Post-American Securities Regulation

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INTRODUCTION

International securities regulation has arrived, in spectacular fashion, at the forefront of the country’s national debate on financial markets reform. The unprecedented scope of the current financial crisis has exposed the enormous risk that can arise with the cross-border sale of securities.1 Meanwhile, the global nature of the Bernie Madoff and Robert Allen Stanford investment frauds, as well as the accounting scandals that toppled once adored multinationals Enron and Parmalat, have illustrated the now international reach of con men.2 As a result, policymakers and scholars have vociferously called upon regulatory authorities to better monitor global markets, protect investors par-

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1. See Steven L. Schwarcz, Systemic Risk, 97 GEO. L.J. 193 (2008) (describing the domestic and international nature of systemic risk and the role of securities regulation in addressing it); see also JOHN R. TALBOTT, CONTAGION 105 (2009) (detailing how the toxic securities supporting the U.S. housing market were purchased not only by U.S. financial institutions, but also by “foreign countries, their central banks, and their commercial banks,” which has threatened the global economy).

participating in such markets, and promote international enforcement cooperation.³

This call to action presents tremendous new challenges for the Securities and Exchange Commission ("SEC"), the primary agency tasked with protecting U.S. investors from fraud. A series of high-profile supervisory lapses has undermined the agency's international reputation.⁴ Furthermore, the agency's regulatory power has steadily declined as transactions and sources of capital have moved offshore.⁵ In the last decade, U.S. stock exchanges such as the NYSE and Nasdaq have merged with foreign competitors to create electronic trading platforms spanning ten time zones.⁶ Emerging markets, meanwhile, have developed sophisticated and highly liquid financial centers that now finance many of the world's largest transactions and attract the participation of U.S. investors.⁷ And foreign market participants, including sovereign wealth funds and international hedge funds, have become important, albeit controversial, contributors to the stability of a domestic banking system in crisis.⁸ Consequently, the SEC is grappling not only with the question of how to reform its domestic oversight, but also how to export its preferred safeguards and reforms in a time of declining U.S. economic and financial influence.⁹


⁴. For an excellent overview of this problem see Jill E. Fisch, Top Cop or Regulatory Flop? The SEC at 75, 95 VA. L. REV. 785 (2009).


⁹. See Howell Jackson, Toward a New Regulatory Paradigm for the Trans-Atlantic
Traditional securities regulation provides few answers. Since World War II, practitioners and scholars alike have viewed the United States as the "capital of capital."\(^1\) Because the United States has the largest and most respected stock exchanges in the world, commentators have long assumed that most multinational companies have little choice but to raise capital here—and, in the process, subject themselves to U.S. regulatory oversight. Consequently, scholars in the field have at least implicitly assumed that U.S. rules were exported de facto, due to the size and importance of the country's capital markets.\(^1\)

Indeed, the first attempts to theorize the SEC's coordination efforts have come from international relations scholars, whose interest in globalization has led to important contributions to the understanding of international financial regulation.\(^1\) In particular, these scholars have identified—and generally lauded—loose, cooperative arrangements between and among like agencies seeking to respond to global issues.\(^1\) They argue that these informal points of

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13. Networks have, however, generated some skepticism from scholars questioning the accountability networks make possible. See Kenneth Anderson, Squaring the Circle? Reconciling Sovereignty and Global Governance Through Global Government Networks, 118 HARV. L. REV.
contact and information sharing, described as “governmental networks” (or “networks”), facilitate swift agreement in core areas of regulatory concern, such as issuer disclosure and corporate governance, by building confidence and trust between experts. All the while, because securities law networks depend on the “soft power” of persuasion, rather than coercion, regulators in large countries like the United States enjoy considerable competitive advantages in advancing their approaches—insofar as regulators in large countries possess superior resources that allow them to promote their agenda, and regulators of smaller markets are inclined to emulate their success.

This Article refines these claims and offers a more comprehensive theory of SEC diplomacy. It argues that although network theory (frequently referred to in the literature as “transgovernmentalism”)16 rightly identifies networks as a useful tool for overcoming information asymmetries, the theory largely overstates the transformative potential of regulatory interconnectivity. Besides overestimating the soft power of network orchestrators like the SEC, network theorists assume that securities regulators always share similar incentives to coordinate rulemaking. Transgovernmentalism implies that interactions between securities regulators comprise what can be described in game theory terms as an “assurance” game, insofar as information asymmetries and a lack of trust form the primary obstacles to cooperation and convergence. Scholars, as a result, view networks as powerful catalysts for convergence, since they facilitate information sharing between regulators.

This Article builds on emerging scholarship suggesting that in a globalized and competitive market for capital, regulators are not necessarily incentivized to adopt the regimes of their foreign counterparts. Specifically, the Article maintains that information asymmetries and mistrust are not the only obstacles to coordination; instead, conflicting regulatory philosophies of national authorities, differing costs of adjusting to foreign regulatory standards, and competition among financial centers for securities transactions also hamper international convergence. Because of these dynamics, interests may be opposed and no agreement may be possible.

Furthermore, even where countries have an overriding preference to set common standards, coordination often comprises what in game theory terms can be described as a modified “battle of the sexes” game, in which regulators would prefer to cooperate, but each strongly prefers cooperating with its own domestic standards in place, rather than to incur the costs of switching to another standard. The Article then demonstrates that the existing regulatory infrastructure in such cases provides few, if any, inherent payoffs that could

1255, 1278 (2005). These voices have not, however, questioned the overall effectiveness of networks.
16. See id. at 5 (describing the networks as “transgovernmental networks”).
change the stalemate. Instead, only where securities regulation touches upon “systemic risks”—defined here as financial risks whose costs are internalized broadly and deeply across borders—will regulators be sufficiently incentivized to cooperate and will networks potentially be capable of realizing significant regulatory coordination. And even here, current practice suggests that coordination is most likely to be undertaken by multidisciplinary networks operating with the support of political elites.

The Article then shows that although most theorists may not have recognized the limitations of U.S. capital markets and the existing network infrastructure, the SEC implicitly has. As the significance of global capital markets continues to grow, the SEC has attempted to enhance the competitiveness of the U.S. regulatory environment, as is increasingly acknowledged.17 The SEC is also considering a surprising and novel institutional form—what this Article describes as “governmental clubs” (or “clubs”), which promote its policies through exclusive associations of similar standard bearers. Specifically, to achieve greater cooperation in the cross-border enforcement of securities laws, explicit membership standards have been introduced into multilateral networks so that regulators are stigmatized or excluded from participation if they fail to sign and adhere to global enforcement agreements. Meanwhile, both to liberalize markets and to incentivize the adoption of (generally more stringent) substantive standards, some SEC officials have suggested creating bilateral clubs through mutual recognition arrangements. Under their proposal, which is facing considerable political resistance, foreign exchanges and foreign broker-dealers would be eligible to enjoy preferential access to U.S. investors if they comply with foreign regulations that are comparable to those of the United States. The Article shows that such “third way” strategies would have the potential in some circumstances to change the payoffs of cooperation so that coordination at high regulatory standards is the dominant outcome.

However, the Article ultimately concludes that different issue areas have distinct strategic structures with varying likelihoods for cross-border cooperation. As a result, the effectiveness of clubs will likely depend on the context in which they are deployed. Mutual recognition would likely be, for its part, a less effective convergence mechanism. First, flexible membership standards may have to be imposed ex ante to secure agreement among countries. Second, even if mutual recognition involves strict membership standards, the high adjustment costs of substantive legal convergence, difficulties of excluding nonparticipants from the club, and the possible availability of alternative arrangements with other regulators all suggest that coordination at higher regulatory standards need not comprise the dominant outcome. On the other hand, in matters of enforcement cooperation, a

17. Brummer, Stock Exchanges, supra note 5, at 1436.
multilateral club will likely comprise a powerful lever for convergence, in part due to the low adjustment costs involved in cooperation and its relatively high reciprocal benefits for members.

In advancing these claims, this Article provides sorely needed analytical clarity for understanding the SEC’s international strategy and sets out a framework for theorizing about its possible regulatory outcomes. In doing so, the Article contributes to the securities law literature by identifying cross-border regulatory collusion as an overlooked form of regulatory power that moves beyond the conventional models of regulatory monopoly and competition that dominate the scholarship. It also contributes to international law and international relations literature by refining core claims of transgovernmentalism and identifying new and unanticipated modes of regulatory coordination.

The Article proceeds as follows. Part I provides a comprehensive overview of the SEC’s tools of regulatory export and summarizes the theory justifying them. Part II then critiques the prevailing theory’s normative claims and shows that networks are often weak mechanisms for coordinating securities law, due to the heterogeneous policy preferences of regulators and the considerable distributive implications of standardization for competing financial centers. Part III examines systemic risk and predicts where networks are most likely to be effective. Part IV returns to the SEC’s current international regulatory strategy and shows how the SEC is increasingly utilizing clubs to promote its regulatory preferences, in the face of declining U.S. economic influence and limited success under governmental networks. Finally, Part V demonstrates how the regulatory outcomes of governmental clubs depend in large measure on the context in which they are deployed and outlines various implications for efficiency.

Although this Article addresses a wide range of securities law matters, it does not address international accounting standards, an important field of securities regulation where some high-profile efforts at coordination have been launched.18 This is in part out of concern for brevity, as well as an acknowledgment of the fact that “private legislatures” consisting of market participants, not regulatory agencies, act as the primary standard setters for international financial reporting.19 Nevertheless, this Article offers a theoretical framework applicable to accounting where regulatory agencies either adopt or help promote the standards devised by these institutions. In doing so, it helps

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explain a wide range of activities in the field.

I

SOFT POWER AND GLOBAL INVESTOR PROTECTION

A. The SEC’s Interest in Exporting U.S. Securities Laws

Recent scholarship has acknowledged that there is an increasingly international market for securities laws. On the sell side, securities regulators and lawmakers “sell” their nation’s laws to ever more mobile firms seeking to raise capital. These laws historically dictate what facts a firm selling securities must disclose to investors and the penalties that attach when companies make fraudulent or misleading disclosures. Firms, in turn, “buy” laws through fees paid to the government in connection with using the rules and compliance with rules purchased. In this market, regulators often compete for securities transactions given the positive economic spillovers they generate, such as high tax revenues and a financial services industry that rewards lawmakers for improving efficiency and their profits.

Firms are not, however, the only potential consumers of a country’s securities laws—a fact curiously overlooked in the literature. Foreign governments are also consumers when they emulate the laws and rules of another regulator, either due to competition for financial transactions or an acknowledgment of another regulator’s superior approach. Though not “purchasers” in a conventional sense, they are very much importers of securities laws that are ultimately used and consumed by that nation’s domestic firms.

The degree of emulation by foreign governments, at least traditionally, has held three critical implications for regulators around the world, and especially America’s primary securities regulator, the SEC. First, the importation of U.S. securities laws potentially impacts the SEC’s ability to deliver on its legislative mandate to protect domestic investors. Historically, as John Coffee points out, securities markets have “long been thought to be affected with a special public interest” of consumer protection. This duty, articulated in the United States in the SEC’s enabling legislation (a response to the financial fraud associated with the 1929 stock market crash), tasks the agency with stomping out fraud by

23. Brummer, Stock Exchanges, supra note 5, at 1481.
issuers who may seek to mislead investors in their financial statements or other public disclosure tied to the offer and sale of securities. It also tasks the agency with helping to ensure market integrity, a task increasingly associated with systemic risk.

Until recently, this mandate was not difficult to fulfill on a territorial basis because U.S. investors generally transacted domestically. The SEC could, in short, demand certain disclosures from firms that operated domestically, police them in the United States, and then punish companies that made fraudulent representations in the disclosures. However, the globalization of finance has made investor protection more difficult. By virtue of technology, U.S. investors regularly transact in foreign markets via computer terminals.26 This mobility, while allowing investors to diversify their portfolios, exposes them to risks of fraud when they transact in jurisdictions subject to inefficient investor protection regimes. Furthermore, the same computer technology that enables investors to move around the world in search of investment opportunities also enables fraudsters, including foreign brokers and dealers, to search the United States for opportunities to con, cheat, and steal money from unwary retail investors.27 A mastermind in one country can orchestrate cold calls from accomplices in a second country to prospective victims in the United States, with the proceeds of the fraud secreted to yet another country. Thus, to the extent that SEC officials can influence foreign regulators, it is believed that investments and market participants will generally be subject to more stringent regulatory policies that will benefit U.S. investors transacting overseas.

The degree to which U.S. rules and regulations are exported also affects less explicit, but equally long-held, objectives, such as lowering the cost of capital for domestic issuers of securities. Where foreign governments adopt or emulate U.S. rules, the transaction costs for U.S. firms engaging in cross-border transactions are likely reduced.28 Generally, whenever issuers offer securities, they must hire lawyers and auditors, alongside investment bankers and their counsel, to examine the business operations and confirm the accuracy of all disclosures.29 Comprehensive legal standards also expose firms to legal risk such as government sanctions or even private suits.30 Cross-border transactions may consequently be very expensive, since firms must comply with two different sets of disclosure requirements. Thus, when U.S. regulators can export their laws, they may be able to reduce the costs of cross-border issuances. Similarly, analysts across jurisdictions may be better able to understand and compare the performance of firms. In both circumstances, the costs of raising

27. See id. at 35 (noting that "[t]echnology and globalization have also created new opportunities for securities fraud").
28. Fleckner, supra note 22, at 2593.
29. Id.
30. Coffee, Racing, supra note 6, at 1794–95.
capital for firms, including domestic companies, is reduced.

Finally, widespread adoption of U.S. norms and practices enhances the prestige and power of the SEC. The SEC, like any bureaucracy, prides itself on growth and clout.\(^1\) To the extent that the SEC directs the regulatory process, it directs a range of subsidiary processes that touch upon virtually every area of financial life, including financial reporting, accounting, and even some issues of legal enforcement. As a result, the extent to which a securities regulator is able to export its laws will determine in large measure the regulator’s ability to impact global subsidiary issues of law that go to the heart of not only issuer protection, but also the functioning of financial markets. This gives significant prestige to regulatory agencies and their leaders.

**B. The Traditional Instruments of Export: What They Are and How They Are Used**

Despite the perceived benefits of regulatory export, U.S. lawmakers and regulatory agencies have largely refrained from exerting extrajurisdictional influence through expansive domestic legislation. Widely accepted principles of comity have instead dictated that the SEC “recognize[] the primacy of the laws in which a market is located.”\(^2\) If the United States did not abide by such tradition, it could risk retaliation from foreign regulators that could pass their own laws, effectively submitting U.S. firms to their regulation. Thus, by adopting a territorial approach to regulation, lawmakers help protect their own firms from the reach of foreign laws.

As a result, for over fifty years the SEC has maintained that registration obligations should not be imposed on offerings with only incidental jurisdictional contacts.\(^3\) The “territorial” or geographically based approach to jurisdiction exemplified in the 1933 Securities Act (Securities Act)\(^4\) and the 1934 Securities Exchange Act (Exchange Act) triggers compliance with U.S.

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31. *See William A. Niskanen, Jr., Bureaucracy & Representative Government* (1971) (asserting that bureaucracies grow because officials seek to increase the budgets they control and so boost their own salary, power, and standing).


33. In Securities Act Release No. 4708, the Commission stated that it would not take any enforcement action for failure to register securities of U.S. corporations distributed abroad solely to foreign nationals, even though the means of interstate commerce are used, if the distribution is effected in a manner that will result in the securities coming to rest abroad. Exchange Act Release No. 33-4708 (July 9, 1964) (29 FR 9828) ("Release 4708"); *cf.* IIT v. Vencap Ltd., 519 F.2d 1001, 1016 (2d Cir. 1975) (resolution of jurisdictional questions in the securities area “depends on construction of exercised congressional power not the limitations upon that power itself” (quoting Steele v. Bulova Watch Co., Inc., 344 U.S. 280, 282–83 (1972))). This approach was later memorialized in Regulation S, which limits the extrajurisdictional application of U.S. law and exempts transactions occurring overseas from U.S. registration—and by definition, regulatory oversight.

securities laws. In short, U.S. securities laws generally apply only where securities are sold on a U.S. exchange or where a company has a significant economic presence in the country, generally defined as having $10 million in assets in the United States and at least five hundred shareholders (three hundred of whom reside in the United States). Only general antifraud rules have an extrajurisdictional application, and even then, enforcement may be extremely difficult.

Because of this territorial approach to regulation, the SEC has depended on less intrusive means of promoting its regulatory standards. First, the SEC has relied on the size of its domestic capital markets as a means of effectuating its regulatory policies. Second, the SEC has sought to build and leverage cooperative, multilateral initiatives with its foreign counterparts in ways that promote coordination at its standards. Each of these methods is described below.

1. Domestic Stock Exchanges

When a foreign issuer lists its securities on a U.S. exchange, it must comply with U.S. securities law. This requirement has made stock exchanges perhaps the most important tool by which the United States exports its securities laws. Since the end of World War II, when many of the world’s capital markets lay in shambles, the size and depth of U.S. stock exchanges have dwarfed their counterparts. Indeed, they have been so dominant that most multinational companies have had little choice but to come to the U.S. to raise capital, either through an IPO or via secondary listings. Furthermore, U.S. exchanges also draw companies that need currency to finance transactions in the country (often acquisitions) and that wish to raise their profile with U.S. investors. These advantages with regard to liquidity have amplified the SEC’s international regulatory power, giving its rules an extrajurisdictional reach.

2. “Governmental Networks”

The SEC, through its Office of International Affairs (“OIA”), has also sought to promote its regulatory agenda through deeper coordination and cooperation with its foreign counterparts on matters concerning

35. Id. §§ 77a–77h.
38. Youssef Cassis, Capitals of Capital: A History of International Financial Centres, 1780–2005, at 207 (2006). This success of the U.S. market continued, though at times unevenly, up through the 1990s, a boom-time for international listings, with the number of foreign companies listed on the NYSE increasing from 100 to almost 400. Id.
(1) cross-border enforcement of securities regulations and (2) the promulgation
of common substantive policy. To achieve such coordination, the OIA
promotes a variety of informal cooperative arrangements and nonbinding
framework agreements, collectively (albeit somewhat deceptively) described
by scholars as "governmental networks."\(^{40}\) Four networks are of particular
importance, and each is outlined below.

\( \textit{a. Bilateral Memoranda of Understanding} \)

As the agency’s focal point for enforcement cooperation, the OIA is
tasked with assisting staff in the SEC’s Division of Enforcement in conducting
investigations and proceedings where wrongdoers, witnesses, evidence, or the
proceeds of a fraud—as defined by U.S. securities laws—are located abroad.\(^{41}\)
It is also responsible for assisting foreign regulators with their investigations
and proceedings where perpetrators, witnesses, evidence, or the proceeds of a
fraud are located in the United States. Such cooperation is useful because, when
regulators seek to enforce laws, both potential violators and the information
needed to build a case against them are often located in foreign countries.\(^{42}\)

To bring about cooperation in this area, since the 1980s the OIA has
facilitated enforcement cooperation through an elaborate network of at least
forty-one memoranda of understanding ("MOUs"). Each MOU has its own
particularities, although most involve the enhancement of a signatory’s
enforcement powers and the identification of cross-border points of contact for
enforcement purposes. Often, foreign counterparts do not have the required
domestic authority to assist the SEC when attempting to enforce their laws, so
the MOUs oblige signatories to seek it from their respective legislatures.\(^{43}\)
Furthermore, there has historically been no common or habitual process
outlining the means by which help can be secured. The MOUs thus work to
establish a procedure by which information will be gathered and to specify
what kind of information will be provided by the foreign agency. Some MOUs,
particularly those involving emerging markets, further include sections that
discuss technical assistance from the SEC in a number of areas, including
clearance and settlement, order handling systems, regulatory requirements

\(^{40}\) In many ways, “network” is itself a poor metaphor for the current regulatory
architecture, because it obfuscates the nature of the relationship between international actors with
the organizational makeup and structure of international bodies themselves. As a result, the
metaphor depicts many key networks as amorphous and institutionally primitive organizations,
which is regrettable given the considerable institutional sophistication evidenced by many
intergovernmental bodies. For the purposes of this Article, however, as well as for the sake of
clarity, I will abide by the more common scholarly terminology.

\(^{41}\) OIA Office Description (2006) (on file with author).

\(^{42}\) SEC. & EXCH. COMM’N, HANDBOOK FOR EMERGING MARKETS (2008) (on file with
author).

\(^{43}\) See Ana Carvajal & Jennifer Elliott, Strengths and Weaknesses in Securities Market
relating to market professionals, and capital adequacy.44

These framework agreements enhance cooperation and promote information sharing, knowledge of other regulatory systems, and trust between regulators. MOUs are not, however, enforceable as a matter of national or international law. Instead, their effectiveness relies on the premise that regulators presumably want to stay in good standing with their peers. Thus, regulators will comply with the terms of the agreement, as most (especially those of major markets) have a strong self-interest in promoting their own powers of cross-border enforcement.

b. Regulatory Dialogues

To advance information sharing and, frequently by implication, the promotion of its own regulatory policies, the OIA participates in a variety of international forums and dialogues. One important, but overlooked, mode of engagement is the “regulatory dialogue.”45 The OIA enters into these regular, bilateral meetings with key counterparts to identify and discuss regulatory issues of common concern, to promote harmonization when possible, and to facilitate cooperation in the exchange of information in cross-border securities enforcement matters.

The nature of such regulatory dialogues will generally differ depending on the parties involved. Dialogues with European authorities have thus far centered on issues concerning convergence in accounting standards. Meanwhile, dialogues with Asian countries have additionally emphasized surveillance and enforcement issues. In virtually all instances, however, the dialogues are key opportunities to initiate conversations between regulators of various countries or to consider or initiate new projects at the multilateral level.

c. IOSCO

The International Organization of Securities Commissions (IOSCO) is even more critical than the regulatory dialogues in promoting cross-border regulatory standards. Launched in its present form in 1983, IOSCO is the primary institution promulgating international standards for securities regulation.46 Since 1984, over 150 regulators have joined the organization; its members regulate nearly 90 percent of the world’s securities markets.47

47. See Int’l Org. of Sec. Comm’ns, IOSCO Historical Background, http://www.iosco.org/
Among IOSCO’s main activities is the promotion of common approaches to securities regulation. This mission reflects a widespread view that even on a national level, laws and regulations governing capital markets have unanticipated spillover effects that affect the integrity of other regulatory systems. Furthermore, without uniformity in regulation, market participants may be able to evade regulation by operating in another country. As a result, IOSCO aims to facilitate cooperation and information sharing, as well as to establish strong standards and an effective surveillance of securities transactions. Most work is carried out by the organization’s Technical Committee, a group of fifteen elite regulators hailing from highly developed countries. Meanwhile, developing countries participate in the Emerging Markets Committee, which, though having a less pronounced legislative agenda, is necessary for the organization to issue global reforms.

Until relatively recently, IOSCO has promoted the Objectives and Principles of Securities Organization ("IOSCO Principles")—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 as its most significant pieces of legislation. Unlike other higher profile regulatory measures that have constituted a more targeted response to conflicts of interest tied to recent financial crises, these two initiatives represent a basic set of institutional and

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48. Raustiala, supra note 12, at 32.
49. See Sec. & Exch. Comm’n, IOSCO Technical Committee, http://www.sec.gov/about/offices/oia/oia_intorg.shtml#iosco (providing that the work is divided into five standing committees including the Multinational Disclosure and Accounting Committee, the Regulation of Secondary Markets Committee, the Regulation of Market Intermediaries Committee, the Enforcement and the Exchange of Information Committee, and the Investment Management Committee) (last visited Jan. 3, 2009).
51. This situation has changed with the Multilateral Memorandum of Understanding (MMOU), an innovative piece of legislation discussed in Part III.
54. Specifically, IOSCO has published a range of important principles-based guidance in the wake of the worldwide financial crises, including a code of conduct for credit rating agencies, regulatory principles designed to improve auditor independence and auditor oversight, and regulatory principles regarding conflicts of interest for financial analysts. See infra notes 148–49.
operational standards embraced by the organization as the signposts of sound regulatory governance and oversight.

IOSCO also participates in a variety of international forums to ensure coordination with other regulators in the insurance and banking communities. For example, IOSCO has worked with the Basel Committee to improve financial disclosure of banks holding securities.\(^5\) IOSCO is also a member of the Joint Forum, an international body consisting of the Basel Committee on Banking Supervision, IOSCO, and the International Association of Insurance Supervisors. The Joint Forum deals with issues common to the banking, securities, and insurance sectors, including the regulation of financial conglomerates.\(^6\) IOSCO even works closely with leading international organizations, including the World Bank and International Monetary Fund ("IMF"), and they have strived under the Financial Stability Action Program to assess client countries' capital markets and their susceptibility to financial risk.\(^7\) IOSCO has also been at the forefront in helping to coordinate common short-term responses to the credit crisis.

However, IOSCO standards are deliberately broad. The organization explicitly acknowledges that there is no single prescription or roadmap to good regulation in the field of securities. Consequently, as with the MOUs, IOSCO’s principles are not legally binding among states.\(^8\) Instead, these principles articulate an aspirational statement of the core elements of an essential securities regulatory framework.\(^9\) Additionally, they provide a yardstick against which progress toward effective regulation can be measured. IOSCO asks its members to assess their compliance with the principles, at times with the help of more sophisticated members. Unless otherwise desired by regulators, the extent to which an IOSCO member falls short of these principles generally remains confidential between international monitors and the member state. Noncompliance with IOSCO rules is not generally met with any retaliation, though it has led to overt economic sanctions in one context. In

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\(^8\) Raustiala, supra note 12, at 31. It is worth noting, however, that IOSCO standards can potentially be made more coercive, for example, their adoption made a condition precedent for IMF or World Bank assistance, though this has not been the case. Id.

2000 and 2001, international authorities publicly identified twenty-three countries as having poor regulatory governance, due in part to their nonobservance of IOSCO standards. This public shaming tarnished the reputations of these jurisdictions and introduced the possibility of countermeasures against them, ultimately leading to significant change among the targeted countries. Notably, the Financial Action Task Force ("FATF")—a muscular, country-based organization chaired by finance ministers and banking authorities—confronted these underperforming jurisdictions, rather than the classic "securities law" networks, though it was supported logistically by securities regulators and international authorities. And even here, FATF's coercive power was limited in reach and scope because it based its determinations regarding a country's subsequent reforms primarily on self-reporting by the governmental authorities of the relevant financial centers.

d. Technical Assistance Programs

The cornerstone of the SEC's technical assistance program is the International Institute for Securities Market Development, a two-week, management-level training program covering the development and oversight of securities markets. This program, organized and taught largely by SEC officials, provides grounding in the basic principles and approaches employed by the agency.

The OIA also conducts a week-long Institute for Securities Enforcement and Market Oversight (the Securities Institute) that covers techniques for investigating securities law violations and methods for oversight of market participants. These sessions not only help promote the SEC's worldview, but also build important contacts for future cooperation when new enforcement actions arise.

Finally, OIA conducts a variety of multiday, regional or mini training sessions for emerging markets. In these forums, of which there were as many as twenty-one in 2008, staff members from the office are sent to foreign countries seeking to improve their securities regulation systems and meet IOSCO's international standards. Though nearly 90 percent of these sessions involved bilateral enforcement training and assessment, training periodically touched upon financial disclosure; in virtually all circumstances, the sessions were a response to requests made by foreign regulators and they were—like the Securities Institute and the mini institutes—often funded by the U.S. Agency

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61. Verdier, supra note 60, at 148.
62. Raustiala, supra note 12, at 33.
63. Id.
64. OIA Technical Assistance Calendar (on file with author).
for International Development (USAID) or the World Bank.

3. Persuasion and Cooperation

Network theory presumes that the aforementioned instruments are effective due to the SEC’s ability to promote its policy preferences through soft power. As collegial, interagency interactions, governmental networks function as peer-to-peer networks that ultimately foster collective problem-solving and innovation. Decision making is not vested in the hands of uninformed political elites. Rather, it is guided by a stable of skilled technocrats who develop shared expectations and trust allowing them to dispense with time-consuming treaties and formal international organizations. Regulators instead execute and rely on less formal instruments that permit rapid responses by regulators, keeping pace with quickly evolving financial markets.

Because networks rely on peer-to-peer interactions, international relations scholars contend that policies are not advanced by military force or coercion, but instead by the power of persuasion and attraction. Regulators must shape not only what interlocutors do at home with their domestic markets, but also what they want in order to convince one another of the superiority of their regulatory approach. Most theorists consequently assume that large countries like the United States have a distinct advantage over other countries in the exportation of their legal regimes. Regulators of small markets have traditionally sought to emulate powerful ones because they aspire to similar levels of success. Meanwhile, regulators of larger, wealthier markets have more resources and are often better positioned to promote their agendas, by hosting conferences, scholars, and regulators. These regulators also have the personnel available to draft position papers, assess reform programs, and shape disputes. These advantages have allowed the SEC “to bring other jurisdictions to the U.S. model, not to modify the U.S. model.”

As a result, international relations theorists view governmental networks as an alternative model of international rulemaking distinguishable from the regulatory competition taking place in other fields like U.S. corporate law, where states ostensibly compete with one another for transactions. Scholars argue that governmental networks avoid a race between sovereigns tightening or relaxing standards to compete with one another. Instead, networks provide a distinctly collective means of international engagement in which regulators

65. Raustiala, supra note 12, at 5.
66. See Verdier, supra note 60, at 162; see also Whitehead, supra note 12, at 704.
68. Id.
69. JOSEPH S. NYE, JR., SOFT POWER: THE MEANS TO SUCCESS IN WORLD POLITICS 5 (2004); Raustiala, supra note 12, at 59; see Slaughter, supra note 12.
70. Raustiala, supra note 12, at 35.
tackle common problems generated by globalization that cannot be addressed on an individual basis. Regulators thus have largely shared incentives to cooperate, and governmental networks provide a potent mechanism for such cooperation.

In addition to an explicit normative preference for transgovernmentalism as a mode of international problem solving, an implicit descriptive theory of the challenges that globalization creates for securities regulators is also embedded in these claims of network power. At its core, transgovernmentalism presumes that the primary obstacle to cross-border regulatory convergence is asymmetric information among national authorities. National regulators presumably have strong incentives to cooperate. For some transgovernmentalists, the very size of U.S. capital markets creates incentives to adopt U.S. regulatory standards abroad due to the "concentrated regulatory power" of the SEC. Like the classical securities law model, this strain in the literature suggests that scale advantages of converting to the dominant U.S. model usually outweigh most other considerations. Networks thus operate as transmission belts for American soft power as foreign regulators adopt U.S. standards.

More ambitious voices in the transgovernmentalist camp further suggest that regulators have strong incentives to cooperate ex ante, irrespective of market strength, due to the inherently common stake that regulators have in the enterprise of securities regulation. All regulators would, it is implied, like to stomp out fraud. However, regulators must first agree upon a common standard for disclosure, surveillance, and enforcement. Moreover, each regulator must then choose that regime. An interdependent world requires broad cooperation; otherwise, fraudsters will just move to the weakest regime, which would effectively mean that the efforts of regulators that adopt the optimal rule would be wasted.

Game theory provides a useful tool with which to clarify and highlight the logic of these assumptions. Ultimately, transgovernmentalism suggests that the coordination of securities regulation is not a problem of dispersed interests, but

72. Transgovernmentalists consequently suggest that the primary obstacle to convergence is not so much an issue of disparate incentives among regulators as it is their desire to cooperate. Raustiala, supra note 12, at 24 (noting that "[w]hile incentives to ‘violate’ ‘obligations’ exist, common interests predominate").
73. Id. at 59.
74. Id. at 75 (discussing how government networks provide "cover" for market-driven convergence).
75. Slaughter & Zaring, supra note 71, at 213. In many ways, such views mirror the "world society" view of standardization popular in the international politics literature, in which actors seeking to coordinate technical rules and regulations have an overriding preference for arriving at a common solution. See, e.g., Walter Mattli & Tim Bütte, Setting International Standards: Technological Rationality or Primacy of Power?, 56 WORLD POL. 1, 9 (2003) (describing the "world society" approach to viewing globalization).
76. Raustiala, supra note 12, at 70 (noting that proponents of transgovernmentalism assert that "an interdependent world entails new forms of governance" (quoting SLAUGHTER, supra note 12, at 183)).
instead is one where parties share similar objectives and preferences but are unaware of the others’ commitment to tackling common problems. Thus, two outcomes exist between any two regulators: a payoff-dominant scenario of cooperation and a risk-dominant scenario in which regulators remain skeptical of cooperation and concerned about unilaterally taking on the risk or costs of operating at a certain standard.

In this situation, which game theoreticians would describe as an “assurance” game, governmental networks supposedly make the non-cooperative outcome less likely. Networks first help to identify optimal approaches, and then make the risk-dominated equilibrium less likely by facilitating trust, information, and joint deliberation. In this way, regulators can swiftly identify optimal regimes and facilitate cooperative action. Over time, standards may even become self-enforcing as they gain currency among network participants and incentivize nonmembers to accept the standards due to their widespread use and scale advantages.

II
THE CASE AGAINST SECURITIES LAW NETWORKS

Although international relations and securities law scholars provide important insights into the functioning of regulatory markets, both groups tend to underestimate the obstacles to international convergence and overestimate the effectiveness of the SEC’s traditional tools. Section II.A demonstrates that U.S. capital markets face new rivals and no longer necessarily act as failsafe tools of regulatory export. Section II.B then demonstrates that transgovernmentalism helps to describe the increasingly disaggregated nature of international coordination, but that its predictions about securities law networks are inconsistent with the relatively limited convergence that they have secured. Section II.C then offers a better account of international securities regulation and argues that, in a globalized financial marketplace, the

77. In general terms, assurance games can be depicted as follows:

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<th>Cooperate</th>
<th>Defect</th>
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<tr>
<td>Cooperate</td>
<td>4, 4*</td>
<td>-1, 0</td>
</tr>
<tr>
<td>Defect</td>
<td>0, -1</td>
<td>0, 0*</td>
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As the matrix above demonstrates, two outcomes (denoted by “*”) comprise what in game theory terms is referred to as “Nash equilibria.” That is, there is a state of affairs where no player can do better by unilaterally changing his or her strategy, even if each player knows the strategies of the other. Applied to our example of securities regulation, this would mean that if both regulators chose to cooperate, then each would receive a payoff of four. If both regulators continue on their own course, there is no payoff, (0, 0), but at the same time, no prospect of loss—the scenario that would arise if one player (or regulator) switched standards, but not the other, a situation illustrated in the lower-left hand (0, -1) and upper-right hand quadrants (-1, 0). Where risk dominates decisionmaking, regulators would chose (0, 0), which is not globally welfare maximizing. Where the prospect of payoffs dominate, (4, 4) would arise as the equilibrium.
coordination of cross-border investor protection often is far from assured. Even where regulators share incentives to cooperate, a “battle of the sexes” game results, where governmental networks will not provide the incentives necessary for coordination in the absence of hegemonic capital markets.

A. The Rise of the Rest

Increasing evidence suggests that U.S. capital markets, though still generally the largest in the world, are increasingly weak instruments of regulatory export. Recent scholarship, as well as commentary by policymakers, has shown that U.S. capital markets are no longer unrivaled. Instead, other countries have developed important financial centers in their own right that challenge America’s traditional dominance. The “rise of the rest” has been particularly startling in the field of securities transactions. In the first nine months of 2007, only 10.1 percent of global IPOs were listed on a U.S. exchange.\(^7\) This represents a dramatic decrease from 44.5 percent in 1996 and an average of 21.2 percent in the period from 1996 to 2005.\(^7\) Equally important, exchanges in the United States captured just 7.7 percent of the total value of global IPOs during the same period.\(^8\) According to recent data, the current credit crisis has done little to reverse this trend. U.S. exchanges captured just 1.9 percent of global IPOs in 2008,\(^8\) and deals in Asia and South America accounted for 72 percent of total IPO value in 2009.\(^9\) Overall, experts predict that New York will soon fall to the third most important hub for IPO financing behind Hong Kong and Shanghai.\(^3\)

Enormous changes in how and where wealth is created in the world have facilitated this development. As macroeconomic imbalances have shifted economic growth in and activity to China, India, and other developing countries, investors and firms have likewise flocked from America to other regions in search of business opportunities.\(^8\) Meanwhile, demand for natural

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79. Id.
80. Id.
resources from the Middle East, Russia, and Brazil have lured capital and helped develop vibrant (albeit at times volatile) regional hubs for finance.

Profound changes in the ways in which capital is raised have also enabled this transformation. For one thing, electronic trading has made investing in foreign markets easier than ever. Whereas in the past, investor orders for overseas securities would take hours, days, or even weeks to conclude, innovations like the Internet have made the execution of orders possible in a matter of milliseconds, thereby dramatically increasing the likelihood of successful order execution. This advancement has made investing in non-U.S. exchanges practical for U.S. investors and has rendered listing on foreign exchanges more plausible for firms. Technological advances have also lowered the barriers of entry to the exchange services business and increased the number of venues open to investors in the process.

Together, these developments have directly impacted the market for securities transactions and, by extension, the market for securities law. As liquidity has become more dispersed, foreign companies seeking capital—either through IPOs or cross-listings—no longer have to do it in the United States. These companies now enjoy more mobility than they have in the past and can list their securities on other exchanges that provide financing at competitive costs of capital. Consequently, U.S. exchanges no longer hold virtual monopolies over securities transactions. As U.S. capital markets have diminished in significance, the "concentration" of regulatory power long enjoyed by the SEC has also diminished. They thus operate as less hegemonic tools of legal export.

B. Empirical Evidence Against Network Power

Close empirical scrutiny also suggests that transgovernmentalism overstates the effectiveness of securities law networks as a means of promoting regulatory convergence. In the world of enforcement, although MOUs are potentially very effective instruments for facilitating cooperation with foreign counterparts on a range of enforcement matters, relatively few regulators have signed MOUs. Indeed, fewer than 25 percent of the world’s regulators have

86. Whereas not so long ago a major exchange would have to purchase an acre of land, construct a trading floor and employ a bank of telephones just to conduct a transaction, trading can now be executed via computers and trading screens located in any number of broker-dealers' offices. Trading technology is also increasingly commercially available to stock markets everywhere, making it possible for even the youngest exchanges to make the technical aspects of their operations first-class. As a result, upstart foreign exchanges have been able to attract more issuers with fewer costs and across national boundaries. This democratization of capital has reduced the traditional dominance of U.S. regulators, who in the past wielded de facto influence due to the dominance of their domestic exchanges. See Brummer, Stock Exchanges, supra note 5, at 1472–73.
signed such agreements with the United States. And even those that have been signed reflect varying levels of commitment, with some covering only bank records, and others obliging assistance in the recovery of brokerage records, evidence of beneficial ownership, and in some cases, phone records. As a result, traditional enforcement MOUs, though valuable means of deterring and punishing cross-border securities violations, have had demonstrably limited reach in establishing global enforcement cooperation frameworks.

Although little information is available to determine the effectiveness of IOSCO (the organization does not monitor its members’ adoption of or compliance with its initiatives) the available data suggest that it faces great challenges in setting international standards. Perhaps most importantly, members have only followed IOSCO’s rules sporadically at best. IOSCO’s disclosure standards have, for example, only been adopted by the United States, and even here, only parts were originally implemented.87 No other countries have explicitly incorporated the agreement in its entirety.88

Meanwhile, recent assessments by the IMF suggest that full implementation of the IOSCO Principles remains a challenge.89 As of 2006, only four of the thirty principles have been implemented by 80 percent or more of IOSCO’s members.90 Moreover, for four other principles, the levels of implementation fall below 50 percent.91

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87. See Fried, Frank, Shriver & Jacobson LLP, The SEC Adopts IOSCO Disclosure Standards for Foreign Private Issuers (1999), http://www.ffhsj.com/index.cfm?pageID=25&itemID=1253 (highlighting ways in which some U.S. standards still diverge from IOSCO standards). Although much in the IOSCO standards was inspired by the existing 20-F—the primary disclosure document for foreign issuers in the United States—significant differences in wording exist between the 20-F and the IOSCO standards. Consequently, the SEC staff is likely to interpret the IOSCO standard in light of analogous provisions in its domestic regulations enumerated in Regulation S-K. Id.

88. Id.


90. Id.

91. Id.
Furthermore, contrary to predictions by transgovernmentalists, implementation is especially poor among low-income countries. Indeed, the data shows that a jurisdiction’s level of compliance with IOSCO Principles generally correlates to its level of wealth. High-income countries show implementation of approximately 70 percent of IOSCO Principles, upper-middle-income jurisdictions show levels of implementation around 60 percent, lower-middle-income jurisdictions show levels of implementation around 50 percent, and low-income jurisdictions show levels of implementation below 50 percent.  

92. Id. at 12.
93. Id. at 13.
94. Id. at 14. In the graph, the term “Regulator” refers to IOSCO principles 1–5, which concern the structure and effectiveness of a regulator; “SRO” refers to IOSCO Principles 6 and 7, which consider the role and structure of self-regulatory organizations; “Enforcement” refers to IOSCO Principles 8–10, which examine the enforcement program and activities of the regulator; “Cooperation” refers to Principles 11–13, which examine the regulator’s cooperation with domestic and international counterparts; “Issuers” refers to IOSCO Principles 14–16, which concern the regulatory regime for issuers; “CIS” refers to IOSCO Principles 17–20, which address the regulatory regime for collective investment schemes; “Mkt. Intermediaries” refers to Principles 21–24, which concern the regulation of market intermediaries; and “Secondary Mkt.” refers to Principles 25–30, which consider the regulation of the secondary markets.
As a result of the low compliance rate, observers have at times viewed IOSCO as an international "talking shop." Although the organization has played a key part in articulating widely respected international standards, even the member states championing its recommended policies do not always follow them in practice. For this reason, regulators have derided some IOSCO legislation as a "toothless wonder," due to the voluntary nature of compliance and its lack of enforcement. Many officials have consequently called for a more robust means of effectuating key IOSCO initiatives and achieving more meaningful forms of convergence.

Only the regulatory dialogues and technical assistance programs are widely perceived as unambiguous successes. Their mandates are, however, notably less ambitious. Regulatory dialogues, on the one hand, are designed not so much to promote convergence as to facilitate information sharing. Meanwhile, technical assistance programs have enjoyed widespread participation from regulators worldwide, though even here the SEC's success does not necessarily imply that that the United States successfully exports all of its regulatory approaches and viewpoints. Instead, the heavily subsidized nature of the conferences—which offer regulators the opportunity to build their regulatory capacity and expertise for little, and in some instances, no cost—explains much of the participation. Regulators are thus free to cherry-pick the rules and regulations that they feel are most appropriate for their system of oversight and ignore rules that they feel are too stringent, costly, or burdensome.

C. What Makes Cross-Border Securities Regulation Difficult:
Four Dynamics that Network Theory Overlooks

1. Divergent Regulatory Philosophies

Ultimately, network theory overlooks four factors that stymie the coordination process and explain why convergence among securities regulators has been so limited. At the most basic level, regulators may have fundamentally contrary views concerning the role of corporations and even capitalism in society. Whereas some regulators, like those in the United States, view corporations as existing to maximize profits for investors, others contend that corporations exist to ensure business survival, promote the state and domestic industries, provide employment, or enhance a society's general welfare. This can be problematic insofar as each view will lead to differing regulatory choices and decisions concerning the role of government in the regulation of

96. Id.
capital markets. Thus, where policies promoted by one regulator conflict with the objectives of another, consensus will be difficult to achieve.

Regulators also differ in their views as to the role and importance of disclosure. For many countries, especially those with widely dispersed shareholders, disclosure lies at the heart of the capital raising process and acts as the primary deterrent to abuse by management. In other countries, however, disclosure is merely a supplemental means of achieving corporate governance. Instead, structural innovations in the firm, like two-tiered boards or employee representation in senior management, are viewed as the primary check on managerial malfeasance.

Finally, regulators differ as to their enforcement philosophies. For a minority of regulators, enforcement comprises a critical aspect of government oversight. As a result, many adopt stiff penalties and an antagonistic relationship with market participants out of a belief that a strong and vigorous enforcement response disincentivizes fraud. On the other hand, other regulators believe that a more subtle response, such as imposing relatively small penalties, will encourage firms to submit to home state rules and proactively consult with the government regarding transactions.

Thus, even where there are real benefits from cooperation, differences in regulatory philosophy may render it difficult for agencies to reach a consensus on securities regulation. Though regulators may coordinate with one another and deepen their understanding of one another’s approaches, few are inclined to cede their regulatory missions and philosophy easily. Instead, opposing viewpoints often facilitate a political power dimension in negotiations: where rules born of democratic processes and national autonomy are trumped by dissonant international obligations or supranational organizations, countries seek to export their national regulatory perspectives to gain influence and avoid perceived sovereignty costs.

2. Adjustment Costs

Agreement is also difficult because there are often significant adjustment costs. Because of history, culture, and custom, countries currently have vastly

98. Id. at 277 (describing French skepticism of the American model of profit maximization).
99. Id. at 275 (noting that the “German system [potentially] prevents the sort of accounting and other fraud perpetuated at US companies such as Enron and WorldCom”).
100. Id.
different kinds of regulations in place.\textsuperscript{103} As in the case of enforcement cooperation, effective compliance with a new international norm may require a country to revise its basic securities regulation framework, and even its basic political structure.\textsuperscript{104} This can be difficult to achieve insofar as regulatory agencies and lawmakers, accustomed to the status quo or resistant to outside interference, may contest such reform from above.\textsuperscript{105} Furthermore, adjustment almost inevitably requires the hiring of skilled staff and the allocation of more resources to enforcement activities. For many states, especially developing countries, such resources and human capital are not available.

Regulators must also consider the compliance costs borne by domestic, as well as foreign, firms when adjusting to new investor protection standards. Higher disclosure standards, for example, frequently require firms to invest more resources into back-office staff and bookkeeping. Fees for third parties, such as lawyers and auditors, will likely also increase in order to ensure compliance with tougher or more comprehensive standards.

Adjustment costs will likely be even higher where securities laws implicate corporate governance. This is because corporate governance changes may require the reform or jettisoning of assets specific to long-standing domestic and regulatory structures, such as the organization of a firm’s internal affairs and management in which considerable political and economic investments have been made.\textsuperscript{106} In such circumstances, not only may the costs of adjustment be high, but also they will be largely asymmetrical. Some firms, because they happen to be operating in a jurisdiction to which standards converge, will internalize few costs. Meanwhile, firms in other jurisdictions will spend more, putting them at a competitive disadvantage due to the allocation of resources to compliance that could have been used in another way.

As with high sovereignty costs, adjustment costs can be prohibitive, or at least render agreement more difficult. Any benefits proffered by cooperation can be seen as flowing to one particular party, or the immediate costs may outweigh the longer-term benefits.

\textsuperscript{103} Id. at 41; see also Mark J. Roe, \textit{Legal Origins, Politics, and Modern Stock Markets}, 120 Harv. L. Rev. 460, 502, 516 (2006) (discussing political economy as the crucial factor in determining if policymakers desire, and are able to build financial markets); Don Langevoort & Donald C. Langevoort, \textit{The SEC, Retail Investors, and the Institutionalization of the Securities Markets}, 95 Va. L. Rev. 1025 (2009) (discussing different traditional market participation in the Europe and the United States and its implications for national regulatory approaches).

\textsuperscript{104} Cunningham, supra note 97, at 278 (explaining the European public’s reaction to Sarbanes-Oxley (“SOX”)).

\textsuperscript{105} Drezner, supra note 102, at 46.

\textsuperscript{106} Id. at 5. This was, for instance, the case with Sarbanes Oxley, the U.S. law which required all firms, including foreign issuers, to use independent audit committees. Though laudable in principle, this requirement conflicted with the statutorily required organization of German and Dutch firms, which required worker participation on a supervisory board with the aim of (ironically) disciplining CEO compensation. See Cunningham, supra note 97, at 8. Thus SOX’s outlawing of non-independent audit committee members in some ways weakened German and Dutch controls on management. Id.
3. Market Pressures

Transgovernmentalist explications of securities law also understate the strong incentives many regulators have not to cooperate with U.S. regulators—or indeed with anyone. This is because 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 pressure from a variety of powerful interest groups that have a direct stake in the robustness of domestic capital markets. As a result, regulators have strong incentives to differentiate themselves from their competitors in order to draw transactions away from their markets.

Financial centers generally compete with one another on the basis of how well they provide liquidity for firms and rules for financing. As to liquidity, a financial center’s ability to offer firms large amounts of capital quickly and at low costs is a major source of competitiveness. Thus, to compete with one another, exchanges and markets employ structural innovations and technologies that draw investors by allowing them to execute their trades quickly.

Regulatory competition, in contrast, occurs on two fronts. On the one hand, some regulators impose stringent rules and regulations on firms raising capital to allow those firms to signal their commitment to sound corporate governance. Many scholars argue that firms in making this commitment can

107. See Licht, supra note 11, at 64 (noting that regulators have an incentive not to cooperate where it would undermine the competitiveness of domestic market participants); see also Stavros Gadinis, The Politics of Competition in International Financial Regulation, 49 HARV. INT’L L.J. 447 (2008) (same). Indeed, even if all countries adopted the same regulatory standards, not all countries would benefit equally. As I have explained in other writings, the competitiveness of a financial market is dependent not only on the law that governs transactions, but also on liquidity. Brummer, Stock Exchanges, supra note 5, at 1455. Liquidity, in contradistinction to law, refers to both an issuing firm’s ability to access capital and an investor’s ability to promptly transact (and exit) from investments at a price that corresponds to the investment’s true value. Both of these dimensions of liquidity thus depend on a large number of traders transacting in a market. To the extent that law is neutralized as a factor, the most liquid markets will inevitably attract the most transactions. This can incentivize less liquid exchanges not to accept all of the rules and regulations of their larger competitors, though they may emulate some of the rules to gain credibility.

108. Verdier, supra note 60, at 170 (stating that public choice may “allow regulators to create a common front to expand their bureaucratic power in their respective states to the detriment of their constituents’ welfare”).

109. See Coffee, Racing supra note 6, at 1780–82 (noting that the United States is one example of this regulatory competition technique); see also Rafael la Porta, Florencio Lopez-de-Silanes, Andrei Shleifer, & Robert W. Vishny, Legal Determinants of External Finance, 52 J. Fin. 1131 (1997) (arguing that strong equity markets require strong minority rights). Indeed, securities markets may not be able to expand to their full potential in the absence of some mandatory legal regimes protecting minority shareholder rights. John C. Coffee, Jr., The Rise of Dispersed Ownership: The Roles of Law and the State in the Separation of Ownership and Control, 111 YALE L.J. 1, 65 (2001) [hereinafter Coffee, Dispersed Ownership]. Nevertheless, even in the absence of highly developed law, equity markets can, and have, still developed. There are a variety of institutional accounts as to why this is the case. See Katharina Pistor & Chengan Xu,
reduce the risk of fraud and managerial malfeasance. Investors, in turn, may be willing to pay a premium for the securities, and the cost of capital for firms may be reduced.10

Meanwhile, other regulators adopt lower standards to appeal to small firms and managers seeking to avoid high regulatory costs. Many firms view the costs of compliance generated by stringent regulation as outweighing the benefits they receive by making credible corporate governance commitments.11 For these firms, the administrative costs of raising capital will be an important consideration. As a result, they will seek rules that reduce adjustment costs tied to the legal, accounting, and other advisory services related to raising capital. Less stringent regulatory standards may also appeal to an issuer’s executives, who may want to reduce as much as possible the risk of liability and lawsuits, both against their company and against themselves. This will especially be the case where, as is often the situation, investors and other market participants may themselves poorly recognize the extent to which countries comply with international regulatory standards.12 With relatively weak market disciplines, regulators, especially (though not exclusively) in developing countries, may adopt weaker, or less threatening, oversight mechanisms to attract more transactions.

4. Convergence as a Coordination Dilemma

The divergent preferences of securities regulators and the firms they oversee indicate that convergence in international securities regulation is not always an assurance problem. Because of often significant asymmetric benefits, ideological proclivities, and adjustment costs, interests may not align and no agreement may be possible.


110. Coffee, Racing, supra note 6, at 1763; see also David Easley & Maureen O’Hara, Information and the Cost of Capital, 59 J. FIN. 1553 (2004) (demonstrating 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 (1994) (demonstrating that disclosures, even in voluntary contexts, add credibility that justify even the divulgence of proprietary information).

111. This apparently was the case with regard to at least some provisions of SOX legislation. See Kate Litvak, Sarbanes-Oxley and the Cross-Listing Premium, 105 Mich. L. Rev. 1857 (2007) (finding that foreign companies listing in the United States suffered a decline in market premiums after the enactment of SOX as measured using Tobin’s q and market-to-book ratios).

112. See generally Brummer, Financial Law, supra note 57, at 38–52 (discussing gaps in monitoring of compliance with international standards).
Furthermore, even when countries desire to find a common solution, they may disagree as to what the solution should be. This latter case is more likely to arise in situations like enforcement cooperation. On the upside, enforcement cooperation allows many regulators to improve the credibility and effectiveness of their own domestic regimes at relatively low cost. And because the securities of major corporations are now traded simultaneously in several countries, regulators of major markets will find it in their common interest to deter cross-border fraud, lest perpetrators strategically conduct their crimes from overseas locations and thereby evade regulatory action. On the other hand, states with fewer investors need worry about cross-border fraud less than those with more investors, making them less interested in enforcement. Furthermore, some states both make and receive relatively few enforcement requests. As a result, their cost-benefit calculus will often be different from those regulators responsible for the governance of larger capital markets, leading to different preferences as to how such an enforcement regime should be developed in terms of intensity and scope.

Again, game theory anticipates such distributive problems and helps clarify the kinds of choices available to regulators. Ultimately, coordination games may have, as the illustration below suggests, two equilibrium outcomes between any two regulators. In distributive problems like these, although cooperation is mutually preferred and would likely enhance a player’s welfare, neither actor is sufficiently incentivized to accept the other’s regime. Coordination depends on other factors, like the order of play (i.e., being a first mover). If, as is often the case, players move simultaneously, the result would be undeterminable and additional negotiations would be necessary.

Things become more uncertain where players have clearly antagonistic interests, a situation that at times arises with substantive capital markets

113. To put this in perspective, consider that the SEC files hundreds of securities fraud cases each year and relies on bank records in approximately 70 percent of the cases. SEC. & EXCH. COMM’N, HANDBOOK FOR EMERGING MARKETS 16 (2008) (on file with author). The SEC has thus argued that “a securities authority that can’t get bank records would likely be unable to successfully investigate over 70% securities fraud cases.” Id. And, considering that many of these bank records are overseas, cooperation between regulators is vital.


115. See again the discussion by the thoughtful scholar Pierre Verdier, supra note 60, at 12. Most battle of the sexes games can be illustrated as follows:

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<th>Option A</th>
<th>Option B</th>
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<tr>
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</tr>
<tr>
<td>Option B</td>
<td>-3, -3</td>
<td>1, 4*</td>
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Notice that, as in an assurance game, two Nash equilibria arise that make coordination difficult. Here, however, each equilibrium outcome is unambiguously superior for one of the players, whereas the other is not. This distribution of gains creates a dilemma for coordination.
regulation. Changes in a regulator's substantive policies may make the jurisdiction less attractive for securities transactions, and diminish the welfare of domestic special interests in the process. Furthermore, changes may be contrary to an authority's traditional regulatory philosophy or, as shown above, entail significant adjustment costs. As a result, coordination may be impossible in light of incongruent jurisdictional interests.116

This dynamic becomes all the more problematic for the SEC in light of the diminished centrality of the U.S. capital markets. Because the U.S. capital markets are no longer always necessary for multinational financing, there will be less de facto convergence through the operation of U.S. securities laws. Furthermore, securities law networks, at least as traditionally constituted, are poorly suited to address distributive conflicts. Securities law networks are, as seen above, coordinating mechanisms in the purest sense. That is, they connect regulators and in doing so reduce informational asymmetries. They are not, however, a locus of power where members first consider a rule.

Thus, in a world of broadly dispersed economic activity, coordination among securities regulators is increasingly difficult, especially for the SEC. U.S. capital markets, though large, are no longer hegemonic, and the governmental networks it has traditionally relied on are ill-suited to peddle influence. There are, as a result, fewer traditional constraints on foreign regulators seeking to attract transactions through less stringent regulations that may overlook or ignore dubious practices.117 Instead, for better or worse, an emerging regulatory market plays an increasingly central role as a disciplining mechanism.

III
THE TRILLION-DOLLAR CAVEAT

For all of their limitations, networks are not destined to ineffectuality. This Part argues that one area in which networks may show promise is systemic risk regulation, insofar as the negative externalities of poor regulation are globalized and, by extension, the interests among disparate jurisdictions aligned. It also argues, however, that even here coordination is not informed so much by traditional networks of securities regulators, as by cross-functional networks in which bank regulators take a leading position alongside political elites.

A. Systemic Risk and Securities Regulation

Traditionally, the primary concern of securities regulators has been investor protection, which has, as discussed above, focused regulators' attention on disclosure, market integrity, and enforcement cooperation. In the wake of the 2008 financial crisis, however, regulators have been preoccupied with other

117. Verdier, supra note 60, at 35.
more complex aspects of financial markets. Specifically, the SEC and its counterparts have invested considerable resources in the regulation of “systemic risk,” which arises where the failure of one financial institution sparks failures in other institutions and in the process undermines the health of capital markets.

This policy focus comprises in many regard a significant change for the agency. Historically, relatively little emphasis on systemic risk has been placed on the transactions of securities firms. This is because securities firms make investments backed by securities that are much more liquid than those of banks, which often are exposed to substantial mismatches with regard to the duration of assets and liabilities. Furthermore, securities firms have not traditionally settled payments, but instead have merely acted as agents for investors in securities offerings and trades. Thus, unlike a bank failure, which might cripple a settlement and payment system if it has large overnight exposures to other banks in the interbank payment system, a large investment bank’s failure would historically have fewer systemic implications. Systemic risk was, as a result, a minor concern for securities regulators, but a major issue for banking regulators.

The rather low level of alarm regarding the systemic risk posed by securities firms began to change, however, in the late 1990s, particularly in the aftermath of the Russian default and the collapse of Long Term Capital Management, a major hedge fund. Regulators noticed that certain kinds of investment firms, especially hedge funds, had been increasingly able to make risky investments without being subject to registration requirements, financial supervision, or capital adequacy requirements. Furthermore, hedge funds had increasingly positioned themselves as counterparties and lenders to large commercial banks and securities firms, and in the process began to facilitate a shadow banking system. In practice, this meant that if a hedge fund made a poor investment decision (due to poor supervision, for example), it might be unable to honor its commitments, and its failure could disrupt and possibly bring down other financial institutions, thereby posing a systemic risk.

These theoretical concerns eventually grew into practical concerns as financial institutions of all sizes engaged in transactions that almost toppled the global financial system. Particularly noteworthy were credit default swaps, which are unregulated contracts whereby one firm agrees to reimburse another firm for any losses it incurs in making loans to a third party if the third party defaults on its payment obligation. These products, at the time entirely unregulated, increased the interdependence of financial institutions, often across borders. Furthermore, because they were traded over the counter and tailored to specific terms, they were difficult to price, impossible to monitor,

119. Id. at 56.
and often very risky.

The institutional failings of private gatekeepers exacerbated this risk even further. Purchasers of the swaps—and other complex real-estate-related securities, for that matter—relied heavily on ratings by credit ratings agencies ("CRAs") "in lieu of conducting independent assessments on the quality of assets."\(^{120}\) Ratings also helped dictate how much capital banks should hold on reserve when investing in securities. However, credit ratings agencies were subject to little regulation. They were not, for example, required to provide information about how to understand and appropriately use ratings or to provide data on the accuracy of their ratings over time.\(^{121}\) Moreover, conflicts of interest plagued the ratings process as ratings agencies were compensated by the same firms whose securities they were tasked to assess.

Thus, in response to the increasing risks permeating securities markets, securities products, and traditional watchdogs, the SEC has increasingly pushed for a wide range of "macroprudential" reforms, at times due to encouragement from its international counterparts. The most important reforms include better regulation of hedge funds, derivatives, and the agencies that rate securities products.

**B. Cross-Functional Networks**

Although securities regulators are increasingly focused on systemic risk regulation, the locus of leadership and agenda-setting with regard to these issues lies not in networks of securities regulators, but in what can be described as "cross-functional networks," in which authorities with different sectoral expertise and power interact with one another to promote financial stability.\(^{122}\) In these arrangements, securities regulators play at best a limited role in setting the policy agenda, even on issues that touch directly on securities regulation.

**1. G-20**

Recently designated the "premier" organization for international economic cooperation,\(^{123}\) the Group of Twenty Finance Ministers and Central Bank Governors ("G-20") provides a forum for banking and finance ministers from

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121. Id. at 31.

122. In this way, these efforts mirrored FATF's, which though operating under a different (and more limited) mandate, also involved a range of cooperation between different functional regulators; notably, very limited direct participation by political elites was involved.

the nineteen of the largest or fastest-developing economies to meet, at times along with heads of state from member countries, to discuss financial, economic, and monetary policy. Furthermore, to facilitate global coordination, the Managing Director of the 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 are said to represent around 90 percent of global gross national product, 80 percent of world trade (including intra-EU trade), and two-thirds of the world’s population.

Perhaps surprisingly, securities regulators do not participate in the G-20, in part due to a perception of systemic risk regulation as lying beyond their purview. Nevertheless, since its launch in 1999, the G-20 has expressed a range of opinions and public communiqués that touch upon the macroprudential regulation of securities firms and products. In the wake of the global financial crisis, the organization promulgated a series of agreed-upon regulatory reforms that touch upon key matters of securities regulation, including:

- **Registration of Hedge Funds.** The G-20 declared that hedge funds or their managers must register and provide regulators with certain required information.

- **Regulation of Credit Ratings Agencies.** The G-20 endorsed the regulation of CRAs and adopted the IOSCO CRA Code of Conduct as a metric for measuring compliance. The group also declared that there should be a dual rating scale or an identifier distinguishing between corporate and sovereign debt, on the one hand, and structured financial products on the other.

- **Regulation of Derivatives.** The G-20 endorsed the President’s Working Group on Financial Transactions by declaring that

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124. Prior to the G-20’s creation, similar groupings designed to promote economic dialogue and analysis had been established, most significantly the G-7. The G-22 met in Washington D.C. in April and October 1998. Its aim was to involve non-G-7 countries in the resolution of global aspects of 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 emerging-market countries. Such a regular dialogue with a constant set of partners was institutionalized by the creation of the G-20 in 1999.


126. Id.


128. ENHANCING SOUND REGULATION, supra note 127; Declaration on Strengthening the Financial System, supra note 127.
transactions in credit default swaps not cleared through a central counterparty be registered. The G-20 also urged the creation of a central counterparty for over-the-counter ("OTC") credit derivatives as an important aspect of reducing systemic risk.\footnote{Declaration on Strengthening the Financial System, \textit{supra} note 127.}

- **Accounting.** The G-20 recommended that accounting standard setters strengthen the accounting recognition of loan loss provisions and dampen the effect associated with fair value accounting.\footnote{Declaration on Strengthening the Financial System, \textit{supra} note 127.}

Like IOSCO's principles, the G-20 communiqués are not enforceable under international law. Instead, disciplinary mechanisms within the G-20 are largely reputational. That is, where a country defects on its obligations, the country may find itself less able to promote policies in the future or encourage other members to comply with G-20 mandates. Outside the group, however, G-20 countries dominate standard setting in networks like IOSCO and the Basel Committee. To the extent that standards are then promulgated, the World Bank and IMF may incorporate the standards and require their adoption by developing countries (or progress towards compliance) as a condition for loans.

2. Financial Stability Board

Like the G-20, the Financial Stability Board (originally named the Financial Stability Forum) was founded in 1999 to promote international financial stability. Its membership, however, originally included not only the G-7 and each member's finance ministry, central bank, and supervisory agency, but also the major international standard setters (including IOSCO and its banking counterpart, the Basel Committee).\footnote{\textsc{Howard Davies \& David Green}, \textit{Global Financial Regulation: The Essential Guide} 113 (2008).} As a result, securities regulators have been able to participate in an independent capacity as part of their country's delegation as well as through IOSCO, though even here they remain dominated by banking authorities.

In its incarnation as the Financial Stability Forum, the group exercised no regulatory authority and had no mandate to generate standards,\footnote{\textsc{Alexander Kern et al.}, \textit{Global Governance of Financial Systems: The Legal and Economic Regulation of System Risk} 75 (2006).} even on a voluntary basis, as IOSCO has done.\footnote{\textit{Id.} at 75. Part of this work has involved the publication of a compendium of best regulatory practice; from 2001 to 2008 the organization produced few reports beyond a series of status reports on ongoing and recent work relevant to sound financial systems. \textit{Davies \& Green, \textit{supra} note 131, at 116.}} The 2008 financial crisis has dramatically changed the organization's activism and international engagement, however. As the only "network of networks" where standard setters, financial ministries, and central banks all interacted, it became an essential platform for
addressing the interdisciplinary nature of the global crisis. It was renamed the Financial Stability Board and given a mandate to monitor global financial stability and promote medium-term reform. The G-20 also expanded the organization’s membership to include representatives from all the G-20 nations—in effect turning the group into the nearest thing the world has to an overarching global financial regulatory group.  

Since the crisis, the Financial Stability Board has issued a series of recommendations and principles to strengthen the global financial system. Among them is the Report on Enhancing Market and Institutional Resilience, which called for limits on bank leverage, higher margin requirements for derivatives trades, and a reassessment of value-at-risk models and fair value accounting. In its Principles for Sound Compensation Practices, the Financial Stability Board set out principles for executive compensation and for compensation to be adjusted for all types of risk, to be symmetric with risk outcomes, and to be sensitive to the time horizon of risks. And finally, in its Recommendations for Addressing Procyclicality in the Financial System, the Financial Stability Board set out a mix of quantitative, rules-based, discretionary measures. These recommendations aimed to mitigate mechanisms that amplify procyclicality in both good and bad times and are to be implemented over time when financial markets have stabilized. Far from comprising “a think tank with nowhere to go,” as one critic has described the Financial Stability Forum, the organization has pushed these recommendations in front of the G-20 and is credited with providing a basis for the G-20’s political communiqués. Likewise, it helped set the basis for deeper coordination in the future between supervisory agencies, central banks, finance ministries, and political elites.

C. Explaining the Tentative Consensus

It is too early to know whether cross-functional networks will ultimately succeed in securing cross-border convergence. Nevertheless, it is worth noting that at least on the front end, regulators have secured a framework for coordination much faster than most traditional governmental networks. Indeed, early reports suggest considerable coordination on a variety of matters, including
capital adequacy for banks engaged in underwriting and securitization activities, central counterparty clearing for derivative instruments, and the examination of credit ratings agencies. These tentative successes warrant a closer look to determine which structural and substantive factors may make tackling systemic risk an exception to the theory of weak network power developed in the first half of this Article.

I. Institutional Design

Several factors may help to explain the success of cross-functional networks. First, the G-20 and Financial Stability Board differ considerably from IOSCO with regard to their institutional design. Perhaps most obviously, the G-20 and Financial Stability Board are not universal networks. Instead, their membership is finite and open only to the largest or fastest growing economies and international standard setters. As a result, their members are likely to be concerned about (and act upon) systemic risk, since they are home to many large financial institutions. Consequently, both the G-20 and the Financial Stability Board have an incentive to double, at least in part, as a coalition of the willing with regard to issues concerning financial stability. And with fewer members, such a coalition would find it easier to monitor compliance (either by members, the organization, or outsiders), which could decrease incentives for defection.

Another important institutional feature is that, unlike IOSCO and the Financial Stability Board, the G-20 invites participation from both regulators and political elites—from finance ministers representing their countries’ executives, to heads of state themselves. This engagement is important in two regards. First, occasional participation by presidents and prime ministers lends more credibility to commitments made by countries, even though the commitments are not memorialized as formal treaties. Because heads of state wield authority over regulators, either directly or indirectly, and can help to hold a wide array of market and governmental actors accountable, their acknowledgment of policy positions creates significant pressure for reform. Their involvement also signals that the highest levels of government are committed to a particular approach and demonstrates to domestic regulators and officials an expectation that they will expect full cooperation in executing their agendas.

Additionally, by engaging political actors with the authority to negotiate on a wide variety of issues, the G-20 allows the negotiation space to encompass

139. The Financial Stability Board reports, for example, that banking supervisors have published proposals for improving capital adequacy with regard to underwriting and securitization activities. Central counterparty clearing for OTC credit derivatives have been launched in the United States and in Europe. The IOSCO Code of Conduct has been implemented by the three largest CRAs and an examination module has been developed to inspect CRAs. FINANCIAL STABILITY FORUM, REPORT OF THE FINANCIAL STABILITY FORUM ON ENHANCING MARKET AND INSTITUTIONAL RESILIENCE (2009), http://www.financialstabilityboard.org/publications/r_0904d.pdf.
a greater range of issues than would be possible among regulators with narrow mandates. Political actors can, as a result, make transfer payments through concessions in other areas. Winners in one area of regulation, say the regulation of credit ratings agencies, can compensate potential losers by making concessions in other areas, such as hedge fund registration or even in matters entirely unrelated to financial regulation, and in that way more easily reach agreement. This flexibility provides cross-functional networks with key practical advantages over more narrow sectoral networks like IOSCO.

2. Systemic Risk as a Pure(r) Coordination Problem

Many of the systemic risks that cross-functional networks seek to address may pose purer coordination problems for regulators and thus make networks more effective instruments for policy cooperation. The 2008 financial crisis has, in particular, spurred a dramatic realignment of regulatory philosophy among countries, including the United States, whereby more stringent regulatory standards are more universally desired. As markets of all sizes and in all geographic locations experience their biggest losses in a generation, and governments implement a range of multibillion-dollar bailouts and market interventions, regulators are becoming more engaged in securities regulation. As a result, the changing cost-benefit analysis of regulatory transition provides new incentives for regulators, from both large and small economies, to adopt more stringent regulations.

Similarly, systemic risk is often allocated broadly, thereby increasing incentives for cooperation. Just as globalization has increased opportunities for global competition, it has also increased the interconnectedness of markets. Securities are sold across borders, and firms provide financial services and

141. Neil Irwin, IMF Puts Cost of Crisis Near $1 Trillion, WASH. POST, Apr. 9, 2008, at D01.
credit protection throughout the world. With the growing interdependence of firms, a negative shock in just one jurisdiction could impact a variety of institutions headquartered in other jurisdictions and trigger a global economic event like the 2008 financial crisis. Consequently, many regulators, especially those responsible for large financial markets, are likely to internalize the costs of under-regulation, though not all to the same extent.

Finally, it is worth noting that the issues under consideration may involve fewer adjustment costs than in areas relating to more traditional forms of investor protection. In many instances, institutions or innovations have been entirely unregulated. As a result, adjustment costs may be more evenly allocated than they might be where firms are (already) subject to often widely disparate rules and regulations, as in the case of disclosure and corporate governance. Movement to a particular standard in the latter case would impose asymmetric costs.

These observations ultimately indicate that cross-functional networks will likely prove to be more useful as a means of policy convergence than the governmental networks that have developed in the securities law context. To be sure, coordination problems will arise. Some jurisdictions could try to hold out to enjoy special benefits. Others may obstruct coordination or free-ride on the coordination efforts of compliers, thereby internalizing fewer costs of systemic risks. Finally, the costs and benefits across jurisdictions may differ. Some countries may, for example, be net exporters of "bad" financial products—whether stocks, bonds, credit default swaps, or other exotic instruments—to foreign investors, and the risks associated with these instruments may be inadequately priced. Some countries may host relatively few financial institutions, and thus face fewer systemic risks when purchasers of the securities fail or face financial difficulty. Such countries will have fewer incentives to cooperate and adopt more stringent regulatory standards.

Still, the nature of the risk presented by systemic financial instability suggests that cooperation comprises a significantly purer coordination problem than perhaps investor protection concerns. Network members do not usually view systemic risks as the problem or preoccupation of one particular player, a dynamic that can arise in investor protection issues and where financial centers are in deep competition with one another. Instead, systemic risk involves at least some degree of shared exposure, which incentivizes greater cooperation—especially with regard to the supervision of financial activities that can undermine the greater global economy and international trade. Information sharing is often the critical obstacle to coordination, which networks are well positioned to address—even, potentially, with regard to securities law networks that execute the agendas set by larger cross-functional fora.
IV
THE EMERGENCE OF A NEW INSTITUTIONAL FORM

Where then does this leave the SEC with regard to its historical mission and international strategy? This Part demonstrates that the limitations of the SEC's traditional policy tools have not gone unnoticed by the agency, even if many theorists have overlooked them. Indeed, in the face of financial globalization, the agency is considering a new institutional strategy to change the payoffs and outcomes of coordination. In matters of enforcement cooperation, membership standards have been introduced into existing governmental networks to exclude foreign regulators from network goods and create reputational costs for noncompliant members. Meanwhile, under a recent mutual recognition initiative, authorities are exploring the possibility of coupling membership standards with preferential access to U.S. investors, to incentivize greater substantive legal convergence in investor protection and market integrity. In transforming governmental networks into more coercive instruments, which this Part describes as “governmental clubs,” authorities hope to facilitate convergence at higher regulatory standards.

A. The Law and Economics of Governmental Clubs

In response to the growing importance of international capital markets, the SEC has increasingly opted for more powerful and coercive instruments to forward its policy objectives. The SEC has not, however, resorted to treaty making, an approach predicted by transgovernmentalism. Instead, the SEC has developed a “third way” for facilitating convergence at its standards. Specifically, the SEC has sought to incorporate mandatory rules into governmental networks, requiring foreign counterparts to comply before they can enjoy the benefits of the network. In doing so, the SEC has transformed open-access securities law networks into “governmental clubs” consisting of similar standard bearers.

Though overlooked in the literature on transgovernmentalism, institutional economists have anticipated and widely discussed this new strategic arrangement. Indeed, economic theory has long suggested that collectivities of individuals (also termed “networks”) need not only serve as open-access venues for collaborative policy formation, as traditional network theory implies, but also can generate their own standards ex ante, where use of the network is contingent on a prospective participant meeting certain conditions or membership standards.

The integration of standards into a network can make compliance with the standard more attractive in two ways. First, it can have a dramatic impact on the standard’s prominence and attractiveness. Often, the widespread adoption

143. See, e.g., RICHARD CORNES & TODD SANDLER, THE THEORY OF EXTERNALITIES, PUBLIC GOODS AND CLUB GOODS (1986); TODD SANDLER, GLOBAL COLLECTIVE ACTION (2004).
of standards among members generates what economists call “positive feedback dynamics,” or networks effects, enhancing the attractiveness of those standards irrespective of the substantive nature of the obligations. By promoting widespread standards, firms no longer have to adopt multiple processes to accommodate multiple regimes; one uniform regime is in place.\textsuperscript{144} By tying benefits to network membership standards, standards are promulgated more widely, thereby increasing their attractiveness.

Second, by conditioning access to network goods and excluding noncompliant regulators, governmental clubs recalibrate members’ cost-benefit analysis concerning the adoption of a standard. Compliance brings not only the benefits associated with the adoption of a standard, but also those associated with the network. In the more formal setting of the World Trade Organization (WTO), for example, a reduced tariff schedule with WTO member-states has incentivized nonmembers to lower their own duties on foreign goods. Such policy is required for WTO membership and is a condition precedent to a country enjoying the benefits of free trade. Similarly, free trade benefits for EU member states have incentivized East European and Baltic countries to adopt free market and democratic reforms in order to be eligible for membership in the organization.\textsuperscript{145}

Although this particular feature of club power has traditionally been associated in the legal literature with country-based international organizations, securities regulators, too, can create similar incentive structures where benefits are contingent upon certain regulatory actions or behaviors. As already discussed, networks provide a range of potential goods that can be enjoyed by participants:

- **Credibility.** By participating in certain institutions, regulators signal their commitment to transparency and sound market governance. Such credibility can, among other things, lower the cost of capital for firms operating in the relevant jurisdictions.

- **Policy Reach.** Networks allow members to advertise domestic approaches and potentially export regulatory policies to the group, thereby amplifying domestic policy reach.

- **Expertise.** Networks provide opportunities for regulators to stay informed on the activities of other regulators as well as develop best practices. Members may also receive feedback from other members about the effectiveness of their approaches and ways to improve their regulation.

- **Enforcement Assistance.** As seen with multilateral MOUs, networks can establish procedures for enforcement cooperation and in the

\textsuperscript{144} Drezner, supra note 102, at 43.

process provide a means of ensuring the integrity of domestic laws.

It is furthermore possible that regulators, as gatekeepers to their jurisdictions, can operate like trade officials and provide preferential access to their capital markets. Specifically, regulators can exempt market participants in ways that allow them to access their capital markets and investors on favorable terms. By definition, such benefits do not arise under governmental networks, which operate largely as open-access fora. However, governmental clubs offer the prospect of leveraging capital markets in ways that make compliance with standards more attractive.

The coupling of network goods with membership standards resets the regulatory calculus concerning the adoption of a standard and increases the costs of noncompliance or backsliding. By not adopting higher standards, a regulator, and by extension the country it represents, is potentially excluded from some benefits that rival jurisdictions may enjoy. Furthermore, where a member of a club does not fulfill its obligations or backslides on commitments, it may face the prospect of public rebuke that can tarnish its reputation and, especially in the securities context, increase the cost of capital for local firms where investors perceive the laxity as heightening their risk. Members additionally face the prospect of having their standing in the group diminished to a second-class status or even of being expelled from the club. This could result not only in stigmatization, but also a loss of access to some of the network’s benefits, such as having a voice in the formulation of international standards or, as outlined above, preferential market access.

B. Two Case Studies in Securities Regulation

Thus far, the SEC is exploring two club strategies in its efforts to promote greater coordination and convergence at its preferred standards. First, the SEC promotes a Multilateral Memorandum of Understanding ("MMOU") aimed at universalizing enforcement cooperation. Second, under its mutual recognition initiative, the senior regulators have argued for the promotion of bilateral clubs that offer liberalized market access as an incentive for regulators to reform their domestic markets and adopt U.S.-style rules and regulations.

1. The Multilateral Memorandum of Understanding

The potential power of membership standards is illustrated perhaps foremost in the SEC’s attempts to promote a global enforcement club through the IOSCO MMOU. This agreement, the centerpiece of new IOSCO efforts at facilitating cross-border enforcement, both builds on and departs dramatically from earlier governmental networks. Like traditional MOUs, the MMOU focuses on regulatory enforcement cooperation and seeks to memorialize procedures whereby regulators can quickly access the information required to enforce securities laws. In doing so, it aims to protect investors better in the
relevant jurisdictions and shore up loopholes in domestic regulatory enforcement.

The MMOU differs dramatically, however, from earlier enforcement coordination approaches. Perhaps most obviously, it achieves its ends multilaterally, between IOSCO members. Additionally, although members are permitted, and even encouraged, to undertake additional bilateral deals, the MMOU serves as a floor for minimum obligations. Furthermore, compliance is coercive. As a precondition to joining IOSCO, prospective members must first become signatories of the MMOU. To do so, 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.\textsuperscript{146} This process involves the applicant regulator filling out a questionnaire about the laws of the regulator’s home country that enable it to carry out the terms of the MMOU.\textsuperscript{147} Based on a review of the questionnaire responses, IOSCO verification teams then make specific recommendations to a screening body regarding the applicant’s ability to comply with each MMOU provision cited in the questionnaire.\textsuperscript{148} IOSCO officials ultimately decide whether to accept the application. Rejected applicants are required to upgrade their national regulations so that they comply with MMOU dictates.

Current members of IOSCO also face pressures that incentivize them to become signatories of the MMOU. Two options are available: sign the agreement as a full “Appendix A” member, or commit to seeking the legal authority that would permit the member to become a signatory.\textsuperscript{149} Under the second scenario, a member would be listed in an “Appendix B” attachment to the MMOU and given a deadline imposed by IOSCO to improve its standards.\textsuperscript{150} Thus, the MMOU, like the FATF, raises the specter of reputational consequences such that a regulator’s noncompliance, especially where chronic or long-term, could adversely affect the cost of capital for firms operating in its markets, its reputation and perhaps even its membership status.

In either case, this approach constitutes a dramatic departure from the classical governmental networks envisioned in international relations literature. Besides providing a means for enforcement coordination, the MMOU also resets the cost calculation for adopting prescribed standards. On its own, the SEC has limited leverage, short of some form of preferential market access or other issue linkages that could also promote the widespread adoption of its

\textsuperscript{147} Id. at 16–18.
\textsuperscript{148} Id. at 12.
\textsuperscript{149} Id. at 12–13.
\textsuperscript{150} Id. at 13. In the upcoming June 2010 meeting of IOSCO officials, regulators expect that Appendix B members will be given until 2013 to move from Appendix B to Appendix A.
standards. This is especially so with regard to emerging markets that neither receive nor make many enforcement requirement requests. However, most regulators may be inclined to sign the MMOU and undertake the verification process. Although the MMOU could impose costs on signatory regulators, like the existing bilateral agreements, the benefits of meeting international standards, having a say in the setting of such standards, and gaining access to members' experience and social outlets would help to prod recalcitrant states to adopt and comply with the club's standards.

2. Mutual Recognition

The SEC is also considering the use of membership standards in its promotion of capital market integration, an approach termed "mutual recognition." This approach—formally initiated in a pilot project with Australia in 2008, but stalled in the wake of the credit crisis—would employ governmental networks as cooperative instruments and potentially as a means of economic leverage. Specifically, instead of being subject to direct SEC supervision, foreign stock exchanges and foreign broker-dealers would apply for an exemption from SEC registration based on their compliance with foreign regulations deemed to be comparable to those in the United States. Part of this compliance would include supervision by a regulator with oversight power and enforcement philosophy similar to that of the SEC.

To establish a framework for such exemptions, the SEC and its foreign counterpart would sign a nonbinding mutual recognition "arrangement" laying out their intent to liberalize market integration in basic terms. At the same time, (bilateral) MOUs would be signed allowing for enhanced enforcement cooperation and information sharing. This arrangement would also contain an undertaking by the foreign regulators "describing in detail how certain regulatory preconditions required by the SEC are met, and a similar undertaking by the SEC providing for reciprocity." U.S. regulators would then evaluate the country's regulations, determining whether they were comparable to those in the United States. Once the SEC has blessed the laws of their home jurisdictions, stock exchanges and broker-dealers in those countries can apply for exemption from SEC registration based on compliance with their home state's laws. Consequently, shares traded on or through those countries could be marketed and sold to U.S. investors without complying with U.S. disclosure and corporate governance rules.

152. Tafara & Peterson, supra note 24, at 32.
153. Id.
154. Id. at 56.
155. Id. at 32.
156. Brummer, Stock Exchanges, supra note 5, at 1454.
Some academics have derided mutual recognition as an unwise instance of capital market liberalization. This is because it may empower international firms to engage in forum shopping, depending on the final rules adopted by national authorities. If, for example, an agreement is in place between the United States and Egypt, an international firm seeking to raise capital could choose the lighter regulatory regime in Egypt and still have access to U.S. investors.

However, some proponents, including the architects of the program, argue that mutual recognition would help incentivize foreign countries to adopt U.S.-style regulations. If the program is successful, foreign regulators could find new incentives to adopt U.S. securities regulations and approaches so that their regimes can be found comparable to the SEC’s. Those countries’ domestic firms would enjoy preferential access to U.S. investors, for one. They would not have to register their securities to access capital markets in the United States. Instead, only compliance with their home state’s regulations would be required. Those domestic exchanges could also enjoy competitive advantages over others as superior sources of liquidity. This is because they could offer prospective issuers access to not only their domestic capital markets, but also to investors in the United States. Exchanges could thus dramatically increase their attractiveness to investors, thereby increasing transaction volume. As a result, the greater pool of liquidity would allow exchanges to sell their services at a premium.

Ideally, these advantages would change the net payoffs for regulators such that the importation of U.S. law is again the optimal outcome. Although convergence in some instances might be costly, or involve the adoption of rules that are contrary to a regulator’s traditions or philosophy, the participants in the regulator’s domestic market could potentially enjoy a range of important competitive advantages, especially over market participants in nonparticipating jurisdictions. Foreign regulators securing such agreements could in turn receive political payoffs for delivering such results, either in the form of raises or promotions from agency executives and political elites, or from jobs in the private sector.

From this perspective, although mutual recognition could significantly—perhaps even radically—liberalize markets, it is at least potentially a highly

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158. Tafara & Peterson, supra note 24, at 32. This approach is also at least predicted by Amir Licht’s analysis of “hegemonic games” where two regulators of asymmetric power bargain over rules. See Licht, supra note 11 at 96 (noting that bilateral negotiations with Canada over disclosure incentivized Canadian regulators to adopt more U.S.-oriented approaches).
159. Brummer, Stock Exchanges, supra note 5, at 1494.
160. Id. at 1463. The larger pool of investors would make exiting an investment easier and lower the risk attendant to purchasing a security. Id. at 1463–64. It would also allow issuers to enhance their brand and knowledge of their company.
coercive instrument, depending on the standards required of foreign regulators to be deemed "comparable." Unlike governmental networks, which operate as open access commons, mutual recognition offers benefits only where comparability can be demonstrated, a process that could involve considerable domestic regulatory reform. Mutual recognition thus operates not only as a coordinating mechanism, but also as an exclusionary tool.\textsuperscript{161} As such, U.S. standards might be promoted, either where regulators make reforms in the context of actual mutual recognition negotiations, or where foreign regulators have an incentive to reform their domestic systems in hopes of eventually qualifying for mutual agreement consideration by the SEC.

\textbf{C. An Explanation of Existing Approaches}

From a structural standpoint, mutual recognition and the MMOU comprise very different approaches to club formation. The MMOU, on the one hand, is carried out multilaterally. This is in large part because enforcement MOUs have relatively few distributive consequences. Although regulators may have differing costs of reordering their institutional structures or sovereignty concerns, and even though deeper cooperation may offer relatively few immediate benefits for some countries, MOUs ultimately involve the process by which cooperation unfolds, not the substantive rules imposed on firms.\textsuperscript{162} As such, enforcement cooperation is designed to enhance, and not erode, domestic regulatory authority.

It is furthermore worth emphasizing that significant incentives for compliance arise, even where some regulators have little to gain from it. Although another less comprehensive form of cooperation might be preferable to a regulator as a matter of pure regulatory cost, the scale of advantages associated with participating in a global accord, coupled with the costs of expulsion from IOSCO or institutional stigmatization, give potential holdouts\textsuperscript{163} an incentive to adopt the standard.\textsuperscript{164} Ideally, multilateralism would promote the equilibrium where deeper cooperation arises as the dominant strategy, to the benefit of IOSCO members.

Mutual recognition, in contrast to the MMOU, adopts a distinctly bilateral approach to coordination. This approach is at least partially justified by the


\textsuperscript{162} Certainly, these costs may be symmetrical for nonmembers. Although considerable consternation has been voiced concerning the fact that members are essentially grandfathered in the agreement, many regulators believe that the Appendix B designation will serve to incentivize most regulators to undertake all necessary reforms for becoming signatories of the MMOU.

\textsuperscript{163} Note that here the ultimate payoffs for IOSCO members will never be negative because the option set always contains the possibility of keeping their original regulation level at zero cost.

\textsuperscript{164} Martin, supra note 114, at 101. Regulators may disagree as to whether or not to add to any commitments beyond, for example, beneficial ownership.
high negotiation costs involved in larger multilateral formats. As discussed above, despite its name, mutual recognition in the securities law context does not necessarily involve the reciprocal recognition by regulators of one another's regimes. Depending on the regulator in question, it may also involve various degrees of substantive convergence, which give rise to a variety of possible distributive issues, as mentioned above. Multilateralism is in many ways a comparatively poorer format for tackling such issues; it exponentially increases the number of issues to be negotiated, as each actor will have its own preferred set of rules and cost calculus to satisfy. The logic of coordination thus suggests that a series of bilateral negotiations (or small groups) is the most efficient strategy for both assessing comparability and, where necessary, securing convergence.

Mutual recognition would also go a step further than the MMOU by providing de facto preferential access to its securities markets, a carrot that makes bilateralism all the more theoretically appealing. Economic theory suggests that where regulators of two large markets negotiate market access, the positive public goods benefits will be equally distributed. If, for example, the United States and the European Union were to enter into a mutual recognition arrangement, such an arrangement could significantly reduce barriers to capital between the two markets. In this dynamic, one would expect either significant concessions from each party or a greater interest in a purer form of mutual recognition where one another's regimes are recognized and fewer reforms required.

Where, however, larger markets negotiate with smaller ones, the capital market benefits will generally be greater for the smaller economy, thereby altering the payoffs of coordination. Thus, if the United States and Colombia were to coordinate their regulatory standards, there is a smaller benefit for the United States. The coordination would not increase sources of capital much, but it would allow U.S. investors to diversify their holdings as well as reduce the chance of fraud overseas. On the other hand, such coordination would likely generate a significant windfall for Colombia, since the opening of the U.S. capital markets allows for cheaper costs of capital and more competitive exchanges.

In principle, this allocation of benefits affects the dynamics of coordination. The likelihood of achieving coordination equilibrium at one country's standards will be a function of that country's relative market size. All else being equal, the larger the difference in relative market size between two regulators, the less interest the big market regulator will have in conforming to the smaller regulator's standards, and the more the smaller regulator will be interested in coordinating at any set of standards. The logical extension of the effect of market size is that once a capital market amasses enough relative size, the only equilibrium outcome would be coordination at that regulator's

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165. DREZNER, supra note 102, at 56.
standards. Even though the regulator of the small market must adopt standards that are not preferred, and even though adjustment costs are high, access to the big regulator’s markets can provide incentives to compromise and adjust.

From this perspective, international relations theory suggests that a series of strategic bilateral coordination arrangements by one actor could potentially lead to a global standard, or at least something close to it that is widely adopted by many jurisdictions. By picking off smaller countries and having them converge at its standard, a regulator of a large capital market like the SEC could create network-size advantages that overwhelm the adjustment costs of other regulators. Standards can thus converge with those of the larger regulator’s with proper sequencing.\footnote{Outcomes should not differ with the introduction of additional actors beyond the two-player model exemplified under mutual recognition. To the extent that governmental clubs offer a larger common market, or other important network benefits, outsiders will have greater interests in joining. The main problem in multilateral contexts will be primarily ones of opportunism. As a result, governmental clubs may require surveillance and punishing regimes to ensure the viability of the alliance.}

However, as the next Part illustrates, the practical implications of such a strategy, though theoretically appealing, will be limited. Even though the coupling of membership standards to preferential markets changes the payoffs of coordination, the increasingly global nature of capital makes a wide range of alternative outcomes possible. The exclusivity of such clubs may also be difficult to maintain. As a result, the outcomes under mutual recognition will diverge from those under the MMOU.

\section*{V \hspace{1em} Evaluating Club Power}

Although governmental clubs alter the payoffs of cooperation, their effectiveness will depend largely upon context. This Part demonstrates that different issue domains have different strategic dynamics, and as a result, hold different consequences for the likelihood of international cooperation. On the one hand, the MMOU is likely to comprise a powerful lever for convergence. As a tool for coordinating enforcement cooperation, the MMOU implies fewer adjustment costs for regulators and, at least for regulators of major markets, relatively high reciprocal benefits from cooperation. Mutual recognition, in contrast, potentially entails flexible membership standards. And even where strict or narrow membership standards are promulgated, higher adjustment costs and a variety of strategic challenges make convergence less likely.

\subsection*{A. The Coercive Power of the Multilateral Memorandum of Understanding}

The MMOU will likely have a significant effect on many of the world’s securities regulators, leading most of them to coordinate at the higher regulatory standard. This is because the MMOU operates in an environment
where, as stated above, there are already significant incentives for most regulators to adopt cooperative measures. Because the securities of major corporations trade simultaneously in several countries, "perpetrators can easily conduct their activities far from the jurisdiction of their victims." It is thus critical for regulators of major markets to cooperate in enforcement matters in order for their own domestic laws to be viable. If they fail to do so, perpetrators could conduct their crimes from overseas locations and evade regulatory action. There are also, relatively speaking, fewer adjustment costs than would be the case under convergence of substantive rules. Although regulators might have to seek additional 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. It is for the regulators of smaller markets, or perhaps more politically sensitive markets, that cooperation constitutes a battle-of-the-sexes game.

The MMOU largely uses the shared interests of most regulators to create institutional leverage through IOSCO to incentivize even outliers to adopt the enhanced enforcement regime. IOSCO membership, and its attendant advantages, acts as a coercive tool to persuade prospective members to change their policies. If regulators refuse to sign the MMOU, they are unable to accede to the only multilateral forum for international policy development for securities regulation. Furthermore, members who do not sign the MMOU face possible stigmatization and loss of credibility, which could hamper the development of their domestic capital markets and lead to potential expulsion from the group.

As a result, the MMOU establishes a relatively simple, albeit powerful, cost calculus for regulators: either they sign the MMOU and commit to enforcement cooperation, which entails relatively few adjustment costs (at least for firms) and significant benefits for regulators, or they expose themselves to reputational costs and possible exclusion from IOSCO. Under this option set, there are strong incentives to sign the MMOU and if possible avoid the Appendix B designation. Already, most members of IOSCO have become signatories to the MMOU or are under review by the screening group and verification teams, and SEC officials predict that those that are on the Appendix B list will be actively working to remove themselves from the list by IOSCO's deadline and improve their domestic enforcement capabilities.

167. Verdier, supra note 60, at 144.

168. Id. To put this in perspective, consider that the SEC files hundreds of securities fraud cases each year and relies on bank records in approximately 70 percent of those cases. SEC. & EXCH. COMM’N, supra note 113, at 16. The SEC has thus argued that "a securities authority that can’t get bank records would likely be unable to successfully investigate over 70% securities fraud cases." Id. Considering that many of these bank records are overseas, cooperation between regulators is vital.
B. The Limitations of Mutual Recognition

Compared to the MMOU, mutual recognition would create far less certain regulatory outcomes, partially due to the possibility that extremely flexible membership standards can be imposed within the club. Depending on the standards used for judging comparability, foreign regulators may not have to undergo many reforms in order for their firms to operate in the United States. Indeed, a conceptually purer form of mutual recognition could be required for agreement given what are likely higher adjustment costs for regulators and firms when adopting different substantive rules. It is important to note, however, that even if the SEC promoted a mutual recognition regime comprised of strict membership standards, the range of possible strategic dynamics makes it clear that convergence at U.S. standards need not comprise the dominant outcome.

1. "War of the Clubs" Scenario

Although mutual recognition would change the payoffs of coordination, cooperation at standards preferred by the United States need not comprise the dominant policy choice, even where strict membership standards exist. One reason for this is that prospective partner regulators may decide to enter into their own countervailing alliances. In creating or joining rival clubs, they could form their own core group of decision makers, promulgating alternative membership standards that reflect their own policy preferences and thus diminish adjustment costs and negative distributional consequences. Furthermore, rival governmental clubs can potentially usurp some of the regulatory space once occupied by other regulators before they joined the original club and adopted stricter standards.

To understand what this means in practical terms, consider a situation where the regulator of a large market approaches the regulator of a small market, Regulator C, and offers the prospect of creating a club alliance with coordination at its preferred standards. Consider further that another unrelated regulator, or group of regulators, has created another club and also offers Regulator C the opportunity to join. In such circumstances, the rival clubs give players like Regulator C at least three options: (1) remain independent, (2) converge with the large-market regulator to create a club, or, in contrast to our earlier examples, (3) join the other club.


170. Indeed, one could envision a fourth option—that the regulator could choose to adopt the standards of both clubs, assuming that they were not mutually exclusive.
Under these circumstances, the size differential between the smaller and larger markets will not necessarily serve as the primary impetus behind coordination if an alternative alliance is available. Instead, the adjustment costs and benefits of adopting stricter standards may play a more central role in a prospective member’s decision making. Where adjustment costs associated with a particular club are high and few benefits (such as lower costs of capital) are evident from adopting the stricter standards, a regulator will rationally join the club with the weaker standards. Thus, in contrast to a single club scenario where defection by a small regulator might provide few benefits, defection here could still enhance the welfare of the firms in the small regulator’s jurisdiction if it involved joining an alternative club.

This scenario has two important theoretical implications. First, it demonstrates that although a governmental club may increase incentives for a regulator to adopt a different standard, it is by no means certain that adoption of the club’s standards will be the dominant choice for other regulators. Instead, many trading blocs could emerge. Second, and closely related, the possibility of multiple clubs implies that significant competition between regulators could continue even as standards underwent harmonization through clubs. Instead of many national regulators vying for transactions, several larger alliances could operate as the focal points for competition. As a result, the depth of the market for law could be significantly reduced, especially where governmental clubs adopt narrow membership standards. However, competition could remain vigorous, as governmental clubs compete to attract transactions and promote their own regulatory norms.

2. “Holes in the Bucket” Scenario

Clubs could also be ineffective at excluding nonparticipants from the club good (the preferential capital market). When this happens, the payoffs from adopting the club’s membership standards and joining the club decrease. Non-participating regulators no longer need to join a club and comply with its rules if they can still access the club good through alternative, less costly means.

Ineffective exclusion can arise wherever there is a change in club policy, or where a member introduces new rules domestically that undercut the exclusion mechanism of the club. The former scenario is rather straightforward. Where, for example, after initially adopting a particular set of membership standards, a club then adopts more flexible rules, club members may cease to adhere to the requirements that are no longer mandatory and do not appeal to regulators and their respective firms.

The latter scenario could arise where a member unilaterally introduces new rules that undercut the club's exclusion mechanism. As a contemporary example of such a dynamic, consider two new SEC projects: mutual recognition, a product of the SEC's Office of International Affairs, and the proposed amendment of Rule 15a-6, a policy introduced by the Division of Trading and Markets.\textsuperscript{172} Mutual recognition, as discussed above, would allow foreign broker-dealers and exchanges to access U.S. capital markets on less burdensome terms than market participants in other jurisdictions would. As such, it changes the payoffs of coordination significantly. However, under the proposed amendment, the SEC would permit all foreign broker-dealers to access U.S. securities markets so long as they only provided research reports to investors that are worth at least $25 million or invest on a discretionary basis at least the same amount.\textsuperscript{173}

In important ways, the proposed Rule 15a-6 would undercut the potential effectiveness of mutual recognition. From a practical standpoint, it would allow foreign broker-dealers to access most U.S. investors \textit{without} their home jurisdictions undertaking any comparability assessment as required under mutual recognition.\textsuperscript{174} This is, of course, a less expensive means of accessing U.S. capital markets, as it entails fewer adjustments by regulators and firms. As a result, there is less incentive to join a club under mutual recognition; a firm will instead seek exemption under Rule 15a-6. Mutual recognition will thus only offer significant benefits for two kinds of market participants: foreign broker-dealers wishing to access investors worth less than $25 million, and foreign exchanges seeking to display trading screens in the United States. As a result, there will be less political pressure for regulators to adopt comparable laws in order to enjoy preferential access.

There is a significant likelihood of similar kinds of exclusion imperfections arising in mutual recognition schemes. Domestic officials often compete domestically with one another for the provision of law, and may seek to outperform one another in a variety of ways, including through market liberalization. Furthermore, regulators may come from different political parties or enjoy different ties to industry and political philosophies. They may have very different ideas about the optimal degree of market liberalization and fail to share the information necessary for a cogent regulatory approach, causing regulatory gaps.


\textsuperscript{173} Id.

\textsuperscript{174} Jackson, \textit{supra} note 9, at 16.
3. Follow the (New) Leader

Finally, as an approach that still depends significantly on the size of U.S. markets to facilitate export, mutual recognition provides a poor bumper to globalization as conceived by the SEC. In one sense, transitioning to foreign standards involves considerable sunk costs for regulators and firms operating in their jurisdictions. Once standards are adopted, equilibrium may arise with few incentives to defect, all else being equal. However, globalization can act as an exogenous event that changes the cost-benefit calculus of cooperation. Assuming globalization continues apace, there will be fewer incentives for foreign regulators to transition to U.S. standards, since the payoffs related to accessing U.S. markets will be smaller. The rise of the rest implies reduced soft power, market power, and coercive power for the United States vis-à-vis the rest of the world. Consequently, more attractive terms may have to be offered, such as less stringent membership standards that lower candidate states’ adjustment costs.

Backsliding on club commitments could also occur over time. Consider, for example, a situation where a U.S. mutual recognition agreement requires high enforcement and surveillance obligations from another regulator. In such circumstances, recurring costs arise for both the United States and its partner, insofar as they must continually devote resources to enforcement. Furthermore, higher regulatory standards make both locales a less attractive venue for capital. Such an agreement may be beneficial for a partner regulator where U.S. markets significantly dwarf others. However, if U.S. capital markets decline substantially in significance, coordination payoffs may not suffice to keep a club partner from backsliding on its commitments and devoting fewer resources to enforcement or other obligations.

These observations suggest that the best long-term means of ensuring power under a mutual recognition arrangement are to have jurisdiction over a competitive and vibrant capital market, as in the case of governmental networks. This goes along with the cross-border promotion of regulatory standards. Only by having a vibrant capital market do regulators enjoy the soft power and financial clout to encourage emulation by others. Consequently, even under mutual recognition, the United States must continue to compete for capital in order to attract foreign transactions and to preserve incentives for club compliance.

175. Assume, for example, an instance where a small jurisdiction must adopt new accounting principles in order to enjoy mutual recognition. Such a requirement would effectively require firms in the jurisdiction to change their bookkeeping procedures, training for accountants, and perhaps even sanctions for non-compliant firms. Assuming that the jurisdiction nonetheless undergoes such reform, it is unlikely that, even if the United States dramatically declines in economic influence, the jurisdiction or its firms will then revert to the status quo ante. Instead, the adoption of standards is primarily a distributive issue on the front end.

176. DREZNER, supra note 102, at 218.
C. Policy Implications

These observations yield three core strategic insights that go to the heart of club power and cross-border convergence.

1. Clubs as Instruments of Regulatory Export

On the most basic level, the SEC’s strategic shifts will likely enhance the agency’s ability to export U.S. laws and regimes more than preexisting approaches centered on governmental networks.

Comparatively speaking, networks are attractive because they provide few, if any, costs for participants. As a result, broader cooperation is likely possible, and no monitoring of obligations is required. Nevertheless, networks have little sway in promoting convergence on issues of distributive import. Even if network members reach agreements, agreements can be fragile and they can be ignored. This leads to their uneven application and to backsliding among participants.

Governmental clubs, in contrast, change the payoffs associated with regulatory coordination with the SEC. Like networks, clubs utilize network contacts to promote joint solutions to common problems generated by globalization. Yet, unlike governmental networks, governmental clubs can operate in a doubly "coercive" manner: they pressure firms through their regulatory contacts and collaboration, and they compel other regulators through new aggregation technologies, such as membership standards. In doing so, governmental clubs impact the provision of law by regulators more profoundly and encourage robust forms of cross-border regulatory convergence.

2. The Challenge of Standards Convergence

Though governmental clubs have comparably greater leverage, the issue area in which they are deployed may impact their coercive effect. As shown above, governmental clubs will likely be more effective in securing enforcement cooperation than standards convergence. This is partially because substantive convergence entails greater adjustment costs than enforcement cooperation. In addition, convergence could negatively affect a jurisdiction’s competitive position in the market for global securities transactions.

As a result, clubs promoting substantive convergence will likely have to offer greater benefits to offset their greater potential costs. The MMOU tries to circumvent the problem by operating through a network in which there are many regulatory participants. With many members, scale advantages can be generated through shared procedural operations and commitments. However, because this approach involves many actors, coordination is more complex than would be the case on a bilateral or regional basis. Perhaps not surprisingly, the MMOU’s scope is thus limited, and the instrument operates almost exclusively as a tool for enhanced enforcement cooperation. Few substantive matters are
addressed.

Mutual recognition comprises an alternative approach that links coordination at preferred standards to nonlegal (market) benefits. Through this strategy, fewer club members are required, which helps lower coordination costs. This approach, however, has a range of important strategic tradeoffs. As discussed above, substantive issues must be negotiated, and clubs may be difficult to manage. Because outsiders may be able to replicate the club benefit of preferred capital market access through coordination with other regulators, actors have a range of strategic options. Furthermore, coordination at U.S. standards may be less attractive due to the diminishing significance of U.S. markets.

Consequently, substantive legal convergence remains an "unsolved" coordination dilemma in international securities regulation, even though mutual recognition changes the payoffs of cooperation. Due to high adjustment costs, market pressures, and divergent regulatory pressures, a mutual recognition scheme would likely achieve limited convergence. Instead of a process that imposes tight convergence standards, a purer form of recognition will likely be required to reduce adjustment costs and thereby make (limited) cooperation more attractive. Thus, significant market liberalization may be the only means of inducing even minor convergence unless other more coercive actions are taken to change the very infrastructure of the international regulatory system.  

3. A Silver Lining

The current limitations of governmental networks and clubs as instruments of export and convergence have implications that many commentators have classified as welfare diminishing in other contexts. This situation exists because a lack of standardization translates into efficiency costs for companies that operate in multiple jurisdictions. Furthermore, the ability of firms to move across borders suggests that regulators will continue to compete for transactions, which could involve the provision of suboptimal or highly imperfect rules.

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177. Major reforms may additionally be required to secure compliance on the back end once rules are agreed upon. See Brummer, Financial Law, supra note 57 (arguing, inter alia, that reforms in institutional monitoring and surveillance may bolster compliance with international financial law).


179. For the former view, see Fox, supra note 11, at 1338–39 (arguing against issuer choice reforms because they would lead to significant underdisclosure); for the latter view concerning the imperfections of governmental provision of law under even competitive conditions, see William W. Bratton & Joseph A. McCahery, The New Economics of Jurisdictional Competition: Devolutionary Federalism in a Second-Best World, 86 Geo. L.J. 201, 230 (1997) (noting that "competition may make [citizens] better off or worse off depending on a dynamic and complex mix of factors that competing governments cannot control").
The dynamics of even limited club power, however, hold a number of possible benefits from the perspective of global welfare. First, club power is enough to induce behavioral changes by regulators where such change will likely generate unambiguous global welfare gains. As suggested above, most IOSCO members will enjoy gains through the MMOU and the enhanced information sharing and cooperation that it makes possible. This will especially be the case for regulators of large markets. Pledges of cooperation among regulators allow club members to better maintain the credibility and efficiency of their domestic securities regimes. Members can more robustly enforce domestic fraud laws and more easily reach witnesses, wrongdoers, and evidence located abroad.

To be sure, the MMOU may present relatively few benefits for some regulators, in particular those who oversee small capital markets. Although they are able to enjoy enforcement cooperation from their fellow regulators, they are less likely to need it, given the less meaningful role of securities markets in their economies. Thus, for some, there may be fewer scale advantages accompanying the establishment of a cross-border regulatory framework. Still, economic theory suggests that the MMOU will likely provide global welfare gains. Securities markets play an ever-increasing role in virtually every country.¹⁸⁰ Having a capable domestic enforcement body is key to maintaining the credibility of such markets. As a result, most signatories will benefit from cooperation, though the degree to which regulators benefit will differ because some may prefer less intrusive forms of cooperation. In any case, the MMOU provides a constructive framework for cooperation that will likely enhance the effectiveness and efficiency of global market governance.

Meanwhile, mutual recognition would present relatively more ambiguous global welfare benefits if implemented, and here clubs are less powerful. On the one hand, unlike some IOSCO members who may sign the agreement in order to retain benefits and a full stake in the organization, MMOU signatories participate to gain something new—specifically, they seek preferential access to one another’s investors. Thus, neither regulator under an MMOU views itself as “worse off” than under the status quo ante. However, mutual recognition may cause firms operating in the jurisdiction to internalize considerable costs that, in the aggregate, constitute a loss in global welfare. For example, where a mutual recognition regime involves few membership standards, firms may be able to evade even beneficial rules by establishing themselves in the jurisdiction that is subject to lighter regulation. To the extent that firms evade efficient rules promoting investor protection, global welfare suffers.

Theoretically, some risks can also arise if mutual recognition involves the adoption of more stringent substantive rules. At its best, mutual recognition provides new incentives for otherwise skeptical regulators to adopt higher

standards that are also more efficient and enhance global welfare. Convergence may also reduce the likelihood of regulatory competition resulting in the dismantling of sound regulation. At the same time, legal homogeneity, when not born of competitive processes, potentially diminishes the experimentation that may be necessary in identifying best practices. Legal homogeneity could also hike up the transaction costs of raising capital across jurisdictions and raise the risks of regulatory error. Consequently, where mutual recognition incentivizes the adoption of inefficient rules, it could generate significant costs for firms operating in those jurisdictions. Thus, the ultimate value of convergence will lie in the optimality of the rule itself. Where the adopted rule or approach is suboptimal, it will generate broad negative externalities for the market participants operating in that jurisdiction.

Ultimately, from a risk perspective, club power has the advantage of promoting those forms of coordination that are most likely to lead to global

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182. This argument, popularized by Roberta Romano in her criticism of regulatory monopolies, holds that where regulators wield total power over the promulgation of laws, they no longer need to be attentive to the needs of market participants. See Roberta Romano, The Need for Competition in International Securities Regulation, 2 THEORETICAL INQ. L. 387, 392–93 (2001). For example, where regulators enjoy power over the market, they have the power to govern markets in a way that either extracts rents from firms or insulates regulators from responsive governance and accountability.

183. Bernard S. Black, Is Corporate Law Trivial?: A Political and Economic Analysis, 84 NW. U. L. REV. 542, 575 (1990). Indeed, the current economic crisis has demonstrated, perhaps above all else, that no one country—including the United States—has all of the right answers with regard to sound economic regulation.

184. An issuer need not, in other words, undertake duplicative compliance obligations when listing securities or selling them to the public. After complying with its domestic obligations, it can market and sell securities overseas. In this sense, uniform standards permit firms to maintain a single production process, rather than accommodate multiple processes for multiple regimes. Similarly, analysts are in a better position to assess and compare companies across jurisdictions, as well as allocate capital to its most efficient uses. This leads to an increase in static efficiency, which in turn increases global welfare. Dreznear, supra note 102, at 43.

185. If a club adopts rules that are welfare diminishing—for example, because they require too much costly disclosure or inappropriately high capital reserves for a particular instrument—and then requires firms to adopt similar measures, all firms could be subject to high welfare costs. Black, supra note 183, at 575. These risks can be particularly significant in a financial crisis. When new dilemmas arise, regulators frequently undertake different regulatory responses, and then observe outcomes across jurisdictions in order to adjust their own regimes. Id. Furthermore, to the extent laws are standardized, a better approach to regulation may not be identified. Companies in jurisdictions may lack incentives to endorse change absent concrete evidence indicating that reforms would constitute an improvement. Id.

186. Similarly, the degree to which one another’s regimes is mutually recognized without convergence, both welfare-diminishing and welfare-enhancing outcomes are possible. On the one hand, foreign firms that are subject to less optimal regulation could be more easily marketed to U.S. investors. On the other hand, where U.S. laws are suboptimal, mutual recognition would allow foreign market participants to access U.S. investors without complying with inefficient or ineffective statutory regimes. As a result, the optimality from a global welfare standpoint will largely depend on the optimality of not only U.S. rules, but more specifically, its optimality relative to that of the foreign jurisdiction.
welfare benefits. At the same time, however, clubs are least coercive where the benefits of coordination are ambiguous, and their limited coerciveness restraints the extent to which bad rules or regulatory approaches are exported abroad. Instead, clubs will prove most potent at substantive rulemaking where adjustment costs are modest and where regulatory philosophies are consonant. In such instances, clubs can help to tilt the choice of law by foreign regulators and promote the adoption of its membership standards.

CONCLUSION

This Article provides an interdisciplinary framework for understanding SEC diplomacy in an age of declining economic influence. In doing so, it makes fresh contributions to the literature on both securities law and international relations.

A. Securities Law

Scholars have long viewed the SEC as wielding a virtual regulatory monopoly over the provision of securities laws both at home and abroad. Recent scholarship has demonstrated that traditionally dominant regulators, like the SEC, have to compete for transactions by offering attractive securities laws because foreign markets have become more economically significant. This observation has enabled a binary regulatory monopoly/competition framework for describing the SEC’s regulatory power.

In response, this Article frames and analyzes the understudied tools of SEC diplomacy to introduce another form of regulatory activity that eludes these two categories. It shows how the SEC and its homologues can (and do) cooperate in ways that curb the choice of law for firms and diminish the incentives of other regulators to construct individual national approaches. Through such cooperation, the SEC can exploit mechanisms designed for information sharing in ways that enhance the likelihood of international coordination at its preferred standards. Nevertheless, due to the costs of adjusting to new standards and other asymmetric interest constellations, governmental clubs will have a limited regulatory impact and will likely be more effective at securing convergence in enforcement cooperation than at securing substantive harmonization of securities law proper.

B. International Relations and International Law

This Article also presents a refined application of transgovernmentalism, a dominant current in the international relations and international law literature that views informal collaborative arrangements between securities regulators as frictionless and largely self-enforcing. It demonstrates that scholars in this literature have generally underestimated the complex strategic dynamics that inform international standard setting. Consequently, theorists have misjudged the power of existing networks to affect cross-border regulatory convergence.
The Article also demonstrates how U.S. securities regulators have recognized these limits and are increasingly turning to "governmental clubs," which introduce membership standards into network structures to promote their policy preferences. The effectiveness of governmental clubs, however, will largely depend on the issue domain in which they are used. Clubs are more likely to be successful in promoting enforcement cooperation than substantive rules convergence due to the difficulty of excluding nonmembers, the possibility of alternative rival clubs, and the inevitable growth of foreign markets. In both cases, however, the inexorable rise of the rest suggests that governmental clubs may provide only temporary relief for regulators, and that long-term capacities to export securities regulations will continue to depend on the competitiveness of domestic capital markets.