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PRIVATE INTERNATIONAL LAW-MAKING

FOR THE FINANCIAL MARKETS

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1.0 INTRODUCTION

In his 2004 Chorley lecture, Simon Roberts argued against the modern trend to "loosen the conceptual bonds between law and government".[1] Roberts is concerned that by expanding the range of what we call law we undermine the meaning of the descriptor. But he is also concerned that "under an onslaught of jural discourse and institutional design, [the] distinctive values of negotiated order, far from being celebrated, are actually effaced."[2]

In financial regulation[3] it is easy to subscribe to this distinction between state-centred law and negotiated rules (whether we describe them as "law" or not). It is common, for example, to distinguish between governmental and "self-regulatory" rules.[4] But this apparent sharp distinction between governmental and self-regulation soon breaks down: self-regulatory organisations often derive (or appear to derive) their

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[1] Simon Roberts, *After Government? On Representing Law Without the State*, 68 MOD. L. REV. 1, 1 (2005). See *id.* at 17: "If we try to represent law — or regulation — as other than a dimension of governing we are surely losing our way."

[2] *Id.* at 23. Roberts describes the value of negotiated orders as follows: "Negotiated orders have their own rationalities: they involve a different orientation to the normative repertoire from those of state law; decision-making is through agreement, reached through cyclical processes of information exchange and learning, rather than the imposed order of a third party; different forms of trust are necessarily involved." *Id*.

[3] By focusing on the regulation of international financial activity (excluding informal financial transactions carried out through mechanisms such as hawala) I am necessarily focusing on regulation produced by actors from developed economies and, in particular by actors from developed western economies.

[4] *See*, *e.g.*, John Braithwaite & Peter Drahos, GLOBAL BUSINESS REGULATION, 28, (2000) ("The last two decades of the twentieth century saw the rise of a 'new regulatory state', where states do not so much run things as regulate them or monitor self-regulation. Self-regulatory organizations frequently become more important than states in the epistemic communities where debates over regulatory design are framed.")

(quasi) regulatory authority from the state.[5] Members of an SRO may find that they have to look beyond their SRO to assess the risks that they will be subject to enforcement action.[6] Self-regulatory rules may be introduced in order to fend off formal governmental regulation. At the same time governmental regulation may look very much like a negotiated order and may give effect to private agendas.

The debate in financial regulation about the respective weights which should be accorded to governmental and self-regulatory rules is a live one. At the end of 2004 the US SEC published a concept release on self-regulation,[7] and proposed new rules to apply to SROs.[8] Governments[9] and international organisations[10] have examined how

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[5] Stock exchanges have always been able to exercise quasi-regulatory powers. Now they commonly exercise regulatory powers under the authority of statutes. *See*, *e.g.*, SRO Consultative Comm., Int'l Org. of Secs. Comm'ns, Model for Effective Regulation, 3 (May 2000) *available at* http://www.iosco.org/download/pdf/2000-effective_self-regulation.pdf ("In several jurisdictions around the world, effective self-regulation existed before statutory regulation. As markets developed, market participants recognized that regulation was necessary in order to protect the integrity of the market. Industry participants recognized that those who were most familiar with the customs and practices of a particular trade were best suited to create rules related to that trade, to enforce those rules and to resolve the disputes that arose from those rules. Moreover, the familiarity with the concepts involved ensured that such disputes were quickly resolved and that the rules for commerce in that particular market continually and quickly adapted to the evolutions in the manner in which trade was conducted."

[6] Jenny Anderson, *A New Inquiry Into Big Board Specialists*, New York Times, C1 (Feb. 7, 2005) (reporting that the Manhattan US Attorney's office was investigating whether NYSE members had cheated customers through illegal trading practices).

[7] Sec. & Exch. Comm'n, Concept Release Concerning Self-Regulation, 69 Fed. Reg. 71256 (Dec. 8, 2004) *available at* http://www.sec.gov/rules/concept/34-50700.pdf .

[8] Sec. & Exch. Comm'n, Fair Administration and Governance of Self-Regulatory Organizations; Disclosure and Regulatory Reporting by Self-Regulatory Organizations; Recordkeeping Requirements for Self-Regulatory Organizations; Ownership and Voting Limitations for Members of Self-Regulatory Organizations; Ownership Reporting Requirements for Members of Self-Regulatory Organizations; Listing and Trading of Affiliated Securities by a Self-Regulatory Organization, 69 Fed. Reg 71126 (Dec. 8, 2004) *available at* http://www.sec.gov/rules/proposed/34-51019.pdf . See also Sec. & Exch. Comm'n, *Proposed Rule Changes of Self-Regulatory Organizations*, 69 Fed. Reg. 60287 (Oct. 8 , 2004) *available at* http://www.sec.gov/rules/final/34-50486.pdf

[9] *See*, *e.g.*, Taskforce on Industry Self-Regulation, Industry Self-regulation in Consumer Markets, v, vii (Aug. 2000) *available at* http://www.consumersonline.gov.au/downloads/selfreg/taskforce/FinalReport/final_report.pdf ("Self-regulation is increasingly being used as an alternative to quasi-regulation and government legislation and there is some overlap between them. Identifying best practice in self-regulation, and identifying the limits of self-regulatory schemes, has important implications for the government's approach toward a more

self-regulation does and can work in financial markets. In recent years SROs have been criticised for being ineffective as regulators of financial market participants.[11] In January 2005, Charlie McCreevy, the EU's internal market commissioner, noted that governance of international standard setters was "becoming a subject of heated public debate".[12] Credit Rating Agencies, hitherto unregulated, may be subject to some form of regulation in the future.[13]

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efficient regulatory framework for both businesses and consumers. The role of government in encouraging self-regulation also has an impact on compliance costs, flexibility and the coverage of self-regulation".. "The Government also has the objective that industry should take increased ownership and responsibility for developing efficient and effective self-regulation where it is the most appropriate regulatory response.")

[10] *See*, *e.g.*, *Model for Effective Regulation*, note 5 above.

[11] *See*, *e.g.*, Restoring the Public's Trust in the New York Stock Exchange, 1 (Sept 24, 2003) *available at* http://www.treasurer.ca.gov/news/releases/2003/20030924nyse.pdf ("the disclosures that led to the resignation of Richard Grasso as the NYSE's Chairman and Chief Executive Officer have revealed that some of the problems that precipitated the market crisis of the past two years are reflected in the conduct of the NYSE itself. It is clear that there is a need for fundamental, urgent, and sweeping reforms at the NYSE, to restore the faith and confidence of investors."); Sec. & Exch. Comm'n, *Concept Release*, *supra* note 7 at 71259; Sec. & Exch. Comm'n, *SEC Charges National Stock Exchange and Its CEO, David Colker, for Failure to Enforce Exchange Rules*, (May 19, 2005) *available at* http://www.sec.gov/news/press/2005-79.htm . Reena Aggarwal, notes some of these criticisms but describes advantages of SROs as follows: "SROs offer the following advantages over government agencies: business interests, ability to self-police, resources, close proximity to the markets, and flexibility." Reena Aggarwal, *Regulatory Infrastructure Covering Financial Markets*, BROOKINGS-WHARTON PAPERS ON FINANCIAL SERVICES, 55, 74 (2001)

[12] Charlie McCreevy, European Commissioner for Internal Market and Services, *Governance and Accountability in Financial Services*, Speech at the Economic and Monetary Affairs Committee of European Parliament, Brussels, Speech 05/64 (Feb. 1, 2005) (The governance, financing, participation in and the accountability of international standard setters, in particular the International Accounting Standards Board, is becoming a subject of heated public debate.")

[13] *See*, *e.g.*, Sec. & Exch. Comm'n, Proposed Rule, *Definition of Nationally Recognized Statistical Rating Organization*, 70 Fed. Reg. 21306 (Apr. 25, 2005) *available at* http://www.sec.gov/rules/proposed/33-8570fr.pdf ; Senate Committee on Banking, Housing and Urban Affairs, Press Release, *Sen. Shelby Announces Banking Committee Priorities, Planned Schedule for 109th Congress* (Jan. 19, 2005) *available at* http://banking.senate.gov/index.cfm?FuseAction=PressReleases.Detail&PressRelease_id=177&Month=1&Year=2005 ; Bank for International Settlements, Committee on the Global Financial System, *The Role of Ratings in Structured Finance: Issues and Implications* (January 2005) *available at* http://www.bis.org/publ/cgfs23.pdf ; IOSCO Technical Committee, *Code of Conduct Fundamentals for Credit Rating Agencies*, (December 2004) *available at* http://www.iosco.org/pubdocs/pdf/IOSCOPD180.pdf ; Sec. & Exch. Comm'n, Concept Release, *Rating*

The argument that domestic financial regulation is influenced by private sector groups through lobbying and capture is not new.[14] Commentators have argued in the past that harmonisation of regulation in the EU allows business groups to have a greater influence on the development of rules than they would at the domestic level. But the capture story is clearly not the only story about regulation. At the domestic level, particularly in an environment with competing regulators, regulators may seek to appeal to different constituencies. State banking regulators in the US are now arguing against the OCC's actions on pre-emption by emphasising that the state regulators protect individual consumers of banking services more effectively than the OCC can.[15] Financial firms do not always succeed in protecting themselves from liability even where they are only doing what other similar firms are doing.

This paper argues that transnational financial transactions create new opportunities for private groups to influence legal and regulatory rules. Internationalization of the financial markets has led to harmonization of financial law. Much harmonization of financial law occurs through processes which are apparently public, state-centred and transparent but in this paper I describe three ways in which private and opaque processes have a significant influence on policy development in the

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Agencies and the Use of Credit Ratings under the Federal Securities Laws, 68 Fed. Reg. 35258 (Jun. 12, 2003) *available at* http://a257.g.akamaitech.net/7/257/2422/14mar20010800/edocket.access.gpo.gov/2003/pdf/03-14867.pdf

[14] *See*, *e.g.*, George Stigler, *The Economic Theory of Regulation*, 2 Bell J. Of Econ. & Mgt. Sci. 3, 3 (1971) ("A central thesis of this paper is that, as a rule, regulation is acquired by the industry and is designed and operated primarily for its benefit."); Jean-Jacques Laffont & Jean Tirole, *The politics of government decision making: A theory of regulatory capture*, 106 QUARTERLY J. OF ECON. 1089 (1991). *Cf.* John P. Burke, Commissioner of Banking, State of Connecticut, Comments to the National Conference of State Legislatures Annual Meeting Salt Lake City, Utah (Jul. 22, 2004) *available at* http://www.csbs.org/pr/speeches/2004/JackBurke_NCSL_Address_072204.pdf ("this amassing of control by Washington insiders is being compounded by the Securities Exchange Commission talking about additional centralization and a push by the insurance industry to have a national charter not subject to state oversight or regulation.")

[15] *See*, *e.g.*, John P Burke, Comments, note 14 above. The Conference of State Bank Supervisors, which describe themselves as "Champions of the State Banking System" include the following language in their Statement of Principles: "Bank supervision is best conducted at the state level, where regulators are accessible and in tune with the local economy"

area of financial law. These are private international law-making through private involvement in public rule-making processes, through contracting, and through the actions of private sector regulatory entrepreneurs.

2.0 PRIVATE INVOLVEMENT IN PUBLIC RULE-MAKING PROCESSES

Rules which affect participants in international financial transactions may be adopted at the supranational level or at the domestic level. Increasingly supranational bodies are developing harmonised rules or principles of financial regulation.[16] Even where supranational rule-making occurs, domestic legislation or rule-making may be necessary for implementation.[17] It is necessary, therefore, to distinguish between private involvement in the work of supranational or transnational public rule-making processes and private involvement in domestic public rule-making processes. At the same time, developments at the supranational level can have a significant impact on domestic rule-making (and vice versa). Regulatory developments in one domestic jurisdiction may have an impact on rule-making in another.[18]

As the volume and impact of supranational rules and principles has increased, so financial firms and their trade associations have begun to try to influence the

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[16] The EU produces binding rules, bodies such as IOSCO produce formally non-binding principles.

[17] *See*, *e.g.*, Office of the Comptroller of the Currency, Federal Deposit Insurance Corporation, Board of Governors of the Federal Reserve System, Office of Thrift Supervision, *Interagency Statement – U.S. Implementation of Basel II Framework Qualification Process – IRB and AMA* (Jan. 27, 2005) *available at* http://www.federalreserve.gov/boarddocs/press/bcreg/2005/20050127/attachment.pdf

[18] *Cf.* Transatlantic Business Dialogue Report to the 2005 EU-US Summit, *A Framework for Deepening Transatlantic Trade and Investment*, 7 (April 2005) *available at* http://128.121.145.19/tabd/media/TABD2005SummitReportFINAL051.pdf ("In spite of the many on-going regulatory dialogues, too often regulators develop and implement rules, regulations and requirements on business in relative isolation. Since regulators are subject to entirely separate legal mandates and legislative oversight, it is difficult for both business and administrations to ensure that their concerns are heard. We respect that sovereign prerogatives and legislative mandates must be taken into account, but we are concerned that, if regulations continue to be developed on both sides of the Atlantic without regard to the impact on the transatlantic market, divergent approaches will emerge which will negatively affect the ability of business to expand trade, investment and innovation. Recent regulatory actions (such as Sarbanes-Oxley in the US, and the chemicals regulation in the EU) have highlighted the need for regulators and legislators to consider the external implications of their actions. It is vital to have a clear structure and process across the transatlantic regulatory landscape, not just in a few sectors.")

development of these rules and principles at the supranational level. Processes which were originated as mechanisms of co-operation between domestic regulators have begun to look more like domestic regulatory processes with increased input from non-state agents. These developments have occurred during the same period in which the anti-globalisation movement has motivated the international financial institutions to focus on increasing the transparency of their actions.[19] Supranational actors seek to increase their apparent legitimacy by involving "stakeholders" or "civil society" in their work.[20] Observers monitor governance in these supranational organisations.[21]

In the absence of generally agreed procedures for supranational governance,[22] standard setters and those whose activities their standards may affect are negotiating

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[19] *See*, *e.g.*, Leo Van Houtven, GOVERNANCE OF THE IMF:DECISION MAKING, INSTITUTIONAL OVERSIGHT, TRANSPARENCY, AND ACCOUNTABILITY, 2, IMF Pamphlet Series No. 53 (Aug, 2002) *available at* http://www.imf.org/external/pubs/ft/pam/pam53/pam53.pdf (noting that some IMF critics argued that the IMF should be "more democratic, more transparent, more accountable, and more participatory.") *Cf.* Report of the Secretary General of the United Nations, in Larger Freedom: Towards Development, Security and Human Rights for All, ¶ 70, A/59/2005 (Mar. 21, 2005) *available at* http://www.un.org/largerfreedom/report-largerfreedom.pdf ("The Bretton Woods institutions have already taken some steps to strengthen the voice and participation of developing countries. But more significant steps are needed to overcome the widespread perception among developing countries that they are underrepresented in both bodies, which in turn tends to put their legitimacy in doubt.")

[20] *See*, *e.g.*, EU Commission, Report on European Governance (2003-2004) 4-5 (Sept. 22, 2004) *available at* http://europa.eu.int/comm/governance/docs/rapport_gouvernance_2003-2004_en.pdf

[21] *See*, *e.g.*, Hetty Kovach, Caroline Neligan and Simon Burall, Power Without Accountability? The Global Accountability Report 1 (2003) *available at* http://www.oneworldtrust.org/documents/GAP2003.pdf

[22] The World Bank and IMF have been working on issues of governance for some time, although their focus has mostly been on domestic governance. *See*, *e.g.*, World Bank, World Development Report 2005, A Better Investment Climate for Everyone, 1 (2004) ("Government policies and behaviors play a key role in shaping the investment climate. While governments have limited influence on factors such as geography, they have more decisive influence on the security of property rights, approaches to regulation and taxation (both at and within the border), the provision of infrastructure, the functioning of finance and labor markets, and broader governance features such as corruption. Improving government policies and behaviors that shape the investment climate drives growth and reduces poverty.") available at http://siteresources.worldbank.org/INTWDR2005/Resources/complete_report.pdf ; D. Kaufmann A. Kraay, and M. Mastruzzi, *Governance Matters IV: Governance Indicators for 1996–2004* (2005) (Draft, May 9, 2005) *available at* http://www.worldbank.org/wbi/governance/pdf/GovMatters%20IV%20main.pdf . The World Bank and IMF have begun to comment on governance issues in supranational standard setters. *See*, *e.g.*, World Bank, IMF, *Comments on draft "IOSCO Consultation Policy and Procedures."*, in IOSCO Public Comments, infra note 67 at 9.

principles of governance.[23] Financial trade associations argue that regulation in the global capital markets should be transparent. For example, the Securities Industry Association says that rules should be adopted only for legitimate public policy objectives, that they should be enforced fairly, and not retrospectively, that they should be publicly available and that they should be "clear and understandable".[24] None of these claims appears to be controversial, although there is scope for debate about when a rule is or is not adopted for legitimate public policy objectives or when rules are "clear and understandable".

Financial firms and their trade associations have a clear incentive to participate in negotiations about governance procedures in supranational standard setting bodies. The Basle Capital Accord taught banks that they needed to pay attention to supranational standards because these standards could affect their bottom line. The EU's financial market integration project also gives financial firms incentives to pay attention to supranational rules. But other groups, such as financial firms' customers, do not have such immediate incentives to participate in these supranational processes. Moreover they often lack the resources to participate effectively. Effective participation in consultations about financial regulation requires time and expertise. It also usually requires a good knowledge of English.[25] Financial regulation is often highly technical and detailed, and at the supranational level, as at the domestic level, the stakeholders who speak loudest and most frequently are regulated financial firms and their trade associations.

Because harmonisation of financial regulation occurs at different levels (supranational, national, sub-national) or layers through processes of agreement and implementation of standards, and because each level of decision-maker is likely to

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[23] *See*, *e.g.*, *infra*, text at note 62

[24] *See*, *e.g.*, Securities Industry Association (SIA), Comments on CESR Draft Statement on Consultation Practices, 2-3 (Nov. 19, 2001) *available at* http://www.sia.com/2001_comment_letters/pdf/CESR.pdf . See also SIA, Discussion Paper, Promoting Fair and Transparent Regulation, *available at* http://www.sia.com/2001_comment_letters/pdf/CESR_-_Appendix.pdf .

[25] *See infra*, text at note 92.

invite public comment on its work, the harmonisation process multiplies the possibilities for well-resourced organisations to influence the content of the rules. A large financial firm or financial trade association is more likely than a small firm to know what proposals exist around the world which may ultimately affect its (or its members') business, and it is more likely than a smaller organisation to have the resources to try to affect the development of the rules. Large well-resourced organisations adopt complex strategies of working together and separately in order to maximise the effectiveness of their voices. Smaller firms' and investors' and depositors' voices may be lost in the hubbub around rule-making created by larger firms and their trade associations.[26]

2.1 TRANSNATIONAL RULE-MAKING

Transnational standards setting bodies such as the Basle Committee on Banking

[26] *Cf.* EU Commission, *European Governance: Better Lawmaking*, COM (2002) 275 final 3 (Jun. 5, 2002) *available at* http://europa.eu.int/eur-lex/en/com/cnc/2002/com2002_0275en01.pdf ("Are the smallest voices really and always heard?"); European Economic and Social Committee, *Opinion of the Section for External Relations on The Social Dimension of Globalisation – the EU's policy contribution on extending the benefits to all* , COM(2004) 383 final, Rapporteurs: Mr Etty and Mrs Hornung-Draus, Rex/182, at para 1.5 (Feb. 23, 2005) (referring to "the findings of the World Commission on the Social Dimension of Globalisation (WCSDG) that market-opening measures and financial and economic considerations have predominated, neglecting their social consequences so far and that these rules and policies are the outcome of a system of global governance insufficiently responsive to the interests and needs of the less powerful players")

Supervision,[27] IOSCO,[28] the OECD,[29] and the IAIS[30] involve technocratic networks of regulators from different states working together to develop harmonised standards for banking, securities and insurance regulation. Other principles which affect financial firms relating to money laundering and terrorist financing controls are developed by the Financial Action Task Force (FATF), a body established by the G7 nations in 1989.[31] By definition such inter-governmental bodies operate at a distance from national democratic processes. The Basle Committee, the OECD, and the FATF are bodies with limited memberships, composed of representatives from a relatively small number of states.[32] Even IOSCO and IAIS which have more inclusive membership arrangements

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[27] *See*, *e.g.*, JOHN BRAITHWAITE & PETER DRAHOS, GLOBAL BUSINESS REGULATION 104 (2000) (describing how central bank governors established what is now the Basle Committee on Banking Supervision in response to the failures of the Herstaat Bank and Franklin National Bank in 1974).

[28] IOSCO is the International Organisation of Securities Commissions, a forum for co-ordinating approaches to securities regulation. IOSCO's web site is at http://www.iosco.org . For a discussion of IOSCO's Principles of Securities Regulation see, e.g., Katherina Pistor, *The Standardization of Law and Its Effect on Developing Economies*, 50 AM. J. COMP. L. 97, 116-120 (2002)

[29] The OECD has addressed issues of financial regulation and governance. See, e.g., OECD, *OECD Guidelines for Insurers' Governance*, (April 28, 2005) *available at* http://www.oecd.org/dataoecd/19/10/34799740.pdf ; OECD, *OECD Guidelines for Pension Fund Governance*, (April 28, 2005) *available at* http://www.oecd.org/dataoecd/18/52/34799965.pdf ; OECD, *White Paper on Governance of Collective Investment Schemes*, 88 Financial Market Trends 137 (March 2005) *available at* http://www.oecd.org/dataoecd/10/10/34572343.pdf

[30] IAIS is the International Association of Insurance Supervisors, which is a co-operative organisation of insurance supervisors. The IAIS website is at http://www.iaisweb.org .

[31] *See*, *e.g.*, Financial Action Task Force on Money Laundering, Annual Report for 2003-4, 3 (Jul. 2, 2004) *available at* http://www.fatf-gafi.org/dataoecd/12/44/33622501.PDF . The FATF has adopted forty recommendations on money laundering and nine special recommendations on terrorist financing. Financial Action Task Force on Money Laundering, The 40 Recommendations (June 20, 2003) *available at* http://www.fatf-gafi.org/dataoecd/38/47/34030579.PDF ; Financial Action Task Force on Money Laundering, Special Recommendations on Terrorist Financing, (Oct. 31, 2001) *available at* http://www.fatf-gafi.org/dataoecd/55/16/34266142.pdf; Financial Action Task Force on Money Laundering, Detecting and Preventing the Cross-border Transportation of Cash by Terrorists and Other Criminals, International Best Practices, (Feb 12, 2005) *available at* http://www.fatf-gafi.org/dataoecd/50/63/34424128.pdf .

[32] *See*, *e.g.*, Power without Accountability, note 21 above at v (noting that the Basle Committee is "made up of a few privileged BIS members, located within the BIS but not ultimately accountable to it and its fifty members.")

tend to be dominated by members from northern, economically developed states. The actions of these supranational standard-setters are not subject to the sort of controls that apply to domestic administrative agencies. Firms and people who may be affected by their pronouncements do not have opportunities to challenge these pronouncements in court. [33]

The IMF and the World Bank encourage states to comply with the standards that bodies such as the FATF, the Basle Committee and IOSCO produce,[34] so that the standards may have significant practical impact although they are not formally binding.[35] On the other hand, standards established by the FATF, the Basle Committee or IOSCO will typically produce a direct impact on firms only when they are implemented within a domestic regulatory system. A domestic regulator is subject to the rules that normally apply to administrative action within its domestic system when it considers how to implement supranational rules domestically. However, whether because of urging by the IFIs or by financial firms, rules developed in transnational standard setting bodies may benefit from a presumption of acceptability when they are considered by a domestic legislator or regulator. And it is probably easier for regulators from the countries that make most of the international standards than for regulators from the

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[33] *Cf.* EU Commission, Communication from the Commission, *Towards a reinforced culture of consultation and dialogue - General principles and minimum standards for consultation of interested parties by the Commission*, COM (2002) 704 final at 10 (Dec. 11, 2002) *available at* http://europa.eu.int/eur-lex/lex/LexUriServ/site/en/com/2002/com2002_0704en01.pdf ("the Commission remains convinced that a legally-binding approach to consultation is to be avoided, for two reasons: First, a clear dividing line must be drawn between consultations launched on the Commission's own initiative prior to the adoption of a proposal, and the subsequent formalised and compulsory decisionmaking process according to the Treaties. Second, a situation must be avoided in which a Commission proposal could be challenged in the Court on the grounds of alleged lack of consultation of interested parties. Such an over-legalistic approach would be incompatible with the need for timely delivery of policy, and with the expectations of the citizens that the European Institutions should deliver on substance rather than concentrating on procedures.")

[34] On the IMF's Standards and Codes Initiative *see*, *e.g.*, http://www.imf.org/external/np/exr/facts/sc.htm. *See also, e.g.*, Alastair Clark, *International Standards and Codes*, FINANCIAL STABILITY REVIEW 162 (Dec. 2000) *available at* http://www.bankofengland.co.uk/fsr/fsr09art7.pdf

[35] Although members of the IMF have an obligation under Article IV of the IMF Articles of Agreement "to collaborate with the Fund and other members to assure orderly exchange arrangements and to promote a stable system of exchange rates".

countries that do not to decide to adjust the standards for domestic conditions.[36] Thus it is possible that people and firms who did not participate in consultations by the international standard setting organisations may have more opportunity to express their views on a proposed domestic implementation in some countries (the more powerful countries) than in others.

The EU's programme for developing harmonised financial regulation differs from the activities of the Basle Committee and IOSCO in a number of ways.[37] First, the EU's harmonised rules are binding on the EU Member States.[38] Member States may not have much discretion about how they go about implementing the rules agreed in EU directives.[39] In addition, the EU Parliament has, and exercises, the right to be involved in the development of the EU's harmonised rules for financial regulation.[40] Thus the EU's measures have more of the quality of bindingness, and more democratic input,

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[36] For example, US banking regulators and the New Basle Accord. Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Office of the Comptroller of the Currency, Office of Thrift Supervision, Joint Press Release, Banking Agencies To Perform Additional Analysis Before Issuing Notice of Proposed Rulemaking Related To Basel II (Apr. 29, 2005) *available at* http://www.occ.treas.gov/scripts/newsrelease.aspx?JNR=1&Doc=KLDCDKRC.xml

[37] The EU and the US are discussing enhanced regulatory co-operation. *See*, *e.g.*, EU Commission, *Communication from the Commission to the Council, the European Parliament and the European Economic and Social Committee - a Stronger EU-US Partnership and a More Open Market for the 21st Century*, COM (2005) 196, (May 18, 2005).

[38] The EU's harmonization measures are now separated into framework measures and more detailed implementing measures. The idea is that the more detailed implementing rules could be changed more easily thus ensuring that the rules could adjust to changing circumstances. This new arrangement was introduced after the Lamfalussy Report. See Final Report of the Committee of Wise Men on the Regulation of European Securities Markets, (Feb. 15, 2001) *available at* http://europa.eu.int/comm/internal_market/en/finances/general/lamfalussyen.pdf (Lamfalussy Report).

[39] *See*, *e.g.*, Financial Services Authority, *The Listing Review and Implementation of the Prospectus Directive*, Consultative Paper 04/16, 12, ¶ 2.6 (October 2004) *available at* http://www.fsa.gov.uk/pubs/cp/cp04_16.pdf (noting that FSA was consulting in relation to areas where FSA had discretion in implementation of directive).

[40] *See*, *e.g.*, European Parliament Resolution on the final report of the Committee of Wise Men on the regulation of European securities markets, *available at* http://www.europarl.eu.int/comparl/econ/lamfalussy_process/ep_position/b5_173_2001.pdf

than harmonised rules or principles developed in other fora.[41]

International and regional organisations which develop rules and standards for international financial activity have recently been taking steps to enhance the transparency of their processes. The FATF may be distinguished from other financial standard setters because although it publicises its work through its website, it does not use the website to seek public comments on its work.[42] The development of money-laundering and terrorist financing controls is treated as an aspect of law enforcement rather than as an aspect of financial regulation even though much of the burden of implementing the resulting rules is borne by financial firms. As money-laundering and terrorist financing control is an enterprise of law enforcement the expertise which is valued in the process of developing standards is law enforcement and regulatory expertise rather than financial sector expertise.[43]

In contrast to the FATF, the Basle Committee, IOSCO and the IAIS all publish documents including their proposed rules and standards through their web pages in order to publicise their work and also to invite public comment. Financial trade associations welcome moves to greater public consultation.[44] However, although some international standard setters have worked to increase the transparency of their processes there is as yet no one method of encouraging public participation, or even of

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[41] The EU's democratic deficit has been noted since the early days. The EU is more democratic in its processes than it was, and more democratic than other international organizations.

[42] The FATF website is at http://www.fatf-gafi.org

[43] *See*, *e.g.*, FATF Annual Report for 2003-4, note 31 above, at 3 ('The delegations of the Task Force's members are drawn from a wide range of disciplines, including experts from the Ministries of Finance, Justice, Interior and External Affairs, financial regulatory authorities and law enforcement agencies.')

[44] *See*, *e.g.*, International Securities Market Association, International Primary Market Association, Danish Securities Dealers Association, London Investment Banking Association, Swedish Securities Dealers Association, Public comments by the above associations on IOSCO's Consultation Report on Code of Conduct Fundamentals for Credit Rating Agencies, *available at* http://www.iosco.org/pubdocs/pdf/IOSCOPD177_25.pdf ("We also recognise that publication of the Code for consultation is part of IOSCO's evolving policy of greater public consultation, the objectives of which, as set out in IOSCO's recent draft Statement of Consultation Policy, we endorse and on which we will comment in due course.")

describing the results of a consultation exercise. This is not surprising given that domestic rules regulating the rule-making activities of regulatory agencies vary, and the international standard setters include members from different jurisdictions with different approaches to administrative procedure. A growing literature focuses on examining and critiquing administrative procedures for global governance, [45] but there is as yet no global standard for supranational administrative procedures.

Documents on very technical subjects may produce limited numbers of comments. For example, when the Basle Committee sought information and views on credit risk modelling it received twenty-two responses. Of these responses nine were "from individual banks or industry associations, five from academics or academic organisations and five from representatives of the consulting, accounting or risk management professions."[46] This Summary of Responses does not name any of the respondents. In some cases it may be difficult to discern from the standard setter's description of the results of consultations not only who commented on a publication or proposal but even how many people and firms commented.[47] In other cases the standard setter may publish the text of comments received on its web pages.[48]

The Basle Committee's work is carried out by representatives of banking

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[45] *See*, *e.g.*, Richard B. Stewart, *US Administrative Law: A Model for Global Administrative Law?*, (forthcoming) 68 LAW & CONTEMPORARY PROBLEMS 7 (2005) *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=723147

[46] *See*, *e.g.*, Basle Committee on Banking Supervision, *Summary of Responses Received on the Report "Credit Risk Modelling: Current Practices and Applications"* 1 (May 2000) *available at* http://www.bis.org/publ/bcbs71.pdf

[47] *See*, *e.g.*, IOSCO Technical Committee, *Principles on Outsourcing of Financial Services for Market Intermediaries, Notice of Final Report, Survey and Summary of Comments*, (Feb. 2005) *available at* http://www.iosco.org/pubdocs/pdf/IOSCOPD186.pdf . Such an approach is consistent with the view that in the context of regulatory processes it is the ideas, rather than their level of support, which matter.

[48] *See*, *e.g.*, Public Comments on Code of Conduct Fundamentals for Credit Rating Agencies, *available at* http://www.iosco.org/pubdocs/pdf/IOSCOPD177.pdf

regulators and central banks from the G10 countries.[49] IOSCO has a much larger,[50] tripartite, membership, including Ordinary members, Associate members and Affiliate members. IOSCO's ordinary members are securities regulators.[51] Only ordinary members have the right to vote, although Associate members participate in IOSCO's President's Committee and Affiliate members which are SROs participate in IOSCO's SRO Consultative Committee.[52] The Associate members and Affiliate members contribute through their membership fees to IOSCO's finances.[53] IOSCO's affiliate members include financial exchanges, non-exchange SROs and international organisations. IOSCO says that it:

> recognizes the importance of maintaining a close dialogue with the SROs and international organizations that make up its affiliate membership and of allowing them to make a constructive input in the work of the Organization[54]

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[49] http://www.bis.org/about/factbcbs.htm

[50] *See*, *e.g.*, Philippe Richard, IOSCO Secretary General, Report, in IOSCO ANNUAL REPORT FOR 2003, 18 *available at* http://www.iosco.org/annual_report/pdf/IOSCO_Annual_Report_03.pdf ("With its year end membership of 171 agencies, IOSCO is very representative of the international community of securities regulators and fully assumes its responsibility of international standard setter for securities market.")

[51] In a jurisdiction where there is no governmental regulatory body an SRO may be allowed to become an ordinary member of IOSCO. See IOSCO Annual Report for 2003, note 50 above, at 29.

[52] *See*, *e.g.*, Philippe Richard, note 50 above at 18 ("IOSCO also has a very active SRO Consultative Committee, which provides important and constant input from the industry.")

[53] In 2003 IOSCO incurred a loss of 291,579 euro. See IOSCO Annual Report for 2003, note 50 above, at 32. A number of IOSCO members have been in arrears with their membership fees. *See*, *e.g.*, Philippe Richard, note 50 above at 18 ("At the end of 2003 outstanding membership fees of more than one year stood at slightly over 50 000 Euros. The Presidents Committee unfortunately had to aggravate, in accordance with Part 12 of the By-Laws, a sanction imposed to the Comision Nacional de Valores of Paraguay (CNVP) for repeated failure to pay its prescribed annual financial contribution. The IOSCO membership of the CNVP was therefore suspended. The Superintendencia de Valores of Colombia is also currently the object of a Presidents Committee sanction for similar reasons. Its voting right was suspended in 2002 and that situation continued in 2003.") The IAIS also incurred a loss in 2003. IAIS Annual Report for 2003 note 55 at 16.

[54] General Information on IOSCO, IOSCO Annual Report for 2003, note 50 above, at 26. The SRO Consultative Committee works with IOSCO's Technical Committee. See *id.* ("The SRO Consultative

The IAIS also has a large membership, including insurance supervisors and regulators from over a hundred and sixty jurisdictions in its membership.[55] The IAIS also has a special membership category for "Observers" which includes private sector entities.[56] The IAIS seeks to involve observers in the work of its Technical Committee.[57] IAIS observers generate significant amounts of revenue for IAIS which may be important given that the organisation has suffered from a mismatch between revenues in US dollars and expenses in Swiss francs in recent years.[58]

In contrast to the Basle Committee, which does not depend on the private sector for its financing,[59] both IOSCO and the IAIS are partly dependent on financing from non-governmental entities which participate in their standard setting processes. In the case of IOSCO the non-governmental entities are SROs, so perform combined

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Committee has designated contact persons with the Technical Committee Standing Committees and Project Teams and is therefore able to provide substantive input related to their regulatory initiatives.")

[55] IAIS Annual Report for 2003, iv (Sept. 2004) *available at* http://www.iaisweb.org/041019_Annual_report_2003.pdf

[56] *See*, *e.g.*, IAIS Annual Report for 2003, note 55 above at iv ("more than 70 organisations and individuals are observers. They represent professional associations, insurance and reinsurance companies, international financial institutions, consultants and other professionals.")

[57] *See*, *e.g.*, IAIS Annual Report for 2003, note 55 above at 8 ("During the year the Technical Committee working parties have continued to receive substantial support from IAIS observers. They have been generous in providing input and comments on a range of issues when requested and respectful of supervisory concerns. Each working party has developed a unique relationship with the observer community that suits both its needs and operating style. This partnership has been productive and has served to improve the quality and relevance of the output.")

[58] In 2003 observer membership fees were $355,000 and members fees were $655,000. IAIS Annual Report for 2003, note 55 above, at 16. *See also* Report from Chair of the Budget Committee, *id*. at 13.

[59] In 2001 the BIS decided at an Extraordinary General Meeting that it should be owned only by central banks and that it would mandatorily repurchase its shares in private ownership. See BIS, Withdrawal of all shares of the Bank for International Settlements held by private shareholders, (Oct.13, 2003) *available at* http://www.bis.org/about/shareswd.htm On a challenge by some of the private owners the mandatory repurchase was found to be lawful by an arbitral tribunal. Permanent Court of Arbitration, Arbitral Tribunal established pursuant to Article XV of the Agreement signed at the Hague on 20 January 1930, Partial Award on the Lawfulness of the Recall of the Privately Held Shares on 8 January 2001 and the Applicable Standards for valuation of those Shares, (Nov. 22, 2002) *available at* http://pca-cpa.org/ENGLISH/RPC/BIS/EPA.pdf

functions of regulation and member interest representation. In the case of IAIS the non-governmental members include insurance companies accounting firms and law firms. IOSCO's accounts do not identify the relative contributions of SRO and governmental members, but IAIS's accounts show that it benefits financially from the participation of non-governmental entities in its membership.[60] The International Financial Standards Board (which is a non-governmental entity rather than an inter-governmental or inter-regulatory entity) has been criticised on the basis that its reliance on private sector financial resources might create conflicts of interest.[61]

Consultation procedures may be more or less formalised and/or theorised. Whereas the Basle Committee has not articulated in any formal way what principles it applies in the context of its consultations with interested parties, in November 2004 IOSCO published a consultation document about its consultation procedures.[62] IOSCO's draft document on consultation policy suggested that IOSCO was concerned with a broadly defined group of interests. In describing its objectives in consulting IOSCO said that it wanted:

> To benefit from the expertise of market intermediaries, exchanges and other market operators, securities clearing and settlement system service providers, endusers and consumers, auditors and auditing companies, and other public authorities, international standard setters, international financial institutions, and regional development banks, when assessing and analyzing regulatory issues.[63]

IOSCO's draft also described the advantages IOSCO saw in increasing the transparency of its operations as being "to enhance the perceived fairness and

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[60] See note 58 above.

[61] *See*, *e.g.*, McCreevy, note 12 above ("the standard setters are currently sponsored by voluntary contributions from contributors ranging from central banks to listed companies, which raises potential issues of conflict of interest. I therefore welcome the Board of Trustees of the IASB's intention to change this.")

[62] IOSCO, *Consultation Policy and Procedures*, Draft for Public Consultation (Nov. 2004) *available at* http://www.iosco.org/pubdocs/pdf/IOSCOPD175.pdf

[63] IOSCO, *Consultation Policy*, supra note 62 at 2.

openness of IOSCO's decision-making process and the visibility and acceptability of its results".[64] IOSCO also suggested that it has an interest in ensuring consistent approaches to common concerns.[65] The document suggested that IOSCO would usually publish comments in an anonymous format on its website.[66] In February 2005 IOSCO published the full text of nine comments on this consultation document.[67] Commenters asked for more information about IOSCO's priorities and agenda,[68] more time to react to IOSCO's proposals,[69] and opportunities to be involved in discussing ideas before a formal consultation.[70] The International Bar Association argued that IOSCO should not publish comments anonymously:

> we submit that IOSCO should not permit any consultations to take place with comments which are anonymous to the public. We understand that internal regulatory deliberations must and should be confidential. Once any proposal is posted for consultation, however, all comments, both formal and informal, should be made in full transparency with attribution, and the extent to which IOSCO is meeting with or receiving information from interested companies, lobbyists or groups should be apparent to all. We therefore recommend that all submissions after the publication of the

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[64] *Id.*

[65] *Id.*

[66] *Id.* at 4.

[67] IOSCO, *Public Comments Received on Iosco's Draft Consultation Policy and Procedures* (Feb. 2005) *available at* http://www.iosco.org/pubdocs/pdf/IOSCOPD191.pdf

[68] *See*, *e.g.*, *id* at 5, 8, 15

[69] *See*, *e.g.*, *id* at 8, 23-24.

[70] *See*, *e.g.*, Comments of the International Council of Securities Associations, *id* at 11 ("The period prior to a formal consultation is a critical and often underappreciated stage in the consultation process. Therefore, we urge IOSCO to place greater stress on consulting with market participants and other informed parties prior to beginning work on a consultation document in order to determine the need for regulatory action and, if such a need exists, what action would be appropriate. Contacts with market participants and other informed parties during this preparatory phase would help focus the debate on the most important and material issues.")

consultation should be public and easily accessible.[71]

In April 2005 IOSCO published a Report on its Consultation Policy and Procedure.[72] Strikingly, while the November 2004 draft referred to IOSCO's interest in benefitting from the expertise of a wide range of potential consultees, including consumers,[73] the April 2005 Report refers merely to its objective of benefitting from "the expertise of the international financial community."[74] Although the Report refers more than once to the "public", the word "consumer" appears nowhere. The April Report also suggests that IOSCO will consider engaging in "pre-consultations",[75] and that comments will be published unless "anonymity is specifically required."[76]

The EU adopts binding rules of financial regulation as directives. Under the Lamfalussy approach EU financial regulation directives should be framework measures, and the detailed implementing rules should be adopted through a comitology procedure involving CESR. In theory the EU directives should set the general framework within which the EU's detailed implementing rules should operate. The EU's legislative process for producing the framework directives is often a lengthy one involving many opportunities for interested parties to express their views on proposals. For example, the Markets in Financial Instruments Directive which was adopted in 2004[77] replaces

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[71] *Id.* at 18.

[72] IOSCO, Report of the Executive Committee of IOSCO, *IOSCO Consultation Policy And Procedure*, (April 2005) *available at* http://www.iosco.org/pubdocs/pdf/IOSCOPD197.pdf

[73] *See supra* text at note 63.

[74] IOSCO, *Executive Committee Report*, supra note 72 at 2.

[75] IOSCO, *Executive Committee Report*, supra note 72 at 4.

[76] IOSCO, *Executive Committee Report*, supra note 72 at 4.

[77] Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC OJ No. L 145/1 (Apr. 30, 2004) *available at* http://europa.eu.int/eur-lex/pri/en/oj/dat/2004/l_145/l_14520040430en00010044.pdf .

the Investment Services Directive of 1993.[78] In 2000 the Commission published a Communication on revising the Investment Services Directive in which it sought comments on a number of issues.[79] Forty-two respondents, including regulators and market participants commented on this Communication.[80] The Commission followed up with a larger consultation exercise including an open hearing.[81] This second consultation produced 69 comments almost entirely from market participants and regulators with one comment from the "shareholder/investor" constituency.[82] The Commission's descriptions of the comments do not identify commentators by name and do not generally identify particular comments with particular categories of respondent. A second consultation took place in 2002, [83] and a proposed directive was published in November 2002.[84] Soon after the MiFID was adopted in 2004 the Commission asked

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[78] Council Directive 93/22/EEC on investment services in the securities field, O.J. No. L 141/27 (1993).

[79] Communication from the Commission to the European Parliament and the Council, Upgrading the investment services directive (93/22/EEC) COM/2000/0729 final, 23-24 (Nov. 15, 2000).

[80] ISD Feedback Synthesis of Responses to COM(2000)729, *available at* http://europa.eu.int/comm/internal_market/securities/docs/isd/revision-isd/isd-feedback-reponse_en.pdf

[81] See http://europa.eu.int/comm/internal_market/securities/isd/revision_en.htm#doc

[82] Revision of the Investment Services Directive (93/22) Summary of Responses to the Preliminary Orientations of Commission Services (July 2001) 2, *available at* http://europa.eu.int/comm/internal_market/securities/docs/isd/2001-07-summ_responses.pdf

[83] By the time the second consultation was announced the Commission said it had received 77 responses to the July 2001 consultation. DG Internatl Market, EU Commission, Revision of Investment Services Directive, Second Consultation, Overview Paper, 2 *available at* http://europa.eu.int/comm/internal_market/securities/docs/isd/2nd-overview-paper_en.pdf

[84] Proposal for a Directive of the European Parliament and of the Council on Investment Services and Regulated Markets, and Amending Council Directives 85/611/EEC, Council Directive 93/6/EEC and European Parliament and Council Directive 2000/12/EC , COM (2002) 625 final, 7 (Nov. 19, 2002) *available at* http://europa.eu.int/eur-lex/en/com/pdf/2002/com2002_0625en01.pdf ("The present proposal has been drafted on the basis of a careful consideration of the 107 responses to these revised orientations.")

CESR to provide advice on possible implementing measures.[85] The Commission does not necessarily follow all of CESR's recommendations in making proposals for measures to implement the level 1 directives.[86]

Unlike the Basle Committee, IOSCO and the IAIS, the EU's CESR[87] operates in the context of a legal framework where participants have developed expectations about consultation.[88] CESR's Charter states that:

> The Committee will use the appropriate processes to consult (both ex-ante and ex-post) market participants, consumers and end users which may include inter alia: concept releases, consultative papers, public hearings and roundtables, written and Internet consultations, public disclosure and summary of comments, national and/or European focused consultations. The Committee will make a public statement of its

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[85] EU Commission, Formal Request for Technical Advice on Possible Implementing Measures on the Directive on Markets in Financial Instruments (Directive 2004/39/EC) (June 25, 2004) *available at* http://europa.eu.int/comm/internal_market/securities/docs/cesr/final-mandate-isd_en.pdf . This formal request was preceded by a provisional mandate in January 2004.

[86] *See*, *e.g.*, European Commission, Working document ESC/18/2005. Explanatory note: Main differences between working document ESC/ 17/2005 andthe CESR level 2 advice (May 13, 2005) *available at* http://europa.eu.int/comm/internal_market/securities/docs/isd/dir-2004-39-implement/esc-17-2005-explanatory_en.pdf

[87] CESR, the Committee of European Securities Regulators, was established by Commission Decision 2001/527/EC of 6 June 2001 establishing the Committee of European Securities Regulators, OJ No. L 191/43 (Jul. 13, 2001) *available at* http://europa.eu.int/eur-lex/pri/en/oj/dat/2001/l_191/l_19120010713en00430044.pdf . CESR should "serve as an independent body for reflection, debate and advice for the Commission in the securities field". *Id*. at Recital no. 8. It also has a role in encouraging implementation of EU securities measures. CESR is composed of representatives of securities regulators from the Member States.

[88] *See*, *e.g.*, EU Commission, *Towards a reinforced culture of consultation and dialogue*, *supra* note 33 at 5 ("By fulfilling its duty to consult, the Commission ensures that its proposals are technically viable, practically workable and based on a bottom-up approach. In other words, good consultation serves a dual purpose by helping to improve the quality of the policy outcome and at the same time enhancing the involvement of interested parties and the public at large. A further advantage is that transparent and coherent consultation processes run by the Commission not only allow the general public to be more involved, they also give the legislature greater scope for scrutinising the Commission's activities (e.g. by making available documents summarising the outcome of the consultation process).")

consultation practices.[89]

The Charter also states that:

> For the purpose of facilitating the dialogue with market participants, consumers and other end users of financial services, the Committee will establish working consultative groups, whenever appropriate.[90]

Rather than merely inviting comments on its proposals, CESR involves market participants in its formal processes through a committee of market representatives.[91] In addition, CESR has established a number of Expert Groups on the various issues it is responsible for. There are three Expert groups for the MiFID, which focus on market transparency, intermediaries and co-operation and enforcement. CESR has not as yet established a committee of consumer representatives, although in May 2005 CESR held a "Consumer Day" on the MiFID and acknowledged the need to interact with consumer groups in future:

> The importance CESR attaches to receiving comments on its advice from representatives of retail clients and consumers was stressed and CESR expressed its concern that the responses received to previous consultations carried out on MiFID, had not reflected sufficiently this set of stakeholders. CESR made it known that it intended to organise similar meetings in the future to continue and develop this dialogue further.[92]

The consumer groups which attended this meeting pointed out that they did not necessarily have the resources in terms of knowledge and staff to be able to prepare "considered responses" to consultations. They also suggested that it would be helpful if consultation papers were more "reader-friendly" and if they were translated from

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[89] Charter of the Committee of European Securities Regulators at para. 5.10.

[90] Id. at para 5.11.

[91] CESR has a Market Participants Consultative Panel. The Committee of European Banking Supervisors has established a Consultative Panel of representatives of market participants to act as a sounding board.

[92] Committee of European Securities regulators, *MiFID Consumer Day – 22 March 2005 Issues on regulation of intermediaries and markets under MiFID "Summary of the main conclusions"* 1 (May 16, 2005).

English into the different national languages.[93] English is the dominant language in the international financial markets,[94] but financial regulation does not only affect professional market participants. Publishing consultation papers only in English tends to favour people in the UK, and members of the elite who either read English or can afford to pay for translators. That CESR operates in English is particularly unusual in the context of the EU, which from the very early days was committed to the principle that citizens should be able to communicate with the institutions in their own language.[95]

CESR publishes comments on its proposals on its website.[96] Financial firms and their trade associations are active commenters on CESR's proposals. Trade associations may file joint comments on CESR proposals,[97] and they may refer to each other's comments in their own responses.[98] Consumers and consumer organisations do not have the resources of time or expertise to participate as effectively in consultations.

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[93] *Id.*

[94] The prospectus directive's reference to a "language customary in the sphere of international finance" is generally understood at least to include English. Directive 2003/71/EC of the European Parliament and of the Council on the prospectus to be published when securities are offered to the public or admitted to trading and amending Directive 2001/34/EC, OJ L 345/64, Art. 19(2) (Dec. 31, 2003) *available at* http://europa.eu.int/eur-lex/pri/en/oj/dat/2003/l_345/l_34520031231en00640089.pdf

[95] Regulation No. 1 of 1958, as amended. All EU residents have the right to communicate with the institutions in their own language (which is an EU official language). This language policy has been subject to stress as a result of enlargement. *See*, *e.g.*, Directorate-General for Translation of the European Commission, *Translating for a Multi-Lingual Community*, 3 (March 2005) *available at* http://www.europa.eu.int/comm/dgs/translation/bookshelf/brochure_en.pdf ("In the interests of cost-effectiveness, the Commission conducts its internal business in English, French and German, going fully multilingual only when it communicates with the other EU institutions, the Member States and the public.")

[96] See http://www.cesr-eu.org/

[97] *See*, *e.g.*, International Securities Market Association, International Primary Market Association, Association of Norwegian Stockbroking Companies, Bankers and Securities Dealers Association of Iceland, Danish Securities Dealers Association, Finnish Association of Securities Dealers, London Investment Banking Association, Swedish Securities Dealers Association, The Bond Market Association, Response to CESR's Consultation on its October 2004 Preliminary Progress Report "Which Supervisory Tools for the EU Securities Markets?" The "Himalaya" Report (Jan. 25, 2005) *available at* http://www.bondmarkets.com/assets/files/CESRHimalayaresponsefinal.pdf

[98] *See*, *e.g.*, *id.* at 3 ("We have seen, and support, ISDA's response to the consultation.")

Europeans have expressed concern about a lack of transparency in the EU's governance,[99] and Siim Kallas, the Commissioner for Administrative Affairs, Audit and Anti-Fraud announced an EU Transparency Initiative in March 2005, although the promised White Paper has not yet been published.[100]

The financial firms and trade associations which comment on CESR's proposals are not limited to firms and trade associations from the EU Member States. Rather, multinational firms and trade associations which represent such firms also comment on CESR's proposals reflecting the international characteristics of financial activity. For example, when CESR issued its Statement on Consultation Practices in 2001[101] the Securities Industry Association commented that it was "supportive of CESR's proposed "Consultation Practices" as an excellent first step towards implementing a fully effective consultation process... such a process best serves all market participants, and is the foundation for deep, liquid and efficient markets."[102] The SIA urged CESR to consult not just at the EU level but also at the international level.[103] Financial trade associations based in the US seek to inform their members about developments outside the US. The Bond Market Association's News Bulletins regularly inform its members about regulatory initiatives in the EU as well as in the US.[104] In April 2005 the Bond Market Association, the IPMA and the ISMA announced that they would integrate their

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[99] *See*, *e.g.*, *Ending corporate privileges and secrecy around lobbying in the European Union*, *available at* http://www.corporateeurope.org/docs/alter-eu.pdf

[100] Siim Kallas, Vice-President of the European Commission and Commissioner for Administrative Affairs, Audit and Anti-Fraud, *The need for a European transparency initiative*, Speech/05/130 at The European Foundation for Management, Nottingham Business School, Nottingham (Mar. 3, 2005).

[101] Committee of European Securities Regulators, Public Statement of Consultation Practices (Dec. 2001)

[102] Securities Industry Association, Re: CESR Draft Statement on Consultation Practices, 1 (Nov. 19, 2001) *available at* http://www.sia.com/2001_comment_letters/pdf/CESR.pdf

[103] *Id.* at 3.

[104] *See*, *e.g.*, Bond Markets News Bulletin (March 2, 2005) available at http://www.bondmarket.com/newsletters/2005/20050302.htm

European activities in the International Capital Market Association (ICMA) in order "to ensure consistent and coordinated global representation of the capital markets and to fully leverage the respective associations' resources and expertise in support of their members."[105]

The increasing amount of international harmonisation of standards for the financial markets is in part a response to concerns about how divergent approaches to regulation may interfere with cross-border financial activity. However, harmonisation occurs in different fora, in regional organisations and in international organisations. International banking organizations need to focus not only on the Basle committee's work on capital adequacy, but on the EU's implementation of the Basle standards (in addition to domestic implementation in the different jurisdictions where they are licensed). Some lobbying energy is focused on persuading harmonisers to use the same approaches to particular issues that have been adopted elsewhere. For example, In commenting on CESR proposals the SIA has urged CESR to copy the approach of US regulators.[106]

In the context of the EU, some commentators have suggested that market participants like a situation where rule-making is centralised so that they can focus their

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[105] The Bond Market Association (BMA), the International Securities Market Association (ISMA) and the International Primary Market Association (IPMA) Press Release, *European Capital Markets Trade Associations Global Partnership to be Established* (Apr. 20, 2005) *available at* http://www.ipma.org.uk/pdfs/200405%20PRESS%20RELEASE%20WITH%20BMA.PDF. This announcement followed an announcement in February 2005 that the IPMA and the ISMA would merge. International Primary Market Association (IPMA) and the International Securities Market Association (ISMA) Press Release, IPMA and ISMA Announce Merger (Feb 3, 2005) *available at* http://www.ipma.org.uk/pdfs/PRESS%20%20RELEASE%20FINAL%20030205.PDF

[106] *See*, *e.g.*, SIA, Comments on the Draft ESCB-CESR Standards for Securities Clearing and Settlement Systems in the European Union of May 2004, 3 (Aug. 3, 2004) *available at* http://www.sia.com/2004_comment_letters/2837.pdf ("In marked contrast to reactions of the banking community in Europe to the ESCB-CESR Standards, U.S. banking institutions were broadly supportive of the Interagency White Paper recommendations. The reasons for this are clear. In their approach, U.S. regulators did not attempt to impose additional regulations on firms considered to play significant roles in critical markets. Rather, they tried to ensure the promulgation of best practices, used market-led initiatives to ensure a robust communications infrastructure, and fostered competition as a means to reduce concentration of risks. We believe a combination of these approaches in Europe would not only fulfil the objective of risk reduction, but also benefit market participants by avoiding the cost of excessive regulation, preserving choice, and encouraging innovation."

lobbying efforts.[107] Thus financial firms might prefer not to have to deal with CESR as well as with the Commission.

Transnational standard setting creates needs for new trade associations, or at least new jobs in existing trade associations. Large multinational multi-function financial firms will belong to a number of different trade associations, and may well make their own separate submissions as part of consultation exercises. Smaller firms with fewer human and financial capital resources have a quieter voice in the consultation process.[108] But, consumer groups are noticeably absent from many of the discussions about financial regulation, distanced from the discussions by lack of resources and by lack of "expertise".[109]

The practice of consultation and response in the context of supranational financial standard-setting and rule-making contrasts dramatically with ideals of bottom-up governance. Consultation processes which tend to exclude smaller firms and consumers are less legitimate than those which are more inclusive. As well as being less legitimate, such exclusive processes may produce different results from more inclusive processes. Financial firms and their trade associations tend to argue against rules and for non-legislative measures,[110] they will argue for certainty for themselves

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[107] *See*, *e.g.*, Centre for European Policy Studies, Prospectus for CEPS Task Force on EU Financial Regulation and Supervision Beyond 2005 An Agenda for the New Commission, 2 *available at* http://ceps01.link.be/files/ProspectusBeyond2005.pdf#search='eu%20parliament%20and%20financial%20regulation' ("while market practitioners often preach the virtues of delegation, most appear more comfortable of their capacity to ensure suitable outcomes if legislative power is kept at level 1. In short, while there is a general agreement that delegation is important, all have significant interests in keeping detailed rule-making power at the centre.")

[108] *See*, *e.g.*, CEPS Prospectus, note 106 above, at 3 ("The extended comitology process and the accompanying consultations place much demand on both market participants and member state authorities in terms of manpower and time. As this is costly, are larger institutions better placed to exercise influence? How can the influence of smaller institutions be ensured?")

[109] *See*, *e.g.*, CEPS Prospectus, note 106 above, at 3 ("Some interests are better organised than others. It is often noted that consumer associations are less present in the consultations and regulatory game having surrounded many of the FSAP-measures. If correct, how can a consumer say be stimulated?")

[110] *See*, *e.g.*, International Securities Market Association, International Primary Market Association, Danish Securities Dealers Association, London Investment Banking Association, Swedish Securities Dealers Association, Public comments by the above associations on IOSCO's Consultation

(and sometimes this will mean less certainty for others), they will argue the costs of regulation and the benefits of deregulation.[111]

2.2 DOMESTIC RULE-MAKING

When domestic regulators work together in networks such as the Basle Committee they may seek comments at home on proposals for harmonisation as they would on purely domestic initiatives.[112] Thus domestic consultation procedures, involving market participants, may influence supranational regulatory initiatives.[113] At other times domestic regulators seek comments on their proposed implementations of supranational harmonised rules.[114] But, as the International Bar Association has pointed out, supranational standards may not benefit from as much discussion and consultation at the domestic level as proposed standards which originate domestically:

> It seems increasingly clear that the essential discussion of standards will take place at the IOSCO level rather than later at the home country level

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Report on Code of Conduct Fundamentals for Credit Rating Agencies, 2, *available at* http://www.iosco.org/pubdocs/pdf/IOSCOPD177_25.pdf (One of the foundation stones of our discussions with legislators and regulators and in our responses to various legislative and regulatory initiatives in recent years has been our strong advocacy of the use of non-legislative measures unless there is evidence of a market failure which industry participants are unable or unwilling to correct.")

[111] *See*, *e.g.*, ISMA et al, note 96 above at 4 ("it is important to recognise that supervisors must be accountable to national authorities who work within the international legal framework that is set up in a process of full democratic accountability. Equally it is essential to recognise that it would not be practical or desirable to submit every individual supervisory action to democratic scrutiny and legislative control. This would also not be consistent with any drive towards deregulation.")

[112] *See*, *e.g.*, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Office of the Comptroller of the Currency, Joint Press Release, *Banking Agencies Announce Publication of Basel Accord Consultative Paper* (Apr. 30, 2003) *available at* http://www.federalreserve.gov/boarddocs/press/bcreg/2003/20030430/

[113] Participation in supranational processes may also affect domestic regulators' actions at home. *Cf.* Stephen Shaffer, *Reconciling Trade and Regulatory Goals: The Prospects and Limits of New Approaches to Transatlantic Governance Through Mutual Recognition and Safe Harbor Agreements*, 9 COLUM. J. EUR. L. 29, 71 (2002) ("A central normative goal of transgovernmental regulatory cooperative efforts is to create frameworks that conduce national regulators to reflexively take into account the impact of their actions on affected, but otherwise unrepresented, foreign constituents, while remaining deferential to distinct national values and priorities.")

[114] *See*, *e.g.*, Financial Services Authority, *The Listing Review*, supra note 39.

> and that home country regulators will increasingly take the position that the standards adopted by IOSCO foreclose further discussion in the home country of the topics covered by these standards. This process is legitimate in democratic rulemaking when, and only when, those same principles have been fully vetted in a public manner at an international level.[115]

Domestic consultations may generate responses from a wider range of participants than consultations by supranational standard-setters. In part this is because consultation procedures at the domestic level may be more inclusive than consultation procedures at the supranational level. The UK's Financial Services Authority has a Consumer Panel[116] and a Small Business Panel as well as a Practitioner Panel.[117] These structures contrast with CESR's emphasis on ensuring only the participation of market participants (and not the participation of consumers of financial services) in its processes.

Transnational financial activity increases the incentives for foreign firms to try to influence domestic rulemaking through campaign contributions[118] and commenting on proposed domestic regulations. For example, in 2000 the US Congress enacted the Sarbanes-Oxley Act, which applies to foreign firms whose securities are traded in the US markets. The statute would have required some foreign companies to have audit committees composed of independent directors, conflicting with requirements in their home jurisdictions. After receiving more than 185 comments on the audit committee independence proposal, the SEC adopted final rules which sought to accommodate the

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[115] Comments of the International Bar Association on *IOSCO Consultation Policy and Procedures* in IOSCO, Public Comments supra note 67 at 18.

[116] See http://www.fs-cp.org.uk/

[117] See http://www.fs-pp.org.uk/

[118] A number of political action committees operating in the US have foreign connections. For example, the Credit Suisse First Boston PAC gave $377,250 to candidates for the US Congress and Senate in the 2004 election cycle. http://www.opensecrets.org/pacs/lookup2.asp?strID=C00111559

difficulties of foreign issuers.[119] The SEC has also adopted regulations specifying that the Sarbanes-Oxley Act's prohibition on loans to directors, which under the provisions of the statute were specified not to apply to insured depositary institutions in the US (a term which could not apply to a foreign bank), would not apply to foreign banks.[120] The SEC has shown itself to be much more willing to work with regulators from other jurisdictions than the US Congress, and than the SEC was itself only a few years earlier.[121] As commentators noticed that regulations make it easier for US issuers than for foreign issuers to avoid the application of Sarbanes-Oxley regulations by deregistering their securities SEC officials suggested that the SEC would make it easier for foreign issuers to deregister their securities in the US.[122]

The enactment of the Sarbanes-Oxley Act and its aftermath illustrate that domestic legislatures may insensitive to the impact of domestic rules on multinational businesses. Whereas Congress enacted a statute which imposed significant burdens on foreign firms, the SEC has been responsive when these firms have raised their concerns. The Transatlantic Business Dialogue has suggested that legislators from Congress and the European Parliament should develop a dialogue to avoid such problems for the future.[123]

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[119] SEC, Standards relating to Listed Company Audit Committees, 68 Fed. Red. 18788 (Apr. 16, 2003) *available at* http://a257.g.akamaitech.net/7/257/2422/14mar20010800/edocket.access.gpo.gov/2003/pdf/03-9157.pdf . The EU-US Financial Markets Dialogue is an attempt to resolve issues like this for the future.

[120] SEC, Foreign Bank Exemption from the Insider Lending Prohibition of Exchange Act Section 13(k), Exchange Act Release No. 34-49616, 69 Fed. Reg. 24016 (Apr. 30, 2004)

[121] Commentators have sometimes suggested that the US "views free trade in securities as everybody else abiding by American rules". Barbara Stymiest, *Towards the development of integrated global markets: is mutual recognition the way forward?*, Speech to the FESE Convention (June 12, 2003) *available at* http://www.fese.be/efmc/2003/report/efmc_stymiest.htm

[122] *SEC Staff Likely to Recommend Rule To Ease Deregistration for Foreign Firms*, 36 BNA Sec. Reg. & L. Rep. 2050 (Nov. 22, 2004). US issuers can deregister if there are fewer than 300 "holders of record' of their securities" whereas foreign issuers can only deregister if they have fewer than 300 beneficial owners in the US.

[123] Transatlantic Business Dialogue, supra note 18 at 20.

3.0 CONTRACTING

Transnational financial activity is accomplished through contracts. Contracts are the core mechanism whereby the market regulates itself.[124] The relationship between contracts and (public) financial regulation in the international financial markets is complex and multi-faceted. Contracts involve risks which regulators need to address in the context of evaluating risks which may damage financial stability.[125] At the same time contracts may be used to limit or shift risks away from financial institutions. Regulations may specify the contents of contracts or may preclude the inclusion of certain provisions in contracts.[126] This section of the paper addresses four themes in this complex relationship between regulation and contracts: contracts are preferable to regulation; contracts function as regulation; contracts constrain regulation; and regulation constrains contracts.

3.1 CONTRACTS ARE PREFERABLE TO REGULATION

Consistent with preferences for no regulation or for deregulation,[127] financial

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[124] In this section of the paper I contrast "regulation" and "contract", but I also want to suggest that contracts control behaviour in ways that are similar to regulation.. *Cf.* Alan Greenspan, *Government Regulation and Derivative Contracts*, Remarks at the Financial Markets Conference of the Federal Reserve Bank of Atlanta, Coral Gables, Florida (Feb. 21, 1997) *available at* http://www.federalreserve.gov/boarddocs/speeches/1997/19970221.htm ("no market is ever truly unregulated. The self-interest of market participants generates private market regulation. Thus, the real question is not whether a market should be regulated. Rather, the real question is whether government intervention strengthens or weakens private regulation. If incentives for private market regulation are weak or if market participants lack the capabilities to pursue their interests effectively, then the introduction of government regulation may improve regulation. But if private market regulation is effective, then government regulation is at best unnecessary.")

[125] *See*, *e.g.*, Basle Committee on Banking Supervision, The Joint Forum, *Credit Risk Transfer*, (March 2005) *available at* http://www.bis.org/publ/joint13.pdf

[126] *Cf. Guidelines for Insurers' Governance*, supra note 29 at 14 ("regulatory authorities must be cautious not to impose highly restrictive rules and wide-ranging prohibitions that severely restrict the discretionary powers of corporate executives.")

[127] This preference is only one preference that financial firms articulate and in fact rational firms would tend to prefer deregulation where rules interfere with their business and regulation where rules would interfere with the business of their actual or potential competitors. *Cf.* Stigler, note 14 above, at 5 ("We propose the general hypothesis: every industry or occupation that has enough political power to utilize the state will seek to control entry."). A firm's or trade group's preference for competition-reducing

market participants will often argue that contracts can be used more effectively or as effectively to achieve objectives for which regulatory solutions are proposed.[128] The euromarkets are often described as markets which came into existence offshore, avoiding the impact of regulations which applied to domestic markets.[129] In the early days relationships in the euromarkets were governed by contract rather than by regulation. Not only did market participants in the euromarkets avoid domestic regulatory authorities, they also avoided courts. Increasingly over time participants in the euromarkets have needed to worry more about the impact (and potential impact) of regulation on their activities.[130] And euromarket participants also now take their disputes to court.[131] A market which seemed 25 years ago to be essentially regulated by non-legal norms is increasingly regulated through legal rules. Still, euromarket participants work to carve out spaces for contract rather than regulation.

Market participants have argued for contracts rather than regulation in the context of sovereign debt. When officials at the IMF proposed to resolve problems associated with sovereign debtors defaulting on their debt through the introduction of a

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rules is not articulated as such but is articulated as a preference for consumer protection or market integrity.

[128] In some domestic jurisdictions, such as the US ("pre-packaged bankruptcies"), bankruptcy solutions are often negotiated solutions. A sovereign bankruptcy regime need not, therefore, be a "regulatory" regime rather than a contractual regime. Opposition to the IMF SDRM proposals may suggest more about market participants' nervousness about the IMF's likely approach to a sovereign bankruptcy regime than about the idea of a sovereign bankruptcy regime as such.

[129] *See*, *e.g.,* Peter Krijgsman, A Brief History. IPMA's Role in Harmonising International Capital Markets1984 – 1994, *available at* http://www.ipma.org.uk/pdfs/History%20of%20IPMA.PDF ("Originating as an offshore market, and not subject to the exclusive regulation of one government or group of governments, Euro-securities initially benefited from the exploitation of inefficiencies in individual domestic markets.")

[130] *See*, *e.g.*, Michael Evans, *Exchanges prepare to deregulate to protect Eurobond business*, INTERNATIONAL FINANCIAL LAW REVIEW (Apr. 2005)

[131] *See*, *e.g.*, *Concord Trust* v *Law Debenture Trust Corporation plc* [2005]UKHL 27 *available at* http://www.parliament.the-stationery-office.co.uk/pa/ld200405/ldjudgmt/jd050428/concor.pdf

supranational equivalent to domestic bankruptcy proceedings,[132] many commentators and market participants argued that a contractual solution would be preferable to this type of regulatory solution. Commentators argued that collective action clauses in bond documentation could solve the problem of holdout creditors in sovereign debt issues where the debtor is unable to meet all of its commitments.[133] Collective action clauses bind creditors to a restructuring agreed to by a specified percentage of creditors.[134] Without such clauses holdout creditors may refuse to accept the terms of a restructuring and demand payment in full of money owing to them.[135] Although bonds governed by New York Law had not traditionally contained collective action clauses, more recently bond documentation for bonds issued by sovereigns subject to New York law have tended to include collective action clauses.[136] However, although collective action clauses now seem to be standard in sovereign bond issues, bondholder voting

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[132] *See*, *e.g.*, IMF, *A New Approach to Sovereign Debt Restructuring: Preliminary Considerations*, (Nov. 30, 2001); IMF, *The Design of the Sovereign Debt Restructuring Mechanism—Further Considerations*, (Nov. 27, 2002) *available at* http://www.imf.org/external/np/pdr/sdrm/2002/112702.htm

[133] *See*, *e.g.*, Adam Lerrick and Allan H. Meltzer, Sovereign Default the Private Sector Can Resolve Bankruptcy Without a Formal Court, Carnegie Mellon Quarterly International Economics Report, April 2002, *available at* http://www.house.gov/jec/imf/bank.pdf . See also *Report of the G-10 Working Group on Contractual Clauses* (Sep. 26, 2002) *available at* http://www.bis.org/publ/gten08.pdf

[134] *See*, *e.g.*, Anne Krueger, IMF First Deputy Managing Director, Sovereign Debt Restructuring: Messy or Messier?, Speech to the Annual Meeting of the American Economic Association, January 4, 2003, Washington, D.C., *available at* http://www.imf.org/external/np/speeches/2003/010403.htm ; *Report of the G-10 Working Group*, supra note 132 at 3 ("The view of the Working Group is that this clause is perhaps the most critical component of the package that is being proposed, because it provides flexibility in reaching agreement on the terms of a restructuring that debtors and creditors find to be in their collective interest. At the same time, use of this clause could ensure that the rights of the supermajority are respected and prevent a small minority of dissident creditors from pursuing disruptive litigation.")

[135] And vulture funds may buy distressed debt with a view to pursuing such claims. *See*, *e.g.*, *Elliott Associates, L.P.* v *The Republic of Panama* 975 F. Supp. 332 (SDNY 1997); *Elliott Associates, L.P.* v *Banco De La Nacion* 194 F.3d 363 (2d. Cir, 1999).

[136] *See*, *e.g.*, John Drage and Catherine Hovaguimian, *Collective Action Clauses (Cacs): an Analysis of Provisions Included in Recent Sovereign Bond Issues (Summary)*, FINANCIAL STABILITY REVIEW, 105, 105 (Dec. 2004) *available at* http://www.bankofengland.co.uk/fsr/fsr17art7.pdf

thresholds vary.[137]

As part of the strategy of arguing against the SDRM and for collective action clauses, a group of financial trade associations (which has been called the "gang of six")[138] worked together to develop "a market-oriented process toward sovereign debt restructuring based on contractual arrangements."[139] A participant in this process commented on "the breadth of the private sector groups that have come together to form this consensus."[140] The gang of six developed standard form collective action clauses for inclusion in sovereign bond documentation.[141]

A contractual solution to the problem of holdout creditors has attractive features: bondholders have notice when they invest that they are buying investments subject to rules which assume collective action in response to issuers' attempts to reschedule debt, and they are, as a result, bound by these arrangements. Thus collective action clauses can help to ensure that no holders of a particular issue of bonds are treated

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[137] *See*, *e.g.*, Andrew G Haldane, Adrian Penalver, Victoria Saporta & Hyun Song Shin, *Optimal Collective Action Clause Thresholds*, Bank of England Working Paper no. 249 (2004) *available at* http://www.bankofengland.co.uk/workingpapers/wp249.pdf

[138] Robert Gray, Chairman International Primary Market Association, *Collective Action Clauses: the Way Forward* 2-3 (Feb. 2004) *available at* http://www.law.georgetown.edu/international/documents/Gray_000.pdf#search='collective%20action%20clauses' ("The International Primary Market Association (IPMA) together with five other trade associations (the "gang of six") took the lead in developing marketable CACs suitable for inclusion in bond contracts governed by both New York and English law.") The "gang of six" was the Bond Market Association, the Emerging Markets Creditors Association, EMTA, the International Primary Market Association, the Institute of International Finance and the Securities Industry Association.

[139] Emerging Markets Creditors' Association, EMTA, Institute of International Finance, International Primary Market Association, Securities Industry Association, The Bond Market Association, Press Release, *Financial Industry Leaders Announce Consensus on Crisis Management and Sovereign Debt Restructuring. Market-Based Principles Agreed By Major Global Associations* (Jun. 11, 2002) *available at* http://www.ipma.org.uk/pdfs/2002,%2011%20June%20Joint%20Press%20Release%20on%20Sovereign%20Debt%20Restructuring.PDF

[140] *Id.* The press release also states: "Other private sector groups such as the EFFAS–European Bond Commission have also expressed support for the private sector principles and fully endorse this press release." *Id.*

[141] EMCA, Model Covenants for New Sovereign Debt Issues, (May 3, 2002) *available at* http://www.emta.org/ndevelop/model.pdf

better than any other holders of that issue. However, contractual arrangements typically bind only parties to the contracts. Thus collective action clauses in the documentation for individual bond issues cannot produce a situation in which all creditors of a particular issuer receive equal treatment.[142]

Although contracts do not bind non-parties they can create positive or negative externalities for non-parties. A contract between a trade association and its members may (or may not) mandate high standards of behaviour that will benefit the members' customers. The same contracts may harm potential competitors who are excluded from membership.

These are some of the reasons for subjecting SROs to statutory controls. But some commentators have pointed out that contracts operate across geographic boundaries (and thus jurisdictional boundaries) in ways that regulation does not.[143] The IOSCO SRO Consultative Committee has argued that self-regulation is useful because it can transcend national boundaries in ways that law and administrative rules cannot.[144] In 2000, Robert Glauber of the NASD announced a "new strategic initiative ... to offer ... regulatory services to other exchanges and regulators, again both here in the U.S. and

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[142] *See*, *e.g.*, Krueger, supra note 133 ("each bond issue would constitute a separate class and CACs would thus not solve intercreditor equity concerns and collective action problems across bond issues or between bonds and other creditors (most importantly banks)"). Although *cf. Report of the G-10 Working Group*, supra note 132 at 5-6 ("The Working Group believes that "aggregation" across a range of different types of creditors for voting purposes under the majority amendment clause, while desirable, is not practicable within a contractually based mechanism. However, it would appear to be legally and contractually possible to have debt instruments issued pursuant to a single master agreement such as a medium-term note programme providing for blended voting under certain circumstances. This approach has a great deal of potential, especially within the context of bonds issued under the laws of a single jurisdiction, and merits further exploration, as medium-term note programmes are increasingly used by emerging market borrowers. It is noted, however, that the Working Group has not focused on the technicalities of this approach in any detail.")

[143] *See*, *e.g.*, Norman S. Poser, *The Stock Exchanges of the United States and Europe: Automation, Globalization and Consolidation*, 22 U. PA. J. INT'L ECON 497, 538 (2001) ("These are not rules promulgated by a government agency, but by contractual arrangements among the participants. This suggests that self-regulation has the ability to finesse the problems of national sovereignty and differing legal systems that stand in the way of developing and enforcing common governmental regulatory standards.")

[144] IOSCO SRO Consultative Committee, supra note 5.

abroad."[145] Ultimately contracts depend on the possibility of enforcement through state processes,[146] but through contracts, markets may harmonise faster, and more effectively, than regulation.

Self-regulation through contract may not be as effective in practice as the IOSCO SRO Consultative Committee and NASD claim. Despite globalization, states still have at their disposal resources which they can invoke to impede the effectiveness of rules developed within epistemic communities without the involvement of state authorities. Scandals may prompt legislatures to enact new tough rules. Self-regulatory rules may be invalidated under competition laws.[147] The global rules which as a practical matter have some effect across national borders are those which either do not (seem to) involve public interest concerns, or which are produced in a manner which entails the consent of at least some states.

3.2 CONTRACTS FUNCTION AS REGULATION

Contracts regulate the behaviour of the contracting parties. The extent to which contracts function as the practical equivalent of regulations varies with the context. Contracts with larger numbers of parties, or contracts concluded in the same form with multiple other contracting parties, such as franchise agreements, tend to have more of a regulatory character than bilateral contracts. SRO rules operate through contract and are

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[145] *See*, *e.g.*, Robert R. Glauber, CEO and President, NASD, Opening Remarks at NASD Fall Securities Regulation Conference, San Francisco, California (Nov.17, 2000) *available from* http://www.nasdr.com. See also NASD, *NASD International Regulatory Services. Delivering Knowledge and Experience Worldwide* (2004) *available at* http://www.nasd.com/web/groups/corp_comm/documents/home_page/nasdw_013328.pdf

[146] Although *cf. e.g.* Margaret Jane (Peggy) Radin, *Regulation by Contract, Regulation by Machine*, 160 JOURNAL OF INSTITUTIONAL AND THEORETICAL ECONOMICS, 1, 4 (2004) http://ssrn.com/abstract=534042 (Suggesting ways in which that standardised contracts could be generally effective without legal enforcement).

[147] *See*, *e.g.,* Office of Fair Trading, Competition in Professions (March 2001) available at http://www.oft.gov.uk/NR/rdonlyres/e2v5ybukef4g57rpmlzhbvfp6gpdazsj4f5vpx53aconsxbdktvaq2733uwkwie3qtd74vdsasfaqhptaviksuzizra/oft328.pdf (analysing competition implications of the rules applying to professions in the UK). *Cf. US* v *Visa USA, Inc*. 344 F.3d 229 (2d. Cir 2003) (holding that rules adopted by both Visa and Mastercard that merchants could not accept competing cards restricted competition and harmed consumers).

designed to function as regulations of their members' conduct. Standard form contracts have more of a regulatory character than individually negotiated agreements.

Financial trade associations have developed standard form contracts for the international financial markets.[148] They have done so as part of their mission to help their members, and they combine efforts to develop standard documentation with the lobbying efforts described above. Financial trade associations may describe the purpose of their standard form contracts programmes as being about risk reduction.[149] Alternatively, or as well, they may say that they are developing standard form documentation in order to facilitate the development of markets.[150] The Loan Market Association (LMA), which has developed standard forms for syndicated loan agreements for the London market,[151] was founded in 1996 "as a response to market conditions and to a perceived willingness on the part of the banking community to bring greater clarity,

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[148] *See*, *e.g.*, Sean M. Flanagan, *The Rise of a Trade Association: Group Interactions Within the International Swaps and Derivatives Association*, 6 HARV. NEGOTIATION L. REV. 211, 229 (2001) (" The initial goal - and one of the key accomplishments of ISDA - has been the development, drafting, and promulgation of standard form documentation for the OTC derivatives industry.")

[149] ISDA describes its activities as follows: "Since its inception, ISDA has pioneered efforts to identify and reduce the sources of risk in the derivatives and risk management business. Among its most notable accomplishments are: developing the ISDA Master Agreement; publishing a wide range of related documentation materials and instruments covering a variety of transaction types; producing legal opinions on the enforceability of netting and collateral arrangements (available only to ISDA members); securing recognition of the risk-reducing effects of netting in determining capital requirements; promoting sound risk management practices, and advancing the understanding and treatment of derivatives and risk management from public policy and regulatory capital perspectives." *See* http://www.isda.org/wwa/wwa_nav.html

[150] *Cf.* Karl Llewellyn, *Book Review*, 52 HARV. L. REV. 700, 701 (1939) ("The general law" is much too general. It needs tailoring to trades and to lines of trading. Nothing can approach in speed and sanity of readaptation the machinery of standard forms of a trade and for a line of trade, built to meet the particular needs of that trade. They save trouble in bargaining. They save time in bargaining. They infinitely simplify the task of internal administration of a business unit, of keeping tabs on transactions, of knowing where one is at, of arranging orderly expectation, orderly fulfilment, orderly planning. They ease administration by concentrating the need for discretion and decision in such personnel as can be trusted to be discreet. This reduces human wear and tear, it cheapens administration, it serves the ultimate consumer.")

[151] Loan Market Association, Multicurrency Term and Revolving Facilities Agreement, in The Recommended Form of Primary Documents, July 2002 (copy on file with author) (LMA Agreement) (get 2004 version).

efficiency and liquidity to the relatively under- developed secondary market that existed at the time, and to enable more efficient loan portfolio management."[152] The Loan Syndications and Trading Association in the US, which has developed Model Credit Agreement Provisions for jurisdictions in the US,[153] states that it developed the model provisions:

> to promote liquidity and efficiency, increase legal certainty, reduce transaction costs in connection with originations activity, and limit legal review for primary and secondary sales to an "exceptions" basis, reducing the time and expense of unnecessary negotiation of boilerplate and other mechanical provisions.[154]

When trade associations are successful in developing standard forms that market participants use, the standard forms can function like regulation in that they set standards for what is normal behaviour in the markets. What is normal may influence a court's interpretation of contracts.[155] Normal contractual terms may also influence the behaviour of market participants. It may be difficult for a borrower to negotiate contractual terms different from those specified in the standard form syndicated loan agreement.[156] The LMA agreement has been designed "to balance the interests of

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[152] *See* http://www.loan-market-assoc.com/Public/lma_abou.asp?Display=Origins.

[153] Loan Syndications and Trading Association, *Model Credit Agreement Provisions*, (Jan. 2004) *available at* http://www.lsta.org/assets/files/Standard_Documents/Primary_Market_Amendment_Practices_and_Agent_Transfer/ModelCreditAgreementProvisions_January2004.pdf (LSTA Model Credit Agreement Provisions")

[154] *Id*. at "Purpose and Scope".

[155] A court will decide whether a contract is ambiguous taking account of the norms of the business context. *See*, *e.g*., *In Re Okura*, 249 B.R.596, 603 (Bankr. SDNY 2000) (a phrase is ambiguous only if it is "capable of more than one meaning when viewed objectively by a reasonably intelligent person who has examined the context of the entire integrated agreement and who is cognizant of the customs, practices, usages and terminology as generally understood in the particular trade or business.")

[156] Association of Corporate Treasurers, *A Guide to the Loan Market Association Documentation for Borrowers*, 12 *available at* http://www.treasurers.org/technical/resources/lma_final.pdf ("*ACT Guide*") ("It can be harder to negotiate a draft which is presented by lenders as a market standard than, for example, a draft which is the standard form of a law firm.")

borrowers and lenders".[157] The Association of Corporate Treasurers ("ACT"), which represents borrowers, says:

> For many Borrowers, it is likely to be advantageous to use as a basis for negotiation a format which is becoming increasingly familiar in the market. It is hoped that this familiarity will make for greater efficiency in negotiation of the loan document and in the syndication process, leading to lower costs for the Borrower.[158]

The ACT lists some of the potentially unattractive features of the LMA standard form,[159] and also lists some "key points for negotiation".[160] However, although the ACT lists the "increased costs clause" as a key clause affecting costs,[161] it does not suggest that this is a provision which may be negotiated.[162] The increased costs clause is designed to protect lending banks (and subsequent acquirers of their interests in any loan) from increased costs associated with changes in regulatory requirements, for example where capital adequacy requirements change over the life of a loan so that the lender has to have extra capital to cover the loan.[163] The increased costs clause is designed to pass

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[157] See the "Joint Statement" at the beginning of the LMA Agreement., reproduced in *ACT Guide*, *supra* note 155 at 10. *Cf. LSTA Model Credit Agreement Provisions*, supra note 152 ("every effort was made to balance the interests of all constituencies in the syndicated lending market: agents, investors and borrowers.")

[158] *ACT Guide*, *supra* note 155 at 12.

[159] *ACT Guide*, *supra* note 155 at 12-13.

[160] *Id.* at 13-14.

[161] *Id.* at 14.

[162] Although some commentators suggest that changes in the Basle Capital Accord should mean that borrowers will want to negotiate to obtain the benefit of reductions in capital requirements that accrue if the borrower's risk profile improves. *See*, *e.g.*, S J Berwin, *Basel II: The Impact on the Margin*, 3 *available at* http://www.sjberwin.com/media/pdf/publications/banking/Basel_II.pdf#search='increased%20costs%20clause'

[163] The lenders can take account of the impact of capital; adequacy rules that apply at the time of signing of the loan agreement by adjusting the loan pricing. *See*, *e.g.*, S J Berwin, *supra* note 161 at 3 ("As the effect of Basel II becomes more settled and as implementation approaches, it is likely that attempts

such costs on to the borrower, but because the clause is drafted by banks and borrowers have limited opportunities to negotiate its terms, the clause does not give the borrower the benefit of any reduced regulatory costs.[164] It is a one-way ratchet in favour of the lenders.

Standard form contracts may develop a dominant position where the market benefits from standardisation and/or where standard setters and regulators encourage the use of standard forms as a form of risk management. In the international financial markets some contractual provisions have more of a regulatory effect than others. For example, provisions of the LMA agreement regulate the relationship between the agent bank and the lenders.

In cases where the market does not use standard forms, international standard setting bodies may encourage market participants to develop or use standard form contracts because of the connection between legal risk and uncertainty. For example, commentators say that parties to swap transactions in synthetic collateralised debt obligation structures are not standardising their contracts.[165] In March 2005 in its paper on Credit Risk Transfer the Joint Forum recommended that "market participants should aggressively continue their efforts towards standardisation of documentation, including for CDOs and other more complex products" in order to reduce legal risk.[166]

Standard form contracts often suit the interests of financial firms and regulators, but they may impose costs on others who are not involved in the drafting process and

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will be made to incorporate specific Basel II pricing into the provisions of the loan agreement. At that point, Basel II will effectively drop out of the increased costs clause, just as some years ago the effect of the current Basel Accord used to be excluded from the increased costs clause once it had been taken into account in the pricing of transactions.")

[164] Although see note 161 above.

[165] Ian Sideris & Simon Puleston Jones, *How to adapt ISDA documents for CDOs ,* INTERNATIONAL FINANCIAL LAW REVIEW (Apr 2005) ("Ultimately, it is unlikely that a single standard form of swap is going to emerge in the synthetic CDO market. The differing requirements of the rating agencies, the continuing demand by investors for bespoke products and the desire of investment banks to create new credit products through which they can make profits in an environment of tightening credit spreads all mitigate in favour of continuing diversity and complexity in the documentation of synthetic CDOs.")

[166] *Credit Risk Transfer*, supra note 124, Recommendation 7 at p. 7.

who will find it difficult to negotiate against the standard form provisions. At times the risk reducing aspects of standard forms may be illusory: where firms are parties to transactions using different standard-forms any inconsistencies between the different forms may cause problems.[167] The Global Documentation Steering Committee in New York works on trying to reconcile differences between standard-forms,[168] and has encouraged different organisations to take account of its work.[169]

3.3 CONTRACTS CONSTRAIN REGULATION

Contracts may constrain or undermine regulation if they are used to shift risks away from regulated firms onto non-regulated entities.[170] Since the development of the Basle Capital Accord banks have changed their relationships with their customers. Rather than acting as a long term lender to a business client a bank prefers to be involved in arranging a financing facility and to sell its participation in the facility to others. The ideal purchaser of a loan participation is an entity which is not itself subject to risk-weighted capital requirements. But if the purchaser is a non-bank financial institution regulators may be concerned about the shifting of risks from a regulated part of the financial sector to a less regulated or differently regulated sector. Similar issues of risk-shifting arise in the context of securitisations[171] and CDOs. The Joint Forum

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[167] *See*, *e.g.*, Thomas A. Russo, Documentation Basis Risk - Hidden Legal Risks in the Infrastructure of Industry Standard Documentation, Address at the 13th Annual Derivatives and Risk Management Conference, April 25, 2003, *available at* http://www.ny.frb.org/globaldoc/Documentation_Basis_Talk.doc ("Use of multiple master agreements allows the parties to tailor the basic terms of their financial transactions to the particular transaction. However, it also results in this documentation basis risk – the risk that transactions that hedge each other will not exactly have matching terms, because they are documented on masters that have inherent differences.") See also Counterparty Risk Management Policy Group, Improving Counterparty Risk Management Practices, June 1999 *available at* http://www.mfainfo.org/washington/derivatives/Improving%20Counterparty%20risk.pdf

[168] *See*, *e.g.*, http://www.ny.frb.org/globaldoc/index.html

[169] *See*, *e.g.*, GDSC Recommendations to the 2002 ISDA Master Agreement, May 7, 2003, available at http://www.ny.frb.org/globaldoc/gsdc_final.doc

[170] For example using credit default swaps to shift the risk of debtor default.

[171] In a securitisation

concluded that this issue should be monitored.[172]

Contracts may also constrain regulation where financial market participants successfully argue that proposed or actual regulations undermine beneficial market transactions. In the US, national banks have been arguing that the states and municipalities do not have the power to subject them to controls on predatory lending because of pre-emption.[173] The OCC has supported this view.[174] One argument that lenders have made to support their arguments for pre-emption is that allowing state predatory lending statutes to control the actions of national banks would impair their

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[172] Joint Forum, supra note 124 at 5 ("With regard to the role of unregulated market participants, the Working Group believes that market discipline as evidenced through effective counterparty risk management is an essential element of a well-functioning marketplace. Market participants should seek to ensure that sufficient measures are taken to address these risks with respect to all counterparties, whether regulated or not. In addition, supervisory authorities have a legitimate basis for seeking to understand the aggregate amount of credit risk that is being transferred outside of the regulated sector. While greater information sharing among supervisors, including developing a common understanding of key concepts and terms, as well as improved analysis of existing and planned reports provided by regulated firms should provide an increased ability to assess such developments, it will be important to monitor progress in this area closely.") *See also*, *e.g.*, International Association of Insurance Supervisors, Iais Paper on Credit Risk Transfer Between Insurance, Banking and Other Financial Sectors Presented to the Financial Stability Forum (March 2003) *available at* http://www.iaisweb.org/03fsfcrt.pdf

[173] State predatory lending statutes tend to be drafted to cover lending within the state rather than lending by state chartered banks. This makes some sense if borrowers cannot easily distinguish between state chartered and national banks and therefore cannot easily work out what rules would regulate predatory lending. Opponents of predatory lending refer to "asset stripping" or "equity stripping" which can happen because of large fees charged in relation to the loans. *See*, *e.g.*, Center for Responsible Lending, *Comments on OCC Working Paper* (Oct. 6, 2003) *available at* http://www.predatorylending.org/pdfs/CRLCommentsonOCCWorkingPaper.pdf ("The primary abuse the North Carolina law, and other subsequent state laws, is aimed at is preventing equity stripping, which occurs when lenders charge excessive fees. The problem of excessive fees for the subprime refinancing borrower is two-fold: the fees seem painless at closing and they are forever. They are *deceptively costless* to many borrowers because when the borrower "pays" them, with a stroke of a pen at closing, he or she does not feel the pain of counting out thousands of dollars in cash. The borrower parts with the money only later, when the loan is paid off and the equity value remaining in his or her home is reduced by the amount of fees owed. And *fees are forever* because, even if a responsible lender refinances a family a week later, the borrowers' wealth is still permanently stripped away.")

[174] OCC, Bank Activities and Operations; Real Estate Lending and Appraisals 69 Fed. Reg. 1904 (Jan 13, 2004) *available at* http://a257.g.akamaitech.net/7/257/2422/14mar20010800/edocket.access.gpo.gov/2004/pdf/04-586.pdf; OCC, Bank Activities and Operations, 69 Fed. Reg 1895 (Jan 13, 2004) *available at* http://a257.g.akamaitech.net/7/257/2422/14mar20010800/edocket.access.gpo.gov/2004/pdf/04-585.pdf

ability to securitise loans.[175] They argue that this would ultimately deprive borrowers of credit.[176]

In a securitisation the originator of income producing assets such as loans will set up a special purpose entity (SPE) to hold income producing assets such as loans and issue securities to investors. If the SPE is sufficiently separate from the originator any assets the originator transfers to the SPE will be removed from the originator's balance sheet. Investors in securities issued by the SPE want to be sure that creditors of the originator are unable to look to the SPE's assets in the event of the originator's insolvency. Investors in the originator want to be sure that there is no risk that unhappy investors in the SPE's securities will seek recourse to the originator. Clear and certain formal legal rules about accounting consolidation, bankruptcy remoteness and the meaning of "true sale" would comfort all of the participants in securitizations. In the absence of clear rules, credit rating agencies have stepped in to define what it takes to make structured financing work by setting detailed criteria for the rating of structured finance transactions.[177] Recently rating agencies have addressed the question of the impact of state predatory lending statutes on securitisations as part of their general focus on structured finance. Standard & Poor's considers various factors including whether predatory lending statutes provide for assignee liability, whether the loan

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[175] State predatory lending statutes commonly affect not just the original lender but also assignees of the loan so that remedies available against the original lender would also be available against assignees who had no opportunity to monitor compliance with the requirements of the statutes. This liability could significantly reduce the value of asset pools in securitisations. See generally The Bond Market Association, *The Secondary Market for Subprime Mortgages. A Common Sense Approach to Addressing Assignee Liability through Federal Legislation* 2 (March 2004) *available at* http://www.bondmarket.com/Legislative/Subprime_Lending_Whitepaper_032904.pdf ("The secondary market must currently comply with a patchwork of more than 40 varying and sometimes vague and conflicting state and local anti-predatory lending laws. Such a regulatory environment negates many of the efficiencies securitization and the secondary market bring to the subprime mortgage market. Anti-predatory lending laws that assign liability to the secondary market for lending violations that cannot be detected in a review of the loan documents will ultimately limit subprime borrowers' access to credit.")

[176] *See*, *e.g.*, The Georgia Bankers Association White Paper, Georgia Fair Lending Act. The Unintended Consequences 5 (Jan. 2003) *available at* http://www.namb.org/government_affairs/fair_lending/GBAissuespredatorylendingwhitepaper.pdf

[177] *See*, *e.g.*, Standard & Poor's, *Legal Criteria for U.S. Structured Finance Transactions* (April 2004) *available at* http://www2.standardandpoors.com/spf/pdf/fixedincome/SF_legal_criteria_FINAL.pdf

categories affected are clearly defined, what penalties apply and how clear the statute is (including whether there are any safe harbors).[178]

Although this example of contracts (the securitisation contracts) potentially constraining regulation (the state predatory lending statutes and also potential federal level regulation of predatory lending)[179] is a domestic example within the US it is not difficult to imagine similar arguments being made in the EU that EU level banking rules pre-empt state actions to protect domestic banking customers like those the states have been taking in the US.[180] And eventually the WTO services agreement may produce similar pre-emptive effects at the global level.

To the extent that contracts, particularly standard form contracts, can constrain or limit regulation it is worrying that the processes which produce the standard form contracts are private and opaque to outsiders and that they do not tend to allow input

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[178] Standard & Poor's, *Legal Criteria for U.S. Structured Finance Transactions*, supra note 176, at 104.

[179] The Standard & Poors analysis in its focus on issues of legal certainty also has implications for possible federal rules on predatory lending. The Bond Market Association supports one Bill currently before Congress. *See*, *e.g.*, Micah S. Green, President, Bond Market Association, Testimony before US House of Representatives Subcommittee on Housing and Community Opportunity, Subcommittee on Financial Institutions and Consumer Credit, Hearing on Legislative Solutions to Abusive Lending Practices (May 24, 2005) *available at* http://www.bondmarkets.com/assets/files/Testimony-Subprime_05-24-05.pdf (The Responsible Lending Act deals with the problems that do sometimes arise from dozens of sometimes vague and conflicting state and local laws by creating a uniform national standard for the terms under which high-cost loans are made. Critically important, these terms are objective and measurable. Under this legislation, borrowers facing foreclosure could bring defensive claims against loan assignees under certain circumstances. Assignees could also be the subject of affirmative claims, or those brought outside of the context of defending against a specific foreclosure claim, unless they could prove that a reasonable level of loan review would not have revealed the lending violation in question. By observing an objective standard for loan review that could reasonably be expected to screen loans with potential predatory lending problems, secondary market participants can avoid potential liability. The Responsible Lending Act also provides purchasers with a "right to cure", or the opportunity to amend a loan and compensate the borrower when they identify loans made in violation of the terms set out in the bill. All claims would be limited to actual damages unless a borrower can prove reckless indifference on the part of an assignee.")

[180] Directive 2000/12/EC of the European Parliament and of the Council of 20 March 2000 relating to the taking up and pursuit of the business of credit institutions, OJ No. L 126/1 (May 26, 2000) *available at* http://europa.eu.int/eur-lex/pri/en/oj/dat/2000/l_126/l_12620000526en00010059.pdf includes a general rule of home control of credit institutions which is the equivalent of pre-emption. See, e.g., EU Commission Press Release, Banking: Commission requests Italy to amend law on excessive interest rates (July 25, 2003) (Commission challenge to Italian rules criminalising usury).

from people who may be affected by them.

3.4 REGULATION CONSTRAINS CONTRACTS

At the same time as contracts may constrain or limit regulation financial firms need to worry about how existing legal rules may affect the contractual arrangements they believe they have made, and about how changes to legal rules may affect their contracts. One result of such anxiety is the type of lobbying activity discussed in Section 2 above.

Some types of legal uncertainty may not matter if market participants can agree to ignore the uncertainty. Within a homogenous community transactions may derive their binding effect from sources other than state-centered law.[181] But actors in the international financial markets are less homogenous than they used to be and they are more likely to resort to litigation to resolve disputes than they were in the past.

When litigation does occur, market participants frequently argue that courts should give effect to the agreements they have concluded and should interpret the law to facilitate this. Financial trade associations may submit amicus briefs in litigation to argue for the market's view. In some places governmental authorities or quasi-governmental authorities encourage the idea that courts should avoid applying the law in unexpected ways. In the UK, the Bank of England appointed a Legal Risk Review

[181] R.B Ferguson, *Commercial Expectations and the Guarantee of the Law: Sales Transactions in Mid-Nineteenth Century England*, in G.R.Rubin & David Sugarman (Eds.) LAW, ECONOMY AND SOCIETY, 1750-1914: ESSAYS IN THE HISTORY OF ENGLISH LAW, 194-198 (1984) (arguing that stock exchange transactions in Britain in the nineteenth century were secure, despite being legally unenforceable).

Committee,[182] then a Financial Law Panel,[183] and most recently a Financial Markets Law Committee to address issues of legal risk.[184]

Regulation may constrain contracts by limiting what a financial firm can achieve by contract. Uncertainties about how courts and regulators will interpret contracts create legal risks that financial institutions need to address as part of their overall risk management strategy required by their regulators.

4.0 PRIVATE SECTOR REGULATORY ENTREPRENEURS

Whether financial transactions take place on regulated markets or not they need institutional support, including support from rules, whether those rules derived from statutes and regulations or from contracts. Financial trade associations act as regulatory entrepreneurs in developing rules which participants in the financial markets follow.[185] Earlier sections of this paper addressed the lobbying activities of financial trade associations and their actions in developing standard form contracts. But financial trade associations also seek to influence market behaviour by the development of instruments such as guidelines and market standards which do not seek in themselves to produce legal effects but which may in fact produce legal effects if they are incorporated in

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[182] *See*, *e.g.*, Final Report of the Legal Risk Review Committee, October 1992, copy on file with author. The Committee noted that "markets cannot function efficiently without a strong legal foundation. Promoting legal certainty, even though it is not the only relevant concern, is therefore of fundamental medium- to long-term importance." Id. at ¶ 1.2. The statement by Millett J. in *In re Charge Card Services Ltd.* [1987] Ch. 150 that " a charge in favour of a debtor of his own indebtedness to the chargor is conceptually impossible" was another factor. See also *Re BCCI No. 8* [1998] AC 214 per Lord Hoffmann ("The doctrine of conceptual impossibility ... has excited a good deal of heat and controversy in banking circles; the Legal Risk Review Committee, set up in 1991 by the Bank of England to identify areas of obscurity and uncertainty in the law affecting financial markets and propose solutions, said that a very large number of submissions from interested parties expressed disquiet about this ruling. It seems clear that documents purporting to create such charges have been used by banks for many years.")

[183] The Financial Law Panel ceased operations in March 2002. The Bank of England had decided that it could not indefinitely provide open-ended support to the Panel. Bank of England, Annual Report 2002, 5 (May 2002) *available at* http://www.bankofengland.co.uk/publications/annualreport/2002report.pdf

[184] The Financial Markets Law Committee's web site is at http://www.fmlc.org/

[185] Some financial trade associations are recognised as self-regulatory organisations in states' formal financial regulatory systems. Others exercise rule-making functions because their membership wishes them to do so without any formal role in any state's financial regulatory structure.

contracts or if regulations refer to them.

The financial industry has produced a host of standards and codes and guidelines covering many different subjects. For example, the Bond Market Association has published Practice Guidelines for trading in distressed bonds,[186] and for GSE European callable securities.[187] The European Securitisation Forum has published securitisation market practice guidelines.[188] Sometimes market standards are designed to fend off regulation.

Private standard setters may have significant influence on the behaviour of market participants through formal recognition of their role. In 2002, for example, the EU adopted a regulation mandating the use of International Accounting Standards by publicly traded EU companies.[189] The International Accounting Standards covered by the regulation are described as follows:

> 'international accounting standards' shall mean International Accounting Standards (IAS), International Financial Reporting Standards (IFRS) and related Interpretations (SIC-IFRIC interpretations), subsequent

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[186] The Bond Market Association, Practice Guidelines for Trading in Distressed Bonds, (Sept. 2004) *available at* http://www.bondmarket.com/assets/files/Practice_Guidelines_for_Trading_in_Distressed_Bonds.pdf

[187] The Bond Market Association, Practice Guidelines for Trading in GSE European Callable Securities, (updated May 13, 2004) *available at* http://www.bondmarket.com/assets/files/2004PracticeGuideforTradeGSEEuroCallableSec.pdf

[188] European Securitisation Forum, Securitisation Market Practice Guidelines, (June 2004) *available at* http://www.europeansecuritisation.com/pubs/Securitisation_Market_Practice_Guidelines_June_2004.pdf

[189] Regulation (EC) No 1606/2002 of the European Parliament and of the Council of 19 July 2002 on the application of international accounting standards, OJ No. L 243/1 (Sept. 11, 2002) *available at* http://europa.eu.int/eur-lex/pri/en/oj/dat/2002/l_243/l_24320020911en00010004.pdf . See also Commission Regulation (EC) No1725/2003 of 29 September 2003 adopting certain international accounting standards in accordance with Regulation (EC) No1606/2002 of the European Parliament and of the Council, OJ No L 261/1 (Oct. 13, 2003) *available at* http://europa.eu.int/eur-lex/pri/en/oj/dat/2003/l_261/l_26120031013en00010002.pdf ; Commission Regulation (EC) No 707/2004 of 6 April 2004 amending Regulation (EC) No 1725/2003 adopting certain international accounting standards in accordance with Regulation (EC) No 1606/2002 of the European Parliament and of the Council OJ No. L 111/3 (Apr. 17, 2004) *available at* http://europa.eu.int/eur-lex/pri/en/oj/dat/2004/l_111/l_11120040417en00030017.pdf

> amendments to those standards and related interpretations, future standards and related interpretations issued or adopted by the International Accounting Standards Board (IASB).[190]

The International Accounting Standards Board is a non-governmental organisation, funded by private sector firms. As such it has been criticised by commentators and is currently in the process of a constitutional review.[191]

Other private sector firms act as regulatory entrepreneurs by setting criteria for market transactions. Credit rating agencies assess the financial condition of issuers of securities in the capital markets, and their decisions about how to treat different liabilities can have an impact on the issuers' ability to raise funds in the capital markets.[192] Credit rating agencies also set detailed criteria for structured finance transactions.[193] Firms which wish to sell securities in a structured financing need to acquire a rating from a credit rating agency in order for the securities to be marketable. They therefore have to ensure that they meet the rating agencies' criteria.[194] Credit ratings are set to influence the level of capital banks are required to hold when they are used as a measure of a

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[190] Regulation on the application of international accounting standards, note 188 above, at Art. 2

[191] See, e.g., IAIS, *Comments on Identifying Issues for the IASC Foundation Constitution Review*, (Feb. 11, 2004) *available at* http://www.iaisweb.org/190IASConstitutioncomments11February2004.pdf ("we recognize the importance of bringing to bear the highest calibre of technical expertise and unbiased professional judgment to standard-setting efforts. At the same time, we believe that the overall process for developing these standards must include sufficient transparency and accountability to ensure that strengths, without appropriate checks and balances, do not risk becoming weaknesses.")

[192] *See*, *e.g.*, OECD, *Corporate Pension Fund Liabilities and Funding Gaps*, 88 Financial Market Trends 69, 91 (March 2005) ("Rating agencies have warned that estimated deficits in company pension schemes are similar to debt. It had previously been thought that credit ratings agencies regarded pensions as long-term liabilities with little negative liquidity implications, at least in the case of those jurisdictions where pensions rank along with non-preferred and unsecured debt in the event of insolvency. Across countries, there are differences in the status of pension creditors, but this status may be subject to change in some countries. For example, making the status of pension creditors "preferred" rather than "unsecured" is likely to affect ratings, particularly for companies where financial indebtedness is already high.")

[193] *See*, *e.g.*, Standard & Poor's note 176 above.

[194] *See*, *e.g.*, BIS, The Role of Ratings in Structured Finance: Issues and Implications (Jan. 2005) *available at* http://www.bis.org/publ/cgfs23.pdf

corporate's risk.

5.0 CONCLUSION

Contracts and regulation intersect in complex ways in the international financial markets. This paper examines some of the ways in which non-governmental actors, in particular financial trade associations, influence regulation in the international financial markets through lobbying, through the development of standard form contracts and through their own quasi-regulatory initiatives. Although some of the ways in which this influence is exercised are apparent because of disclosures by governmental and inter-governmental standard setters and because of disclosures by the financial firms and their trade associations, others are less transparent. Larger and better-resourced firms are able to participate more effectively than smaller firms in these formal and informal processes of regulation and quasi-regulation. Consumers tend to be distanced from these processes by lack of resources, by lack of expertise and because they fail to meet the eligibility criteria for participation. Thus in critical ways these governance processes do not fit well with ideas either of top-down governance or of bottom-up governance.