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Beyond International Standards: Mapping the Future of Capital Markets Regulation

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Key Points

- As a response to multiple financial shocks, international standards have disappointed.
- Consensus seeking has stifled innovation, perpetuating outdated regulatory concepts at a time of rapid market change.
- Markets are complex and idiosyncratic; they may not be receptive to efforts toward producing regulatory harmonization and convergence.
- Alternatives to international standard setting should be explored.
- Possibilities include fora for experimentation in capital markets regulation, the creation of a set of variegated model capital markets laws and a "restatement"-like treatise.

Introduction

Over the last 20 years, and in the wake of multiple shocks to the world's financial systems, international financial standards have proliferated,[1] creating a complex dynamic between national (or regional) regulation and international norms, between hard and soft law. For many years, the belief in the desirability, indeed the inevitability, of regulatory convergence as a response to the difficulties thrown up by the internationalization of capital markets went largely unchallenged.[2] Supporting this belief among policy makers internationally was a well-accepted but misguided hypothesis to the effect that the most developed economies, with the most efficient markets, were a

1 Not all international financial standards are a direct response to specific financial shocks, and shocks can produce divergence at the national level as well as calls for international standards. But some standards are decidedly linked to particular financial crises. The International Organization of Securities Commission's (IOSCO's) original Objectives and Principles of Securities Regulation, for example, appeared in 1998 as a direct response to the Asian financial crisis that began in 1997. Equally, the second iteration of the IOSCO Objectives and Principles in 2010 was a direct response to the global financial crisis. There are numerous other examples.

2 See e.g. L Quinn & E Greene, "Building on International Convergence of the Global Markets: A Model for Securities Law Reform" (Paper delivered at the Securities and Exchange Commission's Major Issues Conference: Securities Regulation in the Global Internet Economy, 15 November 2001).

About the Author

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Over the years, Cally has taught and visited at McGill University, the University of Florida, Duke Law School, the Center for Transnational Legal Studies (London), the Max Planck Institute for International and Comparative Law (Hamburg), the London School of Economics and Political Science, the British Institute for International and Comparative Law (London) and IUC Torino. She was the inaugural P.R.I.M.E. Finance (Lord Woolf) Fellow at the Netherlands Institute for Advanced Studies (Wassenaar, Netherlands) and a Dean's Visiting Scholar at Georgetown Law Center in Washington, DC. In 2018, she will be a visiting fellow at Harris Manchester College, Oxford, and the London School of Economics and Political Science.

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function of a superior legal system, the common law.[3] Thus, regulatory frameworks in certain developed economies (notably the United States) were worthy of emulation and could form the basis for international standards.[4] Internationalized US law and capital markets regulation came to set the standards, playing into a desire by the United States to exert dominance in world capital markets.

However, different forces are now at work. US hegemony of the international markets suffered a blow in the post-crisis world. Rising regulatory action by the European Union and associated unilateralism has also created a new dynamic in international financial standard setting. Different actors now come to the standard-setting process with different motivations and expectations; markets are changing dramatically, shaking regulatory assumptions. Regulatory convergence and harmonization are no longer givens.[5] There is also a growing realization that global coordination by way of standardization itself may be problematic. Problems that slip through one regulatory net could slip through all of them, were they to be closely coordinated. Less coordination may have its benefits.

Looking forward, how will these developments change the course of international financial standard setting and its role in world capital markets? How will this affect the role and activities of IOSCO, the world's pre-eminent standard setter for the capital markets? Is it time to look beyond international financial standard setting?

3 The "legal origins" or "law and finance" literature, as this body of scholarship came to be known, was enormously influential and is still accepted as gospel in certain quarters, such as the World Bank, despite early and continuing academic criticism. See e.g. Cally Jordan, "The Conundrum of Corporate Governance" (2005) 30 Brook J Intl L 983; Cally Jordan & Mike Lubrano, "How Effective Are Capital Markets in Exerting Governance on Corporations? Recent Lessons from Emerging Markets" in Robert E Litan, Michael Pomerleano & V Sunderarajan, eds, *Financial Sector Governance: The Roles of the Public and Private Sectors* (Washington: Brookings Press, 2002); Holger Spamann, "'Law and Finance' Revisited" (2008) Harvard Law School, John M Olin Center Discussion Paper No 12, online: <https://ssrn.com/abstract=1095526>. Although this literature was well accepted by international financial institutions and certain academics, national-level regulators and market practitioners were largely oblivious to it.

4 Regulators in the more developed markets were viewed as having a better understanding of how markets functioned and provided insight into where less developed markets were heading. Secondly, there was also a desire on the part of heavily regulated market participants to level the playing field between more and less developed markets.

5 See John Armour, Martin Bengtzen & Luca Enriques, "Investor Choice in Global Securities Markets" (2017) ECGI Law Working Paper No 371/2017, online: <https://ssrn.com/abstract_id=3047734> ("regulatory coordination seems likely to engender less enthusiasm in the future" at 4).

The Backdrop to IOSCO Standard Setting

Having originated as a focal point for cooperative efforts by national regulators, IOSCO now identifies itself as a standard setter. The Objectives and Principles of Securities Regulation (1998, 2004, 2010) remain IOSCO's best known standards, but a raft of principles, guidelines, methodologies, codes, consultation papers and implementation reports followed.[6]

Early on, IOSCO standard setting attracted the attention of other international bodies, the G7 (and successors), the Financial Stability Forum (FSF) and its successor, the Financial Stability Board (FSB), the International Monetary Fund (IMF) and the World Bank. These international institutions collaborated to develop a financial assessment "tool kit" to be used in diagnostic and prophylactic exercises conducted on a country-by-country basis, and the Financial Sector Assessment Program (FSAP) was launched in 2000. The IOSCO Objectives and Principles of Securities Regulation, which first appeared in 1998, suited their purposes and in this way, IOSCO was drawn, like it or not, into the ambit of international policy networks. The IMF and the World Bank, although not regulators or market institutions in any sense, joined IOSCO. In turn, IOSCO standards were disseminated worldwide through the FSAP exercises.

The speed and brutality of the global financial crisis, emanating as it did from the United States, shook the foundations of US hegemony in the international markets. Equally, US-inspired IOSCO initiatives, designed as predictive and stabilizing measures, had fallen short. With renewed EU regulatory activism since 2009 had come greater European influence in international standard setting and a corresponding diminished US influence in the standard-setting process. As Roberta Karmel notes, the United States has been both leader and follower in international standard setting, and is much less happy with its role as a follower.[7] Little wonder, then, that a commissioner of the US Securities and Exchange Commission (SEC) would complain in 2014 about "top-down, forcible imposition of one-size-fits-all regulatory standards on sovereign nations."[8]

IOSCO standards have disappointed[9] and are, at least in some quarters, under attack. They have not provided the easy fix once hoped for. Internationalization of the capital markets, however, has hardly abated. It is time to think beyond international financial standards as we know them, in mapping the future of capital markets regulation.

Positive Impact of IOSCO Standards

Before identifying the various difficulties associated with IOSCO international standard setting, it is useful to consider its impact in a positive light. IOSCO has served well as a forum for formal and informal regulatory cooperation and communication. Scarcely a capital markets regulator in the world does not participate in IOSCO. The contacts and channels of communication provide a valuable service in fostering international engagement among economies worldwide.

Making use of IOSCO standards, the FSAP exercises conducted by the IMF and the World Bank, much criticized in certain regards, have nevertheless promoted a common understanding of an often poorly understood segment of the economy. While there are still ample opportunities for miscommunication, due to linguistic challenges, diverse practices and the vagaries of different legal systems, IOSCO standards

6 By the author's calculation, IOSCO has produced approximately 555 public reports since 1989. This figure includes 362 final reports and 115 consultation reports.

7 Roberta S Karmel, "IOSCO's Response to the Financial Crisis" (2012) 37:4 J Corp Law 849.

8 Daniel M Gallagher, "Closing Remarks at the SEC's 24th Annual International Institute for Market Development" (delivered at the US SEC, Washington, DC, 16 April 2014).

9 See Cally Jordan, "The Dangerous Illusion of International Financial Standards and the Legacy of the Financial Stability Forum" (2011) 12 San Diego Intl LJ 333; Cally Jordan, "How international finance really works" (2013) 7:5 Law & Financial Markets Rev 256.

and the FSAPs have aided in the creation of a commonly understood language of finance.[10]

IOSCO standards and the FSAP process have also contributed to the popularization of finance, its democratization if you will, at a time when the markets demonstrate growing complexity. Capital markets issues and regulatory difficulties have been forced out of the penumbra of technicality and are no longer the privileged preserve of professional guilds.[11]

The scope and reach of the FSAP exercises,[12] encompassing economies big, small and in-between, have generated an impressive amount of data, some of it spot on. The vulnerabilities in Iceland's financial sector were identified years before the sector imploded. Equally, the broad reach of the FSAP exercises can identify successful initiatives of smaller economies that might not otherwise garner international attention.

Weaknesses in IOSCO Standard Setting

Nevertheless, IOSCO standard setting has demonstrated notable weaknesses. Former SEC commissioner Daniel Gallagher is not far off the mark with his criticism of top-down, assumption-ridden, one-size-fits-all standards, although many of those assumptions may in fact emanate from US regulation. The Objectives and Principles of Securities Regulation, for example, being largely inspired by US regulations and institutions, missed many of the hot buttons of the global financial crisis of a decade ago.[13] The crisis fomented in the interstices of US regulations, and the standards based on them did not send up flares during the FSAP exercises.[14] US securities regulation is also a difficult, idiosyncratic, archaic area of the law. Standards and principles based on US securities regulation inevitably subsumed obsolescent concepts, especially in an area as fast-moving as the capital markets.

Early standards and principles failed to recognize the diversity and complexity of capital markets. The 1998 International Disclosure Standards for Cross-border Offerings and Initial Listings by Foreign Issuers (largely copied from the US Form 20F) was, in effect, only applicable to equity securities.[15] Some 10 years later, a separate set of principles appeared, specifically applicable to debt securities. Equally little heed was paid to differences in legal systems, constitutional imperatives or regulatory approaches when formulating and implementing the international standards.[16]

The FSAP exercises produced ratings based on the level of compliance with international standards, creating expectations among institutional investors. Regulatory initiatives could be adopted simply to influence these ratings and signal compliance to the international markets. Where inappropriate or ineffective, these regulatory initiatives constituted a monumental waste of time and effort, squandering scarce regulatory resources.[17]

The creation of the FSF, and later the FSB, under sponsorship of the G7 and Group of Twenty, respectively, added a new political dimension

10 It is important to note that the FSAP process makes use of a set of 12 different international standards, not just the IOSCO Objectives and Principles of Securities Regulation. Note also that the FSAPs led by the IMF/World Bank should not be confused with the European Financial Services Action Plan (1999), sometimes also referred to as the FSAP.

11 A peer reviewer to this piece commented that perhaps the area of privilege has narrowed and become less obvious. Global banks and global law firms (and, to some extent, global accounting firms) may in general exercise less influence than before, producing greater transparency. Nevertheless, in some areas influence is still substantial and market operations worryingly opaque.

12 IOSCO does not conduct the FSAP exercises; the IMF and the World Bank do.

13 For example, the SEC has only partial and somewhat limited jurisdiction over derivatives and derivatives trading, jurisdiction that it shares with a rival regulator, the Commodities and Futures Trading Commission. This was particularly true prior to the enactment of the Dodd Frank Act (2010): the jurisdiction of the SEC over derivatives products (especially "swaps") had been unclear and then specifically prohibited by the Commodity Futures Modernization Act 2000.

14 Although at least one IMF official identified the US refusal to permit an FSAP to be conducted in the United States as the reason the IMF was blindsided (for the second time in a decade) by a full-blown financial crisis (2008).

15 London solicitors pointed this out in 2001 as part of their critique of incorporation of IOSCO standards by reference into the proposed EU Prospectus Directive. The European Union was primarily a debt market, not an equity market.

16 The law and finance literature justified the use of common law concepts even in civil code countries, since the literature postulated that the legal systems of the latter provided "weak" investor protections.

17 See e.g. Charles K Whitehead, "What's Your Sign? International Norms, Signals, and Compliance" (2006) 27 Mich J Intl L 695.

to international standard setting. IOSCO was no longer in control of its own standard-setting agenda. New regulatory objectives, sometimes difficult to reconcile with traditional regulatory goals of investor protection, were dropped into international standards, systemic stability being a prime example. For members with enough clout, the international standard-setting apparatus could be put in motion to bypass a domestic regulatory impasse.[18]

Increasingly, there is a view that certain kinds of activity are more or less impervious to the application of international standards; these activities are inherently local and need to be addressed at the local level. Market conduct, for example, sensitive to the particularities of market structure and practices, and dependent on local enforcement measures, falls within this category. Going local makes more sense and produces better results than recourse to international standards.[19]

Going beyond International Standards

The goal of this policy brief is to identify useful areas for further research and consideration. Recourse to international standard setting has become an ingrained response to both cross-border and domestic regulatory issues. It is not easy to think beyond international standards. But without doing so, international standards will continue to recycle outdated concepts or validate inappropriate approaches, resulting in potentially ineffectual regulatory action.

A first step would be to jettison the idea that there is one particular set of international best practices. There can be multiple approaches, depending on particular circumstances. Equally worthy of the dustbin is the notion that regulatory harmonization and convergence are either inevitable or desirable. IOSCO has already nuanced its position on harmonization as an ultimately desirable objective in and of itself. The major capital markets — the European Union, the United Kingdom, the United States and now China — are looking to develop regulation tailored to the specifics of their own markets and their aspirations for them. Acknowledging that markets may be diverse and idiosyncratic requires acceptance that their regulation may be so as well. This is not to deny the utility of continued coordination.

This recognition would have implications for the FSAP exercises of the IMF and the World Bank. As with modern grade school report cards, ratings and rankings would be dispensed with in favour of a more nuanced and subjective form of assessment.

A means of breaking the grip of consensus thinking in the formulation of international standards should be devised. The emphasis on consensus stifles audacity and innovation in confronting regulatory issues. A dedicated laboratory or workshop that would encourage thinking outside the box, questioning and testing the assumptions of capital markets regulation, would be welcome. The SEC has long made use of "concept releases" to float trial balloons with new ideas so as to stimulate discussion among market participants, without necessarily committing to a course of action. IOSCO may not be a natural forum for such activities, but it could perhaps act as a clearing house for work produced elsewhere. In moving from speculation to implementation, putting theory into practice would require action of course. There may well be IOSCO members who would be interested in limited scope experimentation with new regulatory techniques.[20]

In terms of alternatives to international standards, it might be worthwhile to also consider the development of model laws, tailored to specific kinds of economies and providing a menu of optional approaches. In the aftermath of the breakup of the former Soviet Union, and the later

18 The US SEC had long wanted to regulate the operations of US credit-rating agencies, but was unable to garner the domestic support to do so. Although the regulation of credit-rating agencies was of little importance to most jurisdictions in the world, nevertheless IOSCO produced multiple codes, principles and studies, for what was quintessentially a US domestic regulatory issue. See Cally Jordan, "The New Internationalism? IOSCO, International Standards and Capital Markets Regulation", CIGI Paper (forthcoming 2018).

19 A peer reviewer of this policy brief queried whether this increased emphasis on the local nature of capital markets regulation was a consequence of the inadequacies of international standards (as the brief notes) or an indication of greater market fragmentation. Separately, the reviewer asked, is IOSCO becoming less relevant as the major US broker/dealers are now part of banks and the major European ones have always been a part of banks? To what extent could a shift away from IOSCO represent a greater emphasis on banking regulation?

20 Some jurisdictions have created regulatory "sandboxes" within which regulatory changes operate, thus containing potentially undesirable and unexpected consequences.

blossoming of Asian capital markets, experts and consultants travelled the world producing a flurry of country-specific corporate and securities laws — many of which, like international standards, disappointed. Academics and policy makers puzzled over why "good law" would fail, sometimes identifying "poor enforcement" as the culprit.[21] With the benefit of hindsight, there may be good lessons to be taken from these experiences.[22]

Surprisingly, despite the frenetic legislative activity of the last 20 years, there are still regulators searching for regulatory models compatible with their legal systems and economic circumstances. The problem can be particularly acute in smaller economies, irrespective of the level of economic development. Regulatory disarray, in the United States and the United Kingdom (both of which have provided models in the past), has not been helpful. In any event, US and UK legislation can be problematic as a model: too complex, dependent on sophisticated financial and legal practitioners for implementation, and common law specific. The European Union, in regulatory high gear since the global financial crisis, may be looking at capital markets with fresher eyes, producing better models, especially for smaller economies.

Producing a set of variegated model laws for capital markets regulation could be a challenging long-term endeavour, at a time when there are urgent, pressing concerns in the markets. Nevertheless, urgency — together with a spirit of innovation and experimentation — can produce desirable results. Finding the best forum in which to produce model laws, and keeping the process depoliticized, might prove to be the greater challenges.

Author's Note

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21 See Daniel Berkowitz, Katharina Pistor & Jean-Francois Richard, "Economic Development, Legality, and the Transplant Effect" (2003) 47:1 European Econ Rev, online: <https://ssrn.com/abstract=290000>.

22 A peer reviewer wondered, as an alternative to model laws, why no capital market "treatise/white paper/restatement" has appeared, one that would identify the basic principles that regulation should address, presumably applicable to all markets, but without adopting a particular approach as to how those principles are implemented. The IOSCO Objectives and Principles of Securities Regulation did in fact attempt to do this. However, the process of creating the IOSCO Objectives, as an IOSCO initiative, was restricted to regulators, primarily developed economy regulators lacking serious research capabilities, and later working in concert with bodies such as the IMF, the World Bank and the FSB. Analysis by academics, think tanks and other interested parties was lacking. Arguably, the European Union, with its depth of resources and natural multiplicity of viewpoints, might be a better locus for creating such an instrument. Alternatively, a consortium of multidisciplinary academic institutions might be an even better venue, in terms of producing a series of treatise-like reports. As always, neutrality and objectivity are hard to come by in such an exercise, which is often captured by hegemonic forces.

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