

# The development of the global markets as rule-makers: engagement and legitimacy

JULIA BLACK

London School of Economics and Political Science

DAVID ROUCH

Freshfields Bruckhaus Deringer

*The first article in this series<sup>1</sup> assessed the extent to which the markets are able to act as rule-makers and the nature of the “normative arena” in which they do so. This article considers how their role could develop and the implications of that in terms of market engagement in the rule-making process and legitimacy. The final article in the series will look at some of the risks this changing landscape creates, particularly in the context of dispute resolution and enforcement.*

## A. The future of the normative arena

The extent of the normative arena – the space within which the markets are instrumental in formulating rules – is set by a number of factors. Many are ultimately the domain of the public sector. But there is an increasingly symbiotic relationship between the public sector and the markets in setting and implementing standards. The future of markets as rule-makers must therefore be seen in the context of the changing role of the public sector in financial governance and, in particular, the sort of standards and rules it is likely to generate.

It is not realistic to talk of an international regime for financial governance if by that we mean Napoleonic design. However, national governance is exercised within an increasingly global environment, in which the financial markets are one of the dominant creative forces. As a result it is being rearticulated by reference to a complex network of regional and global legal and political groupings, both in the financial sector and beyond. This has produced something that can legitimately be described as a system of international financial governance which, if current trends continue,<sup>2</sup> can be expected to provide the basis for something more formalised. Part of that process is likely to involve a growing convergence of domestic regimes with international standards and systems, although harmonising some legal frameworks relevant to the financial sector, such as insolvency and property law, can only ever be a very long-term project.

Political and legal fragmentation is one of the main motivations for formulating market-based, private law solutions and for using regulatory principles which help to create a space within which the markets can make rules. Growing convergence could therefore suggest a diminished role for

the markets as rule-makers. However, that is unlikely to be the case; high levels of fragmentation will persist in some areas for the foreseeable future and, even with convergence, factors such as the dynamism and complexity of the markets are likely to sustain the need for market rule-making.

### 1. International financial governance

Increasingly complex interaction between nation states and regional and international bodies has resulted in a series of relationships that can be regarded as a system of global financial governance.<sup>3</sup> The process is often at its most intense following moments of systemic stress, although that is not the only stimulus.<sup>4</sup> Current financial conditions have resulted in a further surge. However, even before that, there was a growing pressure for greater public sector coordination in its response to the international financial markets.<sup>5</sup> The development of international governance in the financial sector seems likely to be concentrated through these bodies for the foreseeable future and lead to a growing formalisation of relationships. That is partly because they are in place already and the need is immediate – markets tend not to wait for perfection, but to work with what they have.<sup>6</sup> More positively, it is important not to understate the role of intelligent design; while each element in the structure has been established in response to particular needs, this has not been an isolated process – which is why the result is sufficiently coherent to be described as a “system”.<sup>7</sup>

Many of the participants in this system produce sets of standards and principles that are relevant to the shape of the normative arena. Key elements in the system are the Financial Stability Forum (FSF) and the International Monetary Fund (IMF). Both have gained even greater prominence by the need to respond to current market conditions, which

could lead to a further formalisation of their role.<sup>8</sup> The FSF was the child of the G7 which also takes a strategic lead in setting regulatory priorities;<sup>9</sup> it was the G7 that commissioned the FSF to establish a working group of national and international bodies to assess the causes of recent turbulence and to recommend appropriate responses;<sup>10</sup> more widely, in February 2007 it also announced its aim of “G7 free trade in securities based on mutual recognition of regulatory regimes”, which, given the gravitational pull of those economies, could eventually have implications ranging well beyond the G7.<sup>11</sup>

The FSF and IMF bring the coherence necessary to speak of an international regulatory system in a number of ways. The mandate of the FSF includes identifying and overseeing action to address vulnerabilities in the international financial system, improving coordination between the responsible authorities. It describes itself as giving momentum

“to a broad-based multilateral agenda for strengthening financial systems and the stability of the international financial markets . . . [with] the necessary changes . . . enacted by the relevant national and international financial authorities.”<sup>12</sup>

It maintains a compendium of standards that have international recognition as being important to a stable financial system, 12 of which it has identified as deserving priority implementation because of their particular importance.<sup>13</sup> The standards-setting bodies include the Organisation for Economic Co-operation and Development (OECD), the International Accounting Standards Board (IASB), the Basel Committee, the International Organization of Securities Commissions (IOSCO), the International Association of Insurance Supervisors (IAIS) and the Financial Action Task Force (FATF). Many of the same standards and codes are also used by the IMF and World Bank in their Initiative on Standards and Codes, in particular through their Financial Sector Assessment Programme.<sup>14</sup> This involves assessing national regimes for compliance with the standards concerned. The purpose of this is to provide a focus to discussions between the IMF and World Bank and national authorities concerning the soundness of national financial systems. It can also form a basis for private sector risk assessment.<sup>15</sup> Consequently, the wider group of bodies that set these standards can also be viewed as elements within an international financial governance system. As with the FSF, much of their emphasis has been on matters of financial stability, systemic risk and the avoidance of international crime. However, as already noted in the case of G7 securities convergence, some of them increasingly appear to pursue broader policy objectives. Their standards relate both to the manner of regulation and the behaviour of the regulated. The membership of the standards-setting bodies is generally comprised of public sector representatives from individual nation states.<sup>16</sup> By becoming members they agree to seek to apply standards set by the relevant body in discharging their domestic regulatory duties.<sup>17</sup>

If it is argued that a system of governance requires coercion, it must be conceded that these bodies have little by way of direct enforcement powers. However, many nation

states endorse these standards, and the transparency brought by IMF and World Bank monitoring leaves the market to “punish” non-compliance. Jurisdictions with a poor compliance record may find it harder to attract inward investment or may have to pay a higher price for it. The effect is steadily to embed global standards (and, in particular, principles) in national law and regulation with its attendant enforcement mechanisms.<sup>18</sup>

There are areas of financial law where the move towards international standards has been more faltering and which, as indicated in our first paper, tend to set hard limits to the normative arena. The most notable are contract, property and insolvency law. The areas of law concerned are less susceptible to integration by reference to principles or to private law solutions; the creation of international systems would generally require detailed legal reform at a domestic level and existing differences reflect sometimes deep-seated cultural divergences. Nonetheless, internationally recognised bodies are active in seeking harmonisation in these fields: the United Nations Commission on International Trade Law (UNCITRAL) and others in the area of insolvency<sup>19</sup> and Unidroit<sup>20</sup> and the Hague Conference on International Private Law<sup>21</sup> in the area of indirectly held securities. Although it is strictly a private sector body,<sup>22</sup> it is also worth mentioning the success of the International Chamber of Commerce Uniform Customs and Practice for Documentary Credits (UPC 500) in helping to establish a harmonised international approach to letters of credit.

## 2. Regional and bilateral architectures and dialogues

Public sector standards-setting does not only take place at an international level. Regional and bilateral activity between nation states is also affecting the shape of the normative arena. It is easier to achieve consensus between smaller groups of states. It is therefore little surprise that regional architectures are sometimes more formalised, in particular, the EU,<sup>23</sup> but also those developing through bilateral and multilateral dialogues, most notably that between the US and the EU. The potential for regional and multilateral rule-making to have a wider impact on international standard setting has already been noted in the case of the G7 goal of mutual recognition for Member State securities rules. A more obvious example is the steady expansion of the EU.<sup>24</sup> Where significant national groupings are able to reap the benefits of more liquid markets or lower systemic risk by establishing common standards and systems of governance, this can provide an incentive for others to harmonise and bring themselves within the same system and allows the original group concerned to dictate the terms.<sup>25</sup>

Regional experiences can also generate important know-how, relevant to the wider international governance process. The EU project is a case in point. With the original legislative phase of the Financial Services Action Plan complete, the emphasis is now on how to achieve detailed consistency of implementation and application between nation states within the legislative framework.<sup>26</sup> In this respect the “Lamfalussy Level III committees”, ie, the

Committee of European Banking Supervisors (CEBS), the Committee of European Securities Regulators (CESR) and the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS), are likely to gain in significance as fora within which that process will take place. Their role in the EU harmonisation process has been subject to recent consultation which covered, among other things, the balance between the common will and local autonomy. The EU Commission has now published its proposals.<sup>27</sup> The outcome may help to provide a model for wider harmonisation dialogues in due course, particularly because of the broad spectrum of markets it has to embrace, all at varying stages of development. One possibility was a “hardening” of the Level III guidance generated by the Committees towards a rule-based model, with enforcement powers and majority voting. However, the EU Commission’s proposals are more closely aligned with those who argued for a looser arrangement giving greater prominence to co-operation by reference to agreed principles-based outcomes.<sup>28</sup>

The move towards regulatory convergence and mutual recognition between the US and EU markets is also likely to exert an important influence on the wider international financial governance structure and the sort of rules it generates in the years ahead.<sup>29</sup> There has been an informal Financial Markets Regulatory Dialogue between EU policy-makers since 2002. However, the convergence process gained considerable momentum during 2007 at all levels – political, regulatory<sup>30</sup> and in the private sector<sup>31</sup>. Among other things, following the signing of the Framework for Advancing Transatlantic Integration in April 2007, a “lighthouse priority” financial markets work programme was established to be overseen by a newly formed Transatlantic Economic Council.<sup>32</sup> While the process is currently being overshadowed by the immediate need to respond to turbulence in the financial markets, it was announced in February 2008 that US and EU regulators had been mandated to intensify work on a possible framework for EU–US mutual recognition for securities in 2008, one of the objectives identified in the Framework.<sup>33</sup>

Mutual recognition is a dominant theme in discussion of EU–US convergence, involving reliance on another state’s regulatory regime to produce certain agreed regulatory outcomes over detailed harmonisation of rules. This is of particular interest in the current context because of the way it could begin to align a regional partially principles-based financial services regime (in the form of the EU) with a rules-based national regime, through the use of broad principles in preference to detailed rule-making. As the states involved are all members of or are closely associated with the international standards-setting bodies referred to earlier, their national regimes already reflect those international principles to varying degrees and those principles could come to inform consideration of how to achieve greater convergence. The EU–US initiative demonstrates the increasingly multilayered nature of public sector rule-making. It also suggests the way in which local standards in financial sector governance could increasingly converge around ever more focused regulatory principles, progressively descending from the high-level standards currently set through participation in international bodies. The growing

emphasis on principles-based supervision at a national level noted in the first paper,<sup>34</sup> also appears to feature in this process. It holds out the possibility of an international space created by increasingly principles-based alignment of national regimes in which markets act as rule-makers in applying principles to their business.<sup>35</sup> The potential implications of this in terms of private sector engagement are considered below.

### 3. Supervision of international groups

The pressing need for national regulators to co-ordinate their supervision of financial groups operating in multiple jurisdictions is likely to give further impetus to a convergence of local and international standards. The effective supervision of international groups has long been a concern of regulators, but is understandably receiving renewed attention as a result of the recent turmoil in the financial markets.<sup>36</sup> Regulators currently use a range of tools to bring coherence to their relationship with international groups. In addition to the use of “lead supervisors”, the most notable of these are “colleges of regulators” with an interest in a particular corporate group that seek to co-ordinate supervision and share relevant information, and memoranda of understanding whereby regulators agree how they will rely on each other in respect of aspects of their regulation of international groups. Arrangements such as these are driven by the limitations of the international regulatory architecture and the continuing importance for domestic regimes of being involved in the regulation of institutions which are systemically important to them. These factors are likely to sustain the need for multilateral regulatory co-operation for the foreseeable future. As the process is increasingly enabled by domestic law reform, it is likely to add to a more intensive international regulatory dialogue and more harmonised standard setting.

### 4. Public sector rules output: the search for coherence

It has already been suggested that these multilayered processes could foster a move towards more harmonised principles-based regimes. Current discussion of how to achieve coherent public sector rule-making in the international financial markets seems consistent with this.<sup>37</sup> Indeed, all of the methods under consideration are likely to foster a move towards more harmonised, increasingly international, standards potentially enlarging and rationalising the space for market rule-making. Three basic approaches are commonly identified: (i) harmonisation of rules, (ii) mutual recognition and (iii) the creation of “unregulated spaces”. They are not mutually exclusive; indeed, in the current highly fluid environment it is possible to see all three being pursued simultaneously. For example, the EU project shows how the first and second are closely related. Equally, they are not necessarily interchangeable; in some cases there are obstacles that can only ultimately be addressed by detailed harmonisation.<sup>38</sup> The retail markets are a case in point. The absence of a harmonised regime is only one of a number of

factors that means that retail investors still tend to have a domestic bias in their financial affairs. However, the European experience tends to suggest that relatively detailed rule-making would be needed to achieve it. The emphasis of current convergence work is therefore on the wholesale markets. Current conditions have focused attention on sorting out some of the regulatory architecture in areas more directly related to financial stability, but this need not necessarily delay the wider convergence agenda. Indeed, it could act as a catalyst for all three types of rule making. However, even “quick wins” could take some years to realise.

The early European experience has shown the challenges of the first approach detailed rules harmonisation. As indicated previously, this difficulty has also been an important motivation for resorting to principles in international standard setting. In view of that, where detailed harmonisation takes place, it is likely to be a long-term project or to be confined to some of the regional or bilateral contexts identified above, albeit with the potential for a wider gravitational pull on others. The emphasis of rules harmonisation projects is therefore more likely to remain at the level of principles and outcomes, leaving space for markets as well as domestic regulators in the standards-setting process, such as that conducted by the “Level III” committees under the EU Markets in Financial Instruments Directive (MiFID), noted above. However, that does not exclude the possibility of more detailed rules harmonisation, for example, in cases where attempts at mutual recognition flounder over lack of consensus as to areas of detail.<sup>39</sup>

Mutual recognition<sup>40</sup> appears to be a more realistic proposition in some areas, particularly given the success of the process of mutual recognition of international accounting standards.<sup>41</sup> It involves an acknowledgement by regulators in one jurisdiction that another regulatory regime achieves their desired regulatory outcomes, albeit by a different approach.<sup>42</sup> However, it is important to be realistic about the extent to which this level of trust can be developed and not to underestimate the scope for details to get in the way; it cannot be entirely divorced from the concept of harmonisation since a degree of alignment is needed in order to achieve mutual recognition.<sup>43</sup> Like harmonisation, a process of mutual recognition could also involve “gravitational pull”, with additional states entering the mutually recognised space once they achieve a satisfactory level of regulation.<sup>44</sup> In a sense, mutual recognition is, again, a resort to principles, since it involves regimes being assessed by reference to the extent to which they achieve a set of defined regulatory outcomes and not the detailed rules that underpin the process.

The third approach, of creating “unregulated spaces”, clearly leaves the most room for the markets to set their own standards. It would involve more regulators developing approaches similar to the UK’s overseas person exemption<sup>45</sup> or private placement exemptions where regulation achieves no obvious net benefit. The European Commission is currently consulting on whether to introduce such a regime for the sale of investments across the EU to supplement that provided by the Prospectus Directive.<sup>46</sup> However, even this approach presupposes some convergence of rules as to the perimeter of the regulated space.<sup>47</sup>

## B. Engagement: the development of market rule-making in the normative arena

The stimulus given by fragmented legal regimes to market rule-making is unlikely to disappear in the foreseeable future. However, as indicated in the first paper, even without it there would still be compelling reasons for policy-makers to involve the markets in rule-making, and public sector receptiveness to this currently appears to be surviving events in the credit markets. If, as suggested above, in the years ahead there is a dual process of international convergence around common principles combined with increasingly principles-based approaches by national regulators, how might this affect the role of the markets as rule-makers? It seems likely that it would give further impetus to existing trends. Among other things, the role of the markets in rule-making is likely to be increasingly multilayered but with an increasing tendency for standards set at one level to influence the development of those set in another. The number of rule-making fora is increasing, and the process of market rule-making can also be expected to become faster, broader and deeper than at present.

First, the processes considered above clearly operate at many levels – internationally, regionally and nationally. It therefore seems likely that market standards-setting will also increasingly occur in numerous fora, whether it relates to the process of interaction with the public sector in the formulation of broad principles (ie, at the macro-level<sup>48</sup>) or in developing the more detailed standards that operate underneath them (ie, at the micro-level). The precise nature of that engagement would necessarily vary by reference to the situation concerned and yet is unlikely ever to take place in isolation. As with the processes of international and regional rules-convergence considered above, standards set and experience gained in one context may influence those set in others – an interpenetration of standards between different fora. A good example of this is the standard of fairness which occurs in a range of regulatory and legal contexts. To identify a few, the requirement to treat customers fairly appears in IOSCO’s International Conduct of Business Principles and Article 19 of MiFID and hence in the financial services rules of all EU Member States, including the Principles and Rules of the UK Financial Services Authority (FSA). Looking beyond the EU, the regulatory regimes in Bahrain and Dubai do not have a general requirement to treat customers fairly, but they do require “fair” promotions and “integrity and fair dealing” on the part of regulated firms. There are important cultural determinants of what is regarded as “fair” in any given situation, so that “fairness” in one market may not necessarily equate to “fairness” in another. However, where the same institutions and individuals are engaged in standards setting in multiple fora by reference to a similar standard, it seems likely that they will carry understandings applied in one into their engagement in another, so informing the standards-setting process in a different context.

Secondly, the spaces within which market standards-setting can take place seem likely to multiply, aligned around international standards. Emerging markets that want to join the international financial services markets have so far shown



themselves sympathetic to the need to align their rules with international standards.<sup>49</sup> They frequently do not have exhaustively formulated standards and have therefore tended to look to existing models and those with expertise to help put them in place. This process has been particularly notable in a number of the Middle Eastern jurisdictions. To give a few of the more obvious examples, the regime in Dubai is similar in many respects to that in the UK, and Qatar is currently moving down a similar route.<sup>50</sup> There are also similarities between parts of the Saudi Arabian financial services legislation and the UK Financial Services and Markets Act and regulatory standards in all of these states together with Bahrain have been developed by reference to the international principles of IOSCO, the IAIS and the Basel Committee.<sup>51</sup>

Thirdly, the increasing mobility of individuals and the increased ease of communication is likely to result in an acceleration of the transmission of standards and the formation of new ones. Investment professionals, legal and compliance staff, professional services providers and regulators move from New York to London and on to Japan or Dubai or China and carry ideas and experiences from one context into another. A good example on the public sector side is the current chairman and CEO of the Qatar regulatory authority, Philip Thorpe, who is currently involved in establishing a financial services regime in Qatar calibrated to international standards. His initial experience was gained in the UK regulatory sector. Before being appointed to his current post he acted in a similar capacity at the Dubai Financial Services Authority. Cosmopolitan centres such as London may have a particular role in this process of transmission as a meeting place of cultures and standards. But individuals do not even need to move. The process of standard-setting is increasingly facilitated by the same technologies that underpin international markets. Consideration of a particular standard does not need to be confined to those physically present in the same room but can easily involve large numbers of participants joining from a range of jurisdictions in the form of mass conference calls. Draft standards can be rapidly disseminated to and commented on by multiple recipients across the Internet.

Fourthly, the growing opportunities for industry to influence standards at a macro-level and its need to interpret standards at a micro-level should lead to broader and more deliberate engagement with the standards-setting process from all with an interest in it. A variety of interests needs to be considered.

- The role of international financial services groups is critical. They must confront most starkly the challenge of simultaneously operating internationally and locally. Their experiences will continue to drive and inform the standards-setting debate. However, standards require consensus which can only emerge as a result of communication between market participants. At a micro-level, some of that communication takes place on a day-to-day basis as firms and their advisors grapple with the legal and regulatory context in which they operate. However, there is an increasingly important role for more formal dialogues in order to agree approaches to macro standards

setting and to understand what is appropriate when seeking to operate in accordance with principles at a micro-level.<sup>52</sup>

- These patterns also suggest that the role of industry associations will continue to grow as catalysts and fora for industry standards-setting and in the process of articulation. The industry associations have already demonstrated their importance in the normative arena. More regular and intensive engagement by industry associations may lead to greater formalisation of the processes by and through which that happens. We have noted the growing tendency of the public sector to engage in a dialogue with industry as part of its rule-making process. It is likely to be more attractive to public sector bodies as they do that to have something offered to them as the “view of the industry” mediated through a single point of contact. It is important not to forget the significance of practical issues in this respect; not all of the international regulatory committees are well resourced. It is not easy for wealthier nations to remedy this simply by providing greater funding, because of concerns as to impartiality. If industry associations are able to go to them having already worked through proposals with a substantial part of the market, there is a greater prospect of their being adopted. That is not to suggest that individual financial institutions will not maintain a separate voice or join with others in presenting a particular point of view separately from industry associations. But given the complexity of the engagement process, it may be expensive to do so and their voice can only ever represent the views of one participant, however significant. For the same reason, smaller institutions may come to rely increasingly on industry associations alone to represent their interests especially in macro standards setting.

Separately, it is clear that there are benefits for industry participants grappling with the practical outworking of regulatory principles at a micro-level of engaging in an interpretive dialogue in the context of industry associations. In this way, it is possible for individual firms to derive a sense of the standards and practical approaches being adopted by other participants. Finally, as the importance of market rule-making becomes clear, those associations that are currently less active in standards setting may engage more fully to ensure that the interests of their particular sector are properly taken into account. Industry associations address the interests of their members and not anyone else, and one association pressing the interests of its members could have a negative effect on other industry sectors unless their interests are properly represented as well.

As the industry grapples with the challenges of encouraging public sector action on convergence, it also seems likely that there will be cases of co-operation between industry associations on issues that are of common interest to a range of industry sectors. There are already important examples of this such as (i) the work of the International Council of Securities Associations on regulatory convergence; (ii) the EU-US Coalition on Financial Regulation bringing together eight trade associations to press for EU-US rule convergence and mutual

recognition; (iii) the work of a number of industry associations in seeking to agree consensus positions on the implementation of the EU MiFID in the London market in the form of “MiFID Connect”; and (iv) the current joint industry association initiative to formulate agreed standards for the distribution of structured products outside the institutional marketplace.<sup>53</sup>

- International professional services firms that have grown out of the UK and US have long been active in the process of helping to formulate and refine proposals for regulatory reform. As firms like these and their clients continue to internationalise their operations they will need to engage increasingly with the processes described above. They will also be an important port of call for those seeking to apply legal and regulatory principles to their business. Because of the range of firms they advise, they will often have a better sense than the firms themselves of the standards being set by the market. But each situation is different, and as they seek to help clients plot a course through principles-based regimes, they will be actively engaged in the process of defining the standards themselves. Finally, we noted above the tendency for emerging markets wishing to align themselves more closely with the international financial markets to look to more developed markets in modelling their regimes. They also look to international law firms to help them and the international firms have already played an important role in this process of exporting regulatory standards. Inevitably, in doing so, those firms will have reference to the regimes with which they are already familiar and their view of the direction that international regulation will take.

Fifthly, engagement will need to be deeper at the micro-level in those jurisdictions that move towards regulatory principles as the basis for their regime. Regulatory principles tend to broaden involvement in the compliance process. Exclusive control is taken out of the hands of compliance departments. Greater emphasis is placed on the individual day-to-day decisions of investment professionals, with compliance teams increasingly operating as a catalyst for appropriate behaviour and monitoring the extent to which it is happening. This can require a significant reorientation, a subject that has already occupied the minds of regulators. The first paper drew attention to the IOSCO Model Code on Ethics.<sup>54</sup> But the issue has received attention more widely. The importance accorded to creating the right culture in achieving regulatory principles is clear in the work of the UK’s FSA. It issued an early discussion paper on the subject in October 2002 although that initiative has now been subsumed within its subsequent work on principles-based supervision.<sup>55</sup> A more recent example is the objective that the FSA has given firms subject to its “Treating Customers Fairly” initiative to be able to demonstrate by the end of 2008 that they have established cultures that support that standard.<sup>56</sup> It is notable that the growing emphasis on individual responsibility for principled behaviour has taken place at a time of renewed interest in moral philosophical circles in virtue ethics which places character formation over rules or consequences in producing ethical outcomes.

Finally, all of the elements in the engagement process described above are likely to become more genuinely international, introducing new cultural and ethical expectations and norms into the mix. The standards-setting dialogue at present is frequently dominated by institutions with a substantial presence in the European and US markets. As new capital markets develop in jurisdictions such as China, India and the Middle Eastern states, they will expect a clearer voice and, judging by the size of the potential markets, they are likely to get it. Their influence is also likely to be felt over time through the changing ownership of firms participating in the markets and of market infrastructures. The current market turmoil has accelerated this process with the recent resort by a number of the international banks to the “sovereign wealth” funds of China and the Gulf states. At present, they are viewed as “passive” investors, but if their stake increases, it seems most unlikely that it will remain that way.<sup>57</sup>

Thus, it is possible to foresee the emergence of something approaching a “legal and regulatory wikipedia”, operating at multiple levels in which the participants are the market, advisors, industry associations and regulators, but with the public sector acting as an arbiter of acceptability in relation to macro-level standards<sup>58</sup> and an umpire in relation to their practical implementation.<sup>59</sup> In that sort of environment, consensus tends to replace dominance in establishing standards. If so, the ability to foster mutual understanding and to build relationships of trust may be important skills combined with “thought leadership”<sup>60</sup> for those wishing to define the debate.

## C. Legitimacy

The prevalence of private rule-making in the “normative arena” raises the question of its legitimacy. In whose name and by what authority are rules made, and to whom are the rule-makers accountable? On the other hand, since the rule-makers are non-statutory and the standards they produce are voluntary, we could ask whether it matters if they are legitimate or accountable, or at least whether the problem has been overstated. No one is legally obliged to comply; if market participants do not regard a rule-making body and/or its standards as legitimate, they can simply choose to ignore them. Standards are unlikely to emerge unless they command sufficiently broad consensus, and they are unlikely to be observed unless others accept them, so, surely there should be no issues of legitimacy in a competitive regulatory market? Yet, on the other hand, can we really say that the fact that others adopt the rules of a non-statutory organisation should be sufficient evidence of their legitimacy?

### *1. Issues of legitimacy and accountability in the global market place*

The scale and complexity of global financial governance structures do give rise to significant issues of legitimacy and accountability, for a number of reasons. First, private stan-

dards are not necessarily voluntary in practice, despite their “soft law” status. In practice, the marketplace may require compliance, with failure resulting in exclusion by other market participants (the “cold shoulder” given to those who would not accept the edicts of the UK Takeover Panel, for example). Or they may be required within the political community: nation states can find themselves subject to soft law norms through peer pressure, as they were for a time via FATF’s “blacklist” in relation to money laundering, or through the activities of third parties, eg, the World Bank and the IMF’s role in monitoring the observance of standards and codes issued by the transnational committees of financial regulators referred to above.

Secondly, soft law norms can “harden”. Market practices can be given judicial recognition, or can be incorporated into national legal systems. The adoption of the Basel II Capital Accord by the EU, the requirement, again by the EU, that Member States implement the International Financial Reporting Standards issued by the IASB, the incorporation of the FATF principles on money laundering in Australian money-laundering legislation and judicial recognition of the guidance issued by the Joint Money Laundering Steering Group in England and Wales are all examples of this form of “hardening”.

A third, related reason is that standards set by industry associations in particular may not be confined to their members but can be propagated more widely in the market by the organisation, or presented for adoption by the public sector as an alternative to regulatory intervention. Elements of this can be seen in current work by a number of international industry associations in developing a statement of good practice on the production and distribution of structured products.<sup>61</sup>

Finally, where a significant number of participants in the market chooses to operate in a particular way (whether as a result of an industry association code or otherwise) this can have an important impact on outsiders, be they other market participants, governments or consumers – capital rules have a direct impact on banking practices, which in turn can have significant consequences for consumers and manufacturers, as the credit crisis illustrates. The creation of these externalities raises questions as to whether those who are indirectly affected should have a say in what the rules should provide.

Issues of legitimacy and accountability are particularly acute in the case of transnational, non-state regulators and are being thrown into even sharper relief in the context of attempts to grapple with current market conditions. Despite the identification of an emergent global administrative law,<sup>62</sup> these initiatives are nascent and rudimentary. Transnational regulators do not (yet) operate within a constitutional framework. The usual panoply of constitutional mechanisms of accountability and legitimacy which characterises liberal democratic constitutional systems is not necessarily available.

Jurisdiction is a further complicating factor in the transnational, or at least cross-border, context. International standards-setting does not fit neatly within existing legal and territorial jurisdictional boundaries.<sup>63</sup> The mandate of the bodies through which it happens is uncertain, and it is not clear on whose behalf they purport to act and to whom accountability should be owed. In principal-agent terms,

who is the principal for whom these bodies are acting? Lack of jurisdictional boundaries and the problem of identifying “principals” complicate questions of who has a right to call them to account, and how the boundaries of their accountability should be drawn. If standards of democratic accountability are to be introduced, for example, who should be eligible to participate in that democratic process? If mechanisms of legal accountability, such as judicial review, are to be used, which courts have jurisdiction, and how should the jurisdiction of national courts relate to that of the dispute settlement mechanisms (where they exist) of transnational regulators?<sup>64</sup>

Even at a national level the mechanisms of accountability which apply to private rule-making bodies can be attenuated and uncertain. The extent to which the activities of non-state regulators give rise to duties in public law remains contested within England and Wales, for example.<sup>65</sup> On the other hand, the regimes which do apply to them may be inappropriate.

In particular, non-state regulatory bodies can find themselves on the wrong side of competition law, particularly because successful self-regulatory systems share significant features with cartels: members have a community of interests, and share a community of fate – if one goes down, all go down. Membership of the organisation (cartel) can be controlled by the members themselves, and expulsion can have significant reputational and/or economic consequences.

Historically, the state has struck a “governance bargain” with such organisations: granting them monopolies to regulate conduct over particular areas of social and economic life in return for delivery by the organisation of some form of social and economic order, with the implicit (or explicit) threat that the monopoly will be withdrawn should the organisation fail to deliver on the terms the state expects. Medieval guilds, regulation of the professions, the SROs which pre-dated the FSA are all examples of this “governance bargain” – and the Legal Services Act is an example of how the state can intervene when the organisation fails to deliver. The bargain can also be more implicit – the state does not bestow a legal monopoly on an organisation, but simply creates the space in which self-regulation can take place by refraining from regulating that area itself: for example, regulation of the press or, historically, the role of the Takeover Panel in regulating takeovers and mergers, and, more recently, the concept of financial services regulation by reference to principles considered above. But unless explicit legal recognition has been given, organisations that attempt to regulate particular areas of economic life by setting up strict rules of membership and conditions of conduct can find themselves falling foul of competition law, which may not be the most suitable means of public sector oversight. Moreover, even if legal recognition is given to a self-regulatory organisation at a national level,<sup>66</sup> this does not address one of the underlying structural causes of private standards-setting noted above: the mismatch between geographically bounded legal systems and global financial markets.

Further, and in particular where the functions of setting the standards and enforcing them are split between different actors, there can be the problem of “many hands”.<sup>67</sup> As we

have seen above, the different regulatory functions of identifying goals, formulating standards, monitoring and enforcement are often dispersed between a number of participants. This fragmentation of roles and responsibilities can have significant implications for all involved. If the organisation that sets the standards or draws up the rules is not necessarily the same body that will be enforcing them, a further degree of uncertainty and potentially legal risk is introduced for the person who is subject to them as the standards-setter does not have the authority to give final interpretations of its own standards. For the standards-setter, the need for regulatory interpretation makes their rules vulnerable to 'interpretive interference', for example final interpretations of their standards by national courts or other bodies which run counter to their own interpretations, and which could have significant consequences for market practice,<sup>68</sup> but which they do not necessarily have any opportunity to influence. Fragmentation also gives rise to problems of accountability. It is hard to hold the standards-setter to account for the ways in which the rules have been enforced; but potentially difficult to hold the enforcer to account for rules it did not write.<sup>69</sup>

Thus where there are a number of different organisations involved in devising rules at the macro- and micro-level and in enforcing them, the issue is not simply how to call to account a single organisation, but how to call to account a constellation of organisations. Is the appropriate course to identify one regulator and argue that the accountability of the others is derived from and dependent on the accountability of that regulator, as in hierarchical regimes (one for all)?<sup>70</sup> Or is the appropriate course to say that each regulator has to be individually accountable for the activities of the regime as a whole (all for one). Alternatively, should each actor be held accountable just for their own role within the regime (each for itself)? On the other hand, if there is no fragmentation – if those who write the rules are also the sole arbiters of their interpretation – this runs against constitutional values such as the separation of powers, concentrating power in the hands of one organisation to the potential disadvantage of both insiders and outsiders.

Finally, in accordance with what criteria should the legitimacy of such bodies be assessed? Are non-state regulators legitimate because they are comprised of experts, and/or because their rules are effective? Are they legitimate because they conform to norms such as openness and transparency, and their rules conform to Fuller's precepts<sup>71</sup> of being clear, open, prospective and stable? Are they legitimate because they encompass a broad range of participants, either geographically, sectorally or societally?

## 2. Assessing legitimacy

Before we can assess the legitimacy of rule-making within the normative arena, it is worth setting out what we mean by accountability and legitimacy. The two are analytically distinct, though in practice can be closely related. Very broadly, accountability is the means by which legitimacy can be assessed. Legitimacy, in the regulatory context, is an acceptance that a person or organisation has a right to govern both by those it seeks to govern and those on whose

behalf it purports to govern.<sup>72</sup> Those who produce rules may claim legitimacy, and may engage in various strategies in an attempt to gain legitimacy, but the extent to which they succeed depends on the extent to which these are accepted by others.

Here we return to the question raised above: what does an organisation have to do, or be, to be legitimate? Or more particularly, against what criteria is legitimacy assessed, and by whom? IOSCO's Model for Effective Regulation, for example, argues that self-regulatory bodies should, amongst other things, be expert, transparent, accountable, flexible, facilitate coordination and information sharing, and be defined within the context of government oversight.<sup>73</sup> FSA's Criteria for the Confirmation of Industry Guidance exhibit slightly different concerns. In order for guidance to be confirmed by the FSA, it must, *inter alia*, be publicly available and electronic copies must be free of charge; it must not affect the rights of third parties or be anti-competitive; and it must consider consumer interests and views where relevant, which may require consultation with consumer groups or the FSA's Consumer Panel.

We can organise the various legitimacy criteria which are applied to standards-setting bodies, both state and non-state, into four main groups. These are democratic, constitutional, performance and values- and objectives-based criteria.

- *Democratic criteria* are concerned with the extent to which decision-making in the body concerned is congruent with democratic models of governance: who participates, voting rights, veto rights and so on.
- *Constitutional criteria* concern conformity with legal values of procedural justice and other broadly based constitutional values such as consistency, proportionality, fair procedures and oversight by constitutionally established bodies such as national courts, legislatures or executives or international organisations.
- *Functional or performance-based legitimacy criteria* focus on the outcomes and consequences of the organisation, eg, efficiency, expertise or effectiveness.
- *Values- and objectives-based criteria* emphasise the values or ends which the body is pursuing. These may be macro-level goals such as efficient markets, sustainable development or free trade, or more specific sector-based goals.

However, there are challenges in using these criteria to "measure" legitimacy. The precise nature of each set of criteria is not settled. Thus there are different models of procedural justice;<sup>74</sup> competing models of democratic governance (representative, deliberative); different types of functional or performance legitimacy claims (financial, ethical, professional, economic); and obviously competing values and objectives.

There are also potential tensions between the four types of criteria. In applying them to a given situation, there is therefore a need for tradeoffs between them. For example there can be tensions between performance criteria such as speed and efficiency in decision-making and constitutional criteria such as procedural fairness, or democratic criteria such as participation. Or between performance criteria which focus on expertise and, again, democratic criteria which



require broad participation. Or democratic criteria which require broad participation and constitutional criteria such as individualised hearings. In addition, it is not always easy to identify measurable outputs or outcomes to assess whether objectives have been met.

Finally, different people within and outside the organisation may place more emphasis on one set of legitimacy criteria than another. The expertise of a standards-setter, for example, is highly valued by participants in the financial markets, even though this may mean that democratic criteria are compromised. On the other hand, public regulators may emphasise public oversight and broader democratic governance over, or at least as equally as, expertise. For example, the European Commission, IOSCO, the US SEC and the Japanese Financial Services Authority have stated that the IASC Foundation should establish a monitoring body to reinforce the public interest oversight function of the IASC Foundation Trustees and represent the interests of the wider investment community.<sup>75</sup> For these public authorities, expertise in accountancy is not a sufficient condition of legitimacy of the IASC, the IASB and the standards they produce. Regulators are thus likely to be subject to multiple legitimacy claims which differ between themselves quite substantially, and which indeed may be irreconcilable, a point to which we will return below.

### 3. Evaluating the legitimacy of private governance

As we have seen, there is a tremendous variety of bodies engaged in rule-making in the international financial markets, beyond national governments and legislatures. Despite this variety it is nonetheless possible to identify four broad forms of standards-setting or rule-making. In terms of what we have referred to as the “normative arena”, the first is different from the rest. That is because standards-setting at this level is essentially a “public sector” process, applying policy objectives in shaping the normative arena, albeit in a way that is informed and influenced by the private sector. It can nonetheless also be regarded as private in the sense that bodies operating at this level are only very indirectly subject to any form of democratic accountability.

- *Transnational committee standards-setting* in which transnational committees of governmental regulators produce standards for members to implement in their own national regulatory regimes, or to supervise their implementation by self-regulatory bodies within their jurisdictions. Obvious examples are IOSCO, IAIS, the Basel Committee or FATE. Their standards may also be adopted by non-members (eg, the adoption of Basel I and II standards by countries that are not members of the Basel Committee). The EU Lamfalussy Level III committees fulfil a similar function at a regional level, albeit operating within the EU legislative framework.
- *Transactional standards-setting* in which national and transnational groups of market participants draw up standardised documentation to facilitate transactions in particular types of securities. Examples include the documentation produced by ISDA, the Loan Market

Association (LMA) and the Global Master Securities Lending Agreement (ISLA).

- *Market standards-setting* in which national or transnational groups of market participants develop standards, guidance or codes of practice for industry participants. They are often trade associations, eg, the Chartered Financial Analyst Institute’s Code of Conduct for Asset Managers, Analysts and Investment Firms, or the International Capital Market’s Association draft Code of Conduct on Disclosure or ISLA’s UK Stock Borrowing and Lending Code and Guidance, and its best-practices documents. They may be comprised of groups of industry associations – eg, the International Securities Markets Advisory Group, which has produced the Code of Conduct on Clearing and Settlement, applicable in the EU, or in the UK, MiFID Connect, which has produced guidance on the implementation of various provisions of MiFID. Government can sponsor particularly high-profile individuals to develop codes: eg, the successive codes of corporate governance (Greenbury, Cadbury and Hicks) which comprise the Combined Code. Industry associations can do the same: eg, the role of the British Private Equity and Venture Capital Association (BVCA) in commissioning Sir David Walker to develop the Guidelines for Disclosure and Transparency in Private Equity<sup>76</sup> and the Alternative Investment Management Association (AIMA) in asking Sir Andrew Large to produce standards for the hedge fund industry.<sup>77</sup> In contrast, there may be standards produced by groups of market participants but for which no separate organisation is responsible, rather a co-ordinated network of market participants: the Equator Principles are a good example.
- *Individual standards-setting* in which individuals, or individual firms, develop standards that are then adopted by others. This can happen as a result of day-to-day legal and regulatory decision-making by the staff of financial institutions, with each decision with varying degrees of unconsciousness referenced to standards set by others in the market on the basis of word of mouth or previous experience. The process can also operate by reference to standards set by those not directly participating in the market: eg, standards developed by credit-rating agencies which are then used by other market participants and regulators; or the precedents produced by law firms; or the legal opinions issued by leading counsel. Although not developed for use by others, they may nevertheless become standardised throughout sectors of the market, and indeed be adopted by regulators themselves: eg, the use by regulators in developing markets of international law firms or individual legal practitioners to develop their public sector rules noted above.

Slightly different issues arise in assessing legitimacy in the context of each of these forms of standards-setting.

#### (a) Democratic criteria

The extent to which they meet democratic criteria, for example, varies with the relationship of the rule-makers with national governments: whether they are comprised of members of national governments, or overseen by govern-

ments in systems of outsourced or “meta regulation”; the level of rule-making they are engaged in – whether they are elaborating principles enshrined in law or developed by transnational committees of regulators or whether they are formulating their own; the degree to which they are internally democratic; and the extent to which those affected by their standards or on whom the organisation wishes to impose them can participate in their formation.

Transnational committees of regulators are subject to their own national systems of accountability, and are legitimate to the extent that their members are representatives of governments which are regarded as legitimate within their own nation states. For example, the EU Lamfalussy Level III committees have a relatively high level of democratic legitimacy within the confines of the EU model, although a theme in the current discussion of their future role is that of increasing their accountability.<sup>78</sup> However, they may fail against democratic criteria in that the extent to which they represent the international financial community varies significantly, from the broad membership of IOSCO and IAIS to the far narrower membership of the Basel Committee. This narrow membership becomes particularly relevant when such bodies develop standards that they seek to apply not only to their own members but to others as well – as in the case of the Basel Committee, FATF and the IASB. On the other hand, transactional standard setters, like market standard setters, may be regarded as less democratic in that they do not represent the state in any way, nor do they have a particularly clear criteria of membership, although in practice their membership may be broader than that of some of the transnational committees. This characteristic will often be shared by individual standards-setters.

#### *(b) Constitutional criteria*

The extent to which constitutional criteria are met varies, amongst other things, with the individual decision-making procedures operating at the relevant level of standards-setting, including the consultation processes applied; the structure and procedures of any enforcement and dispute-resolution processes; and the publication of rules. Despite its attempts to enhance its consultation practices, for example, the Basel Committee has still been criticised for paying insufficient attention to the needs of the BRICs (Brazil, Russia, India and China) and emerging economies. The extent of conformity to constitutional criteria of bodies setting transactional and market standards is spread over a broad range, but individual standards-setting frequently takes place with only limited reference to constitutional criteria.

#### *(c) Functional criteria*

The extent to which functional criteria are met depends on the degree of expertise and effectiveness the rule-makers are seen to have. The higher the degree of expertise and effectiveness, the higher the evaluation of their legitimacy on functional criteria. It is to preserve and ensure this expertise that membership of non-state rule-making bodies setting transactional and market standards has traditionally been confined to market participants, and not normally extended to consumers or other “public interest” representatives,

notwithstanding the resulting criticisms that such bodies are unrepresentative, and thus “undemocratic”. As indicated in the first paper in this series, it is partly because of this perceived expertise that those setting standards in the context of transnational committees are increasingly entering into a dialogue with transactional and market standards-setting bodies. Law firms and individuals also can have significant expertise and can play a prominent role in developing standards, both at the governmental level, as the example of Philip Thorpe given above, and at the private level. Prominent individual legal practitioners and law firms can in effect make rules through, for example, developing innovative legal devices which are then adopted throughout the markets, and may ultimately be given judicial recognition. Influential opinions of leading counsel can have a highly significant effect on the development of a market: for example, the opinion of Richard Potts QC in 1997 that credit derivatives were not insurance contracts is widely regarded as being the base on which the explosion in their use was founded. The Potts opinion has been accepted as legitimate and binding in the market not only because it suited the market, but because he was accepted as an authoritative voice in the market, and indeed beyond.<sup>79</sup>

#### *(d) Values- and objectives-based criteria*

Finally, and more intractably, the extent to which those setting rules are seen to meet justice criteria varies with evaluations of whether the objective of the rule-making is appropriate and justified. This in turn depends on the framework used for evaluation. That framework can range from micro- to macro-level; from policies on listing rules to models of financial capitalism. We highlighted above the likely dispersal of financial power from the US–UK/EU axis to include Asia and the Gulf. A single US model of financial capitalism in the international financial markets can no longer be taken for granted. This broadening of perspectives is, in turn, likely to have implications for assessments of legitimacy in rule-making both within the normative arena and beyond.

### *4. How do regulators respond to multiple legitimacy claims?*

The legitimacy demands made on those producing rules are therefore varied, often contradictory and frequently contested. The degree to which they are met by public and private rule-makers varies widely. Functional criteria are the most frequently met, but democratic, constitutional and values- and objectives-based criteria are often only partially satisfied, at best. But we cannot call for an increase in legitimacy and accountability without considering what the effects are likely to be. How will the “private” producers of regulation respond? Regulators, like any organisation, can attempt to manage their own legitimacy: building, maintaining and repairing legitimacy in response to demands made on them by others, and their own sense of what measures are both strategically advantageous and/or appropriate.<sup>80</sup> Just as those who are being regulated can respond to regulatory requirements by compliance, manipulation and

avoidance, regulators can respond to demands that they change their ways in order to become “legitimate” in similar fashion: adopting differential strategies of conforming, manipulating or avoiding attempts to render them legitimate and in turn accountable to different legitimacy communities.

They can also be proactive in building legitimacy through developing systems of public consultation, decision-making and reporting,<sup>81</sup> or linking themselves to other organisations that are perceived to be legitimate by those whose legitimacy claims they want to meet: signing up to “codes of practice” on good regulation, for example.<sup>82</sup> Another strategy is to change their internal structures, particularly changing their membership to meet demands that they become more democratic by broadening participation in their decision-making. The International Accounting Standards Committee Foundation provides a good example: it has already changed its constitutional structures and membership to enhance its legitimacy once since its formation, though, as we have seen, financial regulators in the US, EU and Japan are insisting that it do more.

However, changing to meet the demands of others can involve giving up strategies or practices regarded as valid or effective. Non-state regulators, as noted above, are particularly vulnerable as they do not have the authority of law (or legal sanctions) to fall back on, so may need to enrol others to help them enforce their rules. The price of that support may be high, however, and could mean regulators have to change in ways that would not otherwise. For example, when FATF called on the World Bank and the IMF to assist it in enforcing its principles on anti-money-laundering, the price for their support was the abandonment of its “black-list” of non-compliant countries, which FATF had otherwise regarded as an effective sanctioning tool.<sup>83</sup>

Moreover, as noted above, the criteria against which legitimacy is assessed may themselves be contradictory. Meeting one set of criteria may make it less easy to meet another. Broadening membership may make an organisation more “democratic”, but it can reduce its expertise and slow down decision-making, reducing its ability to function effectively. Faced with incompatible legitimacy claims, organisations have a legitimacy dilemma: what they need to do to be accepted by one part of their environment, within and outside the regulatory regime, is contrary to how they need to respond to another part. Even if the conflict between legitimacy communities does not lead to a dilemma, it can have a deleterious effect on the organisation as it seeks to respond to the multiple legitimacy and accountability demands being made on it, suffering “multiple accountability disorder”.<sup>84</sup> In other words, its attempts to respond to the multiple demands may diminish its chances of survival.<sup>85</sup>

### 5. Enhancing the legitimacy of non-state standards-setting

So how can and should the legitimacy of private standards-setting be enhanced? There is clearly no “silver bullet”, no quick fix which can be easily applied and which

would be equally appropriate for every non-state standards-setter, given the variety that exist and the competing criteria against which legitimacy is assessed. But three key insights can be drawn from the above, each of which gives rise to a critical question. First, that in enhancing the “legitimacy” of private standards-setters, conflict is inevitable and trade-offs have to be made. The real issue is who should make these trade-offs? Do we need to create “overseers” of this process – regulators of non-state regulators – or will the same force that lead to a development of non-state rule-making in the first place mean that the creation of such an overarching body is bound to fail? Secondly, standards-setters may not respond to demands to enhance their legitimacy and accountability in ways that can be easily anticipated: they may adopt manipulative or avoidance strategies, or may simply refuse. Whether they can be made to respond will depend in part on the degree to which they recognise a need for the support of whoever is making the demands. So how can we ensure their substantive responsiveness to demands to improve, in particular, their democratic and constitutional legitimacy? Thirdly, enhancing legitimacy is likely to come at a price. The question in the medium term is whether the private standards-setters consider it one worth paying. In the longer term, it is whether public sector regulation will develop in a manner that increasingly circumscribes their scope for choice.

## D. Summary

Current market conditions may stimulate higher levels of public sector regulatory activity in the short term and a growing consistency of approach over time. However, the factors that have been behind the development of the normative arena seem unlikely to disappear. The need to find ways of influencing and mediating between principles developed at a macro-level and their micro-level implementation will remain and could become more pressing. On that basis, it is probable that the nature of rule-making within the normative arena will demand increasingly sophisticated engagement by public and private sectors alike, raising complex issues of legitimacy. These are not easy to resolve in the absence of global governance frameworks or even, quite possibly, with them. In that sense, the process of seeking to remove or reduce uncertainties gives rise to new ones. An important question therefore remains as to the risks of not engaging in the normative arena, and the potential liabilities assumed by doing so. These are unlikely to be removed by the creation of ever more elaborate structures of law and financial regulation. Declining to engage entirely is not a realistic proposition in any event; it is not possible to participate in a market without at least understanding the standards under which it operates, and simply participating is, in some way, to become part of the standards-setting process. One of the most important sources of legitimacy could well lie in the broader and deeper engagement in the process itself. ■

## Appendix 1: issuers of standards included in the FSF Compendium of Standards

- Basel Committee on Banking Supervision
- Committee on Payment and Settlement Systems
- Committee on the Global Financial System
- Financial Action Task Force
- International Accounting Standards Board
- International Association of Insurance Supervisors
- International Auditing and Assurance Standards Board
- International Monetary Fund
- International Organization of Securities Commissions
- Organisation for Economic Cooperation and Development
- Basel Committee Transparency Group and IOSCO Technical Committee Working Party on the Regulation of Financial Intermediaries
- Committee on Payment and Settlement Systems–IOSCO Task Force on Securities Settlement Systems

## Appendix 2: the Financial Stability Forum “top twelve” standards

The Financial Stability Forum has designated the following codes as of particular importance for sound financial systems and deserving priority implementation at a national level depending on the circumstances of the country concerned. “While the key standards vary in terms of their degree of international endorsement, they are broadly accepted as representing minimum requirements for good practice.”<sup>86</sup>

### Macroeconomic policy and data transparency

- *Monetary and financial policy transparency*: IMF Code of

Good Practices on Transparency on Monetary and Financial Policies

- *Fiscal policy transparency*: IMF Code of Good Practices on Fiscal Transparency
- *Data dissemination*: IMF Special Data Dissemination Standard/General Data Dissemination Standard

### Institutional and market infrastructure

- *Insolvency*: the World Bank is co-ordinating efforts to develop a set of principles and guidelines for insolvency regimes. The United Nations Commission on International Trade Law (UNCITRAL) will help facilitate implementation.
- *Corporate governance*: OECD Principles of Corporate Governance
- *Accounting*: IASB International Accounting Standards
- *Auditing*: IFAC International Standards on Auditing
- *Payment and settlement*: CPSS Core Principles for Systemically Important Payment Systems and CPSS/IOSCO Recommendations for Securities Settlement Systems
- *Market Integrity*: FATF The Forty Recommendations of the Financial Action Task Force/9 Special Recommendations Against Terrorist Financing

### Financial regulation and supervision

- *Banking supervision*: Basel Committee Core Principles for Effective Banking Supervision
- *Securities regulation*: IOSCO Objectives and Principles of Securities Regulation
- *Insurance supervision*: IAIS Insurance Core Principles

David Rouch is a partner at Freshfields Bruckhaus Deringer.

- <sup>1</sup> J Benjamin and D Rouch, “The International Markets as a Source of Global Law: The Privatisation of Rule-making?” (2008) 2(2) *Law and Financial Markets Review* 78. These articles are derived from papers produced for colloquia held in the first half of 2008 and jointly organised by London School of Economics (Law and Financial Markets Project) and Freshfields Bruckhaus Deringer. It is hoped that the final article in the series will be published in *LFMR* later this year.
- <sup>2</sup> It is an important qualification. There have been earlier periods of intense financial globalisation such as that at the end of the nineteenth century which came to an abrupt halt with the First World War.
- <sup>3</sup> These relationships are highlighted in “Strengthening the EU Regulatory and Supervisory Framework: A Practical Approach”, a joint HM Treasury and FSA discussion paper, Nov 2007.
- <sup>4</sup> The FSF was established in 1999 following the 1997 Asian financial crisis which also acted as a stimulus to IOSCO to produce its statement of Core Objectives and Principles of

Securities Regulation as a benchmark against which countries could measure the quality of their securities regulation. Likewise the IOSCO Multilateral Memorandum of Understanding (which seeks to facilitate co-ordinated investigation and prosecution of cross-border securities regulation) emerged following the events of 11 Sep 2001.

- <sup>5</sup> This is the theme of the Institute of International Finance (IIF) “Strategic Dialogue on Effective Regulation”, Dec 2006.
- <sup>6</sup> For example, in seeking to further international reform of securities regulation, the IIF and the International Council of Securities Associations (ICSA) have not argued for the establishment of any new public sector bodies, but have engaged in an ongoing dialogue with IOSCO.
- <sup>7</sup> Indeed, bodies such as the Basel Committee, IOSCO and IAIS take active steps to seek to co-ordinate their activities through a “Joint Forum”. This gives them an opportunity to compare the regulatory standards issued by each organisation and to understand the reason for any divergences.
- <sup>8</sup> For example, the British government has proposed that, “To strengthen the ability of the international system to understand the interaction of financial sector risks and economic



- growth, the IMF should complement the work of the FSF. This means that the IMF should enhance its surveillance role to ensure that the implications of developments in the financial sector for individual economies and cross-border linkages are fully understood.” HM Treasury–FSA, *supra* n 3.
- 9 We return below to the limited membership of bodies such as the G7 and the question of legitimacy. For present purposes, it is important to note that their restricted membership does in some sense qualify descriptions of the G7 and the FSF as “global” bodies.
  - 10 See the FSF Working Group on Market and Institutional Resilience – preliminary and interim reports, Oct 2007 and Feb 2008, respectively.
  - 11 See the Statement by G7 Finance Ministers and Central Bank Governors, 9–10 Feb 2007, which states that “To further liberalize cross-border capital markets, we agreed to explore within the G7 free trade in securities based on mutual recognition of regulatory regimes.”
  - 12 [www.fsforum.org](http://www.fsforum.org).
  - 13 For details of the 12 standards and the standards-setting bodies, see Appendices 1 and 2. The full Compendium of Standards can be found on the IMF’s website (see above).
  - 14 See [www.imf.org/external/np/fsap/fsap.asp](http://www.imf.org/external/np/fsap/fsap.asp).
  - 15 See [www.imf.org/external/standards/index.htm](http://www.imf.org/external/standards/index.htm).
  - 16 The International Accounting Standards Board draws on a broader base and could be considered as a private rather than public sector body. It is notable that its standards are much more detailed and more widely accepted than the other standards considered in this section.
  - 17 For example, the regulators that are members of IOSCO regulate more than 90 per cent of the world’s securities markets, covering more than 100 jurisdictions. The Preamble to the IOSCO By-Laws states: “Securities authorities resolve to cooperate together to ensure better regulation of the markets on the domestic as well as on the international level, in order to maintain just, efficient and sound markets: . . . to unite their efforts to establish standards and an effective surveillance of international securities markets . . .”
  - 18 See, eg, the website of the Central Bank of Bahrain which notes that it regulates in accordance with international standards and references a number of the standards in the FSF Compendium. Sometimes the process involves parallel systems developing for international and local business as can be seen in Qatar where the Qatar Financial Centre seeks to operate by reference to “international best practices” separate from host Qatari systems. See [www.cbb.gov.bh/cmsrule/index.jsp?action=article&ID=907](http://www.cbb.gov.bh/cmsrule/index.jsp?action=article&ID=907) and [www.qfcra.com/who/about\\_index.php](http://www.qfcra.com/who/about_index.php), respectively.
  - 19 The mandate given to UNCITRAL by the UN is to pursue the progressive harmonisation of trade law. The UNCITRAL “Model Law on Cross-Border Insolvency” (adopted 1997) is designed to facilitate cross-border co-ordination of cases involving multiple jurisdictions. Its principles have been widely adopted including in Japan, the UK and the US. It does not seek to harmonise substantive insolvency law or procedure. As a result, UNCITRAL also produced a Legislative Guide on Insolvency Law, accompanied by a set of Legislative Recommendations (adopted by the UN in 2004) providing guidance on the elements of an effective insolvency regime. Over time, they may have a normative effect. Other bodies active in this field include the European Bank of Reconstruction and Development (which has produced core principles for insolvency regimes), the International Insolvency Institute and the American Law Institute.
  - 20 The Unidroit Convention on Substantive Rules regarding Intermediated Securities, [www.unidroit.org](http://www.unidroit.org). As with UNCITRAL, the purpose of Unidroit is to pursue the harmonisation of private law.
  - 21 The Hague Convention on Securities held with an Intermediary, adopted 13 Dec 2002, [www.hcch.net](http://www.hcch.net). The US and Switzerland have both signed the convention. Progress has been less smooth within the EU.
  - 22 The ICC’s high-level relationship with the public sector was in some sense defined when in 1946 it was granted first-class consultative status with the United Nations.
  - 23 Within the EU, the process of convergence has become increasingly formalised through the operation of the “Lamfalussy framework”. This involves four levels of public sector rule-making: Level I – framework legislation proposed by the EU Commission; Level II – technical implementing legislation developed by Commission committees of Member State representatives (the European Banking Committee (EBC), the European Insurance Committee (EIC) and the European Securities Committee (ESC)); Level III – committees of national supervisors advising on the above processes and seeking coordination and consistency of implementation between themselves (the Committee of European Banking Supervisors (CEBS), the Committee of European Insurance and Occupational Pension Supervisors (CEIOPS) and The Committee of European Securities Supervisors (CESR)); and Level IV – Commission enforcement of the rules.
  - 24 A further example is the role of the US and UK in the adoption of the first Basel Accord.
  - 25 Consider, for example, continuing accession discussions between the EU and Turkey.
  - 26 In some ways this is also a necessary response to the pace of globalisation which makes grand pieces of legislation a time-consuming luxury; flexibility and adaptability are the order of the day.
  - 27 *Review of the Lamfalussy Process – Strengthening Supervisory Convergence*, EU Commission Communication published on 20 Nov 2007.
  - 28 Not surprisingly, the UK authorities support a principles-based approach – see HM Treasury–FSA, *supra* n 3, 24. However, the system remains in flux. Recent turbulence in particular could result in a more interventionist approach in some areas over time.
  - 29 Indeed, there are those who intend it to do so: “Jointly, we have a window of opportunity to facilitate the smooth integration of China, India, Brazil and others on the world economic stage. The EU and US should lead by example and show how open and competitive markets with sound standards of investor and consumer protection can deliver a thriving transatlantic financial market place.” “A Framework for the 21st Century – The New Global Regulatory Agenda in Financial Services”, a speech by Commissioner McCreevy at the Council on Foreign Relations, Wash-

ington, 7 Feb 2006. It remains to be seen what effect current stresses in credit markets will have on realising this goal.

- <sup>30</sup> See the discussion of “substituted compliance” following the publication of an article entitled “A Blueprint for Cross Border Access to US Investors: A New International Framework” by Ethiopis Tafara and Robert J Peterson Director and Senior Counsel, respectively, of the SEC in the *Harvard International Law Journal*, vol 48, no 1, Winter 2007.
- <sup>31</sup> For example, the continuing work of the EU–US Coalition on Financial Regulation (established in 2005), a group that consists of eight financial services trade associations and which has the joint objectives of accelerating regulatory convergence and mutual recognition and ensuring that the views of the financial services sector are adequately addressed. It issued its second report on regulatory convergence in Apr 2007 identifying priorities for convergence.
- <sup>32</sup> The Framework sets the objective of taking steps, “towards the convergence, equivalence or mutual recognition, where appropriate, of regulatory standards based on high-quality principles” and to “increase cooperation between EU and US financial regulators”. The EU–US dialogue is not the only one of its sort, although certainly the most advanced. For example, the SEC is engaged in regulatory dialogues with the China Securities Regulatory Commission (CSRC), the Japan Financial Services Agency and the Korea Financial Supervisory Commission (all since 2006). The EU is also engaged in regulatory dialogues with Japan, China and India. These can be expected to lead to a transmission of standards and experience: in the words of the Terms of Reference for the dialogue between the SEC and the CSRC, “the authorities will continue to promote the development of a sound securities regulatory system in China through a comprehensive technical assistance program . . . with a view to facilitating further development of China’s securities market regulatory and oversight framework”.
- <sup>33</sup> See <http://www.sec.gov/news/press/2008/2008-9.htm>.
- <sup>34</sup> As indicated, it is stimulated, among other things, by the need to respond to rapidly changing markets and the risk of regulatory arbitrage which applies a pressure to resort to detailed regulatory rule-making only where necessary. The current turbulence in the financial market has inevitably resulted in calls for more active public sector regulation and rule making in some areas. However, public sector commentary to date appears to continue to recognise the importance of harnessing the markets in the regulatory process. For example, the IMF’s April 2008 Global Financial Stability report notes the need to avoid a “rush to regulate” and continues to talk of increased attention by private market participants and the public sector. FSF reports have adopted a similar tone.
- <sup>35</sup> Comments of Ben Bernanke in his speech to the Federal Reserve Bank of Atlanta 2007 Financial Markets Conference in May 2007 (“Regulation and Financial Innovation”) are significant in this respect: “In implementing risk-focused and principles-based policies [in the US], we must also face the reality that finance does not stop at the water’s edge. Financial globalisation and financial innovation are closely tied, with each trend promoting the other. As a consequence, global regulatory coordination and collaboration are more vital than ever. We already work closely with our counter-
- parts in the major industrial countries as well as in international forums. . . . To the extent possible, we should work toward common principles and approaches as well as improved information sharing.”
- <sup>36</sup> This is reflected in the EU Commission proposals for the future of the Lamfalussy regime, referred to above. A speech of Commissioner McCreevy to the EUROFI-Conference in December 2007, provides further colour, “I have called on Ministers to give a higher priority to implementing the EFC report on financial stability arrangements. We cannot wait for a crisis to occur to kick start enhanced supervisory cooperation and coordination for large cross-border banking groups. . . . We do not need more studies or impact assessments. We need solutions.”
- <sup>37</sup> Indeed, the British Government has made clear its desire for principles-based convergence under the Lamfalussy Process which under-girds the EU Financial Services Action Plan. See generally, HM Treasury–FSA, *supra* n 3, which states, for example, “The convergence of regulation and supervisory practices is desirable . . . the UK authorities believe that consistent with a principles-based approach, supervisory convergence is primarily about delivering equivalent regulatory outcomes. Over time and through ongoing cooperation and sharing of best practice, it is likely and desirable that supervisory practices converge” (5, 6). Likewise, Philippe Richard, Secretary General of IOSCO, speaking at a conference at Wilton Park in November 2005 on “Principles in Financial Regulation” stated that, “It has been our belief within IOSCO for some time that in seeking to achieve international convergence, this type of principles-based approach works best of all since it allows for greater adaptability across the board.”
- <sup>38</sup> The frequently cited example is large shareholder disclosure regimes.
- <sup>39</sup> For example, the EU experience of the Prospectus Directive, where the original attempt at mutual recognition has been replaced with a more thorough-going harmonisation of detailed standards.
- <sup>40</sup> In the US, this has received discussion under the label “substituted compliance” following the publication of the article referred to above by Tafara and Peterson, *supra* n 30. The proposal is that foreign stock exchanges and broker dealers would be able to apply for an exemption from SEC registration based on compliance with substantively comparable non-US securities regulations and laws and supervision by a non-US regulator with oversight powers and a regulatory and enforcement philosophy largely similar to that in the US. It would therefore rely on an alignment of the regulatory outcomes sought by the non-US regime with those of the SEC. The grant of an exemption would be supported by arrangements between the SEC and the non-US regulator to share enforcement and supervisory information. It is notable that the emphasis in the article is on retail investor protection and benefit rather than a desire to facilitate the operation of the wholesale markets.
- <sup>41</sup> Most recently, the announcement in November 2007 that non-US issuers applying IFRS would no longer need to reconcile their accounts to US GAAP.
- <sup>42</sup> An example of this is the arrangement that the US CFTC

- has been operating since 1996 which allows non-US broker dealers and exchanges access to the US derivatives markets.
- <sup>43</sup> The example of the EU Prospectus Directive was mentioned above. But the issue extends beyond the EU. For example, it is difficult to see how at present there could be mutual recognition by the US or EU of aspects of the regulatory regimes of some emerging market economies. This would require a greater level of harmonisation than exists at present.
- <sup>44</sup> We highlighted above the possibility of this as a result of the G7 proposal for mutual recognition of member state securities regimes.
- <sup>45</sup> Art 72 of the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 contemplates firms with no place of business in the UK providing certain financial services to persons in the UK without needing to be authorised as long as they comply with the UK financial promotion regime in doing so. Very broadly, this restricts the provision of the services to those customers who are able to assess the risks of dealing with firms that are not UK-regulated.
- <sup>46</sup> Call for Evidence on Private Placement Regimes, EU Commission, April 2007. For responses to the call for evidence, see [http://ec.europa.eu/internal\\_market/investment/consultations/index\\_en.htm#call](http://ec.europa.eu/internal_market/investment/consultations/index_en.htm#call).
- <sup>47</sup> For example, the European private placement regime for securities under the EU Prospectus Directive (2003/71/EC) is effective because all Member States have applied the same perimeter in their national regulation as required by the Directive.
- <sup>48</sup> The distinction between “macro” and “micro” standard setting was made in the first article in this series: see *supra* n 1. The first relates to the process of setting high-level legal or regulatory standards and principles; the second concerns the more detailed process of standard-setting within that framework.
- <sup>49</sup> Whether some of the most potent emerging economies, such as China, India and Russia, will adopt a similar approach remains to be seen.
- <sup>50</sup> For example, see commentary in *Financial Regulator* 2005, 10(3), 19–21.
- <sup>51</sup> In the case of Bahrain, see [www.cbb.gov.bh/cmsrule/index.jsp?action=article&ID=907](http://www.cbb.gov.bh/cmsrule/index.jsp?action=article&ID=907). See also the IMF reports as part of its Financial Sector Assessment Programme at [www.mf.org/external/np/fsap/fsap.asp#S](http://www.mf.org/external/np/fsap/fsap.asp#S).
- <sup>52</sup> Examples include the various industry groups referred to above that have emerged to further the cause of EU–US regulatory convergence and convergence more generally.
- <sup>53</sup> This initiative involves ESF, ICMA, ISDA, LIBA, SIFMA.
- <sup>54</sup> “Model Code of Ethics”, a report of the SRO Consultative Committee of IOSCO, Jun 2006.
- <sup>55</sup> “An Ethical Framework for Financial Services”, Discussion Paper 18, Oct 2002
- <sup>56</sup> “Treating Customers Fairly – Culture”, UK Financial Services Authority, Jul 2007.
- <sup>57</sup> See also figures on total assets held in the US and the EU produced by McKinsey Global Institute Global Financial Stock Database, reported in *Financial Times*, 16 Jan 2007, 38.
- <sup>58</sup> Thus applying an element of external “quality control” that is not present in the wikipedia concept.
- <sup>59</sup> The Basel Committee states in its introduction to its revised Core Principles for Effective Banking Supervision, Oct 2006 that it “acted in close consultation with and built on the work of the Core Principles Liaison Group, a working group that regularly brings together senior representatives from Committee member countries, non-G10 supervisory authorities, the IMF and the World Bank. The Committee consulted other institutional standard setting bodies – the IAIS, IOSCO, the FATF and the CPSS – during the preparation of drafts. . . . Before finalising the text, the Committee conducted a broad consultation that was open to national supervisory authorities, central banks, international trade associations, academia and other interested parties.” As the move towards international regulatory coherence gathers momentum, the constituency involved in this sort of dialogue can be expected to grow and deepen.
- <sup>60</sup> For example, the international discussion provoked by the move of the UK Financial Services Authority towards principles-based supervision.
- <sup>61</sup> ESF, ICMA, ISDA, LIBA, SIFMA, Retail Structured Products: Principles for Managing the Provider-Distributor Relationship, April 2007, available at <http://www.sifma.org/regulatory/pdf/RSPPrinciples0707.pdf>.
- <sup>62</sup> B Kingsbury, N Krisch and R Stewart, ‘The Emergence of Global Administrative Law (2005) 68 *Law and Contemporary Problems* 15.
- <sup>63</sup> See also C Skelcher, ‘Jurisdictional Integrity, Polycentrism and the Design of Democratic Governance’ (2005) 18(1) *Governance* 89.
- <sup>64</sup> Cassese identifies the question of who ensures legal protection for those affected by the decisions of transnational regulators as the “biggest issue of global administrative justice”: S Cassese, “Administrative Law without the State? The Challenge of Global Regulation” (2005) 37(4) *New York University Journal of International Law and Politics* 663, 692.
- <sup>65</sup> See eg *Aston Kantlow v ACC* [2004] AC 456; *Poplar Housing and Regeneration Community Association v Donoghue* [2002] QB 48; *R (on the application of Mullins) v Appeal Board of the Jockey Club* 2005 WL 2673806 (QBD (Admin Ct)), *The Times* 24 Oct 2005, 2673, 806, [2005] EWHC 2197; *R (on the application of West) v Lloyds of London* 2004 WL 852308 (CA), [2004] 3 All ER 25; though in *Graham Bradley v The Jockey Club* 2005 WL 1630757 (CA), *The Times* 14 Jul 2005, 1630, 757, [2005] EWCA Civ 1056 the court held that the supervisory jurisdiction that it exercised over bodies in private law was akin to that exercised in judicial review over public bodies. See generally D Oliver, *Common Values and the Public – Private Divide* (Cambridge University Press, 1999).
- <sup>66</sup> Which seems to be IOSCO’s preferred approach to using self-regulatory organisations: IOSCO May 1990.
- <sup>67</sup> DF Thompson, “The Moral Responsibility of Public Officials: The Problem of Many Hands” (1980) 74 *American Political Science Review* 905, cited in M Bovens, “Analysing and Assessing Accountability: A Conceptual Framework” (2007) 13(4) *English Law Journal* 447, 457.
- <sup>68</sup> ISDA’s submission of an *amicus curiae* brief in *Aon Financial*

- Products v Société Générale*, US Court of Appeal Second Circuit 06-1080-CV (2005) mentioned in the first paper is an example of such 'interpretive interference'.
- <sup>69</sup> D Kerwer, "Rules that Many Use: Standards and Global Regulation" (2005) 18(4) *Governance* 611.
- <sup>70</sup> Adapting Bovens, *supra* n 67.
- <sup>71</sup> L Fuller, *The Morality of Law* (Yale University Press, 1964).
- <sup>72</sup> See discussions in R Barker, *Political Legitimacy and the State* (Oxford University Press, 1990) and D Beetham, *The Legitimation of Power* (London, Macmillan, 1991).
- <sup>73</sup> IOSCO, Report of the SRO Consultative Committee of the International Organization of Securities Commissions, "Model for Effective Regulation", May 2000.
- <sup>74</sup> JL Mashaw, *Bureaucratic Justice: Managing Social Security Disability* (Yale University Press, 1983).
- <sup>75</sup> IOSCO, "Authorities Responsible for Capital Market Regulation Work to Enhance the Governance of the IASC Foundation", IOSCO Media Release 007/2007, 7 Nov 2007.
- <sup>76</sup> Available at <http://walkerworkinggroup.com>.
- <sup>77</sup> Hedge Fund Standards: Final Report, to be overseen by the Hedge Fund Standards Board (January 2008), report available at [www.hfwg.co.uk](http://www.hfwg.co.uk).
- <sup>78</sup> "National supervisory authorities are and should remain accountable at Member State level. However, within the Lamfalussy framework, accountability might be improved with more regular and formalised reporting of the activities of the Level III committees to the Council and the European Parliament." HM Treasury-FSA, *supra* n 3, 7.
- <sup>79</sup> The Law Commissions of England & Wales and Scotland's review of insurance prompted significant concerns from ISDA that they would upset this view, which ISDA argued was in effect settled by the markets' widespread adoption of the Potts opinion: see letter from Richard Metcalfe to Peter Tyldesley of the Law Commission of England and Wales, dated 18 Apr 2006, available at [www.isda.org](http://www.isda.org). See further Law Commission and Law Commission of Scotland, *Insurance Contract Law: Issues Paper 4* (Jan 2008) paras 7.3-7.33.
- <sup>80</sup> Suchman, above 585-601; B Cashore, "Legitimacy and the Privatization of Environmental Governance: How Non-State Market Driven (NSDM) Governance Systems Gain Rule Making Authority" (2002) 15(4) *Governance* 503-29.
- <sup>81</sup> On the use of such practices by state-based regulators to enhance their legitimacy see M Thatcher, "Regulation after Delegation: Independent Regulatory Agencies in Europe" (2002) 9(6) *Journal of European Public Policy* 954.
- <sup>82</sup> A strategy adopted by some of the social and environmental accreditation bodies. See also S Bernstein and B Cashore, "Can Non State Global Governance be Legitimate? An Analytical Framework" (2007) 1 *Regulation and Governance* 347.
- <sup>83</sup> R Hulsse and D Kerwer, "Global Standards in Action: Insights from the Anti-money Laundering Regulation" (2007) 14(5) *Organization* 625..
- <sup>84</sup> J Koppell, "'Pathologies of Accountability': ICANN and the Challenge of 'Multiple Accountability Disorder'" (2005) 65(1) *Public Administration Review* 94.
- <sup>85</sup> See in particular M Power, *The Audit Society: Rituals of Verification* (Oxford University Press, 1997).
- <sup>86</sup> [www.fsforum.org](http://www.fsforum.org).