

THE ROLE AND PROSPECTS OF INTERNATIONAL LAW IN FINANCIAL REGULATION AND SUPERVISION

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ABSTRACT

The financial crisis of 2007–09 resulted in, *inter alia*, challenges for governments to modify financial regulation and supervision so as to ensure stability of financial markets without unduly hindering dynamic market developments. Moreover, the inherent transnational character of any financial market instrument nowadays has to be taken into account. This article discusses the proper allocation of powers in terms of harmonization and decentralization. It addresses conceptual challenges for contemporary financial regulation and supervision based on the idea of regulatory competition. While harmonization should be further pursued, regulatory competition based on a sound international framework of cooperation and coordination is central for successful financial regulation and supervision. There is no one-size-fits-all approach.

I. INTRODUCTION

The global financial crisis of 2007–09, which is more than symbolically tied to the breakdown of Lehman Brothers on 15 September 2008, resulted in challenges for governments and markets alike. Governments—both providing the framework for market activities and having the capacity to intervene in a market if necessary—and the market as a self-regulatory mechanism are trying to cope with the problem of how to prevent a future global economic crisis. For governments, both on the national level and with regard to efforts in international cooperation and coordination, ‘better’ regulation and supervision of financial markets are called for. Modified and/or new models of regulation and supervision are a central element in providing for stable domestic and international financial markets in the future. It is thus not

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surprising that G-20 leaders at the London Summit of 2 April 2009 listed ‘[s]trengthening financial supervision and regulation’—right after ‘[r]estoring growth and jobs’ as a priority in reviving financial markets.¹

Strengthening regulation and supervision is always in potential conflict with the essential freedom of financial markets. There is always a necessity to seek an equilibrium between the two components. The tension between regulation or supervision and market freedom is not a new phenomenon in financial law. What is new, however, is that in strengthening regulation and supervision today, one has also to take into account—at least partially—the need for international regulatory and supervisory cooperation and coordination.

This article sketches some conceptual aspects of the ongoing domestic and international debate on strengthening financial regulation and supervision. This is primarily done from a legal perspective; it does not go into the details of economic theory. We understand ‘regulation’ broadly in terms of the legal framework shaping financial services and transactions. ‘Supervision’ is distinct from regulation as it refers only to the enforcement of regulatory standards. Neither with regard to regulation nor to supervision is this article concerned with questions of liberalization of financial services.² We will thus only discuss measures which are applied on the basis of non-discrimination³ after market entry has occurred.

The article is divided into three main parts: Section II describes and discusses different systems and methods of domestic regulation and supervision as well as related conceptual challenges. Section III discusses new areas and methods of regulation and supervision in reaction to the crisis of 2007–09. Section IV, based on findings in sections II and III, looks into the question of optimal harmonization of financial markets. Section V draws the conclusions.

II. AREAS, SYSTEMS AND METHODS OF DOMESTIC REGULATION OF FINANCIAL MARKETS

A. Classical areas of financial law

Financial regulation is not complete. It does not cover the entire reality of financial markets. There have always been some areas willingly left unregulated by states in order not to hamper the innovative talents and potential of financial actors. In other areas, there was concern and the need for regulation and supervision was recognized and dealt with. Whether or not areas

¹ G-20, ‘Global Plan for Recovery and Reform: *The Communiqué from the London Summit*’, London, 2 April 2009, <http://www.londonsummit.gov.uk/en/summit-aims/summit-communique> (visited 4 August 2010). The decisions made by the leaders of the world’s largest economies at the London Summit are recorded in this communiqué which all leaders signed.

² On this topic, see the paper by Panagiotis Delimatsis and Pierre Sauvé in this issue at 837–857.

³ See the paper by Thomas Cottier and Markus Krajewski in this issue at 817–835.

have been regulated largely depends upon historical antecedents: it is accidental. Most often, financial legislation was enacted after innovative dealings got out of hand and created a crisis. As a result, the matters that are covered by financial legislation do not in any way form a logical or consistent system. The same applies to the content of the legislation: sometimes it addresses the quality of financial actors, sometimes information asymmetries, sometimes market behaviour, and sometimes the infrastructure of the market.

The typical way to regulate financial markets is to demand that actors comply with certain defined conditions. These actors are different financial intermediaries, such as banks, fund managers, brokers, or investment advisers. Underlying their regulation and supervision may be varying concerns. Chief among them is the risk that they might embezzle the funds of their clients or give false advice. Traditional instruments by which financial intermediaries are controlled include the requirement to register and the obligation to turn over certain information to the supervisory authorities.

For some actors, the legal requirements go further, cutting deeply into their organizational structure. This is particularly true for banks. Although banks are in some ways the archetypal financial actors, definitions vary as to what legally makes a bank a bank. There is an abundance of different activities that may constitute 'banking'.⁴ Nevertheless, it can be said that the central reason why banking is regulated in modern societies lies in the risk of the bank not being able to return the funds of its customers when requested to do so. This concern has led to the requirement of obtaining a licence in order to enter the banking business, and to stringent prudential requirements such as those on capital adequacy and liquidity.⁵ Since these measures alone are not sufficient to create the necessary trust in credit institutions, most states have added guarantees partly securing the deposits of customers; these deposit insurance schemes exist in various legal systems.⁶

⁴ See, e.g. European Parliament and Council Directive 2006/48/EC on the taking up and pursuit of the business of credit institutions, OJ 2006 L 177/1, art 4(1) (defining a credit institution as an 'undertaking whose business is to receive deposits or other repayable funds from the public and to grant credits for its own account' or an 'electronic money institution'). Contrast this with the definition of banks in US case law, see e.g. *Exchange Bank of Columbus v Hines*, 3 Ohio St. 1 (1953) (holding that 'the business of banking, in its most enlarged signification, includes the business of receiving deposits, loaning money, and dealing in coin, bills of exchange, etc., besides that of issuing paper money'); *Brenham Production Credit Association v Zeiss*, 153 Tex. 132, 264 S.W.2d 95 (Tex., 1953) (holding that 'the primary function of a bank is to serve as a place for safe keeping of depositors' money'); *City National Bank v City of Beckley*, 579 S.E.2d 543 (W.Va., 2003) (holding that 'having a place of business where deposits are received and paid out on checks, and where money is loaned upon security, is the substance of the business of a banker').

⁵ See, e.g. in the USA: Bank Holding Company Act 1956, 12 USC §§1841ff, Annex A; in the EU: Directive 2006/48/EC, above n 4, arts 9 and 10.

⁶ For a comparative overview, see Asli Demirgüç-Kunt and Edward J. Kane, 'Deposit Insurance Around The Globe – Where Does It Work?', World Bank Policy Research Working Paper No 2679, 2001.

Often they are state-sponsored, but are partly supplemented by voluntary or mandatory private guarantees.

The regulation regarding information asymmetry is designed to counter the marked difference between the two sides of the market, i.e. between the issuers of financial products on one side, and the buyers of financial products on the other. In order to balance such asymmetries and to provide both sides with a fair amount of information, different measures have been adopted. Chief among them is the requirement to make a prospectus available to the client.⁷ Accounting and auditing rules pursue similar goals: they aim at providing the investor with accurate information about the issuer. Another measure that pursues a similar purpose is to impose specific fiduciary duties on intermediaries who sell financial products.

Financial regulation of market behaviour sets the basic rules on what is and what is not allowed in the marketplace. Remarkably, these rules are applicable to everyone, not only those who offer financial products, but also the buyers. Examples of behavioural rules are provisions on insider trading and other fraudulent practices.⁸

Finally, the regulation regarding the financial infrastructure addresses the technical basis of the market, e.g. exchanges or trading platforms. Mostly, this technical basis is the product of private initiatives. Individual actors also contribute to the creation of the norms and standards that are vital for the functioning of the market's infrastructure. However, since a breakdown would create considerable risk for the stability of the whole financial system, modern legislation has set up some minimum requirements as to the operation of these mechanisms. One example is the regulation of exchanges or clearing houses.⁹ A number of these requirements concern the qualities and the organizational structure of the entities themselves in their quality as financial intermediaries and can therefore be considered actor-specific legislation. However, one can also find provisions that govern their transactions, such as clearing and settlement.

B. Systems and mechanisms of regulation and supervision

Supervision of the financial markets and its actors can be organized in different ways. The traditional method is the sectoral model: for each sector of

⁷ See, e.g. in the USA: Securities Act 1933, 15 USC §77e(2)(b), Section 5(2)(b); in the EU: European Parliament and Council Directive 2003/71/EC on the prospectus to be published when securities are offered to the public or admitted to trading, OJ 1003 L 345, at 64, art 3(1).

⁸ See, e.g. for the USA: Rules 10b-5 and 10b5-1, 17 CFR §240.10b-5; for the EU: European Parliament and Council Directive 2003/6/EC on insider dealing and market manipulation (market abuse), OJ 2003 L 96/16.

⁹ See, e.g. in the USA: Securities Exchange Act 1934, Sections 5 and 6, 15 USC §§78 e and f; in the EU: European Parliament and Council Directive 2004/39/EC on markets in financial instruments (MiFID), OJ 2004 L 145/1.

the financial industry, one supervisor is installed. For these purposes, the industry is typically divided into banks, insurance companies, and securities firms. Often, the regulation is split into these three different parts.

Sectoral supervision and regulation has, however, been called into question by a major development in the financial industry: cross-sectoral financial intermediation. Starting in the 1980s, the once clear-cut lines between banks, insurance companies and securities firms blurred. Due to innovative products, the respective business models increasingly overlapped. As a consequence, the organization of supervision was outdated due to the new realities of the industries. Inefficiency and lack of transparency were the results.

Such development led to the search for new models of supervision. One alternative would be an operational model which distinguishes not according to the supervised institution but according to the types of products that are offered. Another alternative is the so-called institutional model. In principle, it follows the sectoral model in that the different financial intermediaries are supervised by different agencies. The new feature extends the functions of the supervisor to all activities of the institutions under its supervision, no matter in which market they take place.¹⁰ An obvious problem for this approach is presented by hybrid intermediaries, which are truly in-between and hard to categorize, such as bank and insurance conglomerates.

Under a functional approach, the competences would be divided among different supervisors according to the supervisory task to be fulfilled. For instance, licensing could be overseen by one supervisor, prudential supervision by another, and standard setting by a third. Such a system was installed in France¹¹ and, to some extent, also in Germany, where the *Bundesanstalt für Finanzdienstleistungsaufsicht* (BaFin)¹² and the *Bundesbank* are jointly responsible for supervision.

The model that has proliferated the most in recent years is integrated financial supervision. Under this model, one supervisor covers the whole financial industry. This 'one-for-all' approach was first adopted in the Scandinavian countries. The UK later followed with the creation of the Financial Supervisory Authority (FSA), and then Germany where the BaFin was charged with supervising banks, insurance companies and securities intermediaries. The advantage of this approach is that it lays the foundation for a one-stop shop system for authorizations and also—possibly—for a single regulatory regime. The drawback of integrated supervision, however, is that it creates gigantic bureaucracies which may not have close contact

¹⁰ See Enrico Cervellati and Eleonora Fioriti, 'Financial Supervision in EU Countries', Working Paper, <http://ssrn.com/abstract=873064> (visited 4 August 2010).

¹¹ Ibid, at 10–11 for a discussion of the French system.

¹² German Federal Financial Supervisory Authority.

with financial actors in the different parts of the industry, nor a sufficient understanding of their specific needs.¹³

C. Conceptual transnational challenges

As the previous section indicates, both the classic areas of financial regulation or supervision and the systems and mechanisms applied are characterized by a certain degree of complexity. One reason for this, and an important aspect of any attempt to strengthen and/or reform financial regulation and supervision, is that ‘form follows function’ in this context.¹⁴ This means that financial regulation and supervision follow the market so that the legal form and substance of financial regulation or supervision is to a large extent dependent on the factual situation of the markets for financial services.¹⁵ The obvious problem of retaining ‘policy space’,¹⁶ in the face of the dominant market power, is not at all new in the context of financial regulation and supervision. What is new in the current situation, however, is that the determining factual situation is not one single market any more (if it ever was). Instead, the complexity of the financial market instruments that have been invented and that are being invented with increasing speed has led to a multitude of markets. Moreover, those markets are not exclusively domestic financial markets, but inherently and comprehensively also global financial markets. The necessarily global functional approach towards financial regulation and supervision implies complex conceptual challenges.

Even though any strengthening and/or reform of regulation and supervision of financial markets has to cope with the challenges of globalization, it is equally important to take note of the ‘domestic embeddedness’ of financial market products. Financial market products are always, and necessarily so, linked to a specific domestic legal order. They are, in other words, children of domestic jurisdiction. An investor buying, for instance, shares in a Luxemburgian investment fund not only trusts the issuer, but also the well-known quality of Luxemburg’s legislation and administrative practices in the area of finance. This is a unique feature of financial market products. Unlike physical products and most services, financial market products always

¹³ For a comparison of the advantages and disadvantages of the dominant models of supervision, see Karel Lannoo, ‘Supervising the European Financial System’, Centre for European Policy Studies Policy Brief No 21, May 2002, at 4.

¹⁴ The famous quotation ‘form follows function’ is from an article written by the architect Louis Sullivan, ‘The Tall Office Building Artistically Considered’, *Lippincott’s Magazine*, March 1896; ‘form follows function’ is used in our context as a classic description of a functional approach to law (functionalism).

¹⁵ Klaus J. Hopt, ‘Auf dem Weg zu einer neuen europäischen und internationalen Finanzmarktarchitektur’, 12 *Neue Zeitschrift für Gesellschaftsrecht* 1401 (2009), at 1402.

¹⁶ On the concept and implications of ‘policy space’ see, e.g. Jörg Mayer, ‘Policy Space: What, for What, and Where?’, UNCTAD Discussion Papers, No 191, October 2008; Kevin P. Gallagher, ‘Policy Space to Prevent and Mitigate Financial Crises in Trade and Investment Agreements’, UNCTAD, G-24 Discussion Paper Series, No 58, May 2010.

feature a particular jurisdiction. They are thus products that are deeply rooted in one specific domestic legal order on the one hand, and increasingly traded on global markets on the other. They are offered not only on their domestic market, but also on a worldwide basis, and in this sense they are 'international' or, more precisely, 'transnational'. Therefore, one may speak of transnational financial products and markets in order to highlight the above-described double character of products and markets, being always both domestic and international.

The transnational character of financial products and markets directly affects financial regulation and supervision. The main consequence in this regard is that international cooperation and coordination of financial regulation and supervision is not primarily about 'levelling the playing field'. As domestic embeddedness is a key feature of financial products, international financial markets need to be characterized by at least some degree of regulatory competition (that is, competition of regulatory systems). Even though regulatory competition is a general feature of economic law-making and enforcement, it has a special importance in the context of financial markets. The basis of financial products—capital—is intangible and may thus be relocated easily to any other jurisdiction. Thus, even though the relocation of financial products always depends on a rearrangement of the legal foundations of the respective product in domestic law, capital (as the basis of financial market products) can be characterized as having a high 'exit' potential. As Hans-Werner Sinn convincingly observed: '[c]apital, except possibly for corporate capital trapped by divided taxes, will be the big winner of systems competition'.¹⁷ The importance of regulatory competition in the area of financial products, already dominant from a theoretical perspective, can also be proven by empirical evidence. Some examples include: the rivalry between Frankfurt and London over being the number one financial marketplace in Europe, and the current struggle as to where the next offshore hub for hedge funds will be.

This, however, does not mean that one should leave the issue of financial regulation and supervision exclusively to domestic jurisdictions in order to score the highest possible positive results of systems competition. As the concept of regulatory or systems competition is based on the idea of a generally functioning 'international regulatory market', it is important to provide all legal rules which are necessary for the functioning of the market. These rules may be called 'meta norms'.¹⁸ In the present context, it is thus an

¹⁷ Hans-Werner Sinn, *The New Systems Competition* (Malden/Oxford: Blackwell, 2003) 60.

¹⁸ For an overview of different aspects of regulatory competition with regard to financial regulation see, e.g. Mahmood Bagheri and Chizu Nakajima, 'Optimal Level of Financial Regulation under the GATS: A Regulatory Competition and Cooperation Framework for Capital Adequacy and Disclosure of Information', 5 *Journal of International Economic Law* 507 (2002).

important task of international law to provide the meta norms necessary to enable regulatory competition among domestic jurisdictions that produce financial market products. Moreover, it is also important to ensure respect for and the effective enjoyment of certain public goods. The most important public good in this regard, and in the present context, is the stability of the international financial system.¹⁹ Other important public goods may be those classically identified in economic theory, such as the environment. Overall, it is thus necessary to establish principles and rules of an international competition order²⁰ so that regulatory competition in financial regulation and supervision may function comprehensively and well, and create positive effects.²¹ All current efforts towards strengthening and reforming financial regulation and supervision by international cooperation and coordination, i.e. by international law, have to be seen from this perspective.

In addition, it is important to realize that domestic financial regulation and supervision inherently tends to have extraterritorial reach and effect. This is mainly because, as indicated, financial products are embedded in domestic legal orders on the one hand and increasingly traded on globalized markets on the other. Extraterritoriality may thus be seen as an inherent characteristic of modern financial products and the law governing them. This in turn causes problems in the same way that extraterritorial jurisdiction causes conflicts more generally.²² It is therefore important to find solutions to these jurisdictional problems on the basis of the principle of cooperation in international economic law.²³

Furthermore, while discussing challenges to strengthening financial regulation and supervision, it is necessary to keep certain differences between

¹⁹ On the stability of the financial system as a (global) public good see, e.g. Heribert Dieter, 'The Stability of International Financial Markets: A Global Public Good?', in Stefan A. Schirm (ed), *New Rules for Global Markets – Public and Private Governance in the World Economy*, (Basingstoke/Hampshire: Palgrave MacMillan, 2004) 23 ff; Michel Camdessus, 'International Financial and Monetary Stability: A Global Public Good', in Peter B. Kenen and Alexander K. Swoboda (eds), *Reforming the International Monetary and Financial System*, (Washington, DC: International Monetary Fund, 2000) 9 ff; Geoffrey Underhill, 'The Public Good versus Private Interests and the Global Financial and Monetary System', in Daniel Drache (ed), *The Market and the Public Domain? Global Governance and the Asymmetry of Power*, (London: Routledge, 2001) 274 ff.

²⁰ On the notion of competition order (Wettbewerbsordnung in German), see Walter Eucken, *Grundsätze der Wirtschaftspolitik*, 6th ed. (Tübingen: Mohr Siebeck, 1990) 245–50.

²¹ On the importance of a meta order with regard to systems competition from a legal perspective see, e.g. Anne Peters and Thomas Giegerich, 'Wettbewerb von Rechtsordnungen', in *Veröffentlichungen der Vereinigung der Deutschen Staatsrechtslehrer* 69 (2010) 38 ff.

²² On jurisdiction and extraterritorial jurisdiction in general see Robert Jennings and Arthur Watts, *Oppenheims International Law, Volume 1: Peace*, 9th ed. (Oxford: Oxford University Press, 2008) para 139.

²³ For a comprehensive study on the principle of cooperation in international economic law, see Christian Tietje, 'The Duty to Cooperate in International Economic Law and Related Areas', in Jost Delbrück (ed), *International Law of Cooperation and State Sovereignty* (Berlin: Veröffentlichungen des Walther-Schücking-Instituts für Internationales Recht an der Universität Kiel Nr. 139, 2002) 45–65.

financial regulation and supervision in mind. There are no specific obstacles in the way of any attempt to harmonize rules and principles of financial regulation by international instruments. Different harmonization strategies may be applied, namely full harmonization or minimum harmonization. While minimum harmonization would leave states the freedom to regulate in areas not covered and with respect to standards not defined by the relevant international instrument, full harmonization would oblige states to implement an international standard without any space for discretion. However, disregarding whether full harmonization, minimum harmonization or—as frequently happens—a mixture of both approaches is applied, states always have discretion over how to implement the respective international standards, i.e. they may find ways and means to smoothly adjust their national legal order to accommodate the new international standard.

As experience in the European Union shows, harmonization is often more complicated with regard to supervision. Supervision is, like all forms of law enforcement, deeply rooted in domestic legal systems and traditions. Moreover, states are very reluctant to allow ‘foreign’ (i.e. also international) law and/or authorities to influence, let alone to determine, domestic supervision. Any attempt to establish some kind of international financial supervisory authority is currently utopian.²⁴

None of these conceptual problems of financial regulation and supervision is entirely new. On the contrary, there has been widespread discussion on these and related issues for several years within the larger framework of the globalization debate.²⁵ The political (and public) reaction to the financial market crisis of 2007–09, however, ignored, at least to some extent, these conceptual problems. Any attempt at strengthening financial regulation and supervision will have to take conceptual problems and issues into account in order to have a chance of success.

III. THE EXTENSION OF AREAS OF SUPERVISION AND REGULATION AND NEW METHODS AFTER THE CRISIS

A. New areas

After the financial crisis had reached its climax in 2008, a number of changes to the existing state of financial supervision and regulation were suggested. Some of them have already been adopted.

One central change is to bring previously unregulated financial intermediaries under supervisory control. This applies, for instance, to hedge funds

²⁴ Creating a central supervisory authority on a supranational level proves difficult, even in the European Union. For details on the *status quo* and the current reform debate, see Matthias Herdegen, *Banking Supervision within the European Union* (Berlin/New York: de Gruyter, 2010).

²⁵ See, e.g. Kern Alexander, Rahul Dhumale and John Eatwell, *Global Governance of Financial Systems: The International Regulation of Systemic Risk* (Oxford: Oxford University Press, 2006).

and private equity funds. It is often said that they constitute a ‘shadow banking system’ next to the traditional—supervised and regulated—banking system.²⁶ Although no direct causal link between these funds and the outbreak of the financial crisis has been demonstrated, in both the US and the EU efforts are being made to require registration by fund managers, to impose capital requirements, and to prescribe or prohibit certain fund activities.²⁷ Other players in the new financial architecture that will be subject to tighter regulation are the credit rating agencies. The EU has adopted a regulation that requires them, *inter alia*, to register with the authorities of the Member States.²⁸ In the USA, measures to improve the accountability and transparency of nationally recognized statistical rating organizations have been taken.²⁹

Furthermore, states seek to render financial supervision more efficient. In the USA, an effort was made to concentrate the supervisory function, which previously had been very fragmented.³⁰ Nonetheless, a new agency in the form of a Bureau of Consumer Financial Protection has been added.³¹ In the EU, besides reform efforts in the Member States, the main direction is to strengthen the supervisory function at the Union level.³²

It is remarkable that on both sides of the Atlantic, the traditional control of financial intermediaries will be supplemented by macro-prudential supervision.³³ In the USA, the Federal Stability Oversight Council was created by the Dodd-Frank Act.³⁴ In the EU, the Commission suggested installing a ‘European Systemic Risk Board’.³⁵ This implies that the traditional focus on the individual institutions will be supplemented by a concern for systemic stability. The institutional setting of this macro-prudential supervision and its interaction with the other supervisors is not yet fully elaborated. In the USA, for instance, much will depend on the regulations that are yet to be enacted.

²⁶ See, e.g. Financial Services Authority, ‘The Turner Review: A Regulatory Response to the Global Banking Crisis’, March 2009, at 21; The High Level Group on Financial Supervision in the EU (‘de Larosière Report’), 2009, at 8.

²⁷ See, for the USA: Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, Public L. 111–203 (Dodd-Frank Act), Title IV, Sections 401 ff. For the EU: see Draft Alternative Investment Fund Managers Directive, COM(2009) 207 final.

²⁸ European Parliament and Council Regulation (EC) No 1060/2009 on credit rating agencies, OJ 2009 L 302/1.

²⁹ See Dodd-Frank Act, Title IX, Subtitle C, Sections 931 ff.

³⁰ See the improvements to supervision and regulation of federal depository institutions proposed by the Dodd-Frank Act, Title III, Sections 300 ff.

³¹ Dodd-Frank Act, Title X, Sections 1001 ff.

³² See the European Commission’s drafts suggesting the establishment of ‘European Supervisory Authorities’ for banks, insurance companies, and securities firms: COM(2009), 501, 502 and 503 final.

³³ For further details on the micro/macro perspective, see Section III:C below.

³⁴ See Dodd-Frank Act, Title I, Subtitle A, Sections 111 ff.

³⁵ See European Commission, Proposal for a Regulation of the European Parliament and of the Council on Community macro prudential oversight of the financial system and establishing a European Systemic Risk Board, COM(2009) 499 final.

As to the reform of the substantive requirements of banking regulations, discussions are under way. They mostly concern enhanced capital adequacy and/or liquidity requirements.³⁶ So far, transatlantic agreement on these reforms has not been reached. What is clear, however, is that micro-prudential standards will be changed in such a way as to take into account macro-prudential concerns: more anti-cyclicality shall be obtained by requiring banks to build up buffers of resources during good times, which they can draw on when economic conditions deteriorate.³⁷

One new area that has appeared on the political agenda since the crisis, and seems set to stay, is the regulation of bankers' remuneration. The former Financial Stability Forum (FSF, now Financial Stability Board) asked for changes in its 'Principles for Sound Compensation Practices'.³⁸ Underlying the changes is the idea that the current remuneration scheme has induced short-term thinking and risk-prone behaviour of bank managers. Efforts to regulate the problem are being made on the national level.³⁹ However, it is hard to tell whether they are really inspired by the FSF's principles or—which seems at least equally probable—by the public outrage over huge bonuses.

A further area that has attracted the interest of legislators since the crisis is the restructuring of credit institutions. It is a well-known aphorism that 'banks live globally and die nationally'. Bail-outs have required taxpayers to put up staggering amounts in guarantees and cash. No wonder that governments are increasingly looking for alternatives. Although it is still totally unclear whether and how the 'too big to fail' logic and moral hazards can be escaped, there is an apparent endeavour for the 'juridification' of bail-outs.⁴⁰ The goal is to remove the topic from the political scene and bring it under a legal framework.

States are also resolved to reform accounting. At a meeting in Washington, DC, in April 2010, finance ministers and central bank governors agreed that a single set of high-quality global accounting standards shall be reached.⁴¹ The aim is to increase transparency for investors and supervisors.

³⁶ See the article by Hal Scott, in this issue at 763–778.

³⁷ See G-20, above n 1.

³⁸ Financial Stability Forum, 'Principles for Sound Compensation Practices', 2 April 2009, http://www.financialstabilityboard.org/publications/r_0904b.pdf (visited 10 October 2010).

³⁹ See, e.g. the draft for a Management Remuneration Act by the German Federal Government, 'Entwurf eines Gesetzes über die aufsichtsrechtlichen Anforderungen an die Vergütungssysteme von Instituten und Versicherungsunternehmen', 31 March 2010, BT-Drucks. 17/1291.

⁴⁰ See, e.g. Dodd-Frank Act, Title II, Sections 201 ff. See Gesetz zur Einführung eines Reorganisationsplanverfahrens für systemrelevante Kreditinstitute und zur Abwehr von Gefahren für die Stabilität des Finanzsystems (German Reorganization Procedure and Financial Stability Protection Bill), 26 August 2009, published in WM (Wertpapier-Mitteilungen) 2009, p. 913.

⁴¹ See G-20, 'Communiqué: Meeting of Finance Ministers and Central Bank Governors', Washington, DC, 23 April 2010, para 4.

Impending regulations increasingly impinge upon the activities that financial institutions may undertake. The Volcker rule as contained in the Dodd-Frank Act prohibits proprietary trading and other capital market activities for banks.⁴² Restrictions are also foreseen for other new techniques. Take, for example, securitizations: the Group of 30 demanded that banks shall keep a 'meaningful' part of the credit risk on their books in order to align their interests with those of the purchasers of collateralized debt obligations (CDOs) or other asset-backed securities.⁴³ This so-called minimum risk retention, or 'skin in the game', has been fixed on both sides of the Atlantic at 5%.⁴⁴

The infrastructure of the financial system is under equally enhanced scrutiny. Particular attention is being paid to the way that credit default swaps (CDS) are traded. While traditionally they have been sold over the counter, an international consensus has emerged that they shall be brought to exchanges and electronic platforms and cleared through central counterparties.⁴⁵ Moreover, individual transactions shall be reported to trade repositories.⁴⁶ The goals are to prevent counter-party risk from concentrating in a few private institutions and to bring more transparency to the market. National plans exist to put these agreements into practice.⁴⁷

B. New methods

The methods used for international cooperation and coordination of financial regulation and supervision are basically known. As there is almost no 'hard' international law on regulation and supervision, different categories of 'soft' law are commonly used.⁴⁸ The typical international soft law instrument in this regard is standardization. The best known example for such soft law standardization with regard to financial regulation is probably the International Convergence of Capital Measurement and Capital Standards,

⁴² See Dodd-Frank Act, Section 619.

⁴³ Group of 30, 'Financial Reform – A Framework for Financial Stability', 15 January 2009, at 8, Core Recommendation I, Recommendation 1 b.

⁴⁴ See for the USA: Securities Exchange Act 1934, above n 9, Section 15G(c)(1)(B) as amended by the Dodd-Frank Act, Section 941; for the EU: Directive 2009/111/EC, OJ 2009 L 302/97, art 1, No. 30.

⁴⁵ See G-20, 'Leaders' Statement: The Pittsburgh Summit', Pittsburgh, 24–25 September 2009, at 9, para 13.

⁴⁶ Ibid.

⁴⁷ See, for the USA: Dodd-Frank Act, Titles VII and VIII, Sections 701 ff; for the EU: Communication from the Commission, Ensuring efficient, safe and sound derivatives markets, COM(2009) 332 final; Future policy actions, COM(2009) 563 final.

⁴⁸ See article by Chris Brummer, in this issue at 623–643.

the so-called Basel Accord.⁴⁹ While the Basel Accord is essentially a non-binding instrument, in other areas of financial regulation a strategy of incorporation is used in order to give non-binding instruments some legal force. This mechanism is used, for example, with regard to accounting standards, which are initially non-binding but are incorporated into domestic legislation.⁵⁰

The general strategy of international cooperation and coordination by soft law instruments was not changed after the financial market crisis of 2007–09. However, G-20 leaders at the London Summit on 2 April 2009 made it clear that the applicable principles for financial market reforms ‘[a]re strengthening transparency and accountability, enhancing sound regulation, promoting integrity in financial markets and reinforcing international cooperation’.⁵¹ All of these principles not only refer to domestic financial markets, but also *per se* to the international financial system. This is due to the simple fact that there was a rapidly emerging consensus that the crisis of 2007–09, at least to some extent, revealed evidence of ‘insufficient coordination among regulators and supervisors and the absence of clear procedures for the resolution of global financial institutions’.⁵² So far, the main response of the international community to this insight was the establishment of the (international) Financial Stability Board (FSB), succeeding the FSF. The FSF was established in 1999 as a reaction to the Asian financial crisis of that time. The FSF was composed of the finance minister, the central bank governor, and a supervisory authority from each of the G7 states and a few other developed countries together with representatives of the most important international financial institutions.⁵³ This composition, i.e. the exclusion of emerging markets and of developing countries, and the rather limited political mandate and support of the FSF, created obstacles in the work of the FSF. Faced with the obvious challenge of strengthening international cooperation and coordination in financial regulation and supervision, there was a pressing need to decide on, and implement, institutional reforms in the international financial system as a reaction to the Asian crisis. The most natural candidate for a more prominent role in this regard was, of course, the IMF. However, the mandate of the IMF was restricted with regard to

⁴⁹ Basel Committee on Banking Supervision, ‘International Convergence of Capital Measurement and Capital Standards: A Revised Framework’, June 2004, <http://www.bis.org/publ/bcbs107.pdf?noframes=1> (visited 4 August 2010).

⁵⁰ See, e.g. European Parliament and Council Regulation (EC) No 1606/2002 on the application of international accounting standards, 19 July 2002 OJ 2002 L 243, at 1.

⁵¹ G-20, above n 1.

⁵² Stijn Claessens, Giovanni Dell’Ariccia, Deniz Igan and Luc Laeven, ‘Lessons and Policy Implications from the Global Financial Crisis’, IMF Working Paper, WP/10/44, 2010, at 7.

⁵³ For details, see Enrique Carrasco, ‘Global Financial and Economic Crisis Symposium: The Global Financial Crisis and the Financial Stability Forum: The Awakening and Transformation of an International Body’, *Transnational Law & Contemporary Problems* 19 (2010), at 203 ff.

financial regulation and supervision.⁵⁴ Moreover, voting rights in the IMF are limited and cannot be opened up to react convincingly to the demands for increased participation of emerging markets and developing countries. Thus, similar to the situation in 1998–99, the FSF was chosen as the more appropriate institution or ‘regime’ for effective international cooperation and coordination.⁵⁵ In this regard, the main purpose of establishing the FSB as the successor of the FSF was to form ‘a stronger institutional basis’ for cooperation with and assistance of national and international financial authorities and institutions so as to help to ensure financial stability.⁵⁶ More specifically, as well as extended membership, the mandate of the (new) FSB was—in addition to the tasks which had been assigned to the (old) FSF—extended to:

a) monitor and advise on market developments and their implications for regulatory policy; b) advise on and monitor best practice in meeting regulatory standards; c) undertake joint strategic reviews of the policy development work of the international SSBs to ensure their work is timely, coordinated, focused on priorities and addressing gaps; d) set guidelines for and support the establishment of supervisory colleges; e) manage contingency planning for cross-border crisis management, particularly with respect to systemically important firms; and f) collaborate with the IMF to conduct Early Warning Exercises.⁵⁷

The FSB is not only a ‘new’ international financial institution with a broad mandate with respect to coordination and cooperation in the area of financial regulation and supervision, it is also a reaction to the important lesson learnt from the crisis that financial macro- and micro-policy need to go hand-in-hand.⁵⁸ Moreover, the establishment of the FSB may be seen as the interesting evolution of an international regime from a ‘very soft’ forum to—albeit still non-binding—a more rule-based institution. Certain similarities with the evolution of the General Agreement on Tariffs and

⁵⁴ Regarding the mandate of the IMF see, e.g. IMF, ‘The Fund’s Mandate: An Overview’, 22 January 2010, <http://www.imf.org/external/np/pp/eng/2010/012210a.pdf> (visited 19 October 2010); IMF, ‘The Fund’s Mandate – The Legal Framework’, 22 February 2010, <http://www.imf.org/external/np/pp/eng/2010/022210.pdf> (visited 4 August 2010); Independent Evaluation Office of the IMF, Biagio Bossone, ‘Integrating Macroeconomic and Financial Sector Analyses within IMF Surveillance: A Case Study on IMF Governance’, BP/08/11, May 2008 http://www.ieo-imf.org/eval/complete/pdf/05212008/BP08_11.pdf (visited 4 August 2010).

⁵⁵ See Carrasco, above n 53.

⁵⁶ *Ibid.*, at 218.

⁵⁷ FSF, ‘Financial Stability Forum Re-Established as the Financial Stability Board’, Press Release, 2 April 2009, http://www.financialstabilityboard.org/press/pr_090402b.pdf (visited 4 August 2010).

⁵⁸ For further details, see the discussion at Section III:C below.

Trade 1947 may emerge in the future.⁵⁹ Finally, the existence of the FSB as the key institution for international cooperation and coordination in the areas of financial regulation and supervision indicates that the dominant strategy remains soft-law oriented. One could thus gain the impression that the entire international approach towards financial regulation and supervision is more or less exclusively power-oriented,⁶⁰ i.e. not based to any great extent on legal principles and rules. This impression, however, would not be accurate. It is important to realize that the G-20 process since Autumn 2008, namely the establishment of the FSB, offers evidence of increasing reliance on legal principle and rules in order to provide international financial stability. Even though what has been agreed by G-20 leaders is not a treaty of public international law and is actually not legally binding at all, the developments described offer evidence that a similar evolution to that which followed the Asian crisis of 1998–99 has occurred. At that time, the international community reacted to a major crisis of the international financial system by strengthening the rule of law, i.e. by moving towards a more legalized international financial system.⁶¹

C. Conceptual transnational challenges

Despite strong political willingness—at least when the crisis was at its peak in 2008–09—to accept internationally coordinated reforms of financial regulation and supervision, as expressed by the establishment of the FSB, it is questionable whether we have seen truly substantive moves to this effect so far. One reason for this might be that it is much easier to produce an internationally acceptable general paper, such as the Communiqué from the London Summit of 2 April 2009, than to reach consensus on detailed and to a large extent technical questions of financial regulation and supervision. Moreover, one may argue that even though some successful reforms have been initiated in the area of financial regulation, this is not true of supervision. Financial supervision seems to have been utilized in some countries during the crisis in order to pursue protectionist interests.⁶²

The observations above lead back to the question of conceptual transnational challenges for reforming financial regulation and supervision. Based on the arguments presented above on regulatory competition and

⁵⁹ See also the paper by Michael Gadbaw, in this issue at 551–574, and see e.g. John H. Jackson, *The World Trade Organization – Constitution and Jurisprudence* (London: Routledge, 1998) 12 ff.

⁶⁰ On the notion of ‘power-oriented’ versus ‘rule-oriented’ approaches in international economic law, see John H. Jackson, ‘The Birth of the GATT-MTN System: A Constitutional Appraisal’, *Law & Policy in International Business* 21 (1980), at 27 ff.

⁶¹ Nicholas Bayne and Stephen Woolcock, ‘Economic Diplomacy in the 2000s’, in Nicholas Bayne and Stephen Woolcock (eds), *The New Economic Diplomacy. Decision-Making and Negotiation in International Economic Relations* (Aldershot/Hampshire: Ashgate, 2005) 291.

⁶² See Hopt, above n 15, at 1401.

the need for international meta norms, it is clear that globalized financial markets have to cope with a prisoner's dilemma: even though it is evident that the greatest welfare gains will be achieved by a strategy of internationally harmonized rules and principles in some core areas of regulation and supervision combined with regulatory competition, states tend to deviate from this model by pursuing national interests, i.e. acting in a protectionist way. This not only negatively affects welfare gains, but inherently poses risks to international financial stability. Even though this is known by the relevant actors, namely states, their protectionist behaviour may very well be explained by rational choice theory.⁶³ Thus, at least to some extent, the international financial system faces similar problems to those faced by the international trading system.⁶⁴ However, what is different is the inherently extraterritorial character of measures concerning financial markets. As with any extraterritorial measure, this raises additional legal problems and transaction costs. The situation is thus similar to competition law as an area of economic law in which there is also insufficient international harmonization and coordination in regulatory and supervisory matters and thus a high level of extraterritorial measures with negative effects and severe legal problems.⁶⁵

The substantive conceptual problem of insufficient international meta norms on financial regulation and supervision also has an institutional perspective. Despite the existence of the newly established FSB and a somewhat strengthened role of the IMF, financial regulation and supervision is almost completely dominated by domestic regulatory and supervisory institutions. Attempts to establish international (or supranational) authorities have failed, even in the EU.⁶⁶ Thus, as financial markets are not only characterized by domestic embeddedness, but also by international (or global) interdependence, the institutional design is not aligned with the scope of financial regulation and supervision, i.e. the domain of the regulator is not the same as the domain of the financial market(s).⁶⁷

A further challenge to international financial market stability is the classic differentiation between a micro and a macro perspective. The criticism on this differentiation and thus the call for a more integrated approach towards

⁶³ For details on the public/rational choice theory and the international economic system see, e.g. Ernst-Ulrich Petersmann, *Constitutional Functions and Constitutional Problems of International Economic Law* (Fribourg: University Press, 1991) 116 ff.

⁶⁴ On the prisoner's dilemma in the international trading system see, e.g. Bernard Hoekman and Michel Kostecki, *The Political Economy of the World Trading System*, 3rd ed. (Oxford: Oxford University Press, 2009) 34 ff and 146 ff.

⁶⁵ See, e.g. Dietmar Baetge, 'The Extraterritorial Reach of Antitrust Law between Legal Imperialism and Harmonious Coexistence', in Eckart Gottschalk, Ralf Michaels, Gisela Rühl and Jan von Hein (eds), *Conflict of Laws in a Globalized World* (Cambridge: Cambridge University Press, 2007) 220 ff.

⁶⁶ For details, see Herdegen, above n 24.

⁶⁷ See Alexander, Dhumele and Eatwell, above n 25, at 15: 'The domain of the regulator should be the same as the domain of the financial market'.

financial regulation and supervision is not new. It was articulated with regard to the Asian crisis of 1997–98⁶⁸ and the IMF actually shifted at that time towards more microeconomic financial regulation. Yet, the capacity of the IMF to follow an integrated approach in this regard is limited by the restrictive mandate of the Fund (IMF Article IV).⁶⁹ For this reason, and because of the cumbersome procedure for changing the founding treaty of the IMF, the establishment of the FSB and the reasonably broad mandate given to it have to be seen as a soft law approach towards better integrated financial regulation and supervision. It remains to be seen whether this new approach will be successful.

IV. WHAT LEVEL OF HARMONIZATION IS OPTIMAL FOR FINANCIAL MARKETS?

The basic question that is still open is on which level financial markets would be optimally supervised and regulated. There are at least three different levels available: the local, regional, and international.

At first sight, the international level seems the most appropriate. Regulation by public international law and/or international soft law responds to the existence of a truly global financial market. As the crisis has shown, national financial systems are not only interdependent, but also integrated. International regulation would fit with this reality. It would avoid disparities of national rules and reduce opportunities for regulatory arbitrage.

However, an internationally harmonized financial system would have a major drawback: it eliminates, to a large extent, the competition of states for the best regulatory regime. As mentioned above, financial products are domestically embedded, meaning that their quality and content is determined to a large extent by the domestic legal system under which they are created.⁷⁰ This creates a competition of systems. The important point is that such competition plays a crucial role in the efficiency of financial markets because no one knows what kind of regulation and supervision is best. Reforming and adapting financial legislation to new needs is therefore a process of discovery. The ‘consumers’ ultimately decide what balance between public oversight and private liberty they think is most appropriate to the risks involved. Total harmonization of regulation and supervision obviously would stall this discovery process because it would eliminate the competition between systems.

There is more: instead of reducing the probability of financial fallout, a uniform global financial regime would increase the risk of global failures.

⁶⁸ See, e.g. Alexander, Dhumale and Eatwell, above n 25, at 208: ‘[a] weak macroeconomic environment is often associated with emerging banking crises’.

⁶⁹ Above n 54.

⁷⁰ See Section II:C above.

This counter-intuitive claim can be proven by a parallel to the problems resulting from the ‘herd behaviour’ of investors: if all state regulators and supervisors were to work in the same way, any unknown risk hidden in the financial markets would have disastrous consequences. While, nowadays, it only affects those states whose legislation and administration is ignorant of or ill-adapted to the risk, under a globally harmonized regime it would affect *all* countries in the world. No longer would there be islands and safe havens that are less affected, such as Spain or Italy who were doing well despite the financial crisis in 2007–09—until it turned into a sovereign debt crisis in 2010. Moreover, it would no longer be possible to empirically determine the performance of different systems and compare their results in real life. We would all be chained to one method of financial regulation, for better or for worse. Improvements could only be suggested in a theoretical way, without testing their viability in practice.

One can thus see that a certain degree of decentralization or localization of financial law has inherent advantages. It works as a permanent laboratory in which different degrees and methods of legislation and supervision are tested. Moreover, it sets the stage for a system of multilayered or multilevel governance in the financial area.⁷¹ Under this system, regulation and supervision can be better adapted to the peculiarities of local markets and at the same time comply with the need for a uniform framework.

On the other hand, the harmful effects that divergences between national regimes and practices are producing cannot be denied. One only needs to remember the negative externalities created by extra-territorial effects of financial legislation or the over-regulation of domestic markets that may be inspired by protectionist instincts.⁷² Hence, the relationship between international harmonization and regulatory competition cannot be an ‘either/or’ one: it has to be an ‘at the same time’ one. The focal point of the discussion on a meta norm for international finance therefore must be to find the right balance between global harmonization and the possibility for states to create new regulatory and supervisory techniques, so that possible welfare gains are not lost and competition between different systems is not stalled. The question is thus not whether we need international cooperation—we certainly do—but what is the optimal *degree*.

In answering this question, it should be noted that competition of systems is not always beneficial. Instead, differentiation is needed. In some areas, divergences between national laws make no sense when seen from an overall viewpoint. This is true, for instance, for bail-out regimes. Peculiar national rules on saving financial institutions can often only be explained by protectionist motives. Differences between restructuring regimes thus serve no useful purpose. Indeed, the rules for restructuring banks should be globally

⁷¹ See the paper by Rolf Weber, in this issue at 683–704.

⁷² See Sections II:C and III:C above.

harmonized or it will never be possible to achieve a fair and equitable framework in which financial institutions can operate. Similar arguments could be made for rules on the infrastructure, for instance CDS clearing. Here again, divergent national rules have only limited usefulness, and the advantages of a global regime seem to outweigh the benefits of competition. Thus, these topics could be addressed by a meta-norm without any damage to the efficiency of financial markets. On the contrary, a global regime would provide the necessary framework for efficient competition of legal systems.

On the other hand, there are areas in which different regimes will be useful. For example, capital requirements for credit institutions may be better regulated on a national level. There is no agreement on how much equity a bank needs to run its business safely. It may thus be a good idea to have states fixing different rules for their institutions. Although at first sight, this might go against the idea of a 'level playing field', its creation is not the major goal of financial law. There are other aims that are of greater importance.⁷³ Moreover, some banks might see the imposition of stricter capital requirements by their law not as a comparative disadvantage but as an edge over their competitors because they breed trust in the minds of the clients. Therefore, some form of competition between states should be allowed with regard to this issue. Similar considerations may apply for bankers' remuneration schemes.

It is apparent that when determining the optimal level of global coordination, it is indispensable to consider this according to the practical problem that has to be solved. Of course, there are no predetermined rules as to which matters should be left to states and which should be dealt with by global fora or institutions. This does not exclude, however, the use of some rules of thumb. For instance, areas which by their very nature lend themselves to extra-territorial legislation should, as a matter of principle, be dealt with on the international level. A case in point is the registration and supervision of credit rating agencies. Since the business model of these intermediaries is global, it makes little sense to entrust their regulation to the whims of the national legislator in the jurisdiction of which they happen to be located. At the same time, the efficient functioning of the rating agencies would be threatened if each state or region were to operate its own registration process for these intermediaries. Rather, what is needed is a transnational regime. The same is true for hedge funds and other lightly regulated masses of capital. The reason why they have become an area of concern is the potential domino effects their breakdown could have on the financial system. As these effects would spill over national boundaries, it is clear that efforts to achieve closer regulation and control of such funds should in principle be globally coordinated.

⁷³ See Section II:C above.

V. CONCLUSION

The role of international law in financial regulation and supervision cannot be determined by an all-embracing formula. There are different levels on which financial problems can be dealt with. Each of them has its purpose and function. For a particular matter, it might be advisable to choose one level, while a different issue would better be left to another.

There can thus be no one-size-fits-all approach. In particular, it would be misplaced to think that global harmonization would offer a magic cure for all of the financial system's ills. Under some circumstances, it can indeed lead to an increase in overall efficiency and welfare. But since it is unknown what kind and degree of oversight and regulation is optimal, in some areas competition between states for the best regulatory regime must be maintained. These findings coincide with arguments put forward under the doctrine of multilayered or multilevel governance, seeking to properly allocate powers and functions to different regulatory levels. This article has offered some indications as to the forms which international financial legislation can take and the areas it should cover. They can serve as yardsticks for the research on individual issues that still needs to be done.