

The Regulation of International Financial Markets

Perspectives for Reform

Edited by

Rainer Grote and Thilo Marauhn

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THE REGULATION OF INTERNATIONAL FINANCIAL MARKETS

International financial relations have become increasingly important for the development of global and national economies. At present these relations are primarily governed by market forces, with little regulatory interference at the international level. In the light of numerous financial crises, this abstinence must be seriously questioned. Starting with an analysis of the regulatory problems at the international level, with only minimal powers entrusted to international organisations, this book develops various possibilities for reform. On the basis of an historical analysis, the book first adopts a comparative approach to national attempts to regulate international financial markets, then outlines the potential of relevant institutions (such as the European Central Bank, Basle Committee, IMF and World Bank) and finally develops a policy perspective. It seeks to provide a framework for analysing options for the regulation of international financial markets from a public international law and comparative law perspective.

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PREFACE

Most of the contributions included in this volume were originally presented during a workshop held at the 'Evangelische Akademie Loccum' in 2001. The editors wish to explicitly acknowledge the financial and logistical support provided by the 'Evangelische Akademie Loccum'. In particular, we appreciate the contribution of Dr Christoph Hüttig to the conceptual framework of the workshop and the establishment of contacts with Benjamin J. Cohen and Axel Peuker through him. Further papers were added and existing papers were revised subsequently, with final editing being done in 2004. The editors are grateful to the VolkswagenStiftung for its financial support in respect of both the workshop and the preparation of the publication. We also appreciate the editorial assistance provided by Michael Weiss. Due to the long editing process which is the sole responsibility of the editors the final versions of the various contributions differ in respect of timing. Authors have, however, successfully contributed to a meaningful interdisciplinary volume which the editors have sought to draw conclusions upon in their final chapter. This chapter also outlines perspective for further research. Finally, the editors wish to express their gratitude to the publisher and all the assistance provided by Cambridge University Press.

ABBREVIATIONS

ADB	Asian Development Bank
AFTA	ASEAN Free Trade Area
AICPA	American Institute of Certified Public Accountants
AMF	Asian Monetary Fund
APA	Administrative Procedure Act
APEC	Asia-Pacific Economic Co-operation forum
ASEAN	Association of South-East Asian Nations
ASEAN + 3	ASEAN + Japan, China and South Korea
ASEM	Asia-Europe Meeting 2000
ATS	Alternative Trading System
ATTAC	Action pour la Taxation des Transactions Financières pour l'Aide aux Citoyens (Association for the Taxation of Financial Transactions for the Benefit of Citizens)
BCBS	Basle Committee on Banking Supervision
BGBL	Bundesgesetzblatt
BIS	Bank for International Settlements

BVerfGE	Sammlung der Entscheidungen des Bundesverfassungsgerichts (Collection of the Decisions of the German Federal Constitutional Court)
CCL	Contingent Credit Line
CEO	Chief Executive Officer
CESR	Committee of European Securities Regulators
CFA	Commodities Futures Act
CFMA	Commodities Futures Modernization Act
CFO	Chief Financial Officer
CFTC	Commodities Futures Trading Commission
CGFS	Committee on the Global Financial System
CIA	Central Intelligence Agency
CMCG	Capital Market Consultative Group
CO	Colorado
CPSIPS	Core Principles for Systemically Important Payment Systems
CPSS	Committee on Payment and Settlement Systems
CTT	Currency Transaction Tax
DC	District of Columbia
DSU	Dispute Settlement Understanding
DTEFs	derivatives transaction execution facilities
EAEC	East Asia Economic Caucus
EAEG	East Asian Economic Group
EASDAQ	European Association of Securities Dealers Automatic Quotation System

EC	European Community
ECB	European Central Bank
ECJ	European Court of Justice
ECOFIN	A configuration of the Council of Ministers of the European Union concerned with economic and financial affairs
ECOSOC	Economic and Social Council
EEA	European Economic Area
EEC	European Economic Community
EMI	European Monetary Institute
EMU	Economic and Monetary Union
ERM	Exchange Rate Mechanism
ESC	European Securities Committee
ESCB	European System of Central Banks
EU	European Union
FASB	Financial Standards Supervisory Board
FATF	Financial Action Task Force on Money Laundering
FBI	Federal Bureau of Investigation
FDI	Foreign Direct Investment
FDIC	Federal Deposit Insurance Corporation
FESCO	Forum of European Securities Commissions
FFIEC	Federal Financial Institutions Examination Council
FFSA	Federal Financial Supervisory Authority (Bundesanstalt für Finanzdienstleistungsaufsicht)

FIRREA	1989 Financial Institutions Reform, Recovery, and Enforcement Act
FSA	Financial Services Authority
FSAP	European Commission's Financial Services Action Plan
FSAP	Financial Sector Assessment Program
FSF	Financial Stability Forum
FSLC	Financial Sector Liaison Committee
FSLIC	Federal Savings and Loan Insurance Corporation
FSMA	Financial Services and Markets Act 2000
GAB	General Agreement to Borrow
GATS	General Agreement on Trade in Services
GATT	General Agreement on Tariffs and Trade
GDDS	General Data Dissemination System
GDP	gross domestic product
HM	Her Majesty
IAIS	International Association of Insurance Supervision
IAPC	International Accounting Practices
IASB	International Accounting Standards Board
IASC	International Accounting Standards Committee
IBRD	International Bank for Reconstruction and Development
ICC	Interstate Commerce Commission

IFAC	International Federation of Accountants
IFIs	International Financial Institutions
IMF	International Monetary Fund
IMFC	International Monetary and Financial Committee of the Board of Governors of the IMF
INSOL	International Federation of Insolvency Professionals
INTOSAI	International Organisation of Supreme Audit Institutions
IOSCO	International Organisation of Securities Commissions
IPO	initial public offer
IRS	Internal Revenue Service
ISA	International Standards on Auditing
ISD	Investment Services Directive 93/22/EEC
LDC	less developed country
MAI	Multilateral Agreement on Investment
MFN rule	most-favoured-nation-rule
MoU	memorandum of understanding
MPIFG	Max-Planck-Institut für Gesellschaftsforschung' (Max Planck Institute for the Study of Societies)
NAB	new arrangements to borrow
NAFTA	North American Free Trade Agreement
NAIC	National Association of Insurance Commissioners

NAMU	North American Monetary Union
NASD	National Association of Securities Dealers
NASDAQ	National Association of Securities Dealers Automated Quotation (system)
NCOIL	National Conference of Insurance Legislators
NCUA	National Credit Union Administration
NEWEX	New Europe Exchange
NFA	National Futures Association
NGO	Non-Governmental Organisation
NJ	New Jersey
NY	New York
NYSE	New York Stock Exchange
OCC	Office of the Comptroller of the Currency
OECD	Organisation for Economic Co-operation and Development
OEEC	Organisation for European Economic Co-operation
OJ	Official Journal of the European Union
OTC	over-the-counter
OTS	Office of Thrift Supervision
RCH	Recognised Clearing Houses
RIE	Recognised Investment Exchanges
ROSC	Reports on the Observance of Standards and Codes
RTC	Resolution Trust Corporation
S&Ls	savings and loan associations

SAIF	Savings Association Insurance Fund
SDDS	Special Data Dissemination Standard
SDRM	Sovereign Debt Restructuring Mechanism
SEC	US Securities and Exchange Commission
SRF	Supplemental Reserve Facility
SROs	self-regulatory organisations
TRIPS Agreement	Agreement on Trade Related Aspects of Intellectual Property Rights
UCITS	Directive 85/611/EEC on Undertakings for Collective Investment in Transferable Securities
UK	United Kingdom
UN	United Nations
UNCTAD	United Nations Conference on Trade and Development
UNICEF	United Nations Children's Fund
US	United States of America
USD	US dollar
WTO	World Trade Organisation
WTO Agreement	Marrakesh Agreement establishing the World Trade Organisation
XBOTs	exempt boards of trade

Introduction: the regulatory dilemma in international financial relations

THILO MARAUHN

I. The globalisation of capital markets: benefits and risks

The globalisation of capital markets has become the subject of a broad public debate.¹ It is no longer perceived as a purely technical topic. Its benefits and risks are part of a truly political discourse that has long left the secluded environment of the financial and academic elite. Benefits and risks of such globalisation are thus not only discussed from the perspective of economic rationality but are assessed against a whole set of heterogeneous values, such as democracy,² human rights,³ and many more. While the debate has thus become much more vivid it is increasingly at risk to be governed by ideological motivations rather than rational arguments. Pleading for rationality does not mean to return to purely technical or even elitist considerations. Rather it aims at establishing a procedural framework to accommodate all the relevant aspects that should be taken into account by political, economic, and other decision-makers. Such procedural framework can effectively be provided by public international law arrangements. While this has been realised in other sectors of an increasingly global

¹ See, *inter alia*, Richard A. Grasso, 'Globalization of Capital Markets', (1997) 21(2) *Fordham International Law Journal* 390–6; Dragana M. Đurić, 'Globalization of Financial Markets', (1999) 50(1082/83) *Review of International Affairs* 15–21; Sol Picciotto and Jason Haines, 'Regulating Global Financial Markets', (1999) 26(3) *Journal of Law and Society* 351–68; Eilis Ferran and C. A. E. Goodhart (eds.), *Regulating Financial Services and Markets in the Twenty First Century* (Oxford, 2001); Joseph E. Stiglitz, 'Principles of Financial Regulation – A Dynamic Portfolio Approach', (2001) 16(1) *World Bank Research Observer* 1–18.

² Chantal Thomas, 'Does the "Good Governance Policy" of the International Financial Institutions Privilege Markets at the Expense of Democracy?' (1999) 14(2) *Connecticut Journal of International Law* 551–62.

³ Cf. Ross P. Buckley, 'The Essential Flaw in the Globalisation of Capital Markets – Its Impact on Human Rights in Developing Countries', (2001) 32(1) *California Western International Law Journal* 119–31.

economy,⁴ capital markets have for one and another reason largely escaped the regulatory power of public international law. Even the academic discourse has long been led by economists and experts in private law with a significant silence on the side of political scientists as well as experts in public law.⁵ The situation seems about to change, most probably due to the topic moving into the wider political arena.

It is against this background that the research for this publication was undertaken. The basic question to be addressed from a variety of angles is whether there is a meaningful potential in the regulation of international financial relations at the level of public international law. In spite of grand rhetoric such as 'international financial architecture'⁶ the present contribution of public international law to a regulatory framework for global capital markets is rather limited. Neither does the reference to an 'international financial architecture' describe an existing regime nor does it provide a blueprint for governance in international financial relations. Rather it covers a great variety of institutions and numerous forms of co-operation among actors on the international financial markets. Whether or not there is a need for and a potential impact of public international law in international financial relations can only be assessed against the background of a much broader analysis.

A first part of this analysis must be a historical one,⁷ considering the factual dimension of the problem and the ups and downs of capital

⁴ Bilateral as well as multilateral agreements related to foreign direct investment rather provide a framework for the settlement of disputes than a set of substantive standards; cf. Christian Tietje, 'Die Beilegung internationaler Investitionsstreitigkeiten', in Thilo Marauhn (ed.), *Streitbeilegung in den internationalen Wirtschaftsbeziehungen. Völkerrechtliche Einhegung ökonomischer Globalisierungsprozesse* (Tübingen, 2005), pp. 47–62 at 49–51. Similarly, the World Trade Organisation (WTO) does not integrate national economies into the global economy but only tears down barriers to economic transactions in between these economies; see Hans van Houtte, *The Law of International Trade* (2nd ed. 2002), at p. 128: 'A free market requires . . . liberalisation of the movement of goods and services as well as the prohibition of restrictions on competition by the market participants.'

⁵ Rochoael M. Soper, 'Promoting Confidence and Stability in Financial Markets – Capitalizing on the Downfall of Barings', (1997) 7(2) *Duke Journal of Comparative and International Law* 651–70; Herbert Kronke, 'Capital Markets and Conflict of Laws', (2001) 286 *Recueil des Cours/Académie de Droit International de La Haye* 245–385; Douglas W. Arner, 'Globalisation of Financial Markets – An International Passport for Securities Offerings?' (2001) 35(4) *International Lawyer* 1543–88.

⁶ Cf. Peter Behrens, 'The International Architecture of Global Financial Markets' (1999) 6(3) *Maastricht Journal of European and Comparative Law* 271–98.

⁷ Such analysis is provided in this book by Benjamin J. Cohen (chapter 1). See also William F. Shepherd, *International Financial Integration – History, Theory and Applications in OECD Countries* (Aldershot, 1994).

internationalisation. In this regard it must be noted that, in contrast to what is sometimes argued, the internationalisation of capital is not a totally new phenomenon.⁸ At the beginning of the twentieth century national capital markets were much more interpenetrated than during the inter-War and the Cold War periods; they were not as segmented and compartmentalised as until some twenty years ago. Nevertheless, developments over the last two decades demonstrate some unique characteristics.⁹ Thus, the cross-border flow of financial assets has exponentially grown, and there is a dramatic increase in the number of foreign listed companies at the major stock exchanges. Also, cross-border mergers, increasingly international portfolio investment strategies, a rapidly growing share of foreign investors in the bond market, and even alliances between stock exchanges have by now become commonplace. The fact that a period of internationalisation a century ago was followed by fragmentation of financial markets can be considered a warning that – at least in theory – regulatory change can reverse the interpenetration of national financial markets.¹⁰

Another part of a kind of preliminary inquiry must be into existing regulations at the national level. A comparative analysis¹¹ of the national regulation of international financial markets can provide insights into perceptions, motivations and reactions of a broad variety of actors towards a regulatory framework. Findings may extend from a more or less positive assessment of national regulation with a beneficial impact on regional and global markets to the identification of a particular need for co-ordinated, if not partially harmonised approaches towards regulatory issues at the international level. If such a need is identified then the question arises what should actually be covered by an international

⁸ Cf. Harald Baum, 'Globalizing Capital Markets and Possible Regulatory Responses', in Jürgen Basedow and Toshiyuki Kono (eds.), *Legal Aspects of Globalization – Conflict of Laws, Internet, Capital Markets and Insolvency in a Global Economy* (The Hague, 2000), pp. 77–132 at 81.

⁹ Such characteristics have been aptly analysed by Richard Dale, 'Regulating the New Financial Markets', in Malcolm Edey (ed.) *The Future of the Financial System* (proceedings of a conference held at the H.C. Coombs Centre for Financial Studies, Kirribilli on 8/9 July 1996) (Sydney, 1996), pp. 215–45 at 220–2, available at <http://www.rba.gov.au/PublicationsAndResearch/Conferences/1996/Dale.pdf>.

¹⁰ Baum, 'Globalizing Capital Markets', above note 8, at p. 81.

¹¹ Cf. the various contributions in this volume by Eilis Ferran (chapter 2), Rainer Grote (chapter 3) and John K. M. Ohnesorge (chapter 4). For a comprehensive comparative approach see, *inter alia*, Jean-Baptiste Zufferey, *Regulation of Trading Systems on Financial Markets* (London, 1997).

instrument. This depends on the existing normative¹² and institutional¹³ framework but must take into account a policy perspective.¹⁴ This, in particular, necessitates an economic and a political analysis of international markets and interventions into such markets. A policy perspective must also address the interfaces between economic, political and legal considerations which are part and parcel of today's debate on the globalisation of financial markets.

Addressing the benefits and risks of global capital markets by way of introduction can only set the scene. To this end, a more or less 'neutral' perspective on historical developments at the outset of a discussion of whether or not – and if so, how – to regulate international financial markets cannot be sufficient. Before developing a regulatory strategy – and there may be at least agreement on 'prudential regulation'¹⁵ (whatever this means) – some benefits and risks of capital internationalisation must be highlighted. While a detailed assessment would go beyond the scope of this introduction, only a brief overview will be given. As a whole the analysis – and this is also the thrust of the present volume as such – takes a fairly general view without putting too much weight on details of specific regulatory issues. This may be the subject of a follow-up project.¹⁶

As far as benefits are concerned, integrated markets are economically advantageous in allowing world savings to be allocated effectively, thus favouring their most productive uses across the globe.¹⁷ Also, a political advantage can be seen in improved possibilities for the management of systemic risks, inherent in financial markets, be they local, regional or global. In a more or less perfect economic and political environment this offers countries in recession options for the external financing of investment and thus for the promotion of economic growth while, on the

¹² See the contributions by Volker Röben (chapter 5), Till Hafner (chapter 6), Qingjiang Kong (chapter 7) and Michael J. Hahn (chapter 8), in this volume.

¹³ Cf. Thilo Marauhn and Michael Weiss (chapter 9), Susan Emmenegger (chapter 10) and Axel Peuker (chapter 11), in this volume.

¹⁴ See Peter Nunnenkamp (chapter 12), Stefan Voigt (chapter 13) Kunibert Raffer (chapter 14), in this volume.

¹⁵ While the concept of prudential regulation is very popular its precise substance and contents are far from clear. Nevertheless, it can be applied in a meaningful way, cf. Sydney J. Key, 'Trade Liberalization and Prudential Regulation – The International Framework for Financial Services', (1999) 75(1) *International Affairs* 61–75.

¹⁶ For some first thoughts consider Rainer Grote and Thilo Marauhn ([Conclusions and agenda for further research](#)), in this volume.

¹⁷ Baum, 'Globalizing Capital Markets', above note 8, at p. 79.

other hand, national policy failures will be punished by low rates of foreign investment.¹⁸ It must be borne in mind that policy failures can be both, excessive regulation imposing non-competitive costs on transactions, or underregulation burdening potential investors with non-manageable risks. Global financial markets thus offer positive incentives. However, such incentives are not without negative counterparts. Some of them are related only tentatively to the internationalisation of capital as such but rather to interrelated developments. This is, among others, true for the innovation in information and communication technologies and the consequential speed of change. But it also applies to other forces of change, such as deregulatory policies which may be perceived as a weakening of democratic control, in particular if paralleled by a tremendous degree of institutionalisation and professionalisation of market participants. Finally, regulatory powers are generally lagging behind when new financial products join the market. The strongest criticism vis-à-vis global capital markets builds upon their inherent risks and the way such risks have been handled until now. The essence of such risks can be easily explained in referring to the operation of the banking system. Success and potential weaknesses build upon the same sources: intermediation and leverage.¹⁹ Intermediation is a process whereby banks collect deposits and lend them on, with deposits being highly liquid and loans less so. The involved maturity transformation leads to an increased amount of money available for income-earning loans. Leverage means this ability of banks to develop an initial cash deposit into loans that are a substantial multiple of that amount. While intermediation and leverage can be the source of economic growth, their downside is the financial risk they create. Such risks have been considered manageable as long as national capital markets and their risks were contained by national borders and the management of such risks remained the responsibility of the national regulator. With the internationalisation of financial markets numerous crises have given rise to the question of whether and how far such risks can be contained or whether these risks are as infectious as to cause world economic crises. Examples that can be given are manifold, with the

¹⁸ *Ibid.*, at 80.

¹⁹ Cf. Gary Gorton and Andrew Winton, *Financial Intermediation*, National Bureau of Economic Research (NBER) Working Paper 8928, 2002; Felicia Marston and Susan Perry, 'Implied Penalties for Financial Leverage: Theory versus Empirical Evidence' (1996) 35 *Quarterly Journal of Business and Economics* 77–97.

Mexican,²⁰ the Asian,²¹ the Russian,²² and eventually the Argentine²³ crises being the most recent (and perhaps the most dramatic).

Referring only to the process of globalisation as the cause of such risks would fall short of proper analysis. What has to be borne in mind additionally is that the public–private dichotomy has seriously changed. The decisive step promoting the development towards globalised capital markets was to remove state controls on external financial relations and to privatise the risk involved. Such privatisation of risks²⁴ – which occurred in the 1970s with the breakdown of the Bretton Woods system²⁵ – stimulated a development that first proved beneficial for most actors in international financial relations. Only when governments failed to introduce alternative risk management strategies such privatisation of risks brought about negative consequences, finally leading to a socialisation of such risks with bail-out strategies. When assessing the benefits and risks of capital market liberalisation, there must also be reference to the object and purpose of financial markets, as well as to their functioning. In a liberal (national) market economy such markets provide the financial means for investment and development. However, the liberalisation of international financial markets, their privatisation, and the parallel process of deregulation have not necessarily led to an

²⁰ Cf. Maxwell A. Cameron and Vinod K. Aggarwal, 'Mexican Meltdown – States, Markets and post-NAFTA Financial Turmoil' (1996) 17(5) *Third World Quarterly* 975–87.

²¹ Drawing consequences out of the Asian crisis see Desh Gupta, 'Lessons from South Asian Currency, Stock Market and Economic Crises – Opportunities for Business', (1998) 7(Special Edition) *Canterbury Law Review* 88–101. See also Ian F. Fletcher, 'An Analysis of International Support Packages in the Mexican and Asian Financial Crises', (1998) *Journal of Business Law* 380–96, with some critical remarks on the handling of the two crises by international institutions.

²² Martin Feldstein, *Economic and Financial Crises in Emerging Market Economies: Overview of Prevention and Management*, NBER WP 8837 (2002); Homi J. Kharas, Brian Pinto and Sergei Ulatov, 'An Analysis of Russia's 1998 Meltdown Fundamentals and Market Signals', (2001) (1) *Brookings Papers on Economic Activity*.

²³ Cf. John V. Paddock, 'IMF Policy and the Argentine Crisis', (2002) 34(1) *University of Miami Inter-American Law Review* 155–87.

²⁴ The privatisation of risks is only part of what has been described as the privatisation of world politics; cf. Tanja Brühl (ed.), *Die Privatisierung der Weltpolitik. Entstaatlichung und Kommerzialisierung im Globalisierungsprozess* (Bonn, 2001); see also Keith E. Maskus and Jerome H. Reichman, 'The Globalization of Private Knowledge Goods and the Privatization of Global Public Goods', (2004) 7(2) *Journal of International Economic Law* 279–320.

²⁵ Cf. Richard Sylla, 'The Breakdown of Bretton Woods and the Revival of Global Finance', (2002) 1 *Jahrbuch für Wirtschaftsgeschichte* 81–8. See also H.S. Houthakker, 'The Breakdown of Bretton Woods', (1977) *Harvard Institute of Economic Research. Discussion Paper* no. 543.

optimal allocation of financial resources. Over the past two decades, financial transactions have not necessarily met the needs of the 'real economy'.²⁶ What can today be described as 'new financial markets'²⁷ is characterised by a high degree of volatility, and must be considered a challenge to a global economic framework aiming at stability and sustainable development. While in the long run, liberalisation may end up in a new market equilibrium, the medium and short-term effects have created a culture of speculation with new actors who perceive themselves affiliated to a new powerful economic and political elite. At the same time something close to a regulatory vacuum has emerged.

While the picture that can be drawn of global capital markets is thus ambivalent and complex, it must be recognised that – notwithstanding political preferences of the various actors involved – the internationalisation (and globalisation) of financial markets can be considered much more a *factum* than a *desideratum*. While the interpenetration of markets may be less than complete, it is still as intense as to allow for such a statement. The decisive question from a public international law perspective is whether existing regulatory frameworks at the national, regional and international level are sufficient in order to safeguard the benefits of international financial markets and to reduce the risks. Within this context it is important to recognise that the liberalisation of financial markets was not in the first place the outcome of a deliberate and legally framed political decision of governments and international organisations but was driven primarily by economic actors who won the support of their respective national governments to open up national financial markets. The only – partial – exception to this is the process of European integration. However, as will be demonstrated within this volume,²⁸ the implementation of the rules on the free movement of capital within the European Union (EU) has only occurred rather late. By way of introduction we will now, nevertheless, first proceed to move forward towards the identification of what may be called the regulatory dilemma in international financial relations.

²⁶ Cf. Piti Disyatat, 'Currency Crises and the Real Economy – The Role of the Banks', (2001) *IMF Working Paper* no. 49.

²⁷ Stephen Hessler, 'Neue Regulierungsmodi für neue Finanzmärkte – Zur Notwendigkeit einer Tobin-Steuer', (2002) 77(3) *Die Friedens-Warte. Journal of International Peace and Organization* 249–77 at 254–5.

²⁸ See the contributions of Till Hafner (chapter 6) and Volker Röben (chapter 5), in this volume.

II. International markets – national regulation

Financial markets are thus indeed *de facto* international, if not global. Such internationalisation has been driven by economic, primarily non-state actors. Nevertheless, it is important to recognise that at least some governmental support was necessary in order to move ahead. Economic internationalisation and globalisation do not take place in a vacuum. They take place in a regulatory environment that is – at least in the beginning – predominantly national.²⁹ This national environment is simply due to the existence of the nation-state as the primary standard-setting and enforcement agency in what has been characterised as the ‘Westphalian system’.³⁰ Regulatory power is first and foremost exercised at the level of the nation-state, economically, politically and legally endowed with sovereignty. Such sovereignty – at least as a matter of principle – is still in existence. However it has been modified to a large extent. Such modification perhaps first took place in the field of economic activities and then extended through to political – and at least to some extent – to legal matters.

In order to identify and understand the role of national regulation in the process of economic internationalisation (and eventually globalisation) one may step back a little and consider a fictitious example. Let us consider the case where two undertakings in two different jurisdictions have become aware of each other and consider it useful to enter into economic transactions – both in goods and in financial services. If such undertakings were both operating within the same jurisdiction their contractual relations would be subject to the laws of the land. However, when involving two jurisdictions they must agree on specific rules which may at least be different from those of one of the two. Even if the two undertakings agree on particular contractual arrangements,

²⁹ For an introductory analysis see Stephen J. Choi and Andrew T. Guzman, ‘National Laws, International Money – Regulation in a Global Capital Market’, (1997) 65(5) *Fordham Law Review* 1855–908; see also Christopher J. Mailander, ‘Financial Innovation, Domestic Regulation and the International Marketplace – Lessons on Meeting Globalization’s Challenge drawn from the International Bond Market’ (1997/98) 31(3) *George Washington Journal of International Law and Economics* 341–92.

³⁰ Today, the phrase ‘Westphalian system’ is used to describe the traditional state-centred system. While there is a tendency to question the predominance of the state, the state enjoys continued relevance in public international law. Cf. Christopher Harding, ‘The Significance of Westphalia: An Archaeology of the International Legal Order’, in Christopher Harding (ed.), *Renegotiating Westphalia. Essays and Commentary on the European and Conceptual Foundations of Modern International Law* (The Hague, 1999), pp. 1–23.

those arrangements are only enforceable if the two different jurisdictions provide the pertinent rules to this end. This involves two dimensions: a jurisdiction must allow its 'own' undertakings to extend their activities beyond national boundaries and it must allow 'foreign' undertakings into the country. As far as the exchange of goods is concerned governments may reduce their involvement to a more or less permissible approach. However, in the field of financial relations the situation is much more complicated. A first complication is related to national currencies which are not only of practical but very often of symbolic relevance. The law of money,³¹ the regulation of a currency, in particular, its exchange,³² is a much more sensitive issue than the regulation applicable to the exchange of goods because the currency is often linked to the concept of sovereignty. Even if this is overcome, a second complication must be borne in mind: financial markets have with their increasing relevance always been under close scrutiny of governments. Even at the national level (at least since economic growth during the nineteenth century) they have never been an exclusively private matter but have always given rise to public interference – the most prominent obviously being the exercise of supervisory powers in the fields of banking, insurance, and securities. With the existence of such a supervisory system at the national level, states can still preserve a large degree of sovereignty within the process of internationalisation by, first, allowing foreign actors in and, second, supervising home actors also abroad. The notion of extraterritorial jurisdiction thus comes into play.³³ This still keeps regulatory powers at the national level.

An internationally active undertaking with a strong economy and a solid government at home will not perceive too many problems if it can rely on the extraterritorial reach of its home government. This, however, only applies to a very limited number of jurisdictions, in particular countries with an already strong position in foreign trade and – after the end of the gold standard – countries with a strong currency that is in

³¹ For an impressive and still relevant study of the law of money see Fritz A. Mann, *The Legal Aspect of Money – With Special Reference to Comparative Private and Public International Law* (Oxford, 1992).

³² Cf. Joseph Gold, *Exchange Rates in International Law and Organization* (New York, 1988).

³³ For a general account of the impact of national regulation on international economic activities see Reuven S. Avi-Yonah, 'National Regulation of Multinational Enterprises – An Essay on Comity, Extraterritoriality, and Harmonization', (2003) 42(1) *Columbia Journal of Transnational Law* 5–34. Focusing on the transboundary administrative activities cf. Christian Tietje, *Internationalisiertes Verwaltungshandeln* (Berlin, 2001).

law (but above all in practice) widely spread and has largely acquired the status of a reserve currency.³⁴ Not only undertakings from other countries but also undertakings originating in such jurisdictions, however, will be confronted with transaction costs when moving beyond national financial markets. Such transaction costs, *inter alia*, are due to the different legal environments and to different supervisory mechanisms. It goes without saying that those costs will be comparatively higher in the case of undertakings originating in economically less strong jurisdictions. It would thus seem fairly natural that an economically active or at least supportive government will support the interests of private actors in reducing such transaction costs – in other words: it will have an interest to reduce the burden of heterogeneous national regulatory environments.

From the perspective of public international law an international agreement dealing with conflict of laws and perhaps even aiming at some approximation or even harmonisation of normative standards comes to mind. However, this has not been the approach that has been adopted in international financial relations. Private actors, regulatory bodies, and governments have chosen a much more pragmatic but at the same time much less transparent, less democratic and – in the long run – perhaps even less sustainable approach: they opted for international co-operation *below* the level of formal juridification. In other words: they have preferred loose co-operation within the framework of international regulatory financial organisations to international treaty-based regimes. This can be proved by numerous examples: the so-called Basle Concordat of 1983,³⁵ the Basle Core Principles for Effective Banking Supervision of 1997,³⁶ and the Basle

³⁴ Most interesting in this regard is the development of the European currency, as illustrated by Patrick F. H. J. Peters, 'The Development of the Euro as a Reserve Currency', (1997) 2(4) *European Foreign Affairs Review* 509–33.

³⁵ The 1983 Concordat is a revision of the 1975 original. For a text of the Basle Concordat of 1983 consult <http://www.bis.org/publ/bcbsc312.pdf>; an analysis of its substance is provided by Peter Cooke, 'The Basle "Concordat" on the Supervision of Banks' Foreign Establishments', (1984) 39(1/2) *Aussenwirtschaft (Zurich)* 151–65. See also C. J. Thompson, 'The Basle Concordat: International Collaboration in Banking Supervision', in Robert C. Effros (ed.), *Current Legal Issues Affecting Central Banks* (Washington: IMF, 1992), pp. 331–40.

³⁶ The Basle Core Principles for Effective Banking Supervision of 1997 present a comprehensive set of twenty-five principles that have been developed by the Basle Committee as a basic reference for effective banking supervision. They are available at <http://www.bis.org/publ/bcbs30a.pdf>; for a discussion cf. William Rutledge, 'Presentation on Basle Core Principles for Effective Banking Supervision', (1999) 2(2) *Review of Pacific Basin Financial Markets and Policies* 161–70.

Capital Accord of 1988,³⁷ replaced by a revised version,³⁸ but also the International Monetary Fund (IMF) sponsored Code of Good Practices on Fiscal Transparency³⁹ as well as the also IMF sponsored Code of Good Practices on Transparency in Monetary and Financial Policies Rules.⁴⁰ Reference may further be made to the International Organisation of Securities Commissions' (IOSCOs') Objectives and Principles for Securities Regulation,⁴¹ to the International Accounting Standards of the Basle Committee⁴² as well as to the International Standards on Auditing of the International Federation of Accountants.⁴³ Another document of particular relevance is the set of Forty Recommendations of the Organisation for Economic Co-operation and Development (OECD)-related Financial Action Task Force on Money Laundering (originally drawn up in 1990, revised in 1996⁴⁴ and supplemented in 2001⁴⁵). All these documents neither qualify as treaties nor can they be regarded as any other type of traditionally accepted source of public international law *stricto sensu*. We thus find a variety of rules

³⁷ The Basle Capital Accord of 1988 sets down the agreement among the G10 central banks to apply common minimum capital standards to their banking industries. The original version is available at <http://www.bis.org/publ/bcbs04A.pdf>.

³⁸ The revision of the Capital Accord was a fairly controversial matter, see Patrik Buchmüller und Christian Macht, 'Basle II und internationaler Bankenwettbewerb', (2003) 58(3) *Aussenwirtschaft (Zurich)* 413–38. On 26 June 2004 central bank governors and the heads of bank supervisory authorities in the G10 countries issued a press release and endorsed the publication of 'International Convergence of Capital Measurement and Capital Standards: a Revised Framework', the new capital adequacy framework commonly known as Basle II (available at <http://www.bis.org/publ/bcbs107.htm>). Generally on the role of such standards see Susan Emmenegger (chapter 10), in this volume.

³⁹ The Code was approved by the Executive Board on 23 March 2001. The text is available at <http://www.imf.org/external/np/fad/trans/code.htm#code>.

⁴⁰ The document is available at <http://www.imf.org/external/np/mae/mft/code/index.htm> (adopted on 26 September 1999).

⁴¹ <http://www.iosco.org/pubdocs/pdf/IOSCOPD125.pdf>.

⁴² <http://www.bis.org/publ/bcbs70.pdf>.

⁴³ <http://www.ifac.org/Store/Category.tmpl?Category=Auditing%2C%20Assurance%20%26%20Related%20Services>.

⁴⁴ Text available at http://www1.oecd.org/fatf/40Recs-1996_en.htm. For further developments visit the website of the FATF at <http://www1.oecd.org/fatf/index.htm>.

⁴⁵ In this regard the interrelationship between organised crime and terrorism has to be borne in mind, as well as the distinctions that have to be drawn between the two; cf., on the one hand, Bruce Zagaris, 'The Merging of the Counter-Terrorism and Anti-Money Laundering Regimes', (2002) 34(1) *Law and Policy in International Business* 45–108 and, on the other hand, Alyssa Phillips, 'Terrorist Financing Laws Won't Wash', (2004) 23(1) *University of Queensland Law Journal* 81–101. The Eight Special Recommendations on Terrorist Financing are available at http://www1.oecd.org/fatf/SRecsTF_en.htm.

in the nature of administrative co-operation and quite often in the form of a code of conduct rather than any type of binding agreement. Nevertheless, these standards are implemented at the national level in an incredibly effective way. Compared to many binding international agreements some of these codes enjoy an impressive implementation record. Most of them, indeed, have become part of regional or national law.⁴⁶

This does not mean that we do not find other types of agreements. Reference may be made, among others, to the General Agreement on Trade in Services (GATS)⁴⁷ and to the regional arrangements in Europe⁴⁸ and North America.⁴⁹ They touch upon financial services – but they are concerned with the liberalisation of such services rather than with their regulation or supervision. The objectives of these (legally binding) agreements are to tear down barriers to trade in (financial) services, neither to uphold them nor to provide a regulatory framework for such services. There are only a very limited number of public international law treaties that follow a regulatory approach. Typically those treaties aim at fighting organised crime, in particular, the financial resources of such crime. They include the OECD Convention on Combating Bribery of Foreign Public Officials in International Business Transactions of 1997,⁵⁰ the Council of Europe Criminal Convention on Corruption of 1999,⁵¹ the Inter-American Convention

⁴⁶ Mario Giovanoli, 'A New Architecture for the Global Financial Market: Legal Aspects of International Financial Standard Setting', in Mario Giovanoli, *International Monetary Law. Issues for the New Millennium* (Oxford, 2000), pp. 3–59 at 45–50.

⁴⁷ See the contribution by Michael J. Hahn (chapter 8), in this volume. Bringing the regulatory approach into the liberalisation provided for by GATS cf. Mahmood Bagheri and Chizu Nakajima, 'Optimal Level of Financial Regulation under the GATS – A Regulatory Competition and Cooperation Framework for Capital Adequacy and Disclosure of Information', (2002) 5(2) *Journal of International Economic Law* 507–30.

⁴⁸ See the contribution by Volker Röben (chapter 5), in this volume.

⁴⁹ See Valerie J. MacNevin, 'Policy Implications of the NAFTA for the Financial Services Industry', (1994) 5(2) *Colorado Journal of International Environmental Law and Policy* 369–99.

⁵⁰ (1998) XXXVII(1) *International Legal Materials* 1; available also at http://www.oecd.org/document/21/0,2340,en_2649_34859_2017813_1_1_1_00.html; the Convention entered into force on 15 February 1999. For a brief analysis of the Convention see Otto Dietrich, 'OECD Convention on Combating Bribery of Foreign Officials in International Business Transactions', (1998) 3(1) *Austrian Review of International and European Law* 159–69.

⁵¹ European Treaty Series no. 173; text available at <http://conventions.coe.int/treaty/en/Treaties/Html/173.htm>.

against Corruption of 1996⁵² and the recent UN Convention Against Transnational Organised Crime of 2000.⁵³ It may thus be argued that the focus of legally binding international regulation so far is limited to fighting criminal activities, including corruption, bribery, and money laundering. It has to be noted that the implementation record of these agreements is mixed.

In spite of all these efforts and political developments two aspects are striking: (1) Up until now, the regulatory framework for international financial markets is provided by a set of institutions rather than by standards. Such interlocking – perhaps sometimes inter-blocking – institutions are not empowered to establish a substantive system of international financial governance but they only serve to co-ordinate the activities of national regulatory bodies and authorities – and this largely limited to economically powerful states. (2) Although there is thus some form of international co-operation it is highly questionable whether the institutions are really international (in the sense that they enjoy a certain degree of autonomy), rather national actors – at least from the perspective of law – seem to be the decisive ones. In other words, there seem to be numerous international activities, but as soon as it comes to regulation in the narrow sense, we must admit that this is national regulation.

Bringing together the findings of the first part of this introduction and the second one, there can be no doubt that there is a globalised capital market as of today. Financial relations are not limited to national or regional markets. Financial transactions are performed within truly international markets. This finding is in sharp contrast with the regulation of such markets. It would not be true to argue that international financial markets are not at all regulated. They are indeed regulated – but rather by national (or in the case of the EU, by regional supranational) law than by public international law. As a commentator, one may perceive this as a kind of misinterpretation of the motto ‘Think globally, act locally’.

We may perceive this as a regulatory dilemma in international financial relations: international markets are regulated in the first place at the

⁵² (1996) XXXV(3) *International Legal Materials* 724. Cf. Robert H. Sutton, ‘Controlling Corruption through Collective Means: Advocating the Inter-American Convention Against Corruption’ (1997) 20(4) *Fordham International Law Journal* 1427–78.

⁵³ UN Doc A/55/383, Annex. For a broad introduction into the Convention cf. Hans-Jörg Albrecht et al. (eds.), *The Containment of Transnational Organized Crime. Comments on the UN Convention of December 2000* (Freiburg i.Br., 2002).

national level and such national legislation is only co-ordinated to a limited extent. There is a certain risk – at least from the perspective of public international law – that regulatory efforts are deprived of their ‘governance potential’ or that a specifically (either politically or economically) powerful national regulator determines the regulatory framework for international financial relations on his own.

III. The public–private dilemma: hybrid regulation

While considerations of effective national implementation may provide arguments in favour of such loose co-operation between regulatory authorities, the problem is much more essential when it comes to the question of who actually is the most powerful player on stage. A large number of institutions, initiatives and *fora*, dealing with risk management in international financial relations, are neither participatory nor democratically controlled. We often identify hybrid forms of regulation where the beneficiaries of the regulatory environment themselves establish the regulatory framework which does not include sanctions or regulations that effectively protect the weaker participants of such markets. Rather we experience some kind of discriminatory regulatory framework, and the failure to agree upon a Multilateral Agreement on Investment (MAI),⁵⁴ the confined club of the G20, and the development of the Basle II Agreement reflect such discriminatory approaches. While it has already been demonstrated that there is little regulation of international financial markets at the level of public international law it must further be stated that the institutions co-ordinating the activities of national regulatory bodies are hardly ever international organisations in the traditional sense. Thus we talk of institutions or international regulatory arrangements rather than of international organisations *stricto sensu*. The following specific characteristics of international institutions that contribute to the regulation of international financial markets have been identified: such institutions largely consist of sub-state actors, they have been informally established, their internal organisation is rather flexible, their ‘arrangements’ are

⁵⁴ On the substance of the envisaged MAI see Rainer Geiger, ‘Towards a Multilateral Agreement on Investment’, (1998) 31(3) *Cornell International Law Journal* 467–75. On its failure see Jürgen Kurtz, ‘NGOs, the Internet and International Economic Policy Making. The Failure of the OECD Multilateral Agreement on Investment’ (2002) 3(2) *Melbourne Journal of International Law* 213–46.

implemented in a decentralised way, there is a lack of transparency (the institutions largely act in secrecy – as far as the general public is concerned), and their ‘outcome’ is of an ambiguous legal quality.⁵⁵

Looking more closely at the actors involved it is noteworthy that the range of institutions is fairly broad – IOSCO is a private organisation that developed out of the Interamerican Association of Securities Commissions and Similar Agencies in 1984, originally incorporated by a private bill of the Quebec National Assembly;⁵⁶ the International Association of Insurance Supervisors (IAIS) is a non-profit corporation incorporated in Illinois;⁵⁷ the Basle Committee is hosted⁵⁸ by the Bank for International Settlements (BIS) which itself has a unique legal basis.⁵⁹ In spite of this multitude of institutional arrangements, two problems can be identified which at the same time must be separated from each other: (1) the involvement of regulatory authorities and civil servants (rather than political agents); and (2) the participation of private actors that are at the same time drafters and addressees of regulatory standards.

As far as the involvement of private actors in regulatory financial institutions is concerned we may not only point towards the difficulty of determining precisely the public–private divide but the advantages of self-regulation come into play.⁶⁰ Many areas of economic activities which are in the interest not only of the individual economic actor but also of the economic community – whether at the local, national, regional or global level – are today being promoted by governments while public authorities at the same time recognise the need to establish a regulatory framework for such activities. This concerns, among others,

⁵⁵ David Zaring, ‘International Law by Other Means: The Twilight Existence of International Financial Regulatory Organizations’, (1998) 33(2) *Texas International Law Journal* 281–330.

⁵⁶ Zaring, ‘International Law by Other Means’, above note 55, at 292, referring to An Act Respecting the International Organization of Securities Commissions, ch. 143, 1987 S.Q. 2437 (Can.).

⁵⁷ See Zaring, ‘International Law by Other Means’, above note 55, at 295.

⁵⁸ The Committee’s mandate can be taken from a press communiqué from the central bank governors, issued through the Bank for International Settlements on 12 February 1975; cf. Zaring, ‘International Law by Other Means’, above note 55, at 287.

⁵⁹ Helmut Coing, ‘Bank for International Settlements’, in: Rudolf Bernhardt (ed.), *Encyclopedia of Public International Law*, vol. I (Amsterdam, 1992), pp. 342–3, with Addendum 1990 by Gunnar Schuster (at 343–4).

⁶⁰ A good example can be taken from James Fisher, ‘Privatizing Regulation – Whistleblowing and Bounty Hunting in the Financial Services Industries’, (2000) 19(1) *Dickinson Journal of International Law* 117–43.

telecommunications, in particular the internet; it applies to the mass media, the approach is used in the field of energy, and a number of other activities which come close to public services (*état providence/Daseinsvorsorge*). Due to the fact that governments are no longer (economically) capable of providing such services they encourage non-state actors, in particular private undertakings, to develop economic activities in the field. In order not to curb such activities in their embryonic stages and in order to reduce transaction costs, governments increasingly rely upon self-regulation or partial self-regulation. Such an approach seems to be workable and provides both sides with some legitimacy while it cannot be easily accommodated with the traditional approach towards democratic legitimacy (which is input-oriented). If following an output-oriented model of democratic legitimacy⁶¹ the participation of non-state (i.e. primarily private) actors in the regulation of financial markets becomes much more acceptable. Whether or not it is even necessary to develop a public-private partnership⁶² in order to develop a regulatory framework for more or less global financial markets is a question that deserves further research. For the time being it may be argued that the involvement of banks, insurance companies, and other financial service providers in the activities of international and regional regulatory institutions has the twofold advantage of bringing expert knowledge into the process of regulation while at the same time facilitating the implementation of any co-ordinated approach since the acceptability of standards that have been developed in a participatory process is much higher than pure governmental regulation.

It must be pointed out that all this is not really new – although it is not a common feature of international regulation. As a rule, states still develop a public international law framework. However, at the regional level – in particular within European integration, including the committee procedures which are commonly referred to as ‘comitology’⁶³ – hybrid regulatory techniques are well known. Such techniques build

⁶¹ On the two models cf. Christian Tietje, ‘Die Staatsrechtslehre und die Veränderung ihre Gegenstandes. Konsequenzen von Europäisierung und Internationalisierung’, (2003) 118(17) *Deutsches Verwaltungsblatt* 1081–96, at 1094 et seq.

⁶² Instructive within the context of the internet Wolfgang Kleinwaechter, ‘Form Self-Governance to Public-Private Partnership. The Changing Role of Governments in the Management of the Internet’s Core Resources’, (2003) 36(3) *Loyola of Los Angeles Law Review* 1103–26.

⁶³ A conceptual approach to comitology is provided by Christian Joerges and Jürgen Neyer, ‘From Intergovernmental Bargaining to Deliberative Political Processes: The Constitutionalisation of Comitology’, (1997) 3(3) *European Law Journal* 273–99.