue with a constant set of partners was institutionalized by the creation of the G-20 in 1999.


50. For a list of communiqués, see Communiqués, G-20, http://www.g20.org/pub_communiques.aspx (last visited Sept. 29, 2010).


and international cooperation, the Financial Stability Board was originally a weak and sleepy organization charged with serving as a locus for intergovernmental coordination. However, in the wake of the 2008 crisis its mandate has grown substantially (triggering a change in its official name to underscore its new powers). Its responsibilities now include assessing weaknesses in the global financial system and advising regulators as to the implications of such weaknesses for regulatory policy. It is tasked with establishing a supervisory college to monitor large international financial services firms.53 In part through this role, and its general economic monitoring obligations, the Financial Stability Board has become an increasingly important player in establishing broad policy principles and objectives.54 Specifically, the organization has issued a series of broad recommendations and principles to strengthen the global financial system, including the Report on Enhancing Market and Institutional Resilience, aimed at improving banking capital adequacy requirements, accounting standards and margin requirements for certain trading activities.55 Similarly, the Financial Stability Board’s Principles for Sound Compensation Practices guides executive compensation, a factor associated with contributing to the bubble that spurred the crisis.56 Finally, in its Report of the Financial Stability Forum on Addressing Procyclicality in the Financial System, the Financial Stability Board proposed a range of measures envisioned to mitigate mechanisms that amplify the procyclicality that exacerbates bubble-driven economies.57

These bodies generally implement their broad regulatory agendas through more granular standard setting by national regulators and the so-called standard-setting organizations. The best known and oldest of the international standard setters is the Basel Committee, a group composed solely of the central bank governors and national bank regulators of the G-20 countries.58 The Basel

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58. Kearl, Alexander, Rahul Dhumale & John Eatwell, Global Governance of Financial Systems: The International Regulation of Systemic Risk 35 (2006). Importantly, although the G-20, like its predecessor organizations, the G-7 and G-8, is not viewed as a standard setter, the organization has issued a range of broad principles and public “communiqués” that touch upon the macro-prudential regulation of securities firms and products. See supra note 50.
Committee seeks to improve the quality of banking worldwide “by adopting international standards of prudential supervision covering such issues as capital adequacy and consolidated supervision of a bank’s cross-border operations.”\(^{59}\)

The committee uses a secretive decision-making process and relies on personal contacts mediated through four subcommittees focusing on policy development, the implementation of standards, accounting standards, and broader (extra-G-20) international regulatory coordination.\(^{60}\) No votes are taken; instead, the Committee works through consensus.\(^{61}\)

Among the Basel Committee’s legislative products is the *Core Principles for Effective Banking Supervision*, which spells out best practices for banking regulators, and the concordat on cross-border banking supervision, which provides broad principles “for co-operation between national authorities in the supervision of banks’ foreign establishments.”\(^{62}\) It is also widely acclaimed for its 1988 accord on capital adequacy (or Basel I), which requires banks of member countries to hold a certain amount of capital on their books for investment activities.\(^{63}\) Under the agreement, ultimately adopted by each member and nearly 100 nonmembers, different kinds of financial activities were assigned different risks; the riskier the activities, the more capital banks were required to hold.\(^{64}\) These rules were revised in a new round of negotiations in 2004 (Basel II), which gave the world’s largest banks substantial discretion in the methodologies used to generate their own internal risk ratings, and again in 2010 (under a presumptive Basel III).\(^{65}\)

The key standard setter for securities regulation is the International Organization of Securities Commissions (IOSCO).\(^{66}\) Like the Basel Committee, it is not formed by treaty or interstate agreement, and thus is not considered by most international relations theorists to be a true international organization.\(^{67}\) Nevertheless, its membership is global, and in contrast to Basel’s more finite membership, over 180 regulatory agencies participate in the organization.\(^{68}\) Due in part to its status as a consensus-based organization, IOSCO has historically passed relatively little organization-wide legislation. Instead, most policy is coordinated through the organization’s Technical Committee, a group of now eighteen countries representing leading developed jurisdictions stemming from

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59. Alexander et al., supra note 58.
60. Id.
61. Id. at 35–37.
64. Daniel Tarullo, Administrative Accountability and International Regulatory Networks 14 (Nov. 4, 2008) (unpublished manuscript) (on file with author).
66. Alexander et al., supra note 58, at 57.
67. Id. at 58.
countries with large domestic markets. Its many legislative achievements include *Objectives and Principles of Securities Organization*—a set of thirty principles outlining the organization’s view of what comprises high-quality securities regulation—and the *International Disclosure Standards for Cross-Border Offerings and Initial Listings by Foreign Issuers*. The organization also boasts a multilateral agreement among regulators securing enforcement cooperation where witnesses or the proceeds of fraud are located in one another’s jurisdiction.

The International Association of Insurance Supervisors (IAIS) acts as the primary coordinator for national regulators of insurance companies and sets minimum standards of supervisory practice for the industry. Initially established in 1994, it soon evolved into a key international standard-setting body and boasts a membership covering more than 160 jurisdictions. “The IAIS’s highest decision-making body is the General Meeting, which takes place once a year . . .” At this meeting, “[a]ll members of the IAIS are entitled to attend . . . and to vote on all proposed resolutions, including all principles, standards, and guidance papers,” though the organization’s Technical Committee has the main responsibility for developing and submitting policy proposals to the General Meeting. The IAIS has developed, much like international securities regulation, a model bilateral agreement on the exchange of information and implementation. It has also developed international best practices, memorialized in its *Insurance Core Principles and Methodology*, which provides guidance for jurisdictions wishing to strengthen their supervisory regimes, and has increasingly focused on matters of systemic risk management by insurance companies.

Alongside these primary regulators are what can be considered other important standard-setting bodies that enjoy much more limited mandates and tackle very specific, technocratic problems of finance. Payment systems, for ex-

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69. See id. at 469 (noting that “[t]he Technical Committee is the key committee for IOSCO policy development”).


72. See infra section V.C.

73. ALEXANDER ET AL., supra note 58, at 61.

74. Id.

75. Id. at 62.

76. Id.


78. The list of such standard setters can be extensive. However, I list above those standard setters that work on matters most commonly associated with “financial regulation.” I thus exclude the IMF’s codes involving monetary and fiscal policy transparency and data dissemination, as I do the World Bank’s insolvency codes.
ample, are addressed primarily by the Committee on Payments and Settlements Systems.79 Meanwhile, the Organization for Economic Cooperation and Development has long been an advocate of corporate governance and has published a range of high-level principles.80 Three specialist standard setters have, however, additionally received especially strong attention from academics. The first is the International Accounting Standards Board (ASB), which, along with participation from the International Federation of Accountants,81 promulgates international guidelines laying out how particular types of transactions and other events should be reflected in financial statements. Additionally, the Financial Action Task Force, discussed in more depth below, was originally designed to promulgate rules against money laundering, and since 2001 has also combated terrorist financing.82

3. International Financial Institutions

Institutions that engage in surveillance and monitoring make up the last important group of global regulatory actors. Although discrete monitoring activities are at times carried out by other organizations, two institutions have been of traditional importance: the IMF and the World Bank.83 Although not generally tasked with devising sector-specific standards for finance per se,84 their missions have evolved over the years to primarily include the monitoring of financial codes and standards.85 They are also, notably, the only international institutions in the international financial architecture whose founding documents—their respective articles of agreement—are formally recognized hard law.

Surveillance has at least traditionally been executed through World Bank and IMF surveillance programs, including semi-regular (usually annual or biannual) consultations the IMF undertakes with each of its members as called for under Article IV of IMF’s Articles of Agreement.86 Increasingly, however, the institu-

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82. See infra section V.A.

83. BLAIR & WALKER, supra note 68, at 462.

84. This does not mean that the institutions have nothing to do with codes and activities that touch on the financial sector. Perhaps most important, the IMF is responsible for establishing standards with regard to government transparency (particularly monetary and fiscal policy) and facilitating better dissemination of data to the public. DREZNER, supra note 5, at 137 tbl. 5.1. The IMF has also been tasked with creating guidelines to help national authorities assess whether a financial institution is systemically important. See G-20 WORKING GRP. 1, ENHANCING SOUND REGULATION AND STRENGTHENING TRANSPARENCY, at xii (2009), http://www.g20.org/Documents/g20_wg1_010409.pdf. Finally, the World Bank is also a key standard setter for insolvency and creditor rights.

85. BLAIR & WALKER, supra note 68, at 462–63. The IMF and the World Bank are, however, very much involved in the propagation of standards concerning monetary and fiscal transparency.

tions rely on other vehicles for surveillance. The most important is the Financial Sector Assessment Program, an initiative administered jointly by the IMF and the World Bank. This program is more rigorous than traditional IMF consultations, and undertakes examinations (financial sector assessments) to identify developmental and technical assistance needs of the jurisdiction in question, determine the risks its practices pose to the international system, and help prioritize policy development and coordination efforts with the local regulator.

Included in financial sector assessments—where, again, experts from international standard-setting bodies, national supervisory agencies, and central bank authorities examine a country’s market stability—are World Bank and IMF Reports on Observance of Standards and Codes (“observance reports” or, more officially, ROSCs), reports that focus on countries’ adherence to targeted international codes and principles. The key standards address issues as diverse as accounting, auditing, anti-money laundering, countering the financing of terrorism, banking supervision, corporate governance, data dissemination, fiscal transparency, insolvency and creditor rights, insurance supervision, monetary and financial policy transparency, payments systems, and securities regulation. In preparing the ROSCs, experts from the World Bank and IMF not only familiarize themselves with the relevant country’s laws and regulations, but also participate in several on-site inspections and interview stakeholders such as law firms, government officials, and financial institutions.

B. REGULATORY AND MARKET APPLICABILITY

The administrative nature of international financial law underscores that it speaks not only to the signatories of agreements, but also to market participants. As such, international financial regulation exhibits what can be considered a distinctly “private” character. Banks, for example, disclose their capital positions according to Basel principles, sometimes even where their home institutions have not adopted or implemented the rules. Similarly, credit rating


88. Id. at 165. Financial sector assessments evaluate four key components of regulation: regulatory governance, regulatory practices, the prudential framework concerning the internal controls and governance of supervised entities, and the financial integrity and safety net available for depositors, investors and policy holders in times of stress and crisis. The objective of the assessments is to identify any gaps from a “stability or development perspective.” WORLD BANK & INT’L MONETARY FUND, FINANCIAL SECTOR ASSESSMENT: A HANDBOOK 8 (2005). Thus the assessments “take into account the risk profile and sources of vulnerability of the [financial] sector” under surveillance. Id.


agencies have complied with some IOSCO mandates, such as placement of codes of conduct on web sites and disclosures to investors as to their services, even when not required to do so under national law.\footnote{Compare \textit{Int’l Org. of Sec. Comm’ns, Code of Conduct Fundamentals for Credit Rating Agencies} 13 (2008), http://www.iosco.org/library/pubdocs/pdf/IOSCOPD271.pdf (instructing credit rating agencies to place links to their codes of conduct on their home webpages), with Thomas Murray, http://www.thomasmurray.com (last visited Sept. 29, 2010) (complying with the IOSCO mandate by providing a link to http://www.thomasmurray.com/code-of-conduct).}

Perhaps not surprisingly, given the potential scope and reach of financial agreements, regulatory processes frequently involve a considerable degree of consultation with market participants across a wide spectrum. Industry groups regularly provide comments on pieces of prospective legislation being devised by international standard setters. Investment banks, lawyers, and securities firms frequently write memoranda for IOSCO and its technical committees when they are contemplating pieces of legislation, as do commercial banks for Basel. Furthermore, where standards for international insurance are promulgated, private parties are formally invited to act as observers. In this capacity, most leading insurance companies, and some law firms and governmental organizations with interests in insurance supervision, participate in IAIS functions though they have no official vote in the organization.\footnote{Alexander et al., \textit{supra} note 58, at 63.}

Meanwhile, industry groups lobby their home agencies with regard to legislation being considered at the national level. It is thus not uncommon for, say, a stock exchange to express its views with the SEC with regard to possible legislation concerning best practices for clearing and settlement of securities being adopted by IOSCO. Furthermore, market actors also participate in the public comment and advice period when national regulators begin implementing international standards in their home jurisdictions. This participation supple-
ments the already robust, frequent contact that market actors have with their respective regulatory bodies while serving on informal panels, making presentations, and engaging in social activities.

It also has a number of effects on the coordination process. On the international level, it serves informative purposes and allows regulators to better understand the practical implications of regulatory rules on their local (domestic) businesses and businesses in other jurisdictions. To the extent that businesses share common concerns, involvement at the international level can help bolster the coordination process. A coincidence of interest between firms does not, however, necessarily imply that rules are globally welfare enhancing, especially where, for example, firms across borders seek a united front to water down certain kinds of (costly) prudential rules in their sector.

Market participants may also differ considerably with regard to the optimality of any regulatory proposal. Specific groups may, for example, have an interest in fighting off competition from foreign firms and seek to do so by persuading (or pressuring) home governments not to adopt certain standards. Opposition by private actors may thus, along with sovereignty concerns or dissonant philosophical implications of a particular rule, help secure the resistance of national regulators to reform proposals or regulatory programs contemplated by international standard-setting bodies.

C. “Enabling” Functionality

Against this backdrop, a proposed rule’s or standard’s route to global recognition and national implementation is far from an easy one—especially where it involves possible distributive consequences. Interactions either between national regulators, or between national regulators and local firms, provide ample occasions for contestation by regulatory or market interests. However, most financial regulators generally frame standards as a means of not so much avoiding tough issues, but engaging them. For them, international financial law operates, as in the corporate law context, as what can be described as an “enabling” mechanism. Its flexibility helps, in other words, to promote cross-border, comprehensive practices by lowering the cost of reaching agreement and building stronger domestic regulatory systems.

1. Heightened Information Production

First, international financial law speaks to simple coordination barriers, such as a lack of trust, by lowering the risk of relation-specific investments associated with assurance problems. Regulators are able to express their intent to enter into the specified regulatory action, and in doing so signal that commensurate actions on their part will not result in wasted resources or undermined or decreased benefits. They are additionally able to do so (if they so choose) with a significant degree of credibility. As a result, the risk-related costs of entering into an agreement can be lowered.
2. Greater Capacity Building

Additionally, international financial regulations have public goods qualities insofar as they provide a range of off-the-rack principles, standards, and rules of good governance, while still allowing flexibility with regard to implementation so that approaches can be tailored to local needs and circumstances.\(^9\) In doing so, countries need not start from scratch by developing regulatory approaches and strategies to new (or even old) problems—a daunting and costly challenge, especially for developing countries. Instead, they can both learn from and expound on international best practices and guidelines that reflect broad, cross-border regulatory concerns and popular consensus rather than only one national regulator’s preferences or biases.

From this standpoint, the enabling functionality of international financial law serves to ease the coordination process while at the same time providing directionality to the provision of cross-border standards. Its soft law quality allows regulators to enter into agreements of varying scope and specificity, and to then clarify (or change) over time the expectations of states as contexts change or more market or regulatory information becomes available. International financial law is thus envisioned to intrinsically have considerable authority and persuasiveness, while at the same time preserving flexibility for sound regulatory responses and application to local conditions.

III. HOW DOES INTERNATIONAL FINANCIAL LAW AFFECT BEHAVIOR?

Recognizing the soft law quality of international financial regulations, international legal theory predicts that global financial rules will enjoy few, if any, backstops to provide discipline against reneging on commitments. This Part shows, however, that these forecasts do not necessarily hold. International financial regulation is instead often buttressed by a range of reputational, institutional, and market disciplines that render it more coercive than traditional theories of international law predict. As a result, regulators that do not comply with international financial standards may still internalize certain costs for defection, even though the standards are technically nonbinding and informal.

A. REPUTATIONAL CONSTRAINTS FOR REGULATORS

Classical international legal theory does not assume that soft law imposes costs on international actors where they choose to defect from agreements that are not legally binding. As discussed above, for most scholars the informality of agreements implies a relative absence of commitment; and in the absence of commitment, no reputational costs can be implied where states change their

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minds and do not follow through on statements of intent. One implication of this thinking is that sub-state actors cannot make credible commitments.

This line of reasoning overlooks, however, that even informal agreements can express “commitments.” In some cases, commitments may be relatively weak, as where soft law comprises a set of observations made by members at international forums, and as such may operate as way stations to a more elaborate regime or expressions of limited consensus among regulators as to the causes, and not the solutions, to emerging challenges. In such cases, agreements take on qualities of broad negative covenants, where signatories or sponsors of the legislation may have wide discretion as to future actions, but are at least expected not to engage in behavior contrary to or conflicting with the values or norms expressed in the legislation.

International financial law may also express specific actions parties to agreements intend to take, and in doing so these agreements constrain self-serving autonomy in a manner similar to affirmative covenants or regulatory contracts. In these circumstances, international financial law may be operationalized through bilateral or even multilateral memoranda of understanding or codes of conduct and best practices. Moreover, precise commitments may be spelled out under these agreements, along with explanatory methodologies or supporting documentation addressing the implementation of agreed-upon standards and principles.

Although the agreements are not legally binding, these instruments are often made with great solemnity. Because international financial agreements are generally made among regulatory agencies, supervisors, and finance ministries, obligations are often necessarily informal. Regulatory agencies do not have the power to unilaterally or independently enter into international treaties. Informality is thus a necessary element of cross-border, inter-agency cooperation. It also does not necessarily detract from the seriousness of the commitments made. International financial agreements often have important consequences for counterparties. Regulators commonly rely on one another in order to execute their domestic mandates. One regulator may, for example, rely on another in order to gain access to witnesses or evidence concerning a domestic violation that may be located in another jurisdiction. Where regulators fail to live up to their commitments to provide assistance, the counterparty will often internalize the costs of the defection. Perhaps it is thus of little surprise that key international agreements are often signed by heads of regulatory agencies with great extravagi-

94. See supra Introduction.
95. See Abbott & Snidal, supra note 39, at 423.
96. Id. at 425 (discussing how some international agreements are viewed as covenants).
97. Id. at 424, 427 (discussing how rationalists view international agreements as expressing contractual commitments, usually between states).
gance and in front of the media, reminiscent of treaty signings between heads of state.

As a result, noncompliance with key international standards, if discovered, will cause other countries to rethink or reevaluate their expectations concerning the regulator’s future behavior (or “reputation”). Imagine, for example, a situation in which two countries enter into a mutual recognition program whereby one party’s firms undertake changes in corporate governance to make its domestic regulatory system more palatable to the other in order for its market participants to gain preferential treatment by that regulator—and then the would-be partner decides not to implement the program and provide such treatment. Although the agreement to establish the program was nonbinding, the aggrieved regulator will be less likely in the future to enter into cooperative agreements with the defecting regulator.

Similarly, if one regulator decides, after signing a bilateral Memorandum of Understanding (MOU), not to cooperate in providing certain kinds of evidence to foreign regulators, the foreign regulators will reconsider its seriousness in cooperation and desirability as a partner with regard to future regulatory work. A regulator could thus imperil its own ability to receive similar assistance in the future and, by extension, undermine its own domestic authority. Not surprisingly, when receiving requests, regulators generally work hard to meet the expectations of counterparties under existing bilateral MOUs, and the agreements are frequently used as a basis for making requests and negotiating cross-border cooperation.

Of course, as in the hard law context, not all defections will generate the same reputational costs. As discussed above, not all commitments carry the same level of obligation.99 Furthermore, some defections may be more warranted than others.100 For example, where compliance entails considerably high adjustment costs or technical know-how, some regulators, particularly those in developing countries, may (successfully) justify their noncompliance as resulting from lack of adequate financing or human capital. Such “impracticability” arguments help deflect costs of noncompliance and shift the onus of compliance back to international standard setters, usually through technical assistance programs. Finally, some agreements may be shown over time to be ineffective—or worse, bad for financial governance. In such instances, a regulator’s defection from its commitments will not necessarily erode its reputation. To the contrary, noncompliance with widely discredited regulatory approaches could potentially enhance a jurisdiction’s reputation as a leader in the international regulatory community.

B. MARKET DISCIPLINES FOR FIRMS

Alongside the reputational dynamics presaged by classic international law is what can be considered an array of possible market disciplines that can inform

99. See supra Introduction.
100. Lipson, supra note 38, at 509.
both firm preferences and, by extension, the decisions of regulators. Where capital markets are operating efficiently, they will reward a firm when it adheres to practices that are viewed by investors as making the firm more profitable. Where, for example, firms disclose clear and useful information concerning their profits, shareholders should reward the company with higher share prices that reflect lower investment risk. Similarly, where firms such as banks and insurance companies set aside large capital cushions, shareholders will likely have more faith in the financial health of the companies, contributing to higher valuations of the firms, just as potential counterparties to financial transactions will likely be more eager to transact with them.

What precisely constitutes efficient rules or standards is, however, often debated. International financial law can help shape the perceptions of investors, lenders and other relevant market participants as to the value of any particular kind of conduct. Soft financial law may, for example, articulate norms that have yet to be systematized or articulated coherently. In pronouncing best practices or rules of thumb, such norms can reinforce or promote their own status. Similarly, soft law can create conventions where none exist by creating expectations by market participants as to how others will or should act, and in the process help nudge investor preferences. And finally, soft law can raise the profile of ideas and techniques that have yet to attain international currency.

International financial law’s influence will, perhaps not surprisingly, be especially strong where investors may not themselves know what to expect or demand from firms in light of new market or industry conditions. In these cases, international financial law can help shape the perceptions of investors, lenders and other relevant market participants as to the value of any particular kind of conduct. Soft financial law may, for example, articulate norms that have yet to be systematized or articulated coherently. In pronouncing best practices or rules of thumb, such norms can reinforce or promote their own status. Similarly, soft law can create conventions where none exist by creating expectations by market participants as to how others will or should act, and in the process help nudge investor preferences. And finally, soft law can raise the profile of ideas and techniques that have yet to attain international currency.

101. This point has perhaps enjoyed its most famous articulation in corporate law scholarship, especially with regard to the “choice” of states under domestic U.S. corporate law. See Roberta Romano, The Genius of American Corporate Law 14–24 (1993) (arguing that firms that choose states with inefficient corporate laws should have lower stock prices); Ralph K. Winter, Jr., State Law, Shareholder Protection, and the Theory of the Corporation, 6 J. Legal Stud. 251, 254 (1977) (“[C]ompetitive legal systems should tend toward optimality so far as the shareholder’s relationship to the corporation is concerned.”).

102. See David Easley & Maureen O’Hara, Information and the Cost of Capital, 59 J. Fin. 1553, 1554 (2004) (showing that differences in the composition of information between public and private information affect the cost of capital, with investors demanding a higher return to hold stocks with greater private information); Frank Gigler, Self-Enforcing Voluntary Disclosures, 32 J. Acct. Res. 224, 224 (1994) (showing that disclosures even in voluntary contexts add credibility that justify even the divulgence of proprietary information).

103. Evidence for the converse of this proposition is readily available: where banks (or for that matter any financial institutions embedded in financial systems as intermediaries) are viewed as having insufficient capital to meet their operational requirements or credit obligations, “runs” on those banks are likely. For a recent description of bank runs, see Carmen M. Reinhart & Kenneth S. Rogoff, This Time Is Different: Eight Centuries of Financial Folly 144–45 (2009).


105. This is often because rules provide a point around which market participants can converge. See Richard H. McAdams, A Focal Point Theory of Expressive Law, 86 Va. L. Rev. 1649, 1654 (2000). For an explanation as to how (domestic) rules can help direct behavior in the face of cognitive biases, see Richard H. Thaler & Cass R. Sunstein, Nudge: Improving Decisions About Health, Wealth, and Happiness (2008).
situations, soft law can provide a means of expressing observations and knowledge from a collective of diverse governmental actors, many of whom may have, due to supervisory responsibilities, insider or nonpublic information. In such situations, soft law can serve as a particularly useful prescriptive instrument and help guide investors in their investment decisions.

In any event, market participants frequently “perceive adherence to [international standards] as a mark of good regulatory practice that will enhance their reputation” and thereby “help them to obtain lower-cost funding from banks and capital markets.” The dominant corporate law scholarship has, for example, long demonstrated that some firms seek to become subject to the laws and supervision of the world’s leading financial centers so that they can signal their strong corporate governance and disclosure for investors. Alexander and Dhumale observe:

Banks and other financial firms that operate outside the G10 will adopt Basel II and other international standards, not necessarily because there will be capital savings or because it may be more convenient for risk management purposes but because they will want to signal to the world that they have moved to the latest, most sophisticated models and have received the approval of the G10 regulators.

Moreover, given their general applicability, international standards are also periodically used by financial analysts and credit rating agencies to assess the viability and future earnings of firms. Thus, where firms ignore or are not in compliance with well-regarded international standards, analysts will at times attempt to evaluate the risk embodied by the compliance gap—even where firms are still abiding by (less rigorous) national hard law obligations. In this way, they operate similarly to how scholars have conceived of U.S. corporate law—where a firm’s choices as to where to incorporate and which default rules with which to comply have been viewed as factors informing the value and cost of capital to the firm. Indeed, in some cases, adherence to standards can even affect the sovereign ratings of debt issued by governments.

106. ALEXANDER ET AL., supra note 58, at 147.
108. ALEXANDER ET AL., supra note 58, at 147.
109. For example, CalPERS, the California Public Employees’ Retirement System, has taken account of the implementation of global financial codes and standards when determining its investment list. Similarly, PricewaterhouseCoopers promulgates a global index that measures the impact of business, economic, legal, and ethical opacity and is specifically designed to show investors the implications of such for cost of capital in thirty-five countries around the world. The Opacity Index, PRICewaterhouSeCOOPeRs, http://www.pwc.fr/the_opacity_index1.html (last visited Sept. 29, 2010).
C. INSTITUTIONAL SANCTIONS

Alongside reputational and market costs, particularly egregious instances of noncompliance with international standards can trigger sanctions by and from international organizations and financial institutions. Because the IMF and World Bank are not only monitors, but also double as lenders of last resort and sources of developmental assistance, they have considerable discretion in making compliance with international standards a condition for receiving loans.\(^\text{111}\) If countries take the loans and then renege on these commitments, they theoretically risk not being able to receive loans in the future. Moreover, where loans can be made in installments, they can be used as policy tools whereby subsequent extensions are made on the basis of steps taken to comply with the standards.

Equally important, the institutional mechanisms supporting the international regulatory infrastructure can also discipline noncompliance. Although many, if not most, institutions are universal organizations, and thus open to all countries, institutions can adopt membership standards and punish those that fail to comply with the standards.\(^\text{112}\) For more exclusive organizations that often operate as governmental “clubs,” organizational mechanisms may provide for expulsion as the ultimate sanction for bad behavior.\(^\text{113}\) By conditioning access to club goods on certain behavior or conduct, governmental clubs recalibrate members’ cost-benefit analyses concerning the adoption of a standard. Compliance brings not only the potential benefits accruing with the adoption of a standard, but also those associated with membership in the club, which could include access to expertise and technical support, enforcement assistance, and expanded policy reach.

Finally, institutions can publicly signal a member’s failure to comply with particular rules or standards. Conventionally, this “name and shame” strategy is associated with public international law institutions like the United Nations and is used when states ignore widespread international law standards such as those concerning human rights and national security. However, these institutional effects can also be employed in the financial regulatory arena as a means of isolating regulators both institutionally (and at times, personally) in the international community.\(^\text{114}\) Institutionally, regulators can be viewed as second-class citizens within their own larger regulatory body. Meanwhile, regulators can face

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111. ALEXANDER ET AL., supra note 58, at 89.
113. DREZNER, supra note 5, at 75–77 (discussing clubs, standards, and the possibility of expulsion); see also Brummer, supra note 4, at 369–70.
114. Embarrassment caused by deviating from network norms operates, for some, as a kind of social tax. Adhering to network-based standards may encourage praise, and deviation may cause embarrassment or shame that results in a loss of prestige or influence among peer regulators as the violation becomes known to others. Charles K. Whitehead, What’s Your Sign?—International Norms, Signals, and Compliance, 27 Mich. J. Int’l L. 695, 709–10 (2006).
social opprobrium from counterparts in the relatively close-knit regulatory community for failing to deliver on the group’s regulatory program.

Shaming can also carry costs beyond institutional and professional reputations. By publicly identifying scofflaw club participants (as well as nonmembers who fail to abide by the club standards), institutions can create new market costs by implying or arguing that uncooperative jurisdictions suffer from poor domestic oversight and market supervision and thus are somehow risky or dishonorable places to do business. As a result, any firm operating in a jurisdiction that is not compliant with the standards of the organization can potentially incur higher costs of capital, and targeted countries may find it more difficult to attract firms to their borders.

IV. IMPEDIMENTS TO COMPLIANCE

Despite the array of tools ostensibly in place to discipline regulators and market participants, international financial law does not always work. Instead, a variety of institutional flaws hamper the compliance pull of global financial standards. As this Part demonstrates, not only is monitoring often weak, but even where it is practiced, flawed information sharing and utilization can hamper the dissemination of information on which disciplining mechanisms rely. The result of these flaws is that the risk-adjusted cost of defection is lowered, heightening the likelihood of noncompliance where significant distributional tradeoffs arise.

A. INEFFECTIVE MONITORING

The efficacy of international financial law depends in large part on the ability of regulators and market participants to identify defections and deviations from globally accepted prudential standards. Monitoring thus serves as a condition precedent to discipline insofar as it is only through the detection and evaluation of regulatory conduct that reputational, market, and institutional disciplines can operate properly. An effective monitoring system can also have important deterrent effects. Simply put, states will be less likely to risk defection if they know that there is a high likelihood that noncompliance will be detected.

Nevertheless, the architecture supporting monitoring is in many regards quite weak. For one, the surveillance of compliance with international regulatory agreements is in many ways haphazard. Full scrutiny by international financial institutions is available for a relatively finite range of instruments. For the most part, only basic (core) legislative standards promulgated by standard setters are incorporated into the financial sector assessments. More prescriptive and often lower-profile rules and standards passed by the standard setters receive little formal monitoring support. Monitoring


116. See id.

117. In practice, this means that only the best practices promulgated by the leading standard-setting bodies—such as IOSCO’S OBJECTIVES AND PRINCIPLES OF SECURITIES ORGANIZATION, supra note 70,
is left to either informal observance by other regulators or more focused monitoring by the standard setters themselves; though possibly successful, such monitoring has limited scope and legitimacy and still lacks on-site inspection.\textsuperscript{118}

Moreover, even where rules are incorporated into financial sector assessments, monitoring of compliance may remain weak. Participation in the assessment programs has until recently been largely voluntary (and remains so for many countries).\textsuperscript{119} As a result, only the best performers are likely to participate insofar as jurisdictions with weaker prudential and supervisory oversight can opt out of the assessments. Furthermore, the data provided to international standard-setting bodies are self-reported by national authorities and can depend on information often provided by regulated financial entities that are themselves subject to little supervisory oversight.\textsuperscript{120} The quality of the information provided in financial sector assessments and observance reports can, as a result, potentially be compromised. Perhaps most obvious, regulators undergoing surveillance—as well as the firms they oversee—will regularly interpret the standards in the light most favorable to their appearing to be in compliance with international standards. Additionally, many countries—particularly developing countries—may have insufficient resources for accurate self-reporting, and thus the data promulgated by regulatory authorities may not accurately depict the level or nature of compliance with international regulatory standards. Not only may regulators have insufficient human capital and compliance resources, but they may also—due to limited experience with financial supervision—under- or over-identify the steps their regimes have taken to meet their commitments.\textsuperscript{121}

These weaknesses underscore in part the broader challenge of insufficient resources inhibiting the monitoring process. Monitoring can be costly. Not only must monitors master the content and objectives of international regulatory standards, they must also familiarize themselves with the regulatory context and particularities of the examinee, a process that in its first iterations can include interviewing domestic regulators and authorities and examining the regulatory infrastructure of the client state. Furthermore, relying on state self-assessment may require the creation of technical, legal, and administrative programs to aid developing countries in their implementation pro-

\textsuperscript{118} In this regard, see supra section V.A. for a discussion of the Financial Action Task Force’s efforts against money laundering, which are limited to combating only bank compliance with money laundering principles, and supra section V.C. for a discussion of IOSCO’s Multilateral Memorandum of Understanding, which touches only on securities enforcement and not substantive matters of securities regulation.


\textsuperscript{121} See CHAYES & CHAYES, supra note 112, at 13–15.
As a result, international monitoring can be expensive and requires the devotion of considerable resources that could be used for domestic purposes by regulators. Where either examiners or examinees lack the political will to sustain such programs, however, the intensity of surveillance will likely diminish.

B. STYMIED INFORMATION SHARING

Information sharing comprises a second key function necessary for disciplinary mechanisms to work. Not only must behavior be monitored, but the resulting data on compliance must also be transmitted to reputational, market, and institutional actors, or to intermediaries of some sort.

Here again the architecture for international financial regulation is often weak. Although in some rare cases institutions may publicize noncompliance, information gained from the key surveillance mechanisms—the observance reports, the financial sector assessments, and informal surveys conducted by national regulators of approaches and techniques of homologues—have traditionally been published only with the permission of the inspected country. It thus remained largely at that country’s discretion as to whether information regarding its compliance was shared with other regulators or market participants.

Decisions to disclose have been case dependent. It is likely, for example, that market mechanisms may pressure some countries to release surveillance reports—assuming that market participants are aware that monitoring was undertaken. As discussed above, a negative report could tarnish the market and regulatory reputation of a country. A country could suffer from both a loss in credibility and higher costs of capital. Consequently, if a regulator knows or expects that a report will draw negative conclusions as to its compliance, it may be inclined not to publish the results of the document. The only disciplining mechanism working contrary to this inclination will be the desire to avoid creating a negative inference among other regulators and market intermediaries that, by choosing not to publish, the regulator is tacitly admitting that the content of the financial sector assessment was negative. Whether this is sufficient incentive remains at this point unclear, insofar as at least one-quarter of countries undergoing observance reports, most of them developing nations, have decided not to publish their financial sector assessments.

122. See id. (discussing the difficulty developing nations had implementing nuclear arms reductions agreements in the 1990s).


124. CHAYES & CHAYES, supra note 112, at 191.

125. For example, under the IMF’s Financial Sector Assessment Program, the results of an investigation of a country’s financial systems are published “only with the permission of the country.” Edwin M. Truman, The IMF and Regulatory Challenges, INT’L SPECTATOR, Mar. 2010, at 37, 49.

126. Clark & Drage, supra note 87, at 166.

127. INT’L MONETARY FUND & THE WORLD BANK, supra note 123, at 18. For developing economies the publication rate is approximately 65%, for emerging nations, 70%, and advanced economies, 100%. Id.
C. NOISY MARKETS (HYPE)

Noise, too, can undermine compliance by unduly hyping the regulatory strengths of some jurisdictions. Governments, for example, often proclaim their adherence to the highest regulatory standards in newspaper and magazine advertisements without specifying precisely what those rules are or how they may compare internationally. Similarly, stock exchanges, trading facilities, and financial institutions hold themselves out in their promotional materials as secure and safe, even though they may be based in countries where they are subject to relatively weak supervision and where few metrics are available to gauge technological or regulatory expertise.

Frothy statements of these and other varieties can often help drown out pertinent information regarding the qualitative nature of a jurisdiction’s oversight. Generally, this kind of cheap talk puts unsophisticated market participants who are unaccustomed to sorting through information at most risk. However, behavioral economics also instructs that noise can impede even sophisticated market participants, either by helping anchor irrelevant data, confirming false opinions in decisions, or allowing an overabundance of short-term information to cloud long-term judgments. Consequently, not only may firm managers be unaware of the signaling advantages (or disadvantages) of raising capital in a particular jurisdiction, but analysts, too, may not accurately price the risk (or may do so at higher cost) than would be the case in the absence of such statements. As a result, noise can help deflect or diminish costs relating to a regulator’s defections from, or noncompliance with, international standards.

D. POOR DATA INTERPRETATION

A final possible impediment to market discipline is the inaccurate market quantification of risk by reputational intermediaries. Even assuming, for the moment, that self-reporting and monitoring are effective, data has to be properly analyzed and assessed. It is unlikely, however, that this routinely occurs.

For the reasons explained above, regulators may not prioritize compliance sufficiently to invest resources into monitoring-related activities like the evaluation of member states’ financial sector assessments. Moreover, even regulators hailing from the wealthiest jurisdictions will not routinely evaluate all financial sector assessments produced by international institutions. They will instead likely focus their activities on key strategic players or particularly egregious and rule-flaunting jurisdictions.


130. This will especially be the case with thin markets or, for the purpose of this Article, where financial institutions raise money or transact with relatively little financial activity.
Meanwhile, market participants, too, may not accurately price the risk (or benefit) of a country’s compliance or noncompliance. Financial sector assessments and observance reports do not provide ratings to market participants with regard to compliance. Instead, they usually (but not always) provide “a principle-by-principle assessment of observance of [international] standard[s].”131 It is, as a result, up to market participants to judge for themselves the significance of the information collected and compiled by international financial institutions. This may present special challenges to private intermediaries, whose staff is generally trained in financial interpretation and analysis—but may be poorly equipped to determine the pricing implications of regulatory decisions.132 And even many attorneys may not necessarily appreciate the meaning of noncompliance in all cases—perhaps not surprisingly, in surveys sponsored by the World Bank, responding market participants have admitted to low utilization rates in their own work.134

131. INT’L MONETARY FUND & THE WORLD BANK, supra note 123, at 44.
132. Furthermore, even if lawyers are hired to assist analysts, no lawyer will understand all of the diverse regulatory approaches adopted by different countries, and thus general assessments of risk will be difficult and costly.
133. Id.
Reacting to these low utilization rates, some private actors have attempted to step into the breach to assist with ROSC data interpretation. The most significant of these actors has been the e-Standards Forum, a private initiative involving, among others, Oxford Analytica and the Wharton Financial Institutions Center, which assesses publicly available ROSC data and examines compliance.135 However, although these examinations are very useful, they are at arm’s length—“assessments of assessments”—and do not involve the actual monitors and the knowledge they have accumulated on the ground and via their interactions with private and public stakeholders. They depend on publicly available information and as such are at times not always reflective of existing regulatory regimes.

The ultimate result of these structural flaws is that the risk-adjusted cost of defection is lowered. Where compliance information is not produced, is not shared, or is underutilized, noncompliance with international standards can at times be a relatively costless choice for national authorities. Consequently, the likelihood of noncompliance is heightened where significant distributional tradeoffs arise.

V. ILLUSTRATIVE CASES AND EXAMPLES

International financial law’s institutional design flaws, along with the different stakes related to the promulgation of any particular rule or standard, suggest a continuum of both disciplinary power and coordination costs for national authorities and market participants. The costs for regulators and firms of adjusting to a particular standard can be significant or small—depending on context—just as disciplining mechanisms may be strong or weak. Different species of international financial law can, as a result, vary significantly with regard to their effectiveness. To provide a thorough description of such regulatory heterogeneity, this Part draws on four case studies illustrating the sometimes disparate compliance pull exhibited by international financial regulation in four increasingly high profile areas of regulation: (A) money laundering, (B) banking supervision, (C) multilateral securities enforcement cooperation, and (D) bilateral securities enforcement cooperation.

A. MONEY LAUNDERING

Some international standards require high adjustment costs and are countered with strong disciplining measures. Perhaps the best example of this kind of scenario is found in the efforts of the Financial Action Task Force (FATF)—an important “specialist” standard-setting body—to curtail money laundering through offshore financial centers.136 Money laundering—a financial transaction which generates an asset or a value as the result of an illegal act—has long been an area of interest to police and banking authorities, largely because it provides the modus operandi by which the drug trade and prostitution are financed. Still, not all countries have an interest in promoting

135. See Delonis, supra note 110, at 609.
136. For discussion of the other specialist standard-setting bodies, see supra notes 78–82 and accompanying text.
greater anti-money laundering regulations—in particular the many offshore financial
centers. Offshore financial centers traditionally serve as destinations of capital for
wrongdoers by offering, in part, lax regulatory systems and secrecy. Stricter regula-
tions would thus impede their competitive advantage and render them less attractive
venues for banking. They are, as a result, instinctively inclined not to cooperate and
have traditionally resisted doing so.137

To respond to this challenge, the FATF was launched in 1989 to improve the
international response to the challenge. As an initial effort, in 1990 the organiza-
tion drafted The 40 Recommendations—a comprehensive set of standards relat-
ing to good governance that addressed the criminal justice system and law
enforcement, the financial system and its regulation, and international coopera-
tion.138 However, given their nonbinding nature, these principles had only a limited
impact; after a decade of only partial effectiveness, the G-7—the international
forum for the world’s leading economies—pushed FATF to adopt more aggres-
sive anti-money laundering policies.139 In response to these pressures, FATF
drew up a list of codes and standards to be used to identify countries that
refused to abide with their standards as well as a schedule of possible countermea-
sures to discipline them.140 Ultimately, twenty-three jurisdictions were identi-
fied as having insufficient laws and monitoring regimes, largely on the basis of
external examinations of their laws and regulatory organizations.141

To urge reform in these jurisdictions, a stick-and-carrot approach was used.
On the one hand, the G-7 pushed for reform and offered technical assistance to
help each country make the requested reforms.142 Meanwhile, the FATF encour-
gaged its members to consider adopting countermeasures against uncooperative
states failing to improve their records, including “bolstering customer identifica-
tion requirements, requiring financial institutions to report transactions linked
with noncooperative countries, and eventually restricting or prohibiting transac-
tions with these countries.”143

These suggestions were followed by the United States, which made its “own
list of noncooperative jurisdictions and impose[d] costly requirements on U.S.
financial institutions doing business with entities therein.”144 On the interna-
tional level, the FATF threatened countermeasures against the Philippines and
Ukraine, and followed through with “sanctions on Nauru in 2001 following
reports that the country was used extensively for money laundering by the

137. See DREZNER, supra note 5, at 124 (describing how regulation reduces the rate of return for
offshore financial centers).
0,3343,en_32250379_32236920_33658140_1_1_1_1,1_1_1,00.html (last visited Oct. 26, 2010).
139. Id. at 142.
140. Id. at 142–43.
pages/0,3417,en_32250379_32236992_1_1_1_1_1,1_1_1,00.html (last visited Sept. 5, 2010).
142. See DREZNER, supra note 5, at 145.
143. Verdier, supra note 4, at 148.
144. Id. (describing relevant provision of the USA PATRIOT Act).
Russian mafia." Ultimately, “the FATF reported substantial improvements in individual countries’ practices” following these actions and its international coordination efforts. And by 2006, the FATF had removed all of the original noncooperative countries from the list. Still, various commentators have expressed skepticism regarding the effectiveness of even such robust countermeasures, because ultimate determinations of compliance by the FATF are based on external review of a country’s laws and self-reporting by the country in question.

In October 2001, shortly after the September 11th attacks, the FATF extended its mandate to cover terrorist financing. Specifically, FATF members issued new international standards, known as the Special Recommendations, which sets out the basic framework to detect, prevent, and suppress the financing of terrorism and terrorist acts. In 2003, the FATF completed a thorough review and update of The 40 Recommendations and elaborated various Interpretative Notes that are designed to clarify the application of specific Recommendations and to provide additional guidance to both members and nonmembers alike.

Nevertheless, the FATF does not enjoy a de facto indefinite life span like many international organizations. Instead, FATF members review its mission every five years; in 2004, during the most recent review, thirty-five FATF members agreed to extend the mandate of the Task Force until 2012. The FATF thus continues to be active in its monitoring activities. Members, on the one hand, participate in a mutual evaluation process whereby the FATF monitors the implementation of the FATF Recommendations through on-site reviews. Furthermore, with regard to nonmembers, the FATF’s International Co-operation Review Group continues to analyze the legislative and regulatory frameworks of high-risk and noncooperative jurisdictions, and reserves the right to recommend specific actions to induce compliance.

145. Id.
146. Id.
147. See High-Risk and Non-Cooperative Jurisdictions, FIN. ACTION TASK FORCE, http://www.fatf-gafi.org/pages/0,3417,en_32250379_32236992_1_1_1_1_1,00.html (last visited Sept. 5, 2010).
148. See, e.g., Verdier, supra note 4, at 148.
150. See supra note 138.
151. The FATF does not have a tightly defined term of action. Instead, the organization periodically reviews its mission: “The current mandate of the FATF (for 2004–2012) was subject to a midterm review and was approved and revised at a Ministerial meeting in April 2008.” See About the FATF, FIN. ACTION TASK FORCE, http://www.fatf-gafi.org/pages/0,3417,en_32250379_32236836_1_1_1_1_1,00.html (last visited Oct. 1, 2010).
152. See Monitoring Implementation of the FATF Recommendations, FIN. ACTION TASK FORCE, http://www.fatf-gafi.org/document/60/0,3343,en_32250379_32236920_34039228_1_1_1_1_1,00.html (last visited Oct. 1, 2010).
153. See High-Risk and Non-Cooperative Jurisdictions, FIN. ACTION TASK FORCE, http://www.fatf-gafi.org/pages/0,3417,en_32250379_32236992_1_1_1_1_1,00.html (last visited Oct. 1, 2010).
B. BANKING SUPERVISION

An interesting counterpoint to such instances of strong discipline can be seen in the banking context with the Core Principles for Effective Banking Regulation (Core Principles), a high-level compendium meant to assist national authorities in establishing and maintaining high regulatory standards. First published in 1997, the Core Principles are generally regarded as the global standard for judging the quality of countries’ banking supervision systems.

As such, the Core Principles articulate twenty-five regulatory governance standards for bank regulation. Among them are principles concerning the objectives, powers, and resources a supervisory system ought to have in place for its effectiveness. Other principles address the permissible activities of banks and prudential regulations that ought to be imposed on banks—including capital-adequacy requirements. Meanwhile, other principles relate to the kinds of remedial measures supervisors should apply when banks do not meet prudential requirements and also address key issues of cross-border banking—like information sharing and the application of global consolidated supervision over internationally active banks.

For the most part, the Core Principles are couched in broad and flexible terms. Still, compliance with them can require that actors expose themselves to a variety of significant costs. Garnering the resources for an effective banking supervisor, for example, can be expensive, and many countries would rather put such resources elsewhere. Moreover, compliance with some of the more demanding prudential regulations embodied in the Core Principles could undermine the competitiveness of domestic banks that leverage light regulatory oversight in order to engage in higher yielding (albeit risky) investment activities.

Yet despite these costs, the Core Principles as a whole are backed by relatively light discipline. Historically, countries have been encouraged, though again, not necessarily required, to undertake financial sector assessments by the IMF. Moreover, as a set of qualitative guidelines, their use by market participants has been limited. Of the twenty principles, perhaps only the Sixth clearly employs what are ultimately quantitative means of assessment. Specifically, it obliges supervisors to impose requirements that are not less stringent than those under the Basel capital adequacy accord for internationally active

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155. See id. at 2.
156. See id. at 5–7.
158. Id.
159. Id. at 10. Other kinds of assessments do, however, take place. Id. at 11.
160. See id. at 23–24.
Compliance with this requirement can in many cases be bolstered by the work of accountants, auditors, and credit-rating agencies that use or inspect such data on the individual-firm level in the course of their own market activities. The other principles, however, are less empirically determinable and require interpretation by banks as to both whether supervisors have complied with their obligations and, equally important, the macroeconomic significance of noncompliance. They thus involve significant transaction costs for reputational intermediaries and monitoring of compliance with them is weak.

Perhaps not surprisingly, surveys of national regulators over the last ten years suggest that many of the Core Principles have been implemented only haphazardly across jurisdictions—even with the high level of generality embraced by the Core Principles. Although most developed countries that were assessed by the IMF and World Bank have been shown to be fully compliant with the code, a recent 2008 study indicated that low- and low-middle-income countries complied just over half of the time. Meanwhile, noncompliance in some areas has been deemed widespread across all countries regardless of wealth and geographic location. For example, “Nearly half the assessed jurisdictions [did] not meet the standards espoused in three principles dealing with the supervision of bank risk management for country, market and ‘other’ risks (e.g., liquidity, foreign exchange, operational, interest rate, and business and legal risks).” And, although “most jurisdictions applied a risk-weighting framework along the lines of Basel I for credit,” demonstrating its pervasiveness as an international standard, the “requirements were not applied on a consolidated basis” across firms, and key risks (including market risk) were not always incorporated into the capital calculation. It was thus, in practice, often under-implemented, even if adopted in name.

161. Basel I employs, for example, a fairly simple ratio for determining the amount of capital a bank must hold on its books that is based on the riskiness of the activities of the bank in question. See Tarullo, supra note 64, at 14. Regulatory capital requirements are consequently easily determined by financial intermediaries. Importantly, however, even these rules may be supplanted by new bank-friendly approaches (Basel II) that rely on self-evaluations and implementation by the largest and most systemically important banks. See id. at 25–26.

162. This is particularly the case for principles that rely on terms that are not defined in the language of the agreement. For example, the nineteenth principle states, “An effective banking supervisory system requires that supervisors develop and maintain a thorough understanding of the operations of individual banks and banking groups.” BASEL COMM. ON BANKING SUPERVISION, CORE PRINCIPLES FOR EFFECTIVE BANKING SUPERVISION 4 (2006), http://www.bis.org/publ/bcbs129.pdf. What this means in practice is, however, far from clear, and it will be difficult (and costly) for banks to determine without any empirical or quantitative data point.

163. This appears to be a feature germane to basic principles and standards forwarded by international standard-setting bodies. See Brummer, supra note 4, at 347 (suggesting low compliance with IOSCO Principles).


165. Id. at 11.

166. Id. at 13. Additionally, the report mentions that lower risk weights were, at times, applied in some categories and that there is an absence of clear authority among government officials to respond to failures by banks to meet minimum capital requirements. Id.
This low compliance with the Core Principles is in many ways predictable.\footnote{167 Indeed, similar codes have met even less respectable fates in other sectors. See Brummer, supra note 4, at 346–49 (showing low compliance of IOSCO member states with the organization’s Objectives and Principles of Securities Organization).} As mentioned above, adjustment costs accompanying the adoption of some principles are often significant, especially where local banks may have to forgo investment opportunities that, due to stiffer prudential regulation and supervision, account for higher risk by increasing their capital reserves. Furthermore, countries can adopt the standards in name, though not actually implement them fully in practice, a tactic especially available where monitoring (and by extension, market or official sector discipline) is low or nonintrusive. Indeed, even where market disciplines may be stronger, as with capital adequacy, considerable evasion of implementation may be possible and is indeed common. Thus, from this perspective, the value of the Core Principles has at least traditionally been in their normative salience as aspirational instruments with which to convince the international community of regulators of best practices, and not as prescriptive articulations carrying coercive “legal” import. Yet even as such, the Core Principles, like their counterparts in other fields, were highly negotiated instruments, perhaps as much due to their long-term, agenda-setting significance as for any short-term demands on compliance by a particular set of national regulators.

C. MULTILATERAL SECURITIES ENFORCEMENT COOPERATION

Not all adjustment costs are as significant as those seen in substantive legal changes embodied by money laundering or core regulatory principles; to the contrary, in many circumstances they can be relatively modest. Still, coordination may be bolstered by strong disciplining mechanisms. This will be the case especially when a multilateral regime is being developed and opportunities to shirk may increase due to difficulty in monitoring. One example of strong disciplining in the context of low adjustment costs is found in the Multilateral Memorandum of Understanding (MMOU) sponsored by IOSCO. The MMOU provides that signatories will, within its framework, provide each other with the assistance necessary to enforce their respective securities laws and regulations.\footnote{168 INT’L ORG. OF SEC. COMM’NS, MULTILATERAL MEMORANDUM OF UNDERSTANDING CONCERNING CONSULTATION AND COOPERATION AND THE EXCHANGE OF INFORMATION 12 (2002), http://www.iosco.org/library/pubdocs/pdf/IOSCOPD126.pdf.} In doing so, the MMOU memorializes a process through which regulators can consult one another when witnesses, evidence, or the proceeds of fraud are located in one another’s jurisdictions. It also requires the enhancement of each signatory’s enforcement powers and the identification of cross-border points of contact for enforcement purposes.\footnote{169 For a fuller account of the MMOU, see Brummer, supra note 4, at 366–68.} Often, foreign counterparts do not have the required domestic authority to assist counterparts seeking to enforce their laws, so the MMOU obliges signatories to
seek it from their respective legislators.\footnote{See Tafara & Peterson, supra note 20, at 58.}

Because this agreement speaks to enforcement, and not substantive areas of convergence, full compliance, as compared to the \textit{Core Principles}, involves far fewer adjustment costs. No radical changes in firm behavior are required:

Although regulators might have to seek additional political powers from their home governments, as well as the resources to live up to their commitments under MMOU, domestic firms are not required to undergo any new compliance procedures. As a result, for many regulators, coordination is already very much an assurance game merely in need of information sharing to facilitate coordination.\footnote{Brummer, supra note 4, at 373.}

It is only for a minority of regulators of smaller markets, or perhaps more politically sensitive markets, that cooperation involves significant tradeoffs.\footnote{Id.}

Nevertheless, the MMOU is buttressed with robust disciplining mechanisms. Verification is inherent to participation: regulators must formally indicate their commitment to mutual cooperation and assistance among IOSCO members, as well as demonstrate that they have the rights and powers under their own national law to comply with the terms and conditions of the agreement.\footnote{See \textsc{Int’l Org. of Sec. Comm’ns}, supra note 168, at 12.}

This process involves the applicant regulator filling out a questionnaire soliciting information concerning the regulator’s home state laws that enable it to carry out the terms of the MMOU.\footnote{See id. at 16–18.} Based on a review of the questionnaire responses, IOSCO verification teams then make specific recommendations to a screening body regarding an applicant’s ability to comply with each MOU provision cited in the questionnaire.\footnote{See id. at 12.} A decision is then finally made by IOSCO officials as to whether to accept the application. An applicant whose application is rejected is required to upgrade its national regulations such that they are compliant with MMOU dictates.

Additionally, IOSCO membership and its attendant advantages are used as coercive tools with which to persuade regulators to opt into the agreement. If the relatively few regulators who are not currently members of IOSCO refuse to sign the MMOU, they will be unable to accede to the only multilateral forum for international policy development in the area of international securities regulation. Furthermore, existing members are required to sign the agreement by 2010, or commit to seeking the legal authority that would permit the member to become a signatory.\footnote{See id. at 13.} Under the second scenario, a member would be listed in “Appendix B,” an attachment to the MMOU—and in the process face

\begin{footnotes}
\footnote{See Tafara & Peterson, supra note 20, at 58.}
\footnote{See id. at 16–18.}
\footnote{See id. at 13.}
\end{footnotes}
possible stigmatization, as well as potential expulsion. Already, seventy-two members have become signatories to the MMOU or are under review by the screening group and verification teams. The number of IOSCO members listed in Appendix B is comparatively low.178

D. BILATERAL SECURITIES ENFORCEMENT COOPERATION

Finally, international financial law can also employ weak disciplining mechanisms in the face of coordination problems involving low adjustment costs. Here, a nice contrast to the MMOU can be seen in bilateral MOUs between securities regulators—the traditional means by which enforcement cooperation has been promoted.

Bilateral MOUs are associated with first-generation attempts at cross-border cooperation for enforcement. Like the MMOU, they entail low adjustment costs. Indeed, many entail fewer adjustment costs than even the MMOU, which requires more extensive capacity building and assistance provision by regulatory authorities. They thus can be seen as imposing fewer restraints on a country’s self-determination and self-governance, though they are still quite helpful in terms of increasing cooperation and the means by which fraud is addressed across borders.

As a (partial) consequence of these lower adjustment costs, the disciplining mechanisms have been far weaker. For one, no inspection of a country’s facilities is required under the bilateral MOUs, and securities authorities do not undertake surveillance of implementation or publish lists of regulators that have failed to implement measures. Instead, countries are, as indicated above, generally exposed post hoc to evaluation and monitoring whenever called on by their counterparts for assistance as provided for by the agreement. Where assistance is not provided, a country’s reputation may suffer, and future assistance from the affronted counterparty may not be as forthcoming as would ordinarily be the case had cooperation been offered. Thus, reputation and the prospect of reciprocal noncompliance act as the primary means of disciplining authorities.

E. A THEORETICAL INTERPRETATION

The various scenarios sketched out above can be theorized as arising along various intersections of both adjustment costs and disciplinary power. Adjustment costs may be substantial, making coordination more difficult, or they may be minor or even nonexistent. Similarly, international financial regulation may be backed by strong or weak disciplinary mechanisms, the (net) strength of which is determined by the kinds of tools employed and the effectiveness with which they operate.

The Financial Action Task Force, for its part, represents a case in the

northwest quadrant of Figure 3, where high adjustment costs were met by strong disciplining mechanisms. These disciplining mechanisms, though still far from perfect given the self-reported nature of some monitoring, seem to have incentivized coordination and most degrees of implementation among blacklisted countries. Meanwhile, the Basel Core Principles, which best fit in the northeast quadrant, were relatively ineffective, in large part because full compliance involves considerable adjustment costs, yet there are relatively weak monitoring mechanisms in place. The Multilateral Memorandum of Understanding used relatively strong disciplining mechanisms in the face of modest adjustment costs in the enforcement cooperation context, as represented by the southwest quadrant. Meanwhile, bilateral agreements, which fit in the southeast quadrant, also operated in the context of low adjustment costs, but had no formal disciplining mechanisms in place, in part due to the de facto monitoring that occurred when regulators were called upon to live up to their commitments.

Together, the case studies illustrate that where weak disciplining mechanisms are employed, coordination will likely only arise where members have high incentives to cooperate and adjustment costs are small. In areas where significant distributive problems arise, however, adjustment costs will often be high, and noncompliance will not be possible. Instead, only when strong disciplining measures are used—usually through a mix of monitoring mechanisms that impose reputational and market costs—is coordination possible. Non-Financial Action Task Force members, for example, were disinclined and indeed had no incentive to adopt and implement stricter money-laundering rules until shaming raised the prospect of negative market implications. Similarly, the MMOU’s inspection apparatus ensured close monitoring, as the prospect of being identified as nonconforming imposed high costs on states that might ordinarily have been disinclined to adopt regulatory reforms (and costs).

Not all disciplinary measures are alike, just as adjustment costs are different
depending on context. Substantive changes in a regulator’s regime are far more likely to be more costly than improving the domestic regulatory architecture for enforcement cooperation.179 Whereas the former may impose changes on both the government and firms, and in some ways even erode the competitiveness of financial centers, the latter only involves changes from regulators that will often heighten the power of domestic regulatory agencies and help ensure the inviolability of domestic rules and statutes.180

Similarly, institutional sanctions may have an even greater impact than market disciplines, at least as they currently operate. By definition, institutional sanctions can involve organizational shaming, and by consequence, market repercussions. Meanwhile, market disciplines or a regulator’s reputation in the international community of regulatory authorities provides weaker disciplinary responses given problems inherent to the surveillance process relied upon by standard setters.

Why then do regulators not always incorporate more organizational disciplines into cross-border financial regimes? Likely for reasons similar to those that make hard law difficult to propagate: organizational responses will, necessarily, require deeper coordination than other forms of disciplines that rely only on monitoring. Agreement must arise among regulators that noncompliance merits sanctions of some sort, and then the group must be able to agree on the appropriate punishment. Due to such coordination barriers, organizational responses have thus far been limited to narrow issue areas, such as money laundering and enforcement cooperation, and not broad regulatory objectives like core principles of regulation. Where such institutional responses have been employed, however, their coercive effect has been significant and helped direct the behavior of regulators in ways that are not obviously in their immediate interests.

VI. INTERNATIONAL FINANCIAL LAW AS “HARD” SOFT LAW

The prospect of coercive international financial law, whatever its structural flaws, compels a rethinking of long-held conceptions of soft law introduced at the outset of this Article. Defining coerciveness along the lines of legal obligation is a highly imperfect exercise: although international financial law is “soft” in terms of its formality, it can in practice be quite “hard.” This overlooked characteristic of soft law raises new normative and practical concerns that have largely escaped scholarly attention. First, the institutional design of international standard-setting bodies carries greater stakes because democratic deficits in organizational structure can have new significance from the standpoint of legitimacy. Second, international financial law’s potential coerciveness creates new implications for regulatory and market efficiency that can help determine

179. See Brummer, supra note 4, at 373.
180. See id.
the optimality of the existing financial architecture.

A. BEYOND THE HARD LAW, SOFT LAW DICHOTOMY

The complex operations of the international financial system challenge traditional academic frameworks that classify hard and soft law along easily cognizable levels of legal obligation. International financial regulation imposes no formal legal requirements on parties and as such is consistently regarded by scholars as soft law. Nevertheless, international financial regulation, at its strongest, defies a number of common and indeed foundational assumptions regarding the operation and compliance pull of informal legal obligations.

First, international financial law weakens, and arguably dispels, the general criticism of soft international law as inherently less coercive—and by consequence, less credible—than hard international law. As we have seen, theorists generally presume that although hard law may make coordination more difficult, it is ultimately more durable. This is because legalization is seen as imposing reputational harms that soft law cannot. In short, defections from agreements are violations of international law, which make cooperation in the future more difficult. Furthermore, legalization presumably legitimizes retaliation that forces states to internalize the consequences of their decisions.

As we have seen, however, similar disciplines can be realized even under soft law regimes. Reputational costs can still be high, even where agreements are informal. Indeed, where regulators fail to live up to their commitments, it may be more difficult for them to put forward their policy preferences in the future, and market participants may internalize higher costs of capital. Furthermore, regulators have leveraged and are capable of leveraging institutions and markets in ways that make defection from even informal law more costly.

International financial regulation also challenges traditional conceptions of hard law as a qualitatively different form of regulatory control exerted by national authorities. As Abbott and Snidal argued in their classic article *Hard and Soft Law in International Governance*, hard law has long been considered more technocratic than its soft law counterpart:

Legalization entails a specific form of discourse, requiring justification and persuasion in terms of applicable rules and pertinent facts . . . . [T]his discourse imposes some constraint on state action: governments will incur reputational costs within the legal community, and often beyond, if they act without a defensible position or without reasonable efforts to justify their conduct in legal terms.181

Such features cause formal international law to be viewed as uniquely capable of mobilizing legally oriented interest groups and expanding the role of legal bureaucracies “within foreign offices and other government agencies.”182

182. Id. at 428.
However, under close inspection these ostensible comparative advantages do not always ring true with regard to all soft law. Certainly, international financial legislation—like many species of hard law—is often pitched at high levels of generality in order to gain consensus from parties. International financial law, however, can also be prescriptive—and, as such, can involve implementing methodologies, specific rules, and clarifying language that lend considerable “legality” to its substance. Furthermore, because of its general applicability, it too involves considerable participation from bureaucracies (and indeed greater specialization therein on foreign affairs issues), lobbyists, and, at times, the private bar.

Ultimately, then, international financial regulation suggests that attempts to classify law as soft or hard on the basis of formal legal obligation is fraught with hazard, and may indeed be impossible. In some ways, employing the soft law label disguises the potential effects on regulatory activities and expectations.183 Moreover, it overlooks that the true nature of “legality” may not be so much the formal status of a particular rule, but the range and activity of supplemental measures supporting the legal mandate.

Collectively, these observations seem to underscore Andrew Guzman’s recent observations that in many ways hard law and soft law operate along a spectrum, and are not dichotomous or qualitatively different forms of regulatory control.184 As with public international law more generally, a hierarchy of rules is not, as Guzman notes, easily recognizable. And the degree to which rules are “binding” should not be conflated with whether they imply a formal legal obligation.185

This is not to say, of course, that international financial regulation is like all other forms of international law. Unlike traditional public international law, or even other areas of the law that address global challenges like human trafficking or the environment, international financial law inherently engages a wider tool set for regulatory discipline. Reputational disciplines are available, along with

183. See Chinkin, supra note 104, at 866 (noting how soft law and hard law designations disguise the role both generally play in international law); see also Andrew T. Guzman & Timothy L. Meyer, International Soft Law, J. LEGAL ANALYSIS (forthcoming 2010) (manuscript at 4) (on file with author) (explaining how soft law is best described as operating along a spectrum). Indeed, a dynamic relationship between “hard” and “soft” law may exist. See Gregory C. Shaffer & Mark A. Pollack, Hard vs. Soft Law: Alternatives, Complements, and Antagonists in International Governance, 94 MINN. L. REV. 706, 710–11 (2010) (noting that not only may soft law regimes be hardened through other regimes, but hard law regimes, too, can be “softened” through linkages to new and emerging soft-law principles).

184. Guzman & Meyer, supra note 183. This idea has in some ways been additionally identified by Robert Ahdieh, who identified regulatory “cues,” effectively nonbinding regulatory strictures between governments, as defined along “some continuum of relative ‘coerciveness.’” Robert B. Ahdieh, Between Mandate and Market: Contract Transition in the Shadow of the International Order, 53 EMORY L.J. 691, 743 (2004). It has also been implied in the recent work by Ryan Goodman & Derek Jinks. See Ryan Goodman & Derek Jinks, How to Influence States: Socialization and International Human Rights Law, 54 DUKE L.J. 621 (2004) (noting how states can be socialized more effectively by making obligations precise and membership to some international organizations contingent).

185. See Guzman & Meyer, supra note 183, at 5.
in institutional remedies, each of which can speak to commitments with various degrees of solemnity. Furthermore, international financial regulation can also apply to or engage market participants, and in the process potentially speak to a far greater range of (distributive) coordination problems than the traditional soft law as envisioned in the traditional public international law literature.

B. LEGITIMACY TRADEOFFS

Yet, to the extent that international financial law is coercive, it can pose significant problems from the standpoint of legitimacy. Most democratic theorists consider legitimacy a key aspect of sound governance; they find it essential that individuals have a voice in shaping the substance of the rules that affect their lives and that when representatives make decisions for others, they should be held accountable for their decisions. For this reason, scholars have frequently been skeptical of the significant role of regulatory authorities—and specifically “independent” agencies like the SEC and Federal Reserve—in formulating and executing financial policy. Because policymakers in such agencies are not generally elected by the public and, once appointed, are often not easily removed by even democratically elected officials, policymaking is to some degree unaccountable to the public and therefore, in the eyes of some, illegitimate.

Whether the existing international architecture exacerbates these challenges is a point of frequent debate. For observers like Daniel Tarullo, international rules can make supervision of cross-border firms difficult, especially where firms can at times be left to implement international standards. Michael Barr and Geoffrey Miller, on the other hand, argue that the international regulatory system has undergone a significant administrative evolution and point out the increasing prominence of public notice and consent procedures. Moreover, in the case of important pieces of legislation like the Basel capital accord, international coordination may even spur the bolstering of domestic review by national authorities.

More difficult to countenance is the sometimes limited participation of countries in setting global rules. As we have already seen, many international standard setters, like the Basel Committee, the G-20, and the Financial Stability Board, are exclusive in their membership or dominated by a narrow band of (usually rich or rising) countries. And even universal organizations like IOSCO may have tight-knit policy cores. Because of these institutional design features,

186. See Anderson, supra note 4.
187. See generally Rüdiger Wolfrum, Legitimacy in International Law from a Legal Perspective: Some Introductory Considerations, in Legitimacy in International Law 1, 6–24 (Rüdiger Wolfrum & Volker Röben eds., 2008) (discussing legitimacy and consent in the context of international law).
188. See Tarullo, supra note 64, at 5, 21.
outsiders to policy cores may be subject to what Michael Dorf describes in a similar context as a de facto “dynamic incorporation” of financial laws, where standards adopted overseas are incorporated domestically with little participation by domestic political leaders.¹⁹⁰ This “mini-lateralist” organizational dynamic arguably violates fundamental principles of international cooperation by allowing institutions to arrogate important financial decisions that should be shared by all countries.¹⁹¹ It also erodes the sovereign rights of small countries by making rules that it expects other countries to follow.¹⁹²

The nonrepresentative nature of these institutions can also have serious policy implications. Regulators, either individually or as a group, may be more inclined to put forward policies that promote or protect their respective market participants, possibly at the expense of nonmembers.¹⁹³ Against the backdrop of institutional design considerations, such considerations suggest that distributive issues are much more likely to be decided in favor of those with direct policy input. Equally important, participants in exclusive organizations—especially those organizations that rely on consensus—may have important sway over the nonproduction of rules insofar as members, again often wealthy countries, can block the production of global welfare-enhancing rules that may disadvantage their local market participants. As a result, soft law presents, as Eilís Ferran and Kern Alexander note, a paradox whereby “success in terms of practical effectiveness feeds the intensity of concerns about the accountability and legitimacy of the relevant actors.”¹⁹⁴

Nevertheless, there are compelling reasons to rationalize the ostensible democratic deficit inherent in international financial regulation. For one, wealthy countries have more experience in the regulation of large, complex financial markets, which makes them the most obvious sources of sound financial laws. The rise of global financial markets is quickly changing the distribution of market (and by extension, regulatory) talent, especially in countries like Brazil, India, and China. However, the growth of foreign financial centers is still a

¹⁹². This has, perhaps not surprisingly, led to at times significant public criticism by outsiders. Indeed, at least one commentator has gone so far as to liken the evolving financial architecture as reminiscent of Prince Metternich’s concert of great powers in Vienna which, among other things, was hostile to democracy and set the stage for imperial conquests later that century. See Anders Åslund, Op-Ed., The Group of 20 Must Be Stopped, FIN. TIMES, Nov. 26, 2009, http://www.ft.com/cms/s/0/d0e0f214-da55-11de-933d-00144feabdc0.html.
¹⁹³. See Anderson, supra note 4.
relatively new development, and few countries have the technical expertise and experience in financial regulation present in leading developed countries to make the same kinds of policy judgments or analyses. Thus the “input” deficiencies with regard to participation may be legitimized in part by the higher quality (and likely more responsive) “output” made possible by more streamlined and experienced decision making.

Second, although undeveloped and emerging nations may be affected by international financial rules, wealthier developed countries generally have more at stake in complex financial rule making. For example, some countries may have a relatively small or concentrated domestic investor base and, therefore, may have less at stake or even less interest in developing sophisticated disclosure or investor-protection regimes. Similarly, if a country is not the site of a leading trading platform or stock market, and has no designs on entering the trading industry, it may have less interest in developing appropriate rules for market microstructure and trading. It is thus logical, and perhaps appropriate, that the key decision makers and crafters of legislation on the matter be those countries that are most affected. Greater numbers of jobs will likely be tied to the successful functioning of the relevant market or industries, giving those countries a stake in the health of the global financial system.

Finally, there are at least some reputational constraints on the ability of even rich countries to operate internationally. It is, for example, likely that illegitimacy itself creates reputational costs that weaken the costs of defecting from the international standard. That is, where rules are viewed by the international community as illegitimate or biased towards certain actors, the cost of one regulator’s decision not to conform to a particular rule may be minimal. Thus, for international financial rules to be both persuasive and coercive, members in standard-setting bodies must refrain from overtly biased or self-serving decision making.

C. SOFT LAW AND EFFICIENCY

Whether the “harder” guises of international financial law will promote efficiency will depend on the nature of the underlying rule. Where rules are welfare enhancing, more coercive laws can help improve compliance by regulators and with it the realization of welfare-enhancing effects. However, “hard” soft law also carries risks. Above all, regulators, too, are prone to errors caused by poor judgment, inadequate information, political lobbying, and hubris.

195. See, e.g., Cunningham, supra note 31, at 273 (noting how Japanese and some European systems have concentrated corporate ownership structures that make sophisticated legal regulations unnecessary).


And where regulators get rules wrong, the costs of error can be internalized by a broad set of actors—and in such circumstances, the more coercive and broadly based the international regime, the greater the costs of regulatory error.  

These risks are far more than theoretical. International standard setters often fail to provide guidance for emerging challenges and commentators have judged existing international regulatory standards, especially in the wake of the global financial crisis, to be inadequate. And even where global standards speak to important challenges, they may be poorly crafted or lacking in important ways. Capital adequacy standards, for example, failed to fully appreciate the conflict of interests of credit rating agencies when assigning to them important roles for evaluating bank risk and off-balance sheet credit risks, just as codes of conduct and best practices failed to fully address financial innovation and new financial instruments.

Rules are also unevenly enforced. This can be due to breakdowns in transparency and information, such that the detection of violations is difficult, or it can be due to the scope of enforcement. Consider, for example, the conditionality requirements imposed by IMF and World Bank loans, which, as discussed above, oblige countries seeking financial support packages to either commit to or implement international standards promulgated by organizations like the Basel Committee, IAIS and IOSCO. This approach is perhaps effective in helping to incentivize compliance with international standards, but has no effect on (generally wealthy) countries that are not recipients of IMF and World Bank assistance. However, as the recent financial crisis has demonstrated, financial crises can also be generated in the West—and indeed, even on Wall Street. As a result, reliance on conditionality requirements will not effectively speak to the varied sources of financial risk in the global marketplace. This under-inclusiveness of enforcement will erode efficiency where rules are welfare enhancing.

At the same time, enforcement may also be directed in ways that are not

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198. This has been, in the eyes of some, especially apparent where one views the larger set of conditions the IMF has imposed on countries in crisis. See Stiglitz, supra note 13, at 44 (arguing that some economic conditions imposed by the IMF actually reduced likelihood of payment insofar as they exacerbated the short term health of the economy).


200. Id. at 34–35. As Dani Rodrik explains,

The Basel process, viewed until recently as the apogee of international financial co-operation, has been compromised by the inadequacies of the bank-capital agreements it has produced. Basel 1 ended up encouraging risky short-term borrowing, whereas Basel 2’s reliance on credit ratings and banks’ own models to generate risk weights for capital requirements is clearly inappropriate in light of recent experience. By neglecting the macro-prudential aspect of regulation—the possibility that individual banks may appear sound while the system as a whole is unsafe—these agreements have, if anything, magnified systemic risks. Given the risk of converging on the wrong solutions yet again, it would be better to let a variety of regulatory models flourish.

welfare enhancing. Again, institutional disciplines are instructive. Because sanctions are driven by the prerogatives of member states who themselves can err, it is possible for institutions to unwittingly punish regulators that do not comply with rules that are welfare diminishing (both for themselves and globally). Specifically, they can shame noncomplying regulators (as with the Financial Action Task Force) or possibly even exclude regulators and firms from participating in international organizations (as in the MMOU).

Market disciplines, in contrast, have the advantage of at least dovetailing with market preferences, which usually (though not always) comport with efficiency and will not necessarily even demand compliance with the international rule. In other words, if the market demands compliance with a particular rule or standard, premiums will be demanded of nonconforming market participants. On the other hand, if the market judges the rules as inefficient, there will be no market penalties. Indeed, from this perspective, market disciplines are not disciplines per se, but arbiters of efficiency.

How well, of course, even market participants fulfill this task will be context dependent. As discussed above, the current architecture is not without its deficiencies. Information is not always shared with market participants, and even where it is, the information may be too costly to be deciphered and thus may remain unused or not fully examined. In the former case, there will be very little market incentive to adopt (or reject) international standards. Compliance will instead rely on reputational and, if applicable, institutional pressures that may not necessarily conform with market preferences. Meanwhile, in the latter case, market participants may draw the wrong lessons from the data and either underreact or overreact in the risk premiums they assign to markets.

The imperfections in the international financial system suggest that significant inefficiencies undergird the system. International financial rules will carry varying degrees of sway, the extent of which will be largely unpredictable. Thus, although international financial law can work positively to both promote coordination and constrain defection, it demonstrates considerable structural weaknesses—including, perhaps most importantly, a limited compliance pull even where disciplines are ostensibly in place.

VII. A BLUEPRINT FOR MODEST REFORM

The relative absence of a uniformly robust and comprehensive regulatory architecture has led some scholars, especially in the wake of the global financial crisis, to suggest that an overhaul of the international financial system is in order. For the most part, calls for reform have focused on the establishment of either centralizing global regulatory activities or, as classical international legal theory predicts, on further legalization of financial law through “hard” international treaties. In that way, it is argued that the global marketplace can be better governed and future systemic risks anticipated and managed.

This Part shows, however, that less dramatic—and likely more effective—changes can be introduced in the international system to increase the effective-
ness of international financial law. Specifically, instead of focusing on the legalization of international financial law, more useful reforms can amplify the pull of international regulations by improving the institutional support system promoting monitoring and information sharing. In that way, not only would the compliance pull of good regulations be enhanced through the application of risk premiums to capital, but the quality of international standards could themselves undergo checks and scrutiny to ensure the application of best standards.

A. THE IMPRACTICALITY OF A GLOBAL FINANCIAL REGULATOR

The global financial crisis has highlighted the shortcomings of existing regulatory architecture like never before. As governments across the world have reeled from the unprecedented economic fallout of financial failure among key financial institutions, the crisis has revealed in stark terms the global risks of poor financial oversight. In response there have been, not surprisingly, growing calls for improved global governance of cross-border transactions and financial institutions.201

The appropriate nature and scope of reform remain, however, hotly debated. Some advocates, especially policymakers in Europe, have called for the establishment of a global financial authority.202 The strongest version of this type of proposal suggests the establishment of a new World Financial Organization (analogous to the World Trade Organization), in which countries seeking access to foreign markets for their financial institutions would have to become members and meet the organization’s obligations for supervision and regulation.203 An independent body of experts would then decide whether countries have met


202. See JOHN EATWELL & LANCE TAYLOR, GLOBAL FINANCE AT RISK: THE CASE FOR INTERNATIONAL REGULATION, at x (2000) (proposing the establishment of a World Financial Authority to act on a global level in the way that national-level financial regulators act); see also FIN. SERVS. AUTH., supra note 201, at 9 (arguing for the establishment of colleges of supervisors for the largest complex and cross-border financial institutions). This is not, however, an entirely European view, especially with regard to securities law experts. See Eric Pan, Challenge of International Cooperation and Institutional Design in Financial Supervision: Beyond Transgovernmental Networks, 11 Chi. J. INT’L L. 243, 283 (2010); see also Eric C. Chaffee, The Internationalization of Securities Regulation: The United States Government’s Role in Regulating the Global Capital Markets, 5 J. BUS. & TECH. L. 187, 191 (2010) (arguing for the centralization of international securities regulation).

203. See ALEXANDER ET AL., supra note 58, at 162, 165 (arguing for the establishment of a Global Financial Governance Council based on treaty commitments by countries to abide by the highest regulatory standards); cf. Arner & Taylor, supra note 53, at 15–26 (discussing possible “hard law” approaches to international finance using the WTO, IMF and European Union or creating a new international regulatory body).
their obligations.204

Under an alternative version of this approach, an existing international organization like the Financial Stability Board or the International Monetary Fund (or even a new organization altogether) should be empowered to not only more vigorously survey and monitor regulators, but also, when necessary, issue rules regarding individual market participant behavior and conduct.205 Ideally, some have suggested, these rules would include consequences for states that fail to comply with the rules and even have direct powers of enforcement against financial institutions of all stripes for breaches of the rules. In light thereof, some academics have gone so far as to suggest formal treaties undergirding the international financial system in ways that mirror other contexts, such as trade.206 In this way, it is argued, gaps in systemic risk regulation and coordination problems stifling regulatory cooperation could be addressed.

As Blackmore and Jeapes note, the idea of “[a] single regulator with a global remit is at first blush an appealing idea promising fewer gaps in multinational regulation, less national competition between regulators and governments . . . , elimination of regulatory fault lines, greater transparency and more consistent application of the rules.”207 Aiming directly at the once-vaunted advantages of networks, current proposals imply the need for some form of global body to help coordinate agreement between countries on reforms as well as possibly to ensure consistent implementation of reform once agreed upon. A global regulator or a “college” of regulatory supervisors “would, it is hoped, also be able to identify and take measures to deal with global macroeconomic imbalances” and risky activities taken by global firms.208

Centralizing cross-border regulatory authority is not, however, without serious challenges that border on the impracticable. Perhaps most obvious, it would be almost impossible to generate the impetus sufficient to create a single, global regulator, because nations would likely refuse to cede sovereignty to such a regulatory body. The establishment of a global authority would require countries to delegate authority to a supranational authority, an act involving a “dynamic” delegation of authority such that any decision made by that authority would, de facto, create changes in the domestic laws of member regulators.209 It

204. ALEXANDER ET AL., supra note 58, at 165.
206. See supra note 205.
207. Blackmore & Jeapes, supra note 201, at S113.
208. Id. at S113.
209. Dorf, supra note 190, at 103.
is unlikely that the legislatures of most countries would agree to such an infringement on their domestic powers of policymaking and governance, especially with regard to large domestic financial institutions and firms. Financial regulation is also, as some scholars have recognized, increasingly linked with monetary and macro-economic policy as well as to the central banks’ role as lenders of last resort. These functions are all performed by state entities, and as such nation states are not very likely to cede power to a global financial regulator while they retain the responsibility as liquidity and capital providers of last resort and the guardians of taxpayers’ money.

Indeed, only some European countries have succeeded in centralizing vast swaths of financial authority in a surpanational regulator (the EU), and even there success has been incremental. Furthermore, differences in regulatory philosophy will, as we have seen in the context of hard law, make delegation to an international regulatory authority difficult, if not impossible. Desirable forms of financial regulation differ across countries depending on national preferences and levels of development, and thus different nations will want to sit on different points along their “efficient frontiers.” Some countries may want to purchase more financial stability than others—and have tighter regulations—at the price of giving up financial innovation. On the other hand, others may seek to develop capital markets more quickly through looser standards, even at the price of stability. In light of such differences, countries will likely vie to assume strategic positions in organizations that give them particular influence or power over the provision of global law.

Finally, the idea of a treaty system for financial regulation seems problematic—especially in light of our previous analysis. As we have discussed above, significant tradeoffs accompany hard law, including more difficult coordination on the front end and heightened legitimacy concerns and costs of regulatory error on the back end. Additionally, it is worth noting that, in the absence of centralization, it is unclear what advantages further legalization of international financial regulation would bring. Though additional solemnity and publicity would be brought to bear on cross-border regulatory commitments, defections from weaker international rules could still go undetected without changing the infrastructural support system. As this Article has demonstrated, noncompliance

210. Abbott & Snidal, supra note 39, at 437 (noting that while sovereignty costs are relatively low when states make international legal commitments limiting their behavior in particular circumstances, these costs rise where states accept external authority over significant decisions and where international arrangements impinge on the relations between a state and its citizens or territory).
213. Rodrik, supra note 200.
214. See id.
most likely arises not because rules are informal, but because noncompliance is rarely both detected and communicated efficiently to market participants. Thus from this perspective, legalization would not only entail greater ex ante costs, but fewer ex post benefits. Furthermore, some existing programs like the Financial Action Task Force appear to be relatively effective, and there is no obvious need to memorialize important institutions through treaty and risk undermining existing practices.

B. LEVERAGING TRANSPARENCY’S “COMPLIANCE PULL”

For these reasons, the idea of international reform is easy to suggest but is difficult to articulate and even more challenging to implement. On the one hand, it is necessary to improve international coordination in order to craft more (and better) rules with greater heft and compliance. At the same time, it is necessary, at least from a political standpoint, to preserve sufficient sovereignty and self-determination for countries to ensure flexibility. There must be a balance struck between compliance pull and flexibility.

Though overlooked by many commentators, there are less dramatic—and likely more effective—changes that can be introduced in the international system to increase the effectiveness of international financial law. These reforms are not, however, based on the macro-structural changes in the regulatory environment. Instead, useful reforms can be implemented to enhance the institutional support system promoting monitoring and information sharing among regulators for weaker international instruments, especially those reliant on monitoring by international financial institutions. In that way, not only would the compliance pull of good regulations be enhanced through the application of risk premiums to capital, but the quality of the international standards could themselves undergo checks and scrutiny so as to ensure the application of best standards.

The institutional design of international financial law has until recently received relatively scant attention in the legal literature from the standpoint of systemic reform and stability. This is in part due to the absence of formal international organizations grounded by treaty that tend to generate, and are most associated with, elaborate institutional designs. Indeed, in part due to the absence of formal qualities as international organizations, network theory in particular assumes away infrastructural sophistication and instead implies a system animated by inchoate administrative organizations themselves tied together by loose associations.215

Yet as demonstrated above, the existing architecture for international finan-

215. This is in large part due to the absence of formal international organizations grounded in or by treaty. Without them, it is assumed that sophisticated institutions cannot arise. This is ironic given the emphasis transgovernmentalists place on social interaction. After all, institutions have long been thought to reduce the transaction costs of coordination, and to the extent that they do, there is no reason why, if governmental networks can support policy coordination, they would not be able to support efficiency-enhancing coordination mechanisms.
cial regulation is in many regards deeply institutional: the players are themselves institutions (whether as finance ministries, regulatory agencies, supervisors, or standard setters) that display sophisticated design elements to facilitate coordination and define the range of distributive asymmetries the international system can handle. Membership rules (such as whether institutions are open or exclusive) work to define how aligned interest will be and what kinds of decision-making processes will be employed for legislation. Similarly, well-defined employment of institutional scope informs the range of distributional problems that can arise—as well as the degree to which tradeoffs or concessions can be made across issue areas.

Instead, what has traditionally been least institutionalized about the international regulatory system is the coordination process. Power is not only divided, but also decentralized among regulators, institutions, and market participants. The extent of compliance thus depends on significant coordinating mechanisms to ensure adequate monitoring and information sharing. Yet it is ironically here, in the horizontal (truly “networked”) relations between participants in the global financial system, where institutional features are all too often frail and compromise information production and dissemination. And in the absence of these basic preconditions for transparency, international standards exhibit weaker pressures for compliance.

This observation is important because it reveals that government policymakers can improve the compliance pull of international financial law by bolstering inter-institutional and market coordination. In this light, several steps can be taken to improve the efficacy of international financial law without necessarily reverting to formal or centralized global regulators. Three modest suggestions are sketched below.

1. Normalizing Surveillance

From the outset, we have seen that one significant obstacle has been the lack of what can be considered “normalized” surveillance, especially by international financial institutions. That is, not all instruments are subject to weak regulatory regimes, though global substantive standards generally are. Mandatory inspections, which themselves lack comprehensiveness, are at best semi-regular. More rigorous inspections are voluntary and follow-ups to such inspections are weak. Thus in many ways a “one-shot” analysis of a country’s financial system is undertaken.

These limitations suggest a need to both standardize and intensify surveillance of weakly enforced instruments. Centralization is but one route to do this and carries significant design risks. “[E]ven if the political will existed to create a single, global regulator, such a regulator would almost undoubtedly be too large and unwieldy to prove effective if its responsibility extended to rule making, supervision and crisis management . . . . Put simply, it is difficult to be
all things to all people . . . "

Instead, a better approach is to improve the surveillance carried out by actors already possessing the institutional competence to act at the global level. One way to do this would be to publicize financial sector assessments and observance reports of countries displaying financial market size such that they potentially pose possible systemic risks to the global economy. This approach has been highlighted by the Financial Stability Board, whose members have committed in principle to undergoing “peer reviews” that could use financial sector assessment reports “among other evidence.” The rigor of such peer reviews beyond financial sector assessments and the scope of these activities remain, however, unclear, especially given initial emphasis by the Financial Stability Board on only those principles relating to cooperation and information exchange, and the unclear consequences for nonparticipation. A more promising approach, announced by the IMF in September 2010, is to make FSAPs (and the entirety of the core principles they incorporate) mandatory for all systemically important countries every five years. Yet even here, more frequent annual or biannual check-ups should be required in order to provide regulators with up-to-date information regarding the financial regulatory initiatives undertaken by systemically important countries and follow up on the efforts made by such countries to address weak points identified in earlier assessments. The results of various surveillance operations could additionally be pushed up to the Financial Stability Board’s plenary meetings (full membership sessions) on an annual or biannual basis and discussed publicly.

Financial sector assessments and observance reports are not, of course, silver bullets, because the international standards on which they are based are themselves in need of substantive reform with regard to their scope and comprehensiveness. Nevertheless, folding these surveillance tools into the IMF’s institutional framework holds considerable advantages. Perhaps most obvious, it would regularize comprehensive assessments and would require that they be administered regularly. As a result, a continuous flow of information regarding a jurisdiction’s regulatory approach would be made possible, as well as information regarding a country’s regulatory approaches. There would thus be no need

218. Fin. Stability Bd., FSB Framework for Strengthening Adherence to International Standards 6 (2010). Furthermore, with regard to compliance with coordination, once a jurisdiction is deemed either “compliant” or “largely compliant” in two of three important relevant international cooperation and exchange principles, that jurisdiction would not require further evaluation. Id. Notably, FSB member jurisdictions have additionally agreed to undergo country and thematic peer reviews. Only Mexico has as of this writing undertaken a country review, though thematic reviews have been launched with regard to a number of areas including residential mortgage underwriting practices and compensation structures.
to rely on a government’s prerogatives as to whether to submit to surveillance or follow-ups, which can be less stringent.

Second, by targeting only countries hosting financial institutions that pose systematic risks, surveillance poses fewer administrative costs. Not all developing countries would, for example, need to undergo periodic review. However, for developed and emerging economies that host large financial markets and institutions, assessment programs would serve as a means by which compliance with international standards could help determine the kind of systemic risk they pose.

Finally, by incorporating financial sector assessments and observance reports, as well as periodic check-ups and scoring, into the Article IV requirements, significant “teeth” will be added to international standards such that they will become more integral to regulatory decision making. By tying assessment participation to IMF membership, submission to the monitoring process can be elevated to a membership standard for one of the world’s premier international organizations. Additionally, the IMF could, as with IOSCO’s Multilateral Memorandum and the Financial Action Task Force’s recommendations, compile lists of countries that fail to or refuse to permit assessments, thereby creating greater market pressure to engage in surveillance.

At the same time, although procedural compliance with assessments is necessary, substantive compliance with international standards would remain largely voluntary. Only where one jurisdiction’s regulations threaten global security or financial stability would more coercive actions potentially be permitted by the international community. Otherwise, where international financial law fails to fully speak to a particular country’s economic reality or market structure, that country can decide to instead follow its own regulatory path, though it must disclose its divergence from established or recognized principles. This leaves space for regulatory choice (for national authorities and, possibly, firms), innovation, and experimentation even where international standards are propagated and international standard setters have developed coordinated regulatory approaches. It also, notably, leaves ample room for a country’s pursuit of domestic economic and social objectives. As a result, it involves far fewer sovereignty costs than would be implied under a scheme of delegation to a global or supranational regulatory body.

220. In this regard, I think primarily of money laundering and terrorist financing, as seen under the FATF, but the same kind of considerations could potentially extend to instances where an international consensus has emerged that the under-regulated trading of certain unregulated financial products could undermine the global financial system.

2. Improving Information Utility

Besides improving surveillance, the information gathered through monitoring should be improved in such a way as to make it more usable by market participants. A variety of measures that draw on innovations could be introduced to achieve such objectives—some are already being practiced in the private assessments by the e-Standards Forum.

As an initial step, a score of compliance accompanied by an interpretative key should be included in reports by international monitors to better provide an indication as to both the substantive and relative levels of a country’s adherence to certain international regulatory codes. These measures could be provided on either of two levels: first, a general indication of a regulator’s implementation of a specific regulatory regime (for example, the Basel capital accords); second, a quantitative measure as to that institution’s compliance with different elements of legislation, where possible. Thus, for core principles presented in sectors like banking and securities oversight, a quantitative measure or score could be provided for each principle. By providing a layered approach to judging compliance, market participants can better grasp both the nature of noncompliance with international standards and the degree to which noncompliance occurs.

Additionally, streamlining the data presented in reports is essential. For the most part, reports are of one of two extremes: either general financial sector assessments, or detailed, verbose observance reports. For market participants, a better approach would be to model assessments after investment prospectuses—the reports these participants use in order to make investment decisions. In short, for every annual assessment, an executive summary should be included, detailing quantitative measures or scores given on compliance. Then, in addition to the executive summary, more detailed explanation could be provided, laying out in depth the process of data gathering and the regulatory measures taken by the government in question. At the end of the report, there should also be the opportunity, if necessary, for regulators to contest the score they earned or to explain their reasons for not abiding by or with the international standard in question. In this way, investors can be fully informed about a financial market’s regulatory governance and use this information to more accurately price the risk premium that should be incorporated into investment decisions.

Finally, in order to help prevent overreliance on the quantitative measures used in the assessments, a rider could be placed on the front of the assessment emphasizing that although such information may be useful in informing decision making, assessments should not be regarded as a statement of financial or regulatory risk, but should be viewed as only one element of a broader set of considerations to take when examining the strength of a financial market.

A number of actors are potentially available to carry out the actual quantitative scoring, especially in light of the decentralized nature of regulatory authority in the international financial system. International financial institutions are, however, likely best in most cases. National regulators are subject to conflicts of interest and private actors, at best, are only able to carry out assessments of
assessments in the absence of a (very unlikely) delegation of such responsibility by the international community. International financial institutions have already assumed the roles in global macroeconomic and financial surveillance and financial codes. Expanding their mandates to scoring makes them more institutionally competent than standard-setting bodies—and even agenda setters, which, as informal organizations, enjoy far fewer resources. Finally, because monitoring is often a source of friction between the monitored and the monitor, it is best separated functionally from standard setting in order to prevent frictions generated during the surveillance process from spilling over into the front-end coordination and production of international rules and standards.

3. Publicity and Public–Private Partnerships

Finally, all IMF members should be required to not only submit to surveillance where they charter businesses or are host to transactions that create systemic risk, but also to permit the publication of the assessment results. This approach, which has not been explicitly adopted under the IMF’s September reforms, would optimally be implemented by making financial sector assessments and observance reports available on the websites of both the World Bank and IMF. A file could be created for each country, charting its compliance history with cooperation, information exchange, and prudential standards. In this way, assessments would be accessible to market participants and organized in ways that would be easy to access and study over time.

Partnerships with market participants and civil society should also be improved. First, the range of consumers can be expanded. When originally conceived, the intended users of surveillance reports were country authorities (for capacity building), international financial institutions, and market participants (primarily credit rating agencies). However, more engagement would be helpful. Besides credit rating agencies and analysts, investor banks and political risk consultancies should be contacted regularly in order to ensure market interpretations of their policy prescriptions. Furthermore, think tanks and academia could be better informed of the policy reports in order to ensure broad dissemination and inspection of both the strength of standards and extent of compliance. To their credit, since 1999 the IMF and World Bank have conducted and encouraged a series of outreach seminars, particularly with private sector actors in mind, though such seminars appear to have been relatively infrequent in light of the global scope of the project. More frequent meetings with stakeholders on methodologies, codes and standards would likely improve their utility.


223. Between 2000 and 2002, for example, no such seminars were conducted in the United States, and seminars were conducted only once in the United Kingdom, France, Germany and China. Benu Schneider, Do Global Standards and Codes Prevent Financial Crises? Some Proposals on Modifying the Standards-Based Approach 39 (United Nations Conference on Trade and Dev., Discussion Paper No. 177, 2005), http://www.unctad.org/en/docs/osgdp20051_en.pdf.
Similarly, international regulators should make more frequent forums in which market participants and other stakeholders can keep abreast of new assessments or changes in assessment methodologies. In this way, not only would users of the assessments enjoy greater utility from the assessments, but also the costs of using the reports would be reduced, thereby increasing the use and amount of data regarding compliance. Equally important, the costs of adapting to new regulatory innovations or changes in monitoring could be reduced by proactive efforts from international financial institutions to address reforms through greater interaction and dialogue with users of the surveillance data.

C. POSSIBLE DRAWBACKS

1. Fewer Substantive Agreements

There are a range of potential drawbacks to improving monitoring and information sharing in the manner outlined above. The existing architecture makes possible a “lower level of commitment . . . that can change over time” as economic and political thinking evolves. However, to the extent that regulators foresee either more likely or more serious consequences to defection, they may be less inclined to commit to certain standards because they will imply greater ex ante sovereignty costs. Consequently, the international architecture envisioned under these reforms could proffer fewer substantive agreements between regulators, particularly with those standards to be included in or adapted to core principles used for financial sector assessment purposes.

Yet in some regards, the costs of forgone international legislation can be considered low, especially in light of the at-times-low costs of defection arising under the existing regulatory architecture. Because regulators can now frequently decide not to abide by their international regulatory commitments, there is little lost benefit from the standpoint of systemic risk regulation if fewer agreements are promulgated under the current system. In such cases, the greatest costs will be from a normative standpoint in the sense that the production of fewer legislative instruments potentially implies fewer tools with which regulations can craft market and global regulatory expectations with regard to best practices and quality supervision.

Moreover, increasing transparency for formal inter-agency agreements concerning the regulation of global systemic risks does not preclude the continuation, in some instances, of classic soft-law instruments like communique’s, joint statements, or policy declarations. Such instruments can continue to provide

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224. See Sokol, supra note 93, at 267.

225. It is worth emphasizing that because soft-law instruments bring the advantage of lower contracting costs, they may continue to perform useful roles in the coordination of global responses to global financial concerns. “Any agreement entails some negotiating costs—coming together, learning about the issue, bargaining, and so forth—especially when issues are unfamiliar or complex. But these costs are greater for legalized agreements.” Abbott & Snidal, supra note 39, at 434.
important means for cross-border coordination among regulators. The availability of such alternatives thus mutes sovereignty cost where it is politically unacceptable. Similarly, some international legislation can, where needed, remain outside the purview of the enhanced regulatory regime outlined above. And parties could continue to have the ability to renegotiate or adjust standards as new circumstances arise. This proposal would, however, create a default mechanism whereby the monitoring of commitments is both expected and institutionally supported where international standards touch on core issues of systemic risk regulation.

2. More Costly Negotiations

The proposal put forward above also implies more costly bargaining, even where agreement between parties can be reached. An advantage of classic soft-law agreements is, as discussed above, their lower contracting costs. However, where more monitoring is employed, the instruments will implicitly be made harder because defection will be made more visible and, by extension, more costly. Consequently, contracting costs for many agreements will increase, and parties will want to analyze in greater depth the substance of an agreement and its possible impact. This, too, will lead to comparatively fewer agreements concluded.

As an initial observation, it is worth noting that greater attention to detail in the bargaining process, especially in a technical area like international financial law, is not bad per se. Not only does it potentially enhance the quality of coordination and force parties to more clearly signal regulatory preferences and expectations for market participants and their supervision, it also helps contain and prevent the proliferation of supervisory agreements and arrangements that escape attention, and by extension, implementation by regulatory authorities. Thus, increased negotiation cost will come with its own set of potentially positive externalities, from higher quality legislation to more comprehensive regulatory coordination and implementation.

Furthermore, just as the proposals outlined above would not obviate other alternative substantive forms of regulation, which, as in the case of sovereignty risks, could mitigate bargaining costs, there are a variety of procedural or institutional innovations to help manage negotiation. As already seen in universal organizations like IOSCO, standard-setting bodies can be structured such that primary policy cores reflect particular stakeholder interests with regard to the resolution of the relevant systemic risk concerns. Alternatively, voting or procedural rules could be adopted to weaken implicit unanimity or super-majoritarian voting rules implied by the consensus-driven legislating of leading standard-setting bodies. In this way, bargaining costs can be reduced and a means for consistent legislating made possible.

3. Regulatory Nudges and Market Inefficiency

A third, though less obvious, argument is that compliance transparency may actually increase the likelihood of inefficient regulation. As some scholars have
already noted, the recent crisis has highlighted limitations not just in the financial industry, but also in national and international regulation and oversight.\textsuperscript{226} Adherence to international standards may, furthermore, seduce some regulators into believing that their regulatory efforts are sufficient, even where they are not. Thus in such situations, the propagation of international standards could inadvertently stymie efforts to innovate among national authorities and improve regulatory techniques, even where they theoretically enjoy choice as to what kind of regulatory approach they wish to adopt.

Similarly, the promulgation of international standards may affect the preferences of investors by nudging their tastes in directions than would otherwise be the case in a world of low or nongovernmental interference.\textsuperscript{227} Here the argument would go that because governmental observations are generally respected, or because investors may believe that governmental information is superior to their own, they may value regulatory dictates more than they should. In such cases, the direction in which investors are nudged could be highly inefficient.

As to the first criticism, it is possible that international regulatory standards could lull some regulators into a false sense of security as to the comprehensiveness and strength of their own regulatory system. And once standards are adopted in, say, supervisory oversight, the pressure for reform in other closely related areas like payment systems may decline. However, it is useful to note that domestic regulators, who at least wield power over their domestic transactions, have rarely exhibited an absence of regulatory innovation. Instead, reforms may suffer due to lobbying, political interference, or hubris generated from an absence of financial crises or a long period of economic or financial stability. Inaction is, however, rarely generated due to the reputation of a particular regulatory regime. If anything, to generate a strong reputation, regulators often engage in frequent and high-profile reforms and innovations.

It is also theoretically unsound to argue that, by definition, governmental regulation and standard setting will always be less efficient than that demanded by investors and financial analysts. Invariably, market participants will have better information about their immediate investments than governmental authorities, and they often possess technical expertise and up-to-date microeconomic information rarely enjoyed by regulators. However, regulators do enjoy superior “macro” informational advantages over market participants in the sense that

\textsuperscript{226} See, e.g., Mario Giovanoli, \textit{The Reform of the International Financial Architecture After the Global Crisis}, 42 N.Y.U. J. Int’l L. & Pol. 81, 89 (2009). The degree to which international rules per se were a cause is, like many other issues concerning the crisis, still contested. That said, most commentators agree that inadequate capital requirements as provided for under Basel (and national banking regulations) at least contributed to the severity of the crisis. Other more disputed matters concern issues like mark to mark accounting, international rules regarding the securitization of bank assets, and the widespread dependence by national and international authorities on ratings by credit rating agencies.

they have access to considerable nonpublic information unavailable to other reputational intermediaries. Furthermore, governments, though less authoritative about market innovations and industry specifics, have a broader vantage point concerning the financial industry and the economy. As a result, their suggestions can be of significant use and interest to market participants seeking to properly price risk.

Indeed, governmental input can be critical in market environments hampered by irrationality or emotion, as is often the case during financial crises, or when there is little precedent or information otherwise available to investors. In such situations, governmental best practices add value to investor decision making or, at a minimum, provide a possible focal point for investors seeking to formulate investment strategies. And again, because international financial law is ultimately nonbinding, it is worth emphasizing that investors, like all other market participants, are ultimately free to disagree with regulatory models and pursue their own investment strategies.

4. The Persistent Problem of Legitimacy

Finally, legitimacy remains a potentially serious institutional challenge. To be sure, substantive legal choice reduces some of the legitimacy tradeoffs discussed in Part VI. A country does not, for example, necessarily have to follow in lockstep with the approaches of international regulatory leaders, even where it is a client state of international financial institutions. Furthermore, the reforms outlined in this Article grant emerging economies a voice in the regulatory process, even if they are not directly involved in the standard-setting process. Countries can defend their particular regulatory approach or implementation strategy in their regulatory disclosures or even challenge the weakness or unsuitability in the prevailing international standard.

Still, this more modest reform strategy does not inherently alter the institutional architecture supporting the provision of law. Certain members are better positioned to both promote and block standards emanating from the organization. Over time, especially as other countries enjoy increasingly sophisticated capital markets and deepen their expertise and regulatory capabilities, this existing regulatory apparatus will likely be less acceptable. Legitimacy shortcomings could also, as mentioned above, hamper the compliance pull of international standards to the extent to which they are viewed as the product of unfair or flawed legislative processes.

These observations suggest that, in the long term, more basic changes will

228. See Brummer, supra note 4, at 371–72, 377 (discussing how new policy leaders can arise when capital is reallocated in the financial world).

have to be introduced at an organizational level to the existing regulatory architecture. It is not likely, for reasons mentioned above, that a new global regulator can be created with the moral authority or mandate to supersede existing organizational arrangements. Nevertheless, less drastic reforms may still be possible to enhance legitimacy. Most importantly, expanded membership in key standard-setting bodies and decision-making groups may have to be introduced. In that way, to the extent that the rules promulgated run contrary to a regulator’s preferences, representation in the decision-making procedures helps justify adherence as well as legitimacy for domestic audiences.230

Already, international financial institutions are beginning to adopt structural changes. The G-20 itself represents a displacement of the G-7—the erstwhile and more exclusive venue of policymaking that dominated economic decision making in the 1990s—and its growth in membership further generated an identical growth in representation in the FSB.231 And “with the G20’s encouragement, IOSCO’s Technical Committee, the BCBS, and CPSS also invited . . . important developing countries as new members,”232 just as the IASB guaranteed developing nation representation on its Board for the first time. Even in the IMF and World Bank, emerging markets are gaining both clout and voting power in international financial institutions.233 As a result, the legitimacy problem is already starting to be addressed, and reforms will have spillovers where international institutions play a role in not only financial policy, but also regulatory surveillance.

These changes do not, of course, answer all legitimacy problems. As Anthony Payne notes, even after recent reforms, at least 150 countries of the 192 countries of the world have no representation at all on the G-20 and FSB, a number representing over one-third of the world’s population and nearly 20% of the world’s GDP.234 And even those new members that do participate often do not have the same number of representatives as the traditional G-7.235 As a result, additional changes will likely need to be made over time. For example, new term rotating membership slots on standard-setting bodies could be reserved for developing countries, or on key policymaking cores like the FSB’s executive organ, the Steering Committee. Additionally, expanded secretariats

231. White House Office of the Press Sec’y, supra note 47.
235. The original G-7 countries, along with Brazil, Russia, India, and China, each have three representative members; a more narrow group of mid-range powers (Australia, Mexico, the Netherlands, Spain, and South Korea) each have two members. See Links to FSB Members, Fin. Servs. Bd., http://www.financialstabilityboard.org/members/links.htm (last visited Oct. 1, 2010). All other members of the G-20 have only one member. Id.
for standard-setting bodies could be provided to international organizations to help shoulder the burden of policymaking that naturally disadvantages resource-poor countries, as well as to help poorer countries engage the standard-setting process earlier on and more vigorously.236

When combined with enhanced transparency and public–private cooperation, such reforms would provide additional means of improving both the effectiveness and legitimacy of the global financial system. In one sense, they pragmatically recognize the importance of legitimacy and the limitations of the existing international architecture by keeping sovereignty costs at bay through the continuation of (formal) soft legal governance and by bolstering further institutional reforms. At the same time, they work to better leverage reputational and market forces such that regulators internalize the costs of their decision making. This approach is not, of course, a cure-all, and carries risks. As recent history demonstrates, markets in particular are not always efficient, just as regulators are themselves prone, like the firms they regulate, to significant cognitive biases. That said, these reforms provide a backstop against regulatory arbitrage and competition that is not only theoretically attractive, but also practicable, even in a world of at times polarized financial interests. As such, they represent an important improvement to the international financial architecture.

CONCLUSION

International financial law is more than the sum of its parts. Though formally a species of soft law, cross-border financial regulations are bolstered by a range of disciplining mechanisms that render it more coercive than traditional theories of international law predict. Not only do reputational considerations discipline the decisions of regulators, even where agreements are nonbinding, but market participants and international organizations may also operate in ways to make defection from international financial agreements costly.

Nevertheless, these disciplinary mechanisms are hampered by a range of institutional flaws that, in practice, limit their own coercive effect and with it what can be considered the compliance pull of global financial standards. This Article demonstrates that monitoring is far from a comprehensive exercise because participation in some of the most important surveillance programs is voluntary and the process depends on self-reporting by national regulators and the firms. The Article also reveals how information generated through monitoring is often not shared with the broader international regulatory community or market participants—and even where it is, it often goes unused due to the complex format through which it is disseminated. As a result, the risk-adjusted cost of defection is lowered, heightening the likelihood of noncompliance where significant distributional tradeoffs arise.

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236. This has already started to occur. See Helleiner & Pagliari, supra note 232 (discussing recent moves to include more developing nations in international standard-setting organizations).
The identification of such design flaws makes possible a series of reforms to improve cross-border financial regulation even where, as is the case of global finance, a global regulator is impractical due to incongruent domestic forms of prudential and supervisory oversight. Surveillance of compliance with international rules should be strengthened by making external assessments mandatory and a condition of membership in the International Monetary Fund. Meanwhile, information sharing between surveillance institutions and market participants should be improved. Countries undergoing surveillance should, among other things, be required to permit the publication of surveillance reports, and ratings of compliance should be exercised to enhance the utility of monitoring operations. Through such reforms, policymakers will be able to leverage transparency and market forces in a constructive way that, though not making compliance with international rules mandatory, more robustly forces financial centers to internalize the costs of their regulatory decision making. Regulators would, as a result, have to weigh more carefully the consequences of ignoring international best practices.