# Governing International Securities Markets: IOSCO and the Politics of International Securities Market Standards

by

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## AUTHOR'S DECLARATION

I hereby declare that I am the sole author of this thesis. This is a true copy of the thesis, including any required final revisions, as accepted by my examiners.

I understand that my thesis may be made electronically available to the public.

## Abstract

What explains the creation and strengthening of international securities market standards through the International Organization of Securities Commissions (IOSCO)? This thesis addresses this question by analyzing the creation and strengthening of four of IOSCO's international securities market standards between 1991 and 2010 relating to the following issues: the governance of cross-border financial crime, the objectives and principles of domestic securities market regulation, the regulation of credit rating agencies, and the regulation of hedge funds.

This thesis argues that the creation and strengthening of these standards is derived from the role and influence of three different political actors: the transgovernmental network of securities market regulators, domestic legislatures, and states. The role and influence of these different political actors differs across issue areas and across time. To account for the differentiated sources of international securities market standards, this thesis proposes a Principal-Agent (PA) analytical framework. Domestic legislatures (the principal) delegate to securities regulators (the agent) the authority to oversee and regulate domestic securities markets by granting regulators specific forms of statutory authority. Exercising discretion within this act of delegation, domestic securities regulators act together in a transgovernmental network to create and strengthen international securities market standards. They are prompted to act by threats to the integrity and stability of developed financial centers from under-regulated or ineffectively regulated foreign financial centers, as well as by new policy preferences of domestic legislatures seeking to regulate previously unregulated financial market actors. Domestic legislatures also use multiple agents to ensure that agents act consistent with their policy preferences: their concerns about the costs of under-regulated foreign jurisdictions can generate direct pressure from states on international financial regulatory institutions to strengthen the implementation of international financial standards.

This thesis makes an empirical contribution to existing literature by analyzing previously understudied international securities market standards. This thesis also makes a theoretical contribution to both IPE literature and PA theory within International Organization (IO)

literature. For IPE literature, this thesis establishes a theoretical framework that accounts for the differentiated role and influence of the transgovernmental network of securities market regulators, domestic legislatures, and states in the creation and strengthening of international securities market standards. For PA theory within IO literature, this thesis highlights the role of the principled professional interests of the transgovernmental network of securities market regulators in creating and strengthening international securities market standards.

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# Dedication

This thesis is dedicated to Wendy Kempthorne and Rhys Brookbanks.

To my mother, your love and your support throughout my life were so important to me through this thesis. The life that you led and your character gave me the inspiration to complete this thesis. I know it was your hope that you would make it to my graduation but I know you will be there in spirit, as you were throughout this thesis.

To my best friend, I naively said that "poetry couldn't change the world" but I know that had you been given half a chance your poetry would have. I wish you could be here to celebrate this with me, with whisky and cigars as we always did. Instead, I will have to make do by dedicating this thesis to you. You were always with me in spirit and the life you led gave me the inspiration to complete this thesis.

I dedicate this thesis to you both and to your memories.

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# List of Abbreviations

| | |
|---|---|
| AIFM | Alternative Investment Fund |
| AIFMD | Alternative Investment Fund Management Directive |
| AMF | Autorité des Marchés Financiers |
| ASIC | Australian Securities and Investment Commission |
| BCBS | Basel Committee on Banking Supervision |
| BSI | Banca della Svizzera Italiana |
| CESR | Community of European Securities Supervisors |
| CFTC | Commodities Futures Trading Commission |
| CIS | Collective Investment Scheme |
| COB | Commission des Opérations de Bourse |
| CONSOB | Commissione Nazionale per la Societa e la Borsa |
| CRA | Credit Rating Agency |
| CRMPG | Counterparty Risk Management Policy Group |
| ESMA | European Securities Market Authority |
| ESME | European Securities Market Experts |
| FOI | Freedom of Information |
| FSA | Financial Services Authority |
| FSAP | Financial Stability Assessment Program |
| FSF | Financial Stability Forum |
| FSOC | Financial Stability Oversight Council |
| G7 | Group of 7 |
| G10 | Group of 10 |

| | |
|---|---|
| G20 | Group of 20 |
| G30 | Group of 30 |
| HLI | Highly Leveraged Institution |
| IASC | Inter-American Association of Securities Commissions |
| IAIS | International Association of Insurance Supervisors |
| IMF | International Monetary Fund |
| IO | International Organization |
| IR | International Relations |
| IOSCO | International Organization of Securities Commissions |
| IPE | International Political Economy |
| ISDA | International Swaps and Derivatives Association |
| LTCM | Long Term Capital Management |
| MAD | Market Abuse Directive |
| MoU | Memorandum of Understanding |
| MMoU | Multilateral Memorandum of Understanding |
| NIFA | New International Financial Architecture |
| NRSRO | Nationally Recognized Statistical Rating Organization |
| OIA | Office of International Affairs |
| OTC | Over-the-Counter |
| PA | Principal-Agent |
| PWG | President's Working Group |
| ROSC | Reports on the Observance of Standards and Codes |
| SC5 | Standing Committee 5 |
| SEC | Securities and Exchange Commission |

# Chapter 1
# Introduction: IOSCO and the Politics of International Securities Market Standards

Financial globalization is defined as the intensified integration of national financial markets. National financial markets have become increasingly interdependent and competitive through the removal of technological and regulatory barriers to the execution of trades and transactions across national borders. A central feature of this new epoch in international financial markets has been the rise of international financial regulatory institutions and the international financial standards they create to govern the global financial market system.

A small sub-set of International Political Economy (IPE) scholarship has focused its research on understanding this phenomenon, and establishing analytical frameworks that explain the emergence of international financial regulatory institutions and the international financial standards they create. This thesis seeks to contribute to this specialist literature by analyzing the International Organization of Securities Commissions (IOSCO) – the international institution responsible for governing global securities markets, which creates, promotes and, to some extent, enforces the adoption and enforcement of international securities standards.

IOSCO has been relatively overlooked by existing literature. Although existing IPE scholarship has analyzed some of the international securities market standards that IOSCO has developed, it has neglected the creation of some of IOSCO's key international financial standards and institutional initiatives to strengthen their implementation. This thesis seeks to address this empirical gap by undertaking an in-depth empirical study of IOSCO and four of its international securities market standards.

This thesis seeks to explain the creation and strengthening of four of IOSCO's international securities market standards including:

1. IOSCO's Principles for Memoranda of Understanding created in September 1991 and its strengthening with the creation of IOSCO's Multilateral Memorandum of Understanding in May 2002

2. IOSCO's Objectives and Principles of Securities Market Regulation created in September 1998 and its strengthening with the creation of IOSCO's Methodology in October 2003

3. IOSCO's Principles for Credit Rating Agencies created in September 2003 and IOSCO's Code of Conduct Fundamentals for Credit Rating Agencies created in December 2004, and their strengthening through the creation of direct regulatory regimes for rating agencies in the U.S. and E.U. before and after the 2007/2008 financial crisis

4. IOSCO's Principles for the Regulation of Hedge Funds created in June 2009 and Systemic Risk Data Requirements for Hedge Funds in February 2010;

## 1.1 What explains the creation and strengthening of IOSCO's international securities market standards?

This thesis seeks to answer this central research question in order to contribute to the specialist IPE literature analyzing the politics of international financial regulation. Since the late 1980s, a specialist literature within IPE emerged to explain the international financial regulatory regime, focusing its analysis on understanding the creation and strengthening of international financial standards.

Analytical approaches in IPE literature on international financial regulation can be categorized within three broad categories: interstate, domestic, and transnational. The three categories of IPE literature are differentiated by the three political arenas that are considered

to be the source of international financial regulation. Existing literature has made important contributions to our understanding of the politics of international financial regulation by identifying the relevant political actors involved in the creation of international financial standards, and the power of each actor in creating and enforcing those standards.

Despite these important contributions, existing literature has a number of important limitations that warrant further study. As noted above, existing IPE scholarship has not analyzed a number of IOSCO's financial standards and institutional initiatives to strengthen their implementation. IPE scholarship has also overlooked some important aspects of IOSCO's international financial standards. Additionally, it has analyzed these standards in isolation from each other. In addressing these empirical limitations, this thesis also reveals important theoretical limitations of existing literature.

Existing literature concludes that international securities standards are derived from three distinct political arenas: domestic, inter-state, and transnational political arenas. This thesis' analysis of the creation and strengthening of four of IOSCO's standards reveals that the influence of these three political arenas is different across issue areas and across time. Consistent with the recommendations of Eric Helleiner and Stefano Pagliari's 2011 review article in *International Organization*,[1] this thesis argues that it is necessary to establish an analytical framework that can account for the influence that these three competing political arenas possess. In an effort to meet the challenge posed by Helleiner and Pagliari, this thesis proposes a Principal-Agent (PA) analytical framework to account for the differentiated influence of the three competing political arenas in the creation of international securities standards. The political arena that influences international securities standards is dependent on whether international securities standards are derived from the policy preferences of securities regulators, domestic legislatures, or states.

### *1.1.1 Who Creates International Securities Market Standards?*

IOSCO's four international standards fall in to two categories. The first category of international securities market standards is predominantly driven by the agency of the

[1] See Helleiner and Pagliari 2011

transgovernmental network of securities market regulators within IOSCO's Technical Committee and its associated policy committees. These international securities market standards are created to address the negative spillovers caused by under-regulated or ineffectively regulated jurisdictions. Under-regulated or ineffectively regulated jurisdictions are predominantly from relatively peripheral financial centers. In the case of Principles for Memoranda of Understanding (to facilitate the prosecution of cross-border financial crime) in September 1991 (IOSCO's *Principles for MoUs* hereafter), Switzerland was the central cause of regulators' decision to create an international securities market standard and is the exception to this general rule. The costs and risks of such negative spillovers have increased as international financial markets have become increasingly integrated and interdependent in the era of globalization.

This category of international regulatory standards seeks to raise the financial regulatory standards of under-regulated or ineffectively regulated foreign financial centers. Alternatively, international securities standards establish cooperative regulatory agreements with foreign financial regulators that enable regulators to share information, provide mutual legal assistance, and to use that information in the prosecution of financial crime. This set of financial standards reflects the pre-existing statutory authority of the majority of developed financial market centers who are members of IOSCO's Technical Committee. Through the creation, promotion and strengthening of international securities market standards, IOSCO's Technical Committee seeks to improve financial regulatory frameworks in foreign financial centers to foster international financial stability and the ability of securities market regulators to regulate their respective domestic securities market.

These cases highlight the validity of a transgovernmental network approach. The transgovernmental network approach was pioneered by Tony Porter, and supported by the work of other transnational scholars such as Anne-Marie Slaughter, Kal Raustiala and David Zaring.[2] Transgovernmental network scholars argue that financial regulators are forming dense networks to share experiences that foster common understandings of how to effectively regulate international and domestic securities markets. Ongoing interactions between regulators establish trust and a gradual coalescence of regulatory preferences. This

[2] Porter 2005a; Porter 2003; Slaughter 2004; Raustiala 2002/2003; Zaring 1998, p. 313 – 324

fosters the creation of cooperative regulatory agreements and coordinated national financial regulatory frameworks. As Porter states that "it would be a mistake to see these arrangements as simply the product of the type of rationalistic competitive bargaining among states that we usually associate with international organizations… what [is] more significant are the networks of regulators and other market actors that cut across the formal structures of states and international organizations and that display considerable autonomy from them [states]."[3]

A transgovernmental network approach argues that the creation of international standards is driven by the principled professional interests of securities market regulators. Securities market regulators create international financial standards to establish governance solutions that enable them to more effectively govern the domestic financial market system they are entrusted to regulate. International financial standards are made necessary by the governance demands of an increasingly global financial system and the associated integration and interdependence of national financial systems.

Two of IOSCO's international securities market standards fit this first category:

1. Principles for Memoranda of Understanding (to facilitate the prosecution of cross-border financial crime) in September 1991

2. IOSCO's Objectives and Principles of Securities Market Regulation endorsed in September 1998

IOSCO's *Principles for MoUs* and IOSCO's *Objectives and Principles of Securities Market Regulation* (IOSCO's *Principles* hereafter) were created at the initiative of the community of securities regulators from developed financial centers. IOSCO's Technical Committee was motivated to create international financial standards to enable domestic securities regulators to effectively prosecute cases of insider trading and financial crime in the era of financial globalization. IOSCO's *Principles* was created to raise the financial regulatory standards of national securities markets. IOSCO's *Principles for MoUs* and IOSCO's *Principles* were created

[3] Porter 2005a, p. 43

in the principled professional interests of regulators acting at the transnational level in order to facilitate strengthened coordination and cooperation between national regulatory frameworks and their respective national securities market supervisors. These standards were created without substantive domestic political pressure, or pressure from foreign relations or state departments. These cases highlight the role and influence of the transgovernmental network of securities market regulators from developed financial centers in the creation of international securities market standards.

The second category of international securities standards examined in this thesis was created to promote the harmonization of national securities market regulatory frameworks amidst the reform of financial market regulation in dominant financial centers. The creation of these standards is contingent on shifts in the policy preferences of domestic political actors in dominant financial centers and the exercise of agency and discretion by the transgovernmental network of securities market regulators. In the cases analyzed, domestic legislatures have expressed their preference for securities regulators to improve the regulation of previously unregulated financial market actors or have indicated a willingness to create new forms of statutory authority to regulate previously unregulated financial markets actors. Domestic legislatures become central actors in the governance of national financial markets in response to financial instability and the politicization of financial regulation.[4] Domestic legislatures establish new forms of statutory authority because they face a different set of political incentives in favor of regulatory reform rather than the regulatory status quo.[5] In response, the transgovernmental network of securities market regulators create international financial standards and cooperate through IOSCO's policy committees to promote the coordination of national regulatory frameworks. Securities market regulators promote the coordination of national regulatory frameworks if they consider it to be in the interests of investor safety, as was the case in the creation of IOSCO's *Principles for Credit Rating Agencies* (IOSCO's *Prnciples for CRAs* hereafter) and IOSCO's *Code of Conduct Fundamentals for Credit Rating Agencies* (IOSCO's *Code of Conduct* hereafter). Alternatively, securities regulators seek to coordinate national regulatory frameworks to establish common standards of regulation that will enable regulators to

[4] Helleiner and Pagliari 2011

[5] Pagliari 2013; Fioretos 2010; Quaglia 2011

monitor the systemic risk posed by internationally active financial firms, as was the case in the creation of IOSCO's *Principles for the Regulation of Hedge Funds* (*Principles for Hedge Funds* hereafter) and IOSCO's *Systemic Risk Data Requirements for Hedge Funds*.

This second category of international securities market standards is explained by both a domestic politics and transgovernmental politics approach. Domestic politics theory argues that international financial standards are created in response to the preferences of domestic political actors.[6] Domestic politics theory has focused its analysis on analyzing the domestic political sources of state preferences for international financial standards. Domestic politics theory within IPE literature is the most diverse literature set as it identifies different sources of domestic political actors' preferences for international financial standards. One set of authors argue that international financial standards are created in response to competitiveness concerns and are intended to be redistributive in favor of domestic financial firms and financial markets.[7] A second set of authors focus on how international financial standards are created once the domestic political context shifts in favor of new regulatory preferences. This set of authors highlight that the policy preferences of domestic political actors are dependent on the structure of domestic political incentives.[8] Due to the nature of the standards this thesis analyzes, this thesis adopts the theoretical approach of the second set of domestic politics scholars. IOSCO's *Principles for CRAs*, IOSCO's *Code of Conduct*, IOSCO's *Principles for Hedge Funds*, and IOSCO's *Systemic Risk Data Requirements for Hedge Funds* do not raise competitiveness issues for dominant financial centers.[9] This set of standards was created after shifts in the policy preferences of dominant financial centers due to shifts in the domestic political context. This category of standards reflects the role and influence of domestic legislatures because their creation was contingent on shifts in the policy preferences of domestic legislatures and shifts in the domestic political context. The ability of securities market regulators to establish international regulatory standards remain contingent on the preferences of domestic political actors.

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[6] See Oatley and Nabors 1998; Singer 2007; Pagliari 2013; Fioretos 2010

[7] Oatley and Nabors 1998; Singer 2007

[8] Pagliari 2013; Fioretos 2010; Quaglia 2011

[9] As Eric Helleiner has analyzed, OTC derivatives market regulation has created competitiveness issues and domestic political actors have expressed interest in international financial standards to address these issues. See Helleiner *Forthcoming*.

This category of standards is also explained by a transgovernmental network approach. Similar to the transgovernmental network approach discussed earlier, IOSCO's Technical Committee was driven to create this category of international securities standards by their principled professional interests because it enabled securities regulators to more effectively govern the domestic securities market system they were entrusted to regulate and to fulfill the regulatory responsibilities delegated to them by domestic legislatures.

Two of IOSCO's international securities standards fit this second category:

1. IOSCO's Principles for Credit Rating Agencies in September 2003 and IOSCO's Code of Conduct Fundamentals for Credit Rating Agencies created in December 2004.

2. IOSCO's Principles for the Regulation of Hedge Funds created in June 2009 and IOSCO's Systemic Risk Data Requirements for Hedge Funds in February 2010

IOSCO's Technical Committee created IOSCO's *Principles for CRAs* and IOSCO's *Code of Conduct* after domestic legislatures in the U.S. and E.U. had expressed a preference for improving the regulation of rating agencies whilst not subjecting rating agencies to a direct regulatory regime. IOSCO's *Principles for CRAs* was created to promote the coordination of national regulatory frameworks for rating agencies amidst their review in the United States (U.S.) and European Union (E.U.). IOSCO's *Code of Conduct* was created to establish an internationally consistent regulatory framework for rating agencies that took into account the domestic political constraints in the U.S. and E.U. Securities market regulators were driven to create international financial standards for rating agencies to ensure consistent assessments of credit worthiness across jurisdictions. Securities market regulators' decision to create international financial standards for rating agencies was contingent on shifts in the policy preferences of domestic political actors and their decision to review the regulation of rating agencies after their politicization from 2001 – 2003.

IOSCO's Technical Committee created IOSCO's *Principles for the Regulation of Hedge Funds* (*Principles for Hedge Funds* hereafter) in June 2009. IOSCO's Technical Committee only

created international securities market standards after policy preferences in the U.S. and E.U. domestic legislatures shifted in favor of the direct regulation of hedge funds after the 2007/2008 financial crisis. Before the 2007/2008 financial crisis, the U.S. Securities and Exchange Commission (U.S. SEC) (and the majority of securities regulators) favored the direct regulation of hedge funds in order to monitory the systemic risk they posed to the wider securities market. The U.S. SEC sought the statutory authority to regulate hedge funds but was rebuffed by Congress because the domestic political balance of power in the U.S. and E.U. favored the continued indirect regulation of hedge funds. As a result, IOSCO's Technical Committee produced reports and principles relating to the valuation of hedge funds and other investment protection issues rather than for hedge funds themselves. This demonstrates the role and influence of domestic legislatures in the creation of international financial standards.

After the 2007/2008 financial crisis, domestic political actors were incentivized to regulate hedge funds because of the highly visible role hedge funds played during the crisis, and due to cases of highly publicized financial fraud by hedge fund managers such as the Bernie Madoff scandal. IOSCO's Technical Committee created IOSCO's *Principles for Hedge Funds* and IOSCO's *Systemic Risk Data Required for Hedge Funds* to promote coordinated national regulatory frameworks in the U.S. and E.U. during the reform of hedge fund regulation in these jurisdictions to enable regulators to monitor the systemic risk posed by hedge funds.

The four international financial standards analyzed in this thesis and the analytical frameworks that explain their creation are represented in Table 1.1 below:

**Table 1.1 IOSCO's Four International Financial Standards**

| Issue Areas | | | | |
|---|---|---|---|---|
| | **Cross-Border Financial Crime and Insider Trading** | **National Securities Market Regulatory Frameworks** | **Credit Rating Agencies** | **Hedge Funds** |
| **Standards and Date of Creation** | Principles for Memoranda of Understanding<br>September 1991 | Objectives and Principles of Securities Market Regulation<br>September 1998 | Principles for Credit Rating Agencies<br>September 2003 | Principles for the Regulation of Hedge Funds<br>June 2009 |
| | | | Code of Conduct Fundamentals for Credit Rating Agencies<br>December 2004 | Systemic Risk Data Requirements for Hedge Funds<br>February 2010 |
| **Explanatory Framework** | Transgovernmental Network Theory | Transgovernmental Network Theory | Domestic Politics and Transgovernmental Network Theory | Domestic Politics and Transgovernmental Network Theory |

### *1.1.2 What Explains the Strengthening of IOSCO's Securities Market Standards?*

Of the four international securities standards analyzed as part of this thesis, three of IOSCO's standards have been strengthened. IOSCO's Multilateral of Understanding (IOSCO's *MMoU* hereafter) in May 2002 and IOSCO's Methodology for Assessing Implementation of IOSCO's Objectives and Principles of Securities Market Regulation (IOSCO's *Methodology* hereafter) in October 2003 are institutional initiatives created by IOSCO's Technical Committee, aimed at strengthening implementation and improving the adoption of IOSCO's financial standards. IOSCO's *Principles for CRAs* and IOSCO's *Code of Conduct* were strengthened after domestic legislatures chose to regulate rating agencies through direct regulatory regimes rather than through voluntary industry codes of conduct.

These three cases of strengthening international securities market standards highlight the role of different political actors.

The creation of IOSCO's *MMoU* is explained by a transgovernmental network approach. IOSCO's *MMoU* was created in May 2002 in response to the September 11 terrorist attacks on the United States. Despite the association of IOSCO's *MMoU* with September 11 and traditional foreign policy concerns, IOSCO's Technical Committee did not create the initiative after being subject to domestic political pressure or pressure from their respective state departments or finance ministries. Instead, IOSCO's *MMoU* was created out of regulators' concern about the incomplete global regulatory coverage of information sharing agreements and how this would affect their ability to prosecute cases of financial crime. The September 11 terrorist attacks revealed the limitations of IOSCO's existing bilateral network of MoUs and emphasized the necessity of establishing global regulatory coverage for information sharing agreements through a multilateral regulatory regime. Rather than the idea being proposed by a U.S. regulator, as would be expected if it was created in response to foreign policy concerns, the idea to create IOSCO's *MMoU* was proposed by a non-U.S. regulator at the first meeting of IOSCO's Technical Committee after September 11.[10]

The creation of IOSCO's *Methodology* is explained by an inter-state and transgovernmental network approach. IOSCO's *Methodology* was driven by the preferences of powerful states and the community of securities market regulators within IOSCO's Technical Committee. First, IOSCO's *Methodology* was created after IOSCO's Technical Committee was subject to pressure from powerful states to improve financial regulatory standards in peripheral financial centers after the Asian Financial Crisis. The IMF and World Bank pressured IOSCO's Technical Committee, of behalf of powerful states, to create a comprehensive assessment methodology from the creation of IOSCO's *Principles* in 1998 through to the decision to create the *Methodology* in October 2001. Powerful states sought to strengthen implementation of international financial standards after the Asian Financial Crisis in 1997 when they recognized the costs of under-regulated foreign jurisdictions to the stability and profitability of their domestic financial centers. This is explained by an inter-state analytical

[10] Friedman 2011

framework, which argues that international standards are created when it is in the material interests of powerful states or a coalition of powerful states.[11]

Second, IOSCO's *Methodology* was created after the transgovernmental community of securities market regulators recognized the benefits of improving the adoption of IOSCO's international standards in the wake of the September 11 terrorist attacks. September 11 drew regulators' attention to the dangers of under-regulated peripheral jurisdictions to the security and integrity of developed securities markets. This highlights the validity of a transgovernmental network approach as IOSCO's Technical Committee agreed to create IOSCO's *Methodology* when regulators recognized the importance of improving financial regulation in peripheral jurisdictions.

The strengthening of IOSCO's international credit rating agency standards is explained by a domestic politics approach. The implementation of IOSCO's *Principles for CRAs* and IOSCO's *Code of Conduct* were strengthened by the decision of domestic legislatures to directly regulate rating agencies. The U.S. chose to directly regulate rating agencies in 2006 through the creation of the Credit Rating Agency Reform Act. Despite the U.S. creating the first direct regulatory regime for rating agencies before the crisis, the regulatory regime remained weakened by continued Congressional pressure to respect the First Amendment rights of rating agencies. It took the 2007/2008 financial crisis to create a comprehensive and substantive direct regulatory regime for rating agencies. The policy preferences of domestic political actors in the U.S. and E.U. shifted in favor of comprehensive regulatory reform of rating agencies because of widespread reports of conflict of interest, issues relating to securitized debt markets, rating agencies' undervaluation of risks, and their overall contribution to the 2007/2008 financial crisis. The strengthened implementation of IOSCO's *Principles for CRAs* and IOSCO's *Code of Conduct* is explained by shifts in the domestic political contexts of the U.S. and E.U.

[11] Simmons 2001; Kapstein 1989; Kapstein 1992; Drezner 2007; also see Gilpin 2001; Keohane 1984

The three cases of the strengthening of IOSCO's international financial standards and the analytical perspectives that explain their creation is summarized in Table 1.2 below:

**Table 1.2 The Strengthening of IOSCO's International Financial Standards**

| Issue Areas | | | | |
|---|---|---|---|---|
| | **Cross-Border Financial Crime and Insider Trading** | **National Securities Market Regulatory Frameworks** | **Credit Rating Agencies** | **Hedge Funds** |
| **Strengthening of International Securities Market Standard** | Multilateral Memorandum of Understanding<br><br>May 2002 | Methodology for Assessing Implementation of IOSCO's Objectives and Principles of Securities Market Regulation<br><br>October 2003 | The creation of direct regulatory regimes in the U.S. and E.U. before and after the 2007/2008 financial crisis | N/A |
| **Explanatory Framework** | Transgovernmental Network Theory | Inter-State and Transgovernmental Network Theory | Domestic Politics Theory | N/A |

### *1.1.3 Principal-Agent Theory – Accounting for Differentiated Sources of International Securities Standards*

An analysis of four of IOSCO's international securities market standards reveal that the creation and strengthening of international securities market standards are explained by the role and influence of the transgovernmental network of securities market regulators, domestic political actors and states. The role and influence of each of these political actors is different across issue areas and across time. Existing theoretical approaches to international financial regulatory politics recognize the role of different political arenas in the creation of international financial standards but conclude that international securities market standards are derived from the preferences of specific political actors from different political arenas.

This thesis argues that it is necessary to establish an integrative approach that can account for the differentiated political sources of international financial standards across cases.

How are we able to account for the differentiated sources of international securities standards across the lifetime of IOSCO? This thesis states that a PA analytical framework can explain outcomes at IOSCO. PA theory provides us with an analytical tool to explain when international securities standards are derived from financial regulators acting through transgovernmental networks, and when they are derived from domestic political actors and states.

PA theory is derived from American domestic politics literature from the 1970s and International Organization (IO) literature that emerged in the 1990s. PA theory in IO literature was cemented by the publication of the major edited volume *Delegation and Agency in International Organizations*.[12] PA theory states that international organizations are representative of a principal-agent relationship in which states delegate authority to IOs in order to achieve specific tasks. Outcomes at IOs can be explained by both the agency and discretion granted to IOs through the act of delegation, and the mechanisms of control exercised by states to ensure IOs act consistently with their preferences.

PA theory in IO literature has focused on how the bureaucratic political interests of IO staff combined with states' exercise of control ensure that IOs act consistent with the preferences of powerful states. PA theory in IPE literature, pioneered by David Singer, has analyzed how the bureaucratic interests of domestic financial regulators combined with the mechanisms of control exercised by domestic legislatures, ensures that outcomes at international financial regulatory institutions reflect the preferences of domestic political actors in dominant financial centers.[13] This thesis argues that PA theory's underlying theoretical assumption that regulators' interests are bureaucratic and material has led PA theory to under emphasize the role and influence of transgovernmental networks in the creation of international financial standards. This thesis, therefore, adopts a modified PA analytical framework that recognizes

[12] Hawkins et al. 2006a
[13] Singer 2007

the principled professional interests of securities market regulators as an important explanatory factor in the creation and strengthening of international financial standards.

In the regulation of domestic securities markets, a PA relationship exists between the domestic legislature (acting as the principal) delegating authority to domestic securities regulators (acting as the agent). Domestic legislatures delegate securities regulators the authority to oversee and regulate domestic securities markets. Domestic legislatures do so by establishing legislation that grants securities regulators specific forms of statutory authority. The domestic legislature delegates securities regulators the task of implementing their statutory authority through regulatory rules that provide guidance to financial market actors as to how that statutory authority is interpreted and will be implemented.

Securities regulators are granted considerable discretion by domestic legislatures because of the technical nature of securities market regulation.[14] Discretion is defined by Hawkins et al. as "specifying the principal's goals but not the specific actions the agent must take to accomplish those objectives."[15] Securities regulators use the discretion granted to them by domestic legislatures to establish international securities market standards at the transnational level. The nature of this delegation chain is highlighted in Figure 1.1 below:

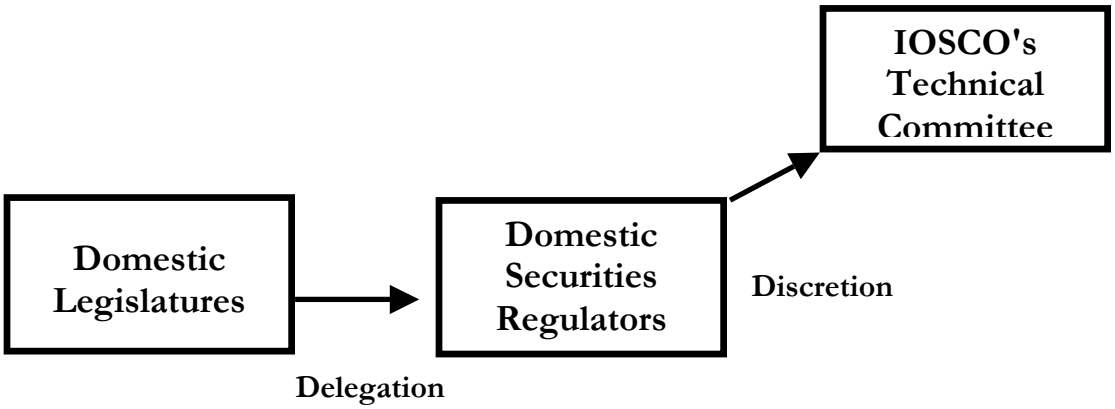



**Figure 1.1 The Delegation Chain in the Creation of International Securities Market Standards**

[14] Porter 2005a; Porter 2005b; Singer 2007
[15] Hawkins et al. 2006b, p. 8

International securities market standards are created with the "zone of discretion" granted to them by domestic legislatures. When acting within this "zone of discretion", regulators are acting consistent with the preferences of their respective states and domestic legislatures, whilst acting independently of domestic political pressure. International securities market standards are created to establish cooperative agreements with regulators from foreign jurisdictions, to export national regulatory frameworks to under-regulated or ineffective regulated foreign financial centers, or to promote common regulatory frameworks between national jurisdictions. These standards are created to fulfill the regulatory responsibilities of domestic securities regulators that are delegated to them by domestic legislatures and are created in their principled professional interests.

Consistent with a PA analytical framework, domestic legislatures also retain mechanisms of control to ensure regulators act consistent with their preferences. As David Singer's PA model highlights, domestic legislatures place political pressure on domestic regulators by threatening their autonomy, prestige and future career opportunities. Domestic legislatures are able to achieve this through public hearings, control of the agencies' budget, and legislative intervention.[16] In the case of credit rating agency standards, domestic legislatures utilized these mechanisms to indicate that improving the regulation of rating agencies was a policy priority. This thesis also highlights that domestic legislatures exercise control by granting or withholding statutory authority from securities market regulators. This is demonstrated in the case of international hedge funds standards. The transgovernmental network of securities market regulators have created international securities standards to promote the harmonization of national regulatory frameworks after domestic regulatory reforms in dominant financial centers. The creation of these standards is contingent on domestic legislatures delegating securities regulators the task of regulating previously unregulated financial market actors. In the case of IOSCO's *Priniples for CRAs* and IOSCO's *Code of Conduct*, domestic legislatures had indicated a preference for improving the regulation of rating agencies. In response, IOSCO's Technical Committee created IOSCO's *Principles for CRAs* and IOSCO's *Code of Conduct* to establish common regulatory principles and an internationally consistent regulatory regime in response to the domestic legislatures' changed policy preferences. IOSCO's *Principles for Hedge Funds,* a majority of members sought to

[16] Singer 2007, p. 22

create international hedge funds before the financial crisis, but were forced to wait until after the crisis because key domestic legislatures were unwilling to grant securities regulators the statutory authority to do so.

In order to explain the role and influence of the inter-state political arena, it is necessary to re-introduce the concept of multiple agents to PA literature.[17] Kenneth Arrow first introduced the concept to PA theory in 1984. Kenneth Arrow states, "the many-agent case offers new opportunities for inference of hidden actions (or of hidden action) if the uncertainty of the relation between the action (or the agent's observation) is the same for all agents."[18] The concept of multiple agents highlights how domestic securities market regulators are not the only agent responsible for international securities market standards and that there is considerable overlap in the responsibilities of foreign affairs and finance ministries and domestic securities regulators. Foreign affairs and finance ministries also represent the interests of domestic legislatures and have seniority over domestic securities market regulators. Their role and function of finance ministries and treasure departments is to represent the interests of the state and they traditionally view issues through the material interests of the state. This accounts for the influence of the inter-state political arena in the creation of IOSCO's *Methodology*, through the IMF and World Bank, when securities regulators were subject to external political pressure to create a comprehensive assessment methodology from 1998 – 2001. The nature of this delegation chain and the impact of multiple agents is represented in Figure 1.2 below:

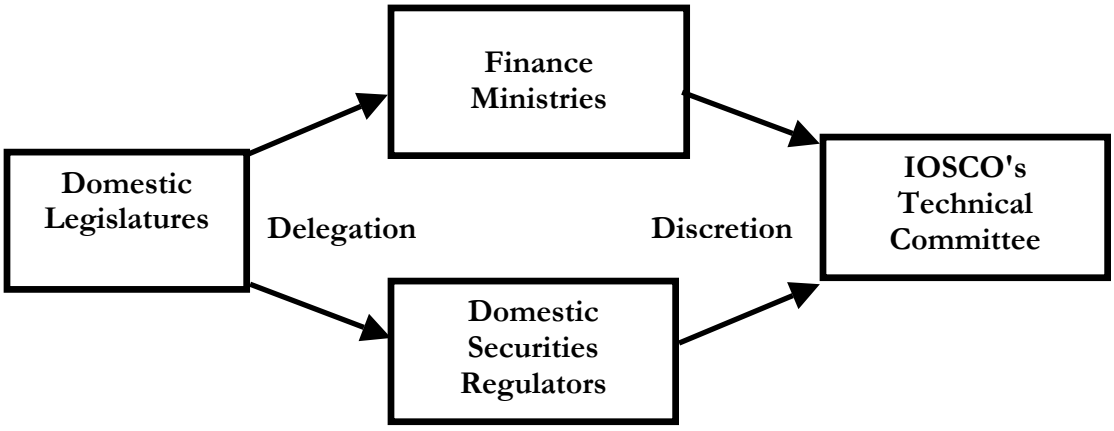



**Figure 1.2 The Delegation Chain in International Securities Market Regulation**

[17] Arrow 1984
[18] Arrow 1984, p. 16

### *1.1.4 Summary*

Existing approaches to the study of international financial regulation have established competing analytical frameworks to understand the politics of international financial regulation. These existing approaches have identified the political actors responsible for the creation of international financial standards, the interests of those actors, and the source of their power in creating and enforcing international financial standards. This thesis builds on the contributions of existing literature, focusing the analytical framework of this thesis on answering central research questions posed by existing literature. Current analytical approaches, however, are unable to account for the differentiated sources of international securities standards across issue areas and across time. It is necessary to adopt an integrative approach to understanding the politics of international financial regulation. This thesis argues that a PA analytical framework offers an opportunity to integrate the insights of the three competing analytical approaches of IPE literature.

A PA approach argues that within the act of delegation securities market regulators are subject to mechanisms of control and are granted a "zone of discretion" to determine how the legislatures' goals are obtained. Securities market regulators have utilized this "zone of discretion" to create international financial standards to enable them to fulfill their domestic regulatory responsibilities. Securities regulators are also subject to pressure from the state through the influence of multiple agents. Finance ministries and foreign affairs departments also monitor the outcomes of international financial standard-setters and place pressure on domestic securities regulators to improve the adoption of international financial standards in response to the perceived cost of under-regulated or ineffectively regulated financial markets.

A PA analytical framework enables us to identify when and under what conditions international financial standards are derived from the influence of domestic political actors and states, or the agency of financial regulators from developed financial centers acting through a transgovernmental network. Securities regulators use this "zone of discretion" when it is in their principled professional interests by creating international financial standards to respond to threats to the integrity and stability of their respective domestic

securities markets. Domestic political actors exercise control when they face domestic political incentives to regulate new financial market actors. States exercise control when they perceive that IOSCO has failed to establish adequate institutions to reduce the costs of under-regulated or ineffectively regulated financial markets.

### 1.2 Research Methodology and Sources of Analysis

This study utilizes a process tracing research method based on qualitative analysis. Primary policy documents of IOSCO and national and regional financial regulatory organizations, web sites, and secondary sources including academic journals and journalistic publications were utilized to identify IOSCO's central institutional initiatives and to identify the potential motivations for the creation of these institutional initiatives. To further explore publicly available information, an exhaustive keyword search was conducted to identify the political context surrounding the creation of these institutional initiatives and any further information regarding the design of these initiatives and the motivation of competing actors in their creation.

Given the limited availability of primary and secondary documents surrounding the activities of IOSCO, it was necessary to buttress the information provided from these sources through interviews with leading securities market regulators and other political actors. Therefore, I conducted a series of interviews, with the approval of the University of Waterloo's Office of Research Ethics: ORE #17195. During the research project, I sent out forty-five interview requests and was able to successfully complete twenty-five interviews with regulators, journalists and former Finance Ministers from eight different countries. Interviews were conducted to establish the political context of important events in international securities market regulation. This process sought to understand who was interested in pursuing institutional initiatives at IOSCO, the motivation of those actors, the logic of those actors in pursuing those institutional initiatives, and the level of political pressure placed on those actors during the process.

Interviewees were predominantly from developed securities market centers. This is because research suggested that IOSCO's institutional initiatives were led by, and involved, regulators

from developed securities markets and that securities regulators from emerging or developing markets did not play a central role. Interview requests were made to regulators from emerging and developing markets but only one interview request was returned.

To ensure a comparability of interviews whilst maintaining the ability to learn new information from interviewees, this thesis adopted a "semi-structured" interview approach. A semi-structured approach was adopted in order to ensure that commonalities between interviews could be identified whilst granting interviewees the opportunity to further elaborate and identify new and important trends, motivations and political pressures in international securities market regulation. Where permission was obtained, the names and positions of the interviewees are disclosed. Where permission was not obtained, the names and positions of interviewees are kept confidential at interviewees' own request.

Empirical material for IOSCO's institutional initiatives that strengthened the implementation of IOSCO's standards was predominantly acquired from interviews and publicly available information from IOSCO's website, due to little journalistic information, and secondary resource material available on this subject. Post-crisis empirical material was predominantly acquired from IOSCO's publicly available information, the websites of national securities regulators and journalist materials were acquired through exhaustive keyword searches relating to specific regulatory issue areas. Regulators were largely unwilling to be interviewed on issues that were still being discussed privately.

### 1.3 Object of Analysis: The International Organization of Securities Commissions

IOSCO was established in 1983 after members of the Inter-American Association of Securities Commissions agreed to disband the regional organization and establish a new, global regulatory institution. IOSCO is a universal organization with 115 securities market regulators from diverse locations. IOSCO retains an internal set of by-laws that outline the rights and responsibilities of its members and defines the constitution of its various committees and boards. IOSCO is a consensus-based organization that promotes the development, implementation and adherence to "internationally recognized and consistent standards of regulation, oversight and enforcement in order to protect investors, maintain

fair, efficient and transparent markets, and seeks to address systemic risks."[19] IOSCO does so through the creation of policy reports that identify common problems in market issue-areas and common solutions to policy problems by identifying a common basis for legal oversight regimes, monitoring mechanisms, and enforcement regimes.

In order to achieve the aims of the organization IOSCO has seven organs of power: the IOSCO Board,[20] IOSCO's President's Committee,[21] its four Regional Committees,[22] the Emerging Market Committee,[23] its Research Committees and policy Task Forces, the Self Regulatory Organization Consultative Committee, and the Assessment Committee.[24] At the heart of the organization are "IOSCO's Standards" found in IOSCO's policy reports produced by the IOSCO's seven Policy Committees.[25] The IOSCO Board establishes and approves the program of activities of the Policy Committees. Previously, the program of activities of IOSCO's policy committees were determined by IOSCO's Technical Committee, comprised of regulators from mostly developed securities market systems before a resolution to change IOSCO's internal structure in April 2011.[26] The only obligation of

[19] IOSCO 2010a
[20] The IOSCO Board is responsible for setting the program of activities at IOSCO, IOSCO's annual budget, recognizes Consultative Committees and Regional Committees, and recommends the appointment of new members and member sanctions. The IOSCO Board is elected every two years and in 2012 there were 32 members of IOSCO's Board.
[21] IOSCO's President's Committee is comprised of all ordinary members of IOSCO (those who represent national securities market regulators) and each member is given one vote each. The President's Committee is responsible for reviewing and approving the resolutions of the IOSCO Board, electing the IOSCO board, admitting new members, determining annual dues, and sanctioning members for failing to pay their annual dues.
[22] IOSCO has four regional committees split between Africa/Middle-East, Asia-Pacific, European, and the Americas and is intended to act as a forum of discussion on topics common to its members and distribute information amongst its members.
[23] The Emerging Markets Committee is required to act in concert with IOSCO's By-Laws and reports to IOSCO's Board. The Emerging Markets Committee has historically produced regulatory reports on regulatory issues for emerging securities markets. The role and function of the Emerging Market Committee has substantively declined since IOSCO reconstituted its central decision-making organs in 2012, as it wanted to reduce differences between emerging and developing markets.
[24] The Assessment Committee was created in 2011 to "ensure full and consistent implementation of the Objectives and Principles across the organization's membership and to disseminate the best goal's and practices and approaches for meeting this goal." From IOSCO 2011a, p. 5
[25] The seven policy committees are: the Multinational Disclosure and Accounting, Regulation of Secondary Markets, Regulation of Market Intermediaries, Enforcement and the Exchange of Information, Investment Management, Credit Rating Agencies, and Commodities Futures Markets Committees.
[26] IOSCO, 2011b

membership is to pay their annual dues of between €12,500 and €30,000 depending on the national income per capital and total GDP of each member.[27]

IOSCO was incorporated as a private organization by a private members bill of the Quebec National Assembly in 1987. In its early years, IOSCO's Secretariat was based in Montreal and had four staff members. The organization moved to Madrid, Spain in 2001 after the Spanish government won the tender process by offering tax breaks to the organization, and a former Ministry of Finance building to house the organization and renovation costs.[28]

IOSCO's secretariat has expanded since 1983 with 25 full time staff, part of which are secondees from IOSCO's membership.[29] IOSCO's secretariat staff are organized in to six different teams to coordinate the work of the related work streams within IOSCO including: Policy, Emerging Markets, *MMoU*, Technical Assistance, Education and Training, and Research. The research department was established after the 2008 financial crisis and its role is to support the work of the Policy Committees and the Emerging Markets Committee and to help overcome any internal disagreements between members of the Policy Committees. The *MMoU* team is responsible for obtaining signatories to the *MMoU* by promoting the benefits of becoming a signatory and providing guidance and training on what regulatory policies and legislative reforms need to be adopted to become compliant and accepted as a signatory to the agreement. The Technical Assistance department is responsible for providing technical assistance, guidance and training to members seeking to comply with IOSCO's international financial regulatory principles for securities markets. The Policy team coordinates all of IOSCO's policy work streams, including work with other international financial regulatory institutions such as the Financial Stability Board (FSB), the Joint Forum, and others. The Education and Training team coordinates and organizes the education and training program's for IOSCO's members in response to their reported education and training desires and needs.[30]

[27] IOSCO, 2011c
[28] Davies 2012
[29] Obtained with the assistance of IOSCO's General Secretariat.
[30] Obtained with the assistance of IOSCO's General Secretariat.

Senior members of national financial regulators conduct the work of IOSCO's Policy Committees (also known as Working Committees or Standing Committees) across borders. Research and policy reports are compiled individually and members often meet together in a single location to complete the reports. The work of IOSCO's Policy Committees is done in concert with their everyday duties of their home regulator.[31] The policy reports and regulatory principles that are produced by IOSCO's Policy Committees are published bearing the name of IOSCO's Technical Committee and, now, IOSCO's Board. This indicates that the work of IOSCO's Policy Committees is endorsed by IOSCO's Technical Committee.

IOSCO's constitution and institutional design reflects the common characteristics of a transgovernmental network. IOSCO has a relatively small secretariat staff, has relatively informal decision making processes, and, most importantly, its outcomes are driven by its members rather than the institution itself. The standards analyzed in this thesis were not driven by the secretariat staff but by the regulators within IOSCO's Technical Committee and policy committees.

IOSCO's reports promote the adoption of common regulatory standards through the process of persuasion and establishment of common understandings between IOSCO members. IOSCO promotes the expansion of regulatory standards to more peripheral financial centers through its internal institutional initiatives, resolutions, and training and education programs that provide technical assistance to regulators from emerging or developing securities markets. These initiatives are aimed at enabling IOSCO's members to adopt domestic financial regulatory frameworks consistent with IOSCO's *Principles* and other financial regulatory standards created by IOSCO's Policy Committees.

### 1.4 Case Studies: IOSCO's Four International Financial Standards

This thesis analyzes four of IOSCO's international securities market standards. These standards have been chosen because they were critical in promoting strengthened

[31] Bergstraesser and Kunz 2011

cooperation and coordination between national securities supervisors from the institution's inception in 1984.[32]

### *1.4.1 Principles for MoUs and IOSCO's MMoU*

IOSCO's *Principles for MoUs* were created in September 1991. IOSCO's *Principles for MoUs* were created after securities market regulators had identified the threat of under-regulated or ineffectively regulated securities markets in foreign jurisdictions to the integrity of developed capital markets in the early 1980s. Cross-border financial crime, predominantly in the form of insider trading, created the first global public policy problem domestic securities regulators faced that necessitated a cooperative regulatory regime. The prosecution of financial crime has historically been a central regulatory responsibility for securities market regulators. In response to the threat of cross-border financial crime, securities market regulators negotiated a unique governance solution to the prevailing problem of cross-border financial crime, initiated the creation of an international institution to deal with the issue, and formed international financial regulatory principles to identify common principles that should be incorporated in MoUs signed with foreign regulators. The creation of IOSCO's *Principles for MoUs* demonstrates the agency of securities market regulators who created an international securities market standard at the transnational level to fulfill the domestic regulatory obligations delegated to them by their respective domestic legislature.

The recommendations and regulatory principles identified by IOSCO's senior members were used to lobby domestic legislatures to grant regulators new statutory powers that would enable them to sign and execute MoUs with foreign regulators. Securities regulators' use of IOSCO recommendations to obtain legislative reforms from their respective legislature highlights the direction of causation. Transnational policy preferences are transmitted to national policy preferences, demonstrating the agency of regulators and the influence of the transnational political arena. Furthermore, as Michael Mann, the first Director of the Office of International Affairs at the U.S. SEC and pioneer of MoUs to govern cross-border financial crime, stated, this "was a change in terms of looking at the outside world, where the SEC really was able to lead the negotiation with the support of Justice and the State

[32] This thesis has not analyzed OTC derivatives markets because it has been analyzed by existing IPE literature. See Helleiner and Pagliari 2010; Pagliari 2013; Helleiner *Forthcoming*

Department; and work out something that was a memorandum of understanding."[33] The creation of MoUs in the late-1980s was the first case in which securities market regulators were influential actors in the governance of international securities markets.

IOSCO strengthened implementation of its *Principles for MoUs* through the creation of IOSCO's *MMoU*. IOSCO's Technical Committee proposed creating IOSCO's *MMoU* a month after the September 11 terrorist attacks on the United States. Regulators were aware that an investigation into the perpetrators of the attacks, in particular into possible securities violations, would have been hampered by holes in the network of bilateral MoUs governing information sharing and mutual legal assistance. September 11, therefore, revealed limitations in the existing web of bilateral MoUs, and regulators recognized the necessity of creating a more comprehensive cross-border financial crime regime.[34]

The association of the September 11 terrorist attacks with the creation of an international financial standard might suggest that securities regulators created the standard in response to, or were acting preemptively to, the requests of their respective foreign affairs departments or domestic political pressure. Securities regulators at the meeting in which the idea was initially proposed stated that the idea was not proposed by U.S. regulators; the most likely source of the idea if it were in response to such pressures. Furthermore, before September 11 securities regulators had discussed the limitations of the existing regime and had discussed whether it was necessary to strengthen the regime.

Regulators were the central political actors in the creation of international financial standards to govern cross-border financial crime. Regulators responded to threats to the integrity of their respective domestic securities markets and exercised the discretion granted to them by their domestic legislatures in negotiating an international solution to the regulatory issues they faced.

[33] The Securities and Exchange Commission Historical Society 2005, p. 9
[34] Tanzer 2011

### *1.4.2 The Creation of IOSCO's Principles and IOSCO's Methodology*

IOSCO's Technical Committee initiated the creation of IOSCO's *Principles* in 1995 when regulators from developed financial markets felt the effects of an increasingly integrated global financial system. In 1995, international securities markets experienced a watershed moment when the risky bets of rogue trader Nick Leeson (from Barings' Singapore offices) caused the collapse of London's oldest mercantile bank. The incident revealed the effects of regulatory failure in foreign jurisdictions for the stability of regulators' home jurisdictions. This caused securities regulators to begin work on creating the first comprehensive set of international financial regulatory standards for securities market regulation.

The idea of creating a comprehensive set of international securities standards was proposed by Ed Waitzer, then head of IOSCO's Technical Committee and Chairman of the Ontario Securities Commission. The idea did not have the full support of the Technical Committee as many questioned whether it was appropriate to identify a universal standard for securities market regulation. Some securities regulators argued that it was necessary to adapt national regulatory frameworks to national historical, political, legal and market contexts. IOSCO's *Principles* were created in early 1997 after IOSCO's Technical Committee members had enough support to begin the internal policy process. After a lengthy review process IOSCO's *Principles* were endorsed at IOSCO's Annual Conference in Nairobi in 1998.

IOSCO's *Principles* were strengthened through the creation of IOSCO's *Methodology* in October 2003. The creation of IOSCO's *Methodology* was driven by two political forces. First, IOSCO's Technical Committee faced increasing pressure to create an objective method of assessment to assess compliance with IOSCO's *Principles* by the International Monetary Fund (IMF) and World Bank. IOSCO's Technical Committee faced increasing pressure to create an objective method of assessment to assess compliance with IOSCO's *Principles* by the IMF and World Bank. Since the creation of IOSCO's *Principles* in 1998 the IMF's Monetary and Capital Markets Department was under pressure to conduct effective surveillance of states' compliance with international financial standards.[35] IOSCO had long resisted efforts to create a more specific set of international regulatory principles due to fears that they would

[35] Elliot 2011; MacLaren 2011

be interpreted too narrowly and would not account for historical, institutional and jurisprudential differences between states.[36] Tension reached its peak in a 2001 meeting of IMF, the World Bank and IOSCO, when it was apparent that IOSCO was unable to resist for any longer, and that if IOSCO continued to resist, another institution would write the *Methodology*.[37]

Second, IOSCO's *Methodology* was created in the immediate aftermath of the September 11 terrorist attacks. A taskforce was established at the same meeting of the Technical Committee that created IOSCO's *MMoU*. In the wake of the attacks, securities regulators felt it was necessary to improve the level of adoption of IOSCO's international financial standards and to raise financial regulatory standards around the world. The September 11 terrorist attacks were a potent symbol of the dangers of unevenly regulated securities markets in the international system. The attacks on the United States, the present threat of financial crime, and the threat of under-regulated financial centers shifted the Technical Committee's views on the necessity of clearly defined international standards. This caused the Technical Committee to place increased emphasis on ensuring that IOSCO's *Principles* were comprehensively implemented and, in turn, accepted the necessity of creating IOSCO's *Methodology*.[38]

The confluence of events makes the case of IOSCO's *Methodology* difficult to categorize. This case reveals that IOSCO was subject to pressure from powerful states through the IMF and World Bank. Powerful states sought to reduce the costs of under-regulated jurisdictions in light of the Asian Financial Crisis. Regulators, however, were also keenly interested in raising the quality of securities market regulation in foreign jurisdictions in the wake of the September 11 terrorist attacks. The creation of IOSCO's *Methodology* can be explained both through preferences of states and financial regulators within IOSCO's Technical Committee. IOSCO's *Methodology* is explained by an inter-state and a transgovernmental network perspective.

[36] Cameron 2011
[37] MacLaren 2011
[38] Corcoran 2012

### *1.4.3 International Credit Rating Agency Regulation*

IOSCO's *Principles for CRAs* and IOSCO's *Code of Conduct* were created in September 2003 and December 2004 respectively. These international securities market standards were created after the politicization of rating agencies in the U.S. and the E.U. from 2001 - 2003. In response to the perceived failure of rating agencies to warn investors of the impending collapse of large, publicly listed companies, U.S. and E.U. domestic legislatures had indicated a preference for improving the regulation of rating agencies. At the same time, they had also indicated that they were unwilling to directly regulate rating agencies because of domestic political constraints. U.S. and E.U. domestic legislatures indicated their preference for improving the regulation of rating agencies through public statements by domestic politicians, public hearings, the creation of committees reviewing the regulation of rating agencies, the drafting of public reports, and legislation requesting further technical advice from securities market regulators.

IOSCO's *Principles for CRAs* was created in order to promote a coordinated regulatory approach to rating agencies amidst their regulatory review in the U.S. and E.U. IOSCO's *Code of Conduct* was created to establish an internationally consistent self-regulatory regime. IOSCO's *Code of Conduct* established a regulatory response to improve the regulation of rating agencies whilst taking account of domestic political constraints. The transgovernmental network of securities market regulators sought to coordinate the national regulatory approaches of the U.S. and E.U. to ensure common assessments of creditworthiness across jurisdictions in the interests of investor safety.

Implementation of IOSCO's international standards for rating agency regulation was strengthened by the creation of direct regulatory regimes for rating agencies in the U.S. and E.U. The U.S. established the first direct regulatory regime in 2006 under the Credit Rating Agency Reform Act. The 2006 Act was driven by the narrow political interests of a Pennsylvanian Congressmen Michael Fitzpatrick and Paul Kanjorski, who sought to promote competition in the rating agency market to support the efforts of Egan-Jones, (a Pennsylvania-based rating agency) to expand its market share. The 2006 Act remained limited because of continued Congressional pressure to respect the First Amendment Rights

of rating agencies, which made the U.S. SEC rule-making process slow and cumbersome. The 2007/2008 financial crisis produced a substantive shift in the policy preferences of domestic political actors in the U.S. and E.U. Widespread cases of conflicts of interest issues in the securitized debt market matched with the undervaluation of risk by rating agencies led policymakers, regulators and the public to perceive that rating agencies were central actors in the 2007/2008 financial crisis. This changed the domestic political incentives of policymakers in favor of the direct regulation of rating agencies.

The case of international rating agency standards demonstrates the validity of a domestic politics and transgovernmental network approach. Securities market regulators created IOSCO's *Principles for CRAs* and IOSCO's *Code of Conduct* in response to shifts in the policy preferences of domestic legislatures. This shift in policy preferences was driven by domestic political imperatives. The transgovernmental network of securities market regulators exercised agency in creating international credit rating agency standards to promote the adoption of coordinated national regulatory frameworks. The transgovernmental network of securities market regulators was driven to create these standards by their principled professional interests. The strengthened implementation of IOSCO's international rating agency standards is explained by a domestic politics perspective. The creation of a direct regulatory regime in the U.S. was initially driven by the narrow political interests of U.S. Congressmen. The creation of comprehensive direct regulatory regimes was driven by shifts in the policy preferences of domestic legislatures in dominant financial centers in the wake of the 2007/2008 financial crisis. This demonstrates the validity of a PA analytical framework. International credit rating agency standards were created in response to the preferences of domestic legislatures. Securities regulators then exercised their discretion in creating international securities market standards to promote coordinated national regulatory frameworks.

### *1.4.4 International Hedge Fund Regulation*

IOSCO's created IOSCO's *Principles for Hedge Funds* in June 2009 and IOSCO's *Systemic Risk Data Requirements for Hedge Funds* in February 2010. IOSCO's international hedge fund standards were created once the domestic political context of the U.S. and E.U. shifted in

favor of the regulation of hedge funds in the wake of the 2007/2008 financial crisis. Before the crisis, the U.S. and the U.K., which are the home jurisdictions of the largest hedge fund industries in the world, forestalled any attempts to create international standards for hedge funds. In the U.S., the U.S. SEC sought the regulatory authority to required hedge funds to register with the U.S. SEC due to the increased exposure of retail investors to hedge funds. The U.S. SEC's effort to required hedge funds to register was struck down by a U.S. Circuit Court judge and U.S. Congress was unwilling to grant the U.S. SEC clear statutory authority. The majority of securities market regulators in IOSCO's Technical Committee favored the regulation of hedge funds but domestic legislatures in dominant financial centers did not. This forced regulators to limit IOSCO's work to producing a series of reports on regulatory issues for regulated retail investment firms including: a 2003 report titled, *Regulatory and Investor Protection Issues Arising from the Participation by Retail Investors in (Funds-of) Hedge Funds*,[39] a 2006 report titled *The Regulatory Environment for Hedge Funds: A Survey and Comparison*,[40] and *Principles for the Valuation of Hedge Fund Portfolios* in November 2007.[41] The U.S. SEC and other regulators were unable to propose international regulatory principles for the regulation of hedge funds because domestic legislatures in dominant hedge fund jurisdictions had not granted their securities regulators the statutory authority to do so.

After the 2008 financial crisis, domestic policy preferences changed. The highly visible role of hedge funds as a central cause of the crisis, the highly publicized case of financial fraud by Bernie Madoff, and a shift in the domestic balance of political power away from the hedge fund industry towards institutional funds meant that the U.S. now favored the direct regulation of hedge funds. Within the E.U., the U.K. continued to favor the indirect regulation of hedge funds. However, Germany, France and a majority of E.U. members sought to establish a comprehensive direct regulatory regime for hedge funds. The U.S. had indicated that they were willing to regulate hedge funds. As a result of a shift in the domestic political contexts of the U.S. and E.U., domestic legislatures had indicated that they were willing to directly regulate hedge funds. In early 2009, the Obama Administration was in the process of reforming the 1940 Investment Advisers Act, which would ensure that hedge

[39] Technical Committee of IOSCO 2003a
[40] Technical Committee of IOSCO 2006
[41] Technical Committee of IOSCO 2007

funds were required to register with the U.S. SEC.[42] In April, 2009 the E.U. proposed the Alternative Investment Advisers Fund Manager Directive (AIFMD).[43] These shifts in the policy preferences of the U.S. and E.U. culminated in the Group of 20 (G20) declaring that hedge funds or hedge fund managers would be required to register with a national regulator and be subject to ongoing supervisory requirements in April 2009.[44]

After domestic legislatures in dominant hedge fund jurisdictions declared their intent to require hedge fund managers to be registered with national securities regulators and be subject to ongoing supervisor requirements, IOSCO's Technical Committee created international regulatory standards for hedge funds. IOSCO's *Principles for Hedge Funds* were created in June 2009 to establish common regulatory principles to inform the upcoming legislative and rulemaking process. In particular, IOSCO's Technical Committee created common registration, information and reporting requirements. Common information and reporting requirements were of particular interest to securities regulators because it was necessary to enable securities regulators to monitor internationally active hedge funds. In February 2010, IOSCO's Technical Committee created *Systemic Risk Data Requirements for Hedge Funds*, which outlined what systemic risk data would be required from hedge fund managers to enable securities regulators to monitor the systemic risk they posed. IOSCO's *Systemic Risk Data Requirements for Hedge Funds* established a more comprehensive list of reporting requirements after national rulemaking processes, in combination with coordination through IOSCO, identified what information was necessary to track the systemic risk posed by hedge funds.

The E.U.'s regulatory reform process established a differentiated national regulatory framework for hedge funds, which is considered to be discriminatory against U.S.-based hedge funds. The adoption of a differentiated national regulatory regime for hedge funds in the E.U. further highlights the differentiated role and influence of domestic legislatures and the transgovernmental network of securities market regulators. The role and influence of the transgovernmental network of securities regulators is limited to establishing common regulatory principles within the current statutory authority granted to them by domestic

[42] Price Waterhouse Coopers 2009
[43] European Parliament 2009
[44] Technical Committee of IOSCO 2009a

legislatures. The nature and scope of the statutory authority or statutory obligations placed on financial market actors is determined by domestic legislatures.

The creation of international hedge fund standards is explained by a domestic politics and transgovernmental network perspective. Domestic legislatures exercised control over securities market regulators by withholding statutory authority from securities regulators before the crisis and enabling the creation of international financial standards after the crisis. This caused securities market regulators to create international standards that reflected their current statutory authority rather than their policy preferences. Once the policy preferences of domestic legislatures shifted in favor of the direct regulation of rating agencies, securities market regulators exercised their discretion in establishing international hedge fund standards to promote the creation of coordinated national regulatory frameworks. This demonstrates the validity of a PA analytical framework. International hedge funds standards were created once domestic legislatures' policy preferences shifted in favor of the regulation of hedge funds. Securities regulators then exercised their discretion in creating international securities market standards to establish common regulatory approaches to hedge funds, to enable them to effectively undertake their domestic regulatory responsibilities.

## 1.5 Brief Outline of the Dissertation

This thesis analyzes the creation of international securities standards from the establishment of IOSCO in 1983 through to the post-2007/2008 financial regulatory reform process. Analyzing the creation of four of IOSCO's securities market standards over the lifetime of the institution provides us with important case studies to analyze and understand the politics of international securities market regulation and the political drivers of regulatory cooperation. This thesis argues that the creation of international securities market regulation is explained by the role and influence of the transgovernmental network of securities market regulators, domestic legislatures and states.

Chapter 2 reviews existing international financial regulatory politics literature including existing analysis of IOSCO. International financial regulatory politics literature provides guidance on the central research question of this thesis. This chapter will demonstrate that

there are important empirical and theoretical gaps in IPE literature that necessitate further empirical investigation and theoretical innovation. To do so, this chapter summarizes existing international financial regulatory politics literature, their contributions, and discusses its current analytical and empirical limitations. Critically, IPE literature has not yet analyzed a number of important international securities standards including the creation of IOSCO's *Principles*, IOSCO's *Methodology*, IOSCO's *MMoU*, and IOSCO's *Systemic Risk Data Requirements for Hedge Funds*. IPE literature is also unable to account for the differentiated political sources of outcomes at IOSCO over time. PA theory provides an important contribution to IPE literature. PA theory offers an analytical framework that accounts for how and under what conditions regulators demonstrate agency in exercising discretion to create international financial regulators standards. PA theory achieves this by identifying how domestic legislatures exercise control over securities market regulators and how the policy preferences of domestic legislatures is a necessary condition for the creation of international financial standards. This chapter also discusses a number of limitations to PA theory to identify how this thesis' analysis of international financial standards, and the analytical framework it has adopted, seeks to contribute to existing PA literature.

Chapter 3 analyzes the creation of IOSCO's *Principles for MoUs* and their strengthening through the establishment of IOSCO's *MMoU*. The creation of an information sharing and mutual legal assistance regime to assist in the prosecution of cross-border financial crime was driven by the community of securities regulators within IOSCO's Technical Committee. The MoU regime was initiated by the US SEC's Michael Mann who proposed the creation of an informal and flexible MoU to cover information sharing and mutual legal assistance between U.S. and Swiss regulators in 1983. The MoU regime expanded when European securities regulators approached the U.S. to establish common regulatory principles for MoUs. These common regulatory principles would be established through a new global regulatory body called IOSCO, which was established in 1983. IOSCO's Technical Committee strengthened the implementation of IOSCO's *Principles for MoUs* through the creation of IOSCO's *MMoU* in 2002. IOSCO's *MMoU* was proposed one month after the September 11 terrorist attacks on the United States, revealing limitations to the existing bilateral network of MoUs. This empirical case highlights how regulators responded to the

systemic threats posed by under regulated financial centers to the integrity of securities markets in developed financial centers.

Chapter 4 analyzes the creation of IOSCO's *Principles* in the wake of the Asian Financial Crisis and the strengthening of IOSCO's *Principles* through the creation of IOSCO's *Methodology*. This chapter highlights how IOSCO's Technical Committee responded to the heightened perception of the systemic threat of under-regulated jurisdictions in 1995 by proposing the creation of international securities market standards. This chapter also analyzes the creation of IOSCO's *Methodology* in October 2003. IOSCO's *Methodology* was created after IOSCO's Technical Committee received substantive pressure from powerful states to create a more comprehensive international securities market standard in order to raise financial regulatory standards in more peripheral financial centers. IOSCO's *Methodology* was also created in the wake of the September 11 terrorist attacks, causing regulators to recognize the benefits of strengthening the implementation of IOSCO's *Principles* and raising the standard of financial regulatory frameworks in foreign jurisdictions. This chapter highlights the agency of securities market regulators in the creation of international securities market standards as well as the influence of powerful states.

Chapter 5 analyzes the creation and strengthening of international credit rating agency standards. This chapter analyzes the creation of IOSCO's *Principles for CRAs* and IOSCO's *Code of Conduct*. The chapter reveals that IOSCO's *Principles for CRAs* and IOSCO's *Code of Conduct* were created after domestic legislatures in the U.S. and E.U. had indicated a preference for improving the regulation of rating agencies. The creation of IOSCO's international credit rating agency standards is explained by both a domestic politics and transgovernmental network perspective. IOSCO's *Principles for CRAs* and IOSCO's *Code of Conduct* was strengthened by the U.S. and E.U.'s domestic legislatures decision to establish direct regulatory regimes for rating agencies. The strengthened implementation of IOSCO's regulatory standards for credit rating agencies is explained by a domestic politics perspective.

Chapter 6 analyzes the creation of international hedge fund standards. To do so, this chapter analyzes the policy preferences of regulators and domestic legislatures in the U.S. and E.U. This chapter reveals that hedge funds became a regulatory issue after the Asian Financial

Crisis and in the wake of the collapse of Long Term Capital Management, a U.S.-based hedge fund. International regulatory initiatives addressing these issues reflected the preferences of the U.S. and U.K. Before the 2007/2008 financial crisis, the U.S. SEC sought to require hedge funds to register with the U.S. SEC but was denied by the U.S. Circuit Court and U.S. Congress. This caused IOSCO to limit its reports and regulatory principles to the exposure of regulated securities firms to hedge funds rather than hedge funds themselves. After the 2007/2008 financial crisis, the domestic political context of the U.S. and E.U. shifted, favoring the direct regulation of hedge funds. As a result, IOSCO created *Principles for Hedge Funds* in June 2009 in an effort to promote coordinated regulatory approaches to the regulation of hedge funds in the U.S. and E.U. At the same time, the E.U. created a different regulatory framework for hedge funds. International hedge fund standards demonstrate the role and influence of domestic legislatures and the transgovernmental network of securities market regulators in the creation of international securities market standards.

Chapter 7 concludes the thesis by discussing the key findings of the thesis, the main contributions of this thesis to existing literature and identifies potential research agendas for further research.

# Chapter 2

# Governing Global Securities Markets: Explaining the Creation and Strengthening of International Securities Regulation

## 2.1 Introduction

What explains the creation and strengthening of IOSCO's international securities standards? This chapter begins to address this question by analyzing how existing literature has explained the creation and strengthening of international financial standards.

Since the 1980s, IPE literature began analyzing the politics of international financial regulation due to the emergence of international financial regulatory standards. This specialist literature within IPE has sought to explain the creation and strengthening of international prudential financial standards.[1] This specialist literature has made a number of important contributions to the study of the politics of international securities standards.

Empirically, the focus of early scholarship was on the politics on international banking standards, and international capital adequacy standards in particular.[2] However, a number of IPE scholars have turned their attention to the politics of international securities standards. Existing literature has analyzed six international securities market regulatory issue areas and standards so far, including: IOSCO's cross-border listings and disclosure standards,[3] international capital adequacy standards for securities firms,[4] IOSCO's *Principles for MoUs*,[5] hedge fund regulatory principles,[6] over-the-counter (OTC) derivatives markets,[7] and credit

[1] Helleiner and Pagliari 2011 p. 170
[2] Kapstein 1989; Kapstein 1992; Wood 2005; Drahos and Braithwaite 2000, p. 114 - 119
[3] Underhill 1995
[4] Underhill 1995; Singer 2007
[5] Simmons 2001
[6] Fioretos 2010
[7] Tsingou 2006; Coleman 2003; Helleiner and Pagliari 2011; Helleiner *Forthcoming*

rating agencies.[8] Existing literature has overlooked a number of important institutional initiatives and international regulatory standards for securities markets created by IOSCO.

Theoretically, IPE literature has formed three competing analytical categories to explain the creation of international financial standards. The three competing analytical categories are differentiated by the distinct political arena from which international financial standards are considered to be derived from including: the inter-state, domestic political and transnational arena. Within these distinct political arenas, IPE scholars have identified the role and influence of four political actors including: states, domestic political actors, transgovernmental networks of financial regulators, and transnational private financial market actors. IPE literature has identified how international financial standards help these four political actors to obtain their interests. Furthermore, existing scholarship has identified the differentiated sources of power of each political actor that enables them to create, promote and enforce international financial standards.

Current analytical frameworks proposed by IPE scholars provide an important basis for understanding the politics of international securities market regulation and the creation of international financial standards. This thesis seeks to build on the work of existing scholarship rather than proposing wholesale theoretical change.

Despite the important contributions of existing literature, there are important limitations that this thesis seeks to address. Existing literature's limitations are empirical and theoretical. There are three empirical limitations to existing literature. First, existing literature has overlooked important institutional initiatives and international regulatory standards for securities markets created by IOSCO. Current literature has not yet conducted in-depth empirical analysis of IOSCO's *Principles*, IOSCO's *Methodology*, IOSCO's *MMoU*, and IOSCO's *Systemic Risk Data Requirements for Hedge Funds*. This thesis seeks to fill this empirical gap by examining previously unanalyzed international securities market standards. Second, existing literature's analysis of IOSCO's *Principles for MoUs* and IOSCO's *Code of Conduct* has overlooked a number of important political dynamics that this thesis considers important to understanding the politics of these issue-areas. Third, existing literature has analyzed

[8] Pagliari 2013

international financial standards either in isolation of each other or has analyzed financial standards from a single era.

The second limitation to existing literature is theoretical. This thesis reveals that international securities market standards have been created to obtain the preferences of the transgovernmental network of securities market regulators, domestic political actors and states. The extent to which international standards are created in the interests of these political actors differs across issue areas and across cases. To account for the differentiated sources of international financial standards, it is necessary to adopt an integrative theoretical approach. As Helleiner and Pagliari argue, "more effort should be devoted to the task of integrating insights from developments in all three of these political contexts."[9] This thesis seeks to work towards this aim and address the limitations of existing literature through the use of PA theory.

This thesis utilizes a PA model to explain the creation and strengthening of international securities market standards. A PA approach provides the theoretical tools to account for the differentiated political sources of international securities market standards. PA theory achieves this by establishing that securities regulators are simultaneously subject to control by the domestic legislature and are granted discretion to create international financial standards. A PA analytical model recognizes that, through the domestic institutional environment, international financial standards can be created in the principled professional interests of the transgovernmental network, the political interests of domestic political actors and the material interests of states.

In order to develop this argument, this chapter will discuss existing literature, its contributions, and its limitations. This thesis proposes a PA analytical framework to overcome these limitations, as it is able to account for how and when the relevant political actors exercise influence over the creation and strengthening of international financial standards.

[9] Helleiner and Pagliari 2011

## 2.2 The Political Economy of International Financial Regulation

A specialist literature in IPE emerged in the late 1980s, focusing on the political economy of international financial regulation. Four theoretical frameworks have emerged that fit within three broad categories to explain the creation and strengthening of international financial standards: interstate, domestic, transgovernmental network and transnational private actor theories of international financial regulation.[10] These theoretical frameworks are differentiated by their conception of which political actors drive the creation and strengthening of international financial standards. In doing so, IPE scholars attribute power and authority to different political actors in the international system. Current scholarship analyzing the politics of international financial regulation provides an important basis to explain the creation of international securities market standards.

## 2.3 Interstate Politics of International Financial Regulation

Interstate theories argue that the creation and strengthening of international financial standards is driven by the material interests of powerful states. Interstate theories are divided between realist and neoliberal institutional approaches. A neoliberal institutionalist approach focuses on the incentives for states to create cooperative institutions. A realist approach argues that international financial standards are created to protect the competitiveness of dominant financial centers by utilizing international organizations to mitigate the costs of adjustment caused by financial regulatory reform in dominant financial centers. International financial standards achieve this by ensuring that competing financial centers are subject to the same regulatory demands. All interstate scholars argue that the power of states to create, enforce and promote regulatory harmonization is derived from their relative market size. The threat of excluding market access from these large and valuable financial centers ensures compliance with their regulatory preferences.

[10] Helleiner and Pagliari 2011

### *2.3.1 Explaining States Preference for International Financial Regulation*

Interstate scholars argue that international financial standards are created in the material interests of states. Consistent with state-centric approaches in IPE and International Relations (IR) literature, interstate scholars emphasize how international institutions help facilitate powerful states' pursuit of their material preferences.[11]

Ethan Kapstein's pioneering work on international banking regulatory standards in the 1980s adopted a neoliberal institutionalist approach.[12] Neoliberal institutionalist scholars emphasize how self-interested states create international financial regulatory standards to help overcome coordination problems and realize joint gains from cooperation.[13] Ethan Kapstein highlighted that emerging issues in international banking crises were symptomatic of the interdependence problems associated with globalization. States and regulators needed to identify "how to benefit from increased economic intercourse while pursuing legitimate national objectives, such as bank safety and soundness."[14] In the absence of an international regime, competition between international banks led to a decline in banking capital adequacy that threatened the safety and soundness of domestic and international financial markets. Regulators felt pressure to allow declining banking capital requirements to maintain the competitiveness of domestic financial firms. Banking supervisors negotiated the Basel Capital accord, which would "remove this source of competitive advantage and help to create a 'level playing field' on which international banks can compete."[15] The Basel Capital Accord was created by states in order to obtain joint gains from cooperation by establishing a single capital adequacy standard, which would protect against a regulatory race to the bottom. This ensured that competition between financial centers did not affect the financial stability of domestic and international banking systems. Kapstein's approach, therefore, argues that international financial standards are cooperative, Pareto-improving institutions that help protect the international and domestic banking system from financial instability by coordinating the policy frameworks of states.

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[11] See Gilpin 2001, p. 77; Keohane 1984
[12] Kapstein, 1989; also see Keohane 1984
[13] Keohane 1984
[14] Kapstein 1989, p. 324
[15] Kapstein 1989, p. 323

Later interstate scholars adopted a more realist approach. Realist approaches emphasized that powerful states create international financial standards in order to manipulate the distribution of resources to favor their domestic financial markets and financial firms. Realist IPE scholars characterize the international system as a system comprised of competing states concerned about the distribution of resources. As prominent realist IPE scholar Robert Gilpin explains, "states have a strong incentive to take actions that safeguard their own values and interests, especially their power and freedom of action, and they also attempt to manipulate market forces to gain power and influence over rival states or to favor friendly states."[16] Realist scholars recognize that states establish cooperative governance mechanisms but only because such mechanisms are in their material interests because they are redistributive.

In the realist tradition, a second school of interstate theories argues that states from dominant financial centers created international prudential standards to obtain relative gains over competing states by exporting higher regulatory standards. Beth Simmons concurs, stating that regulatory harmonization was not cooperative or "Pareto-improving."[17] The United States established regulatory systems in response to domestic political and regulatory concerns.[18] The United States exported its regulatory preferences to foreign jurisdictions when foreign regulators' failure to harmonize was costly to U.S. financial markets. Daniel Drezner's book *All Politics is Global* makes a similar argument, arguing that international prudential standards were created when U.S. and E.U. policy preferences were consistent. International financial standards were created to export the costs of adjustment on to foreign states.

### *2.3.2 The Exercise of Power by States from Dominant Financial Centers*

Interstate scholars emphasize that international financial regulatory agreements are created and enforced through the exercise of power by states from dominant financial centers. Kapstein emphasized that consensual knowledge was an important variable because it

[16] Gilpin 2001, p. 77
[17] Simmons 2001, p. 600
[18] Simmons 2001, p. 595

created a common basis for agreement between regulators.[19] However, national regulatory differences remained and "these differences could not be quickly smoothed by research, no matter how compelling."[20] The international regulatory agreement was only established once the U.S. and U.K. established a powerful alliance due to common policy preferences for risk-weighted capital adequacy requirements. Kapstein re-emphasized this point in his 1992 *International Organization* article, arguing that central bankers are not an epistemic community because there is no "substantial body of consensual theoretical and empirical knowledge on international banking."[21] International prudential standards were not driven by the convergence of regulatory preferences but were obtained through the leadership and exercise of power by the U.S. and U.K.[22]

Drezner's book states that market size is an important determinant in the creation and enforcement of international financial standards. Drezner argues that, "a great power concert is a necessary and sufficient condition for effective global governance over any transnational issue. Without such a concert, government attempts at regulatory coordination will be incomplete, and non-state attempts will prove to be a poor substitute."[23] Beth Simmons argues that the concentration of financial power in the U.S. and U.K. enables regulators from these financial centers to independently obtain their regulatory preferences at home and export their preferences to foreign financial centers.[24] David Bach and Abraham Newman's study of the adoption of insider trading laws concludes that a strong relationship with the U.S. SEC has a greater impact on the adoption of insider trading laws than membership at IOSCO. Bach and Newman's study statistically demonstrates the influence of powerful states on regulatory harmonization.[25]

Elliot Posner argues that outcomes in international financial regulation have been driven by shifts in the balance of power between the U.S. and E.U. This shift has caused the U.S. to be increasingly accommodative to the E.U.'s policy positions from 2002 onwards. Regional

[19] Kapstein 1989, p. 324
[20] Kapstein 1989, p. 336
[21] Kapstein 1992, p. 268
[22] Kapstein 1992, p. 281
[23] Drezner 2007, p. 5
[24] Simmons 2001, p. 595
[25] Bach and Newman 2010

integrative political processes led to the centralization and harmonization of financial regulation within the E.U., creating a larger common financial market. Posner states that the creation of this large common market improved the bargaining position of European regulators, forcing the U.S. to adopt a more conciliatory approach. European securities regulation became centralized through the adoption of a series of laws that formed part of Europe's accelerating integration project.[26] In the same vein, Lucia Quaglia argues that the E.U.'s centralization of regulatory responsibilities has strengthened the regulatory capacity of the E.U. and enabled them to obtain their interests in international financial standards.[27] Posner states that the argument that regulators leverage market access to large and attractive financial markets to obtain their policy preferences does not explain changing international regulatory dynamics because U.S. to European equity market capitalization remains unbalanced and has increased from "approximately 2:1 in 1994 to 2.5:1 in 2003.[28] Instead, Posner argues that it is the expansion of regulatory authority and authority over a greater number of foreign firms that strengthens the bargaining authority of European regulators.

Posner analyzes political regulatory dynamics in six major regulatory disputes after 2002 including: the supervision of financial conglomerates, accounting standards, public company auditors, corporate board composition, deregistration of foreign issuers and stock exchanges. From 2002 onwards, these policy disputes saw the U.S. make mutual adjustments to placate the concerns of E.U. regulators.[29] Posner argues that the case provides a basis for fruitful dialogue between realist and constructivist theorists. Posner states that the "improved E.U. bargaining leverage set the stage for serious dialogue, showing that iterative processes may breed deliberation and thereby the trust necessary for mutual recognition and other forms of sovereignty-sharing in contexts that lack formal institutions."[30] Reiterative negotiations led E.U. regulators to become aware of their altered power capacities, informing their strategies, goals and identities.[31]

[26] Posner 2009, p. 692
[27] Quaglia 2012
[28] Posner 2009, p. 679
[29] Posner 2009, p. 672
[30] Posner 2009, p. 693
[31] Posner 2009, p. 693

Randall Germain's analysis of the governance of international financial markets adopts a historical materialist approach. Germain focuses on a number of social, economic, ideational and power factors in explaining the governance of the international financial system. As will be discussed later, Germain's historical materialist perspective argues that the global economic and social order favors the interests of private financial market actors. At the same time, Germain argues that the balance of power between states is an underlying determinant of the nature of international financial governance. Germain argues that the prospects for effective international financial regulatory cooperation are relatively weak because "the effectiveness of international cooperation is dependent upon the interests and willingness of states to engage in negotiations with each other."[32] Furthermore, Germain argues that the international monetary order is "created by states, and that the aims, interests, and powers of major states are the principal moving forces to investigate."[33] Germain reiterates this argument in his analysis of the post-crisis financial market order. Germain describes the prospects of effective regulatory cooperation by stating the following:

> "even as we see an effort to strengthen the institutional framework of regulation at the international level, we should recognize that on many measures the most important institutional regulatory changes will take place at the national level, and most critically among the key financial powers."[34]

Germain's assessment of the prospects of subjecting the governance of financial markets to deliberative democratic processes also concludes that historically, the governance of financial markets has been framed in national terms and that this is problematic given the global scale and nature of finance.[35] Germain argues that the structure of financial governance offers some prospect for being subject to transnational deliberative democratic processes,[36] but the current regime is undergirded by the exercise of power by dominant states. Therefore, at present, the governance of international financial regulation is driven by the policy preferences of powerful states.

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[32] Germain 1997, p. 143
[33] Germain 1997, p. 5
[34] Germain 2009, p. 681
[35] Germain 2010, p. 494
[36] Germain 2010

Interstate theories argue that international financial standards are created and enforced by states with dominant financial centers. The power of states is derived from their relative market size. The threat of excluding foreign financial centers from gaining access to these large, attractive and systemically important financial markets ensures the adoption of international financial standards and enables regulators from these powerful states to lead negotiations in the creation of international financial standards. As Beth Simmons also argues, the relative size and attractiveness of these markets also means "much of the world's financial regulatory expertise… is concentrated in the United States and United Kingdom."[37] This further strengthens the power of states with dominant financial centers in negotiations with foreign jurisdictions, enabling them to secure their policy preferences.

### *2.3.3 New Questions in Financial Regulatory Literature: Institutional Design*

Interstate theories of international financial regulation opened up new avenues of scholarship as they began to ask questions about the sites of international financial governance and variation in the types of international institutions used to pursue international prudential standards.

Simmons' analysis of international prudential standards focuses on explaining variance in the institutional design of international financial regulatory institutions from private regulatory institutions to formal multilateral institutions and informal transgovernmental networks. Simmons asks, "whether harmonization will be economically or politically induced" and what "role, if any, [will be] played by international institutions in the process."[38] The system of governance pursued by the U.S. is determined by two variables: negative externalities and the incentives to emulate. Negative externalities are the cost of other countries' failure to harmonize. The incentive to emulate is the anticipated willingness of countries to harmonize with the U.S.' system of governance as determined by the costs of adjustment and the benefits derived from regulatory adjustment.

[37] Simmons 2001, p. 594
[38] Simmons 2001, p. 591

Consistent with the rational design literature,[39] Simmons argues that states' level of investment, as reflected in the institution's design, is dependent on the expected costs of peripheral states' failure to comply with the preferences of powerful states. States will invest heavily in formal international organizations when the negative externalities of non-harmonization are high and will undertake smaller investments for less costly cases of non-compliance. Alternatively, when there is a high incentive for other states to follow the U.S.' lead, market institutions will likely occupy the role such was the case in international accounting standards. Drezner states that the U.S. forms small "club" institutions that enable the dominant states to set the regulatory agenda and force the costs of adjustment on other states.[40]

### *2.3.4 Interstate Theories of IOSCO and International Securities Market Regulation*

Two sets of scholars have applied an inter-state theoretical framework to the study of IOSCO and the governance of international securities markets. First, Beth Simmons' analysis of variation in institutional design includes IOSCO's information sharing and mutual legal assistance regime. Simmons concludes that states have established a weak regulatory regime to govern information sharing because the costs of failing to establish an effective regime to powerful states is comparably low.[41]

Second, Abraham Newman and David Bach's analysis of the U.S. SEC's and IOSCO's influence on the adoption of insider trading laws concludes that the U.S. SEC is more influential than IOSCO in the adoption of insider trading laws. Bach and Newman conduct quantitative analysis to measure the strength of the relationship between the adoption of insider trading laws and 1) membership within IOSCO in a given year, 2) the signing of an MoU with another country, and 3) the signing of an MoU with the U.S. SEC.[42] Bach and Newman conclude that the signing of an MoU with the U.S. SEC makes it four times as likely that the country will adopt insider trading laws but that membership in IOSCO increases the likelihood that insider trading laws are actually enforced. Bach and Newman's analysis highlights how the U.S. SEC uses "transgovernmental ties to export its regulatory

[39] See Koremenos et al 2001
[40] Drezner 2007
[41] Simmons 2001, p. 615
[42] Bach and Newman 2010, p. 507

model."[43] Bach and Newman's analysis emphasizes that relationships with powerful states are a necessary and sufficient condition for regulatory harmonization rather than international institutions. International institutions have a secondary effect by providing the necessary training and support to develop domestic regulatory capacity, which leads to the utilization of enforcement powers.

Interstate scholarship has contributed some important theoretical concepts to the study of international financial regulation and provides an important basis to understand the politics of international securities market standards. Interstate scholars usefully argue that international financial standards are not entirely functionalist but are created to address materialist concerns. The creation and enforcement of international financial standards address these concerns by raising regulatory standards in foreign financial centers. This is evident in the case of IOSCO's *Methodology*. Interstate scholars have also argued that powerful states are able to enforce international financial standards through relative market size and the threat of exclusion. This dissertation shows that a number of regulatory initiatives have benefited from the material powers of states with dominant financial centers including IOSCO's *Principles* and IOSCO's *MMoU* program, even if those standards were created in the principled professional interests of securities regulators.

### *2.3.5 Limitations of Interstate Theory to the Politics of International Securities Market Regulation*

Despite the useful contributions of interstate theories, they have a number of important limitations. As noted above, interstate scholars have only analyzed the adoption of insider trading laws and IOSCO's MoU information sharing regime. Interstate scholars have overlooked a number of important international securities standards. Furthermore, even in the cases that have been studied, existing interstate scholarship has conducted limited and incomplete empirical studies. Bach and Newman's analysis of the adoption of insider trading laws overlooks the role and influence of IOSCO's *MMoU* in the facilitation of states' adoption of insider trading laws. IOSCO's *MMoU* requires states to adopt a series of legislative reforms that enable regulators to identify, investigate, and prosecute cases of financial crime. Insider trading is the most common form of financial crime. In overlooking

[43] Bach and Newman 2010, p. 507

the role of IOSCO's *MMoU*, Bach and Newman establish an inaccurate indicator of IOSCO's influence in the adoption of insider trading law. Simmons' analysis of information sharing was also unable to include an analysis of the creation of IOSCO's *MMoU* because it was created after the time of her publication.

The analysis of IOSCO's *MMoU* in chapter three reveals that the creation of IOSCO's *MMoU* was driven by the preferences of the transgovernmental network. The association of the creation of IOSCO's *MMoU* with the events of September 11 suggests that it was created as an *ex ante* response to the concerns of foreign affairs departments and finance ministries. Within weeks of the September 11 terrorist attacks, a non-U.S. regulator had proposed the idea of creating the *MMoU* to strengthen the adoption of IOSCO's *Principles for MOUs*.[44] IOSCO's *MMoU* was created because regulators recognized the impact of gaps in the bilateral network of MoUs and how this presented a threat to the integrity of national securities markets as well as national security. This highlights that inter-state analytical frameworks are unable to wholly account for the political dynamics of the adoption of insider trading laws and that international regulatory principles for insider trading laws were driven by the community of regulators at the transnational level.

Finally, domestic politics scholars have highlighted the role of the U.S. SEC and the policy preferences of the U.S. in creating international financial standards. This thesis demonstrates that, whilst the role of the U.S. SEC has been important in the creation of IOSCO's standards, a number of regulators from outside the U.S. have been integral in the creation of IOSCO's standards. In contrast to the argument of Bach and Newman, European regulators, and France in particular, were critical in the creation of international regulatory principles for MoUs and the adoption of insider trading laws by foreign jurisdictions. Furthermore, Canada's Ed Waitzer proposed the idea of creating IOSCO's *Principles* in 1995 and Hong Kong's Tony Neoh again pioneered the idea in 1997. Furthermore, a non-US regulator proposed the creation of IOSCO's *MMoU* to govern cross border financial crime in the wake of the September 11 terrorist attacks.[45] These developments demonstrate that

[44] Friedman 2011. Felice Friedman, former Acting Director of the Office of International Affairs at the U.S. Securities and Exchange Commission, was unable to recall specifically which regulator proposed the creation of a Multilateral MoU but recalls that it was a non-U.S. regulator.
[45] Friedman 2011

the U.S. was not always a central actor in the creation of international securities standards and that regulators from middle powers were important political actors. This suggests the importance of an ideational perspective rather than a market power focus to understand the creation and strengthening of international securities market standards.

## 2.4 Domestic Political Theories

Domestic politics scholarship argues that international standards are created in the political interests of domestic political actors. Consistent with interstate theories, domestic political scholars argue that domestic political actors from dominant financial centers are able to create and enforce international financial standards by leveraging access to their large and attractive financial markets. Domestic political scholars differ from interstate theorists in that they focus their analysis on analyzing the domestic sources of state preferences by examining domestic political contexts. Domestic political theories unbundle the state as a unitary actor, seeking to unveil the domestic roots of state preferences in the international system.

Domestic politics scholarship is the most diverse literature set within international financial regulatory politics literature. Domestic politics scholars identify different domestic political mechanisms that explain the creation of international financial standards. One set of scholars highlights that international standards are created to address the competitiveness concerns of domestic political actors. A second set of scholars highlights that international financial standards are created after shifts in the policy preferences of domestic political actors due to changes in the domestic political context.

### *2.4.1 The Preferences of Domestic Political Actors*

Domestic politics theories identify different domestic political sources of preferences for international financial standards. This section will discuss and summarize the different domestic political sources of international financial standards identified by existing literature.

The first set of scholars argues that international standards are created to address the competitiveness concerns of domestic political actors after unilateral increases in domestic regulatory demands. Thomas Oatley and Robert Nabors' 1998 *International Organization* article

directly responds to Kapstein's seminal article on the Basel Capital Accord in arguing that the accord was not aimed at addressing coordination problems but at satisfying domestic political concerns.[46] Oatley and Nabors' public choice approach contends that international agreements are demonstrative of rent-seeking behavior by domestic politicians. Domestic politicians seek to obtain the greatest number of votes from voters and campaign contributions from the financial industry. Voters expressed their preference for banks to assume the cost of risk from overseas debt through higher capital adequacy standards rather than direct state assistance. Banks sought to maintain their competitive advantage against foreign banks through relatively low capital adequacy requirements.[47]

Oatley and Nabors state that U.S. banking regulators pursued an international financial standard to satisfy the interests of domestic political actors. To simultaneously satisfy demands for financial stability and maintain the competitive advantage of domestic banks, domestic politicians placed direct pressure on banking regulators to form an international agreement with foreign regulators. Congress threatened Japanese banks with the prospect that they would no longer be able to secure funding from their preferred financial market if they did not raise their capital adequacy standards.[48] The Basel Capital Accord was redistributive because "the U.S. proposal sought to transfer income from Japanese commercial banks to compensate American commercial banks for the costs of regulation demanded by voters. Moreover, international capital adequacy regulations were instituted only through U.S. policy makers' use of financial market power."[49] Oatley and Nabors argue that the Basel Capital Accord was more focused on satisfying domestic political problems than providing effective policy solutions to prevailing problems in the international financial system.

Singer investigates what causes regulators to create international financial standards. Singer adopts a PA analytical model to understanding what causes regulators to create international financial standards. Singer's theoretical framework focuses on the domestic political environment of financial regulators and how domestic political institutions, combined with

[46] Oatley and Nabors 1998, p. 35
[47] Oatley and Nabors 1998, p. 42 – 46
[48] Oatley and Nabors 1998, p. 51
[49] Oatley and Nabors 1998, p. 36

the bureaucratic political interests of regulators, transmit the policy preferences of domestic political actors to the international level. Singer states that a PA relationship exists between Congress and financial regulators, enabling Congress to place pressure on financial regulators when they perceive that regulators are failing to act in their interests.[50] As Singer states, "the prospect of intervention by legislators therefore creates *ex ante* constraints on a regulator's range of policy choices which ensures that the principal can maintain some control over the agent."[51] Regulators respond to the political pressure of domestic politicians in order to secure their own bureaucratic political interests. Regulators' interests are in maintaining their autonomy, prestige and future career opportunities.

The interest of Congress is in maintaining the financial stability of domestic financial markets and the competitiveness of domestic financial firms. Financial regulators are able to secure the stability of the domestic financial market system by raising regulatory demands on domestic financial firms. However, increased regulatory demands on domestic financial firms come at a cost and impact their competitiveness. When domestic financial markets face twin shocks to their stability and competitiveness, regulators' "win-set" closes forcing regulators to seek an international financial standard that enables regulators to export domestic financial regulatory demands to foreign financial centers.[52] When unilateral increases in domestic regulators do not impact domestic financial firms' competitiveness, regulators do not pursue international financial standards. In sum, Singer argues that international standards are created to satisfy the domestic political dilemmas that financial regulators face, and that international financial standards are ultimately derived from the preferences of domestic politicians. International financial standards are redistributive since they are created to export the costs of adjustment to foreign financial centers.

Eric Helleiner's analysis of post-crisis governance of global OTC derivatives concludes that changes in the governance of OTC derivatives markets are explained by developments in the transnational, interstate and domestic political contexts. Helleiner states that domestic political shifts favoring strengthened regulation of OTC derivative markets in the U.S. caused U.S. policymakers to become leading advocates in the creation of international

[50] Singer 2007, p. 22
[51] Singer 2007, p. 22
[52] Singer 2007, p. 23 – 31

regulatory standards to ensure U.S. derivative markets can compete on a level playing field. Furthermore, U.S. policymakers threatened to revoke access to U.S. markets if their home jurisdiction failed to comply with U.S. regulation.[53]

A second group of scholars focus on changes in the domestic political context in dominant financial centers to explain the creation of international financial standards. A special issue of *Review of International Political Economy* proposes a historical institutionalist approach to analyze domestic sources of state preferences. The special issue focuses less on the preference for regulatory harmonization and more on policy preference change in response to environmental uncertainty. Paralleling domestic neo-pluralist theory, the theoretical framework of this set of scholars expects interests groups embedded within state institutions to have their policy preferences form the basis of state negotiating positions. States will pursue policies that capture the greater benefits to preferred domestic interest groups.[54] National domestic political processes impact international agreements by establishing whose preferences are given the greatest weight in international negotiations.[55] The historical institutionalist approach focuses its analysis on "how the characteristics of public policy institutions shape actor behavior, interests, and strategy, especially in moments of environmental uncertainty."[56]

Orfeo Fioretos applies the historical institutionalist approach to explain why the U.S. was willing to accept international hedge fund regulation when it previously was not.[57] Fioretos concludes that the creation of international hedge fund regulation was induced by a change in the balance of preferences between the U.S., U.K., France and Germany in the wake of the 2007/2008 financial crisis. France and Germany long maintained a preference for direct regulation. Germany's preferences derived from the fact that its domestic banking markets focused on providing long-term funding manufacturing firms, while France's stemmed from its historical tradition of state-intermediated finance and consumer protection. Those states alone did not negotiate from a strong enough bargaining position to obtain international

[53] Helleiner *Forthcoming*
[54] Farrell and Newman 2010, p. 620
[55] Fioretos 2010, p. 701
[56] Farrell and Newman 2010, p. 616
[57] Fioretos 2010

regulatory agreement due to the dominance of the U.S. and U.K. hedge fund industry. U.S. and U.K. hedge fund dominance, in combination with their competitive advantage, led the U.S. and U.K. to prefer indirect industry-led regulation and made them unwilling to establish an effective international agreement.

The U.S. domestic political balance tipped away from favoring the hedge fund industry towards the increasingly influential institutional investor industry, which preferred direct regulation. Domestic political change within the U.S. altered the international balance of power because the U.S. favored the direct regulation of hedge funds. This established an effective coalition for international regulatory standards for hedge funds. Only the U.K. favored indirect regulation to maintain the profitability and competitiveness of London's financial market. Due to changes in the domestic political context of the U.S. and E.U., and because the international balance of power shifted in favor of the direct regulation of hedge funds, IOSCO created the first international standard for hedge funds.

Stefano Pagliari makes a similar argument in his 2013 doctoral thesis analyzing the politics of hedge funds, credit rating agencies and OTC derivatives market regulation. Pagliari argues that policy makers' preference for favoring market-based mechanisms or predominantly state-based regulation is determined by "the degree of public salience of different financial domains."[58] He argues that the degree to which financial products and firms are subject to state-based regulation is determined by the domestic political incentives for E.U. and U.S. politicians to intervene. In a Working Paper analyzing the changing role of international financial regulatory institutions, in relation to credit rating agencies and hedge funds, Pagliari argues that domestic political forces have driven financial regulatory dynamics rather than the preferences of international financial regulatory institutions. Pagliari states that, despite the flurry of activity at IOSCO, its "expansion has been the result of pressures from political actors at the domestic and international level, which have weakened the capacity of international regulators to influence the international agenda and to shaping the path of domestic regulatory capacities."[59] Pagliari concludes that domestic political actors are the

[58] Pagliari 2013, p. ii
[59] Pagliari 2011

main force in driving financial regulatory reforms rather than regulators acting through IOSCO.

Helleiner and Pagliari focus on the role of domestic political change in dominant financial centers to explain the politics of regulatory change after the crisis and, in particular, shifting policy preferences from private self-regulation to public regulation. Helleiner and Pagliari argue that shifts in policy preferences towards direct, public regulation of hedge funds and OTC derivatives is explained by shifts in the preferences of domestic political actors in the U.S. and the U.K. Helleiner and Pagliari's chapter argues that elite policy makers changed their views on "the merits of market discipline and self-regulation," and that private financial sector members "came to favor regulation both for defensive reasons at a moment of weakened political legitimacy and for more positive reasons of improving the functioning of their industry."[60] Pagliari argues that the sustained politicization and high salience of financial regulatory issues creates "strong incentives for elected policy makers to reverse [market-based governance arrangements]."[61]

Similarly, in a 2003 chapter, William Coleman concludes that the domestic political and institutional context of securities market regulation in the U.S. and U.K. gave rise to an international private regulatory regime for OTC derivatives markets before the crisis. Coleman states that the U.K.'s business culture "translated into an ideology supporting 'practitioner-based self-regulation.'"[62] The overly cumbersome legalistic approach of the U.S. left OTC derivatives markets outside of the statutory authority of independent U.S. regulatory agencies.[63] The domestic institutional context of U.S. and U.K. regulators gave rise to a quasi-public/private regulatory regime for OTC derivative markets. Furthermore, private market actors established an effective regulatory response to regulators and policymakers' concerns. The International Swaps and Derivatives Association (ISDA), and the Master Agreement it shaped, established an effective international private self-regulatory regime. This private regulatory regime was complemented by the creation of a basic

[60] Helleiner and Pagliari 2010, p. 89
[61] Pagliari 2013
[62] Coleman 2003, p. 281
[63] Coleman 2003, p. 283 – 285

information-sharing regime between IOSCO members through the Windsor Declaration in May 1995.[64]

David Bach analyzes why international financial regulation is created through transgovernmental networks rather than other institutional forms of governance. Bach notes the diverse array of governance institutions that have been utilized to govern the global economy, including formal state-based international organizations, private self-regulatory regimes, and transgovernmental network-based organizations. Bach contends that institutional diversity internationally reflects institutional diversity of issue areas domestically. Bach argues that the institutional arrangements of states, derived from domestic political processes, influence the dynamics of international financial regulation. That is because, "how a domestic market is regulated determines who can leverage domestic market access in pursuit of a global regulatory agenda, thereby defining the constitutive actors for regulatory cooperation and thus setting policy areas on distinct governance trajectories."[65]

A majority of scholars focused on domestic politics agree with interstate theorists that the power of states from dominant financial centers is necessary to reach agreement between states. Andrew Walter is the notable exception, arguing that peripheral states only adopt international standards when it is in the interests of dominant domestic political interest groups. Andrew Walter's analysis highlights that the adoption of financial standards is dependent on domestic political preferences rather than the exercise of power by dominant states. He discussed a wider array of actors involved in the policy process than those identified by other scholars. The adoption of reforms is dependent upon the balance of power between pro-reform and status quo interest groups in each different issue-area. This approach explains variations in the level of implementation and enforcement of various financial reforms across different issue areas in East Asian states. East Asian states placate the international community by adopting mock compliance, whereby states legislate financial reforms without intending to enforce them.[66]

[64] Coleman 2003, p. 288 – 290
[65] Bach 2010, p. 570
[66] Walter 2008

### *2.4.2 Domestic Politics and IOSCO*

A number of domestic politics scholars have analyzed the politics of international securities markets and the work of IOSCO. Domestic politics scholars have covered international capital adequacy standards for securities firms, hedge funds, OTC derivatives market regulation and credit rating agencies.

David Andrew Singer analyzes the efforts of regulators to create an international capital adequacy standard for securities firms. Singer's analysis establishes that in response to bouts of financial instability in the U.K., U.K. regulators pursued an international capital adequacy standard through IOSCO. Singer reveals that the U.S. SEC defeated the proposition in 1992. The U.S. did not wish to accept an international capital adequacy standard that endorsed the U.K. and E.U.'s lower capital adequacy standards. Singer argues that U.S. regulators didn't seek an international financial standard because U.S. regulators were able to address financial instability in domestic financial markets through unilateral regulatory reforms and because only U.K.-based investment firms faced a declining share of the global investment market. The U.S. SEC did not need to create an international financial standard to address the political pressure placed upon them by domestic politicians.[67]

David Bach concludes that diversity in international governance arrangements are explained by diversity in domestic institutional arrangements. IOSCO's transgovernmental network character is explained by the delegation of broad sweeping authority to the U.S. SEC. Bach states that IOSCO's outcomes and international securities standards reflect the preferences of the U.S. SEC. IOSCO was created and began governing global securities markets "when financial globalization in the early 1980s threatened to undermine the agency's ability to uphold strict domestic standards."[68] International securities market agreements, therefore, are created when U.S. securities regulators require cooperation with foreign supervisors to enable them to effectively govern their domestic securities markets.

[67] Singer 2007, p. 67 – 95
[68] Bach 2010, p. 576

Fioretos has highlighted that international regulatory standards was only made possible by shifts in the domestic political contexts of powerful states. These shifts enabled a coalition of powerful states to create an international financial standard for hedge funds.[69] Eric Helleiner's work analyzing the creation of OTC derivative market standards, concludes that one of the reasons why an international standard was created was because the U.S. increased regulatory demands on U.S. OTC derivative markets, which threatened their competitiveness.[70] International standards for OTC derivative markets helped export the adjustment costs to foreign jurisdictions. Pagliari's analysis of IOSCO's hedge fund and rating agency regulation are driven by the preferences of domestic political actors rather than the preferences of members of IOSCO and the transgovernmental network of regulators.[71] Coleman concludes that the domestic institutional context of securities regulators in the U.S. and U.K. has given rise to a private self-regulatory regime for OTC derivatives markets that is complemented by basic information sharing between national securities regulators.[72]

Domestic politics scholars have identified how shifts in domestic political contexts can cause states to favor international financial standards when they previously resisted any efforts to create them. This is of particular importance in the post-crisis financial regulatory reform process when states that previously opposed regulatory harmonization now favored it.

David Singer's adoption of a PA analytical framework has usefully identified how international securities market standards are the result of the delegation of authority from the domestic legislature to securities market regulators and the exercise of discretion by securities market regulators. Furthermore, this has identified how securities regulators are subject to domestic political pressure despite being granted wide sweeping authority and power. This has brought light to how the preferences of domestic political actors are transferred to the transnational level through transgovernmental networks such as IOSCO.

There are a number of cases in which the creation of IOSCO's international securities standards can be explained through the preferences of domestic political actors. Domestic

[69] Fioretos 2010
[70] Helleiner *Forthcoming.*
[71] Stefano Pagliari 2013, p. ii; Pagliari 2011
[72] Coleman 2003, p. 271 – 292

politics scholars, therefore, make an important contribution to our understanding of the politics of international securities market regulation.

### *2.4.3 Limitations to Domestic Politics Theory*

As this section has discussed, domestic politics theory makes some important contributions to our understanding of the politics of international securities market regulation. As such, this thesis uses the main tenets of domestic politics theory to explain the creation of some of IOSCO's international securities market standards. The critical limitation to domestic politics theory is that it overlooks the role and influence of the transgovernmental network of securities market regulators. As the previous section discussing inter-state IPE literature had established, there are a number of international securities standards that cannot be accounted for without understanding the role and influence of securities market regulators. This section will focus its criticism on Singer's PA analytical approach.

The main limitation to Singer's PA analytical framework is that securities market regulators' motivation in creating international securities market standards is not limited to addressing threats to the competitiveness of their domestic financial center. This thesis' analysis of IOSCO's *Principles for MoUs,* IOSCO's *Principles*, IOSCO's *MMoU* highlight cases in which the transgovernmental network of securities market regulators drove the creation of international securities standards. These standards did not serve the material interests of states or domestic legislatures and were not created to address competitiveness concerns. These international securities standards were created to enable securities market regulators to more effectively govern the securities markets they were delegated to regulate, and to respond to threats to the stability and integrity of their domestic financial centers. This highlights that the transgovernmental network of securities regulators working through IOSCO is an important and consequential political actor. Furthermore, this demonstrates that ideational factors are a core driver in the governance of international securities markets and the creation of international securities standards.

Singer's PA analytical framework echoes the limitations of PA theory in IO literature, which will be discussed in detail later. Singer focuses on the exercise of mechanisms of control over

securities regulators by domestic legislature and does not grant enough attention on the importance and influence of discretion in the creation of international securities market standards. By focusing on the exercise of mechanisms of control, Singer's PA analytical framework overlooks the agency of securities market regulators, the influence of the transgovernmental network of securities regulators, and the centrality of ideas in the creation of international securities market standards. Furthermore, Singer assumes that the only interests of securities regulators are bureaucratic and material. This overlooks the ideational interests of securities regulators in creating international standards that enable them to more effectively govern international securities markets. This thesis recognizes that domestic legislatures exercise control over the creation of international securities market standards, predominantly by withholding statutory authority from securities regulators. This is demonstrated in the case of IOSCO's *Principles for CRAs*, IOSCO's *Code of Conduct*, and IOSCO's *Principles for Hedge Funds*. This thesis also recognizes that states can exercise control over IOSCO's outcomes when they perceive that the institution is not acting in their interests, as demonstrated in the case of IOSCO's *Methodology* in October 2003 and IOSCO's updated *Code of Conduct* in May 2008. However, Singer's analytical framework fails to account for when IOSCO's outcomes are influenced by the exercise of control by domestic legislatures and when they are derived from the transgovernmental network of securities market regulators.

## 2.5 Transgovernmental Network Theory

A transgovernmental network approach to international financial standards emphasizes the role of dense networks of financial regulators in creating international financial standards and in coordinating national financial regulatory frameworks.

### *2.5.1 International Financial Standards and the Preferences of Transgovernmental Networks*

A transgovernmental network approach argues that international standards are created by the preferences of financial regulators acting through transgovernmental networks. Transgovernmental network theory emphasizes that their overarching interest in effective governance of financial markets explains the creation of international financial standards. Transgovernmental theory argues that the creation of international financial standards

reflects the gradual coalescence of policy preferences around the technical demands of the system, rather than particularistic national interests. Andrew Baker calls international financial regulatory institutions, such as IOSCO, "technical problem-solving networks."[73]

Transgovernmental network theory borrows heavily from functionalist theory pioneered by David Mitrany. Mitrany's functionalist theory argued that states were increasingly rationalizing the policy making process by delegating authority to functionally specific, task-orientated institutions within states. This act of delegation was believed to lay the foundations of new international governance arrangements characterized by consensual agreements between like-minded actors and the decline of particularistic state interests.[74] As David Mitrany notes, "by linking authority to a specific activity [functionalism] seeks to break away from the traditional link between authority and definite territory."[75] In the spirit of Mitrany's work, Porter argues that international financial regulatory standards are created to fulfill the governance demands that an increasingly integrated and complex international financial system places on financial regulators.[76] Tony Porter's earlier work argued that intense competition and a lack of private regimes in banking regulation necessitated the creation of relatively strong international banking standards. In contrast, the lack of competition and stronger private regimes in securities markets means that, by comparison, international securities market standards were weaker.[77] This demonstrates that Porter argues that international financial regulatory institutions and the standards they create are driven by functional concerns rather than the materialist concerns highlighted by domestic politics or inter-state politics scholars. Porter argues that the technical and practical nature of networked regulatory institutions, such as IOSCO, causes regulators to "conform to the technical demands of the system rather than to the political interests of the states that appoint them."[78]

From this perspective, international financial standards are created to more effectively govern the international financial system. International financial standards are created to

[73] Baker 2009, 204
[74] Mittrany 1975; Zaring 1998, p. 313 – 324; Porter 2003, p. 526
[75] Quoted in Porter 2003, p. 526
[76] Porter 1993; Porter 2005a
[77] Porter 1993
[78] Porter 2003, p. 526

respond to the increasing complexity, integration and interdependence of national financial systems. Transgovernmental scholars emphasize the impact of transgovernmental networks, operating at the transnational level, on national regulatory preferences and regulatory frameworks. As David Zaring explains, international financial regulatory institutions cause states to become enmeshed "in a web of technical cooperation and international organizations."[79] Inter-state and domestic politics scholars emphasize the role of the state and domestic political preferences in creating international financial standards. Transgovernmental network scholars argue that international standards are derived from the preferences of the transgovernmental network of financial regulators, and that the preferences of this community of regulators are predominantly functionalist rather than materialist.

Tony Porter's functionalist approach expects outcomes of transgovernmental networks to reflect international best practice, and the policy preferences of the informed regulatory community, rather than the particularistic interests of states or regulators themselves.[80] Porter, however, recognizes the strengthened role of private market actors in the creation of international financial standards and in influencing the substance of those standards.[81] Furthermore, Andrew Baker argues that the policy preferences of transgovernmental networks are narrowly defined because they privilege "a particular view of the world largely derived from neoclassical economic theory."[82] Porter and Baker argue that regulators are focused on effectively governing the international financial system but the way that securities regulators govern is influenced by their ideational framework.

### *2.5.2 The Power of Transgovernmental Networks*

Transgovernmental network theory highlights the authority of a community of regulators who operate through transgovernmental networks. Transgovernmental network theories, therefore, focus on the accumulation of power by financial regulators and, by association, the power of transgovernmental networks.

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[79] Zaring 1998, p. 316
[80] See Porter 2003; Porter 2005a
[81] Porter 2005a, p. 103 – 116; Porter 2005b, p. 1138 – 1168
[82] Baker 2009, p. 209

Trasngovernmental network scholars argue that two issues and processes have empowered financial regulators and transgovernmental networks: technical complexity and interdependence. First, as Tony Porter highlights, technological complexity in domestic and international financial systems has led to the delegation of authority away from the central state towards specialist, technical and independent state agencies. Technical and specialized actors become empowered because technical issues preclude the involvement of traditional political processes and actors.[83] Second, the interdependence of national economic and financial systems has increased international policy demands on states causing central states to delegate authority away from the executive and traditional loci of foreign policy making towards more specialized independent agencies. States have responded to the changing demands of the global system. As Kal Raustiala puts it, "as the problems policymakers address have gone global, this argument claims, so have the policymakers."[84]

These forces, driven by globalization, have led states to delegate authority to functional, specialized and largely independent government agencies. As Anne-Marie Slaughter states, "the state is not disappearing, it is disaggregating into its separate, functionally distinct parts. These parts—courts, regulatory agencies, executives, and even legislatures—are networking with their counterparts abroad, creating a dense web of relations that constitutes a new, transgovernmental order."[85] A transgovernmental network perspective argues that domestic political actors and states have become increasingly deferential to the preferences of regulators and other technical actors. The preferences of these actors are being increasingly influenced and informed by their interactions with their foreign counterparts within transgovernmental networks.

Transgovernmental scholars argue that international financial standards are enforced through ideational influences rather than more traditional sources of power, such as relative market size. This is evident through the argument of transgovernmental network scholars that the development of peer-to-peer ties and collegial relationships facilitate a gradual coalescence of regulatory preferences. Transgovernmental scholars emphasize the role of ideas in structuring the governance of international financial markets.

[83] Porter 2003; Porter 2001
[84] Kal Raustiala 2002/2003, p. 4
[85] Slaughter 1997, p. 184

### *2.5.3 Institutional Design and Transgovernmental Network Theory*

Transgovernmental network scholars emphasize the distinct institutional and legal character of these networks from traditional international organizations. Networked international institutions are characterized by their relatively informal internal structure, flexible internal governance arrangements and decentralized bureaucracies. Concurrently, these institutions' effectiveness relies on the development of peer-to-peer ties and relationships through constant interaction rather than formal negotiations.[86] Porter argues that this is because of the technical functional nature of these networks as form follows function.[87] Transgovernmental network scholars argue that this form of international cooperation provides a viable alternative to the liberal internationalism that previously dominated the international system.[88]

### *2.5.4 Transgovernmental Network Theory and IOSCO*

Transgovernmental theorists state that IOSCO is one of a series of institutions in which regulators' frequent interactions foster a convergence of regulatory preferences and consequent regulatory harmonization. Porter states that a "technical systems approach will be confirmed if the history reveals a set of relatively robust institutional arrangements that have evolved through their interactions with an evolving technical system."[89] Porter states that IOSCO's work is consistent with this approach as it is characterized by constant interactions between the world's leading regulators with a focus on the production of technical reports and standards. Porter's research on credit rating agency regulatory reform after the crisis argues that IOSCO's approach to rating agency reform reemphasizes the technical nature of IOSCO's work and the emphasis on technical policy reports to identify appropriate solutions to prevailing problems.[90]

Critical to the argument is the empowerment of regulators to establish international agreements on behalf of states. Porter states that public sector officials "have developed so

[86] Raustiala 2002/2003; Zaring 1998; Baker 2009, p. 201
[87] Porter 2003, p. 526
[88] Slaughter 2004
[89] Porter 2003, p. 535
[90] Tony Porter 2010, p. 69 – 71

much autonomy from the states that these officials ostensible represent, that it is a problem to treat them as simply a negotiating forum for states."[91] Transgovernmental network scholars including Kal Raustiala, David Zaring and Andrew Baker have undertaken comparably limited empirical studies of IOSCO. These scholars focus on the internal governance arrangements, how IOSCO's members harmonize their regulatory frameworks through persuasion and consensus rather than formal agreements between states,[92] and how neoclassical economics has influenced international financial standards.[93] David Zaring and Kal Raustiala have also highlighted how IOSCO has established cooperative governance mechanisms such as IOSCO's MoU program for information sharing to enable regulators to effectively regulate their national markets in an increasingly global financial system.[94]

Transgovernmental network scholars have contributed to the study of the politics of international financial regulation by highlighting the role and influence of financial regulators in governing the international financial system. These scholars have demonstrated that international financial standards are created in response to the negative spillovers of an interdependent global financial system. This insight has revealed that the preferences of regulators are not solely driven by the material interests of states and domestic political actors but are also ideational. Financial regulators do create international securities standards to more effectively govern the international financial system, and their creation is driven by the principled professional interests of regulators. Financial regulators retain a principled professional interest in governing international financial markets effectively, which is reinforced through their professional training, experience, and expertise. Transgovernmental network theory has demonstrated that financial regulators play an important role in the governance of global financial markets. Their importance is demonstrated by regulators' ability to act semi-autonomously from domestic legislatures and states in creating international financial standards.

[91] Porter 2005, p. 13
[92] Raustiala 2002/2003; Zaring 1998
[93] Baker 2009
[94] Raustiala 2002/2003, p. 31; Zaring 1998, p. 296

### *2.5.5 Limitations of Transgovernmental Network Literature*

Despite the important contributions of transgovernmental network literature, there are a number of limitations within this approach that need to be addressed. The first limitation is empirical. Transgovernmental network literature has not analyzed IOSCO's initiatives in detail. Transgovernmental network literature has only summarized and briefly analyzed the international financial standards and regulatory initiatives created at IOSCO and other international financial regulatory institutions.

The second limitation to transgovernmental network literature is that international financial standards are not entirely derived from the preferences of regulators. As noted above, scholars working within the domestic politics and inter-state approaches have shown effectively how international financial standards are also derived from the preferences of domestic political actors and the material interests of states. This dissertation confirms this insight, showing a number of international securities market standards that are derived from these actors.

This thesis also highlights how securities market regulators are unable to obtain their preferences. For instance, because the U.S. SEC was not granted the statutory authority to regulate hedge funds, IOSCO's Technical Committee was unable to endorse international hedge fund standards. Instead, IOSCO's Technical Committee shifted its focus to the risk and regulated funds' exposure to hedge funds, reflecting the limits of their statutory authority. Despite the majority of securities market regulators supporting the regulation of hedge funds, the U.S. and E.U.'s domestic political context caused regulators to create regulatory principles for investment funds that fell under their existing statutory authority.

The third limitation to transgovernmental network theory is that it overlooks the role of more traditional forms of power in enforcing international financial standards. Transgovernmental network scholars have overemphasized the role of social interactions and ideas in enforcing international financial standards. International financial regulatory standards are enforced through a combination of ideational forces and threats of restricting market access to dominant financial centers. Financial regulators have relied on ideational

forces through technical assistance programs that transmit knowledge from central financial markets to more peripheral financial centers. Financial regulators also rely on regulatory diplomacy, which touts the material and reputational benefits of adopting financial regulatory reforms. Financial standards have also relied on domestic legislatures in dominant financial centers threatening to restrict market access for foreign financial firms if foreign jurisdictions fail to comply with international financial standards.

## 2.6 Transnational Private Financial Market Actor Models

Transnational private financial market actor models contend that international standards are derived from the preferences of transnational private financial market actors. Transnational private financial market actors predominantly seek the harmonization of national regulatory frameworks, the promotion of capital liberalization, and an expansion of free-market regulatory models that rely on private self-regulatory regimes. Transnational private financial market actors are able to obtain these preferences through their preferential access to transgovernmental regulatory networks and through their superior technical expertise relative to financial regulators.

### *2.6.1 International Financial Standards and the Preferences of Transnational Private Financial Market Actors*

Transnational private financial market actor scholars contend that international financial regulatory outcomes reflect the preferences of private transnational financial groups. International financial standards serve their interests because they promote the harmonization of national regulatory frameworks enabling greater capital mobility, expansion of capitalist relations and replication of the Anglo-American free-market capitalist model.[95] Geoffrey Underhill argues that international financial standards reduce the transaction costs associated with operating in foreign financial markets, expand financial firms' access to foreign, more peripheral financial centers, and liberalize domestic securities markets to favor financial innovation. As he puts it, "the work of IOSCO is characterized by low-profile negotiations to harmonize securities regulation and supervision in order to

[95] Soederberg 2004; Soedeberg 2003; Underhill 1995; Underhill and Zhang 2008

facilitate the emergence of transnational securities issuance and trading."[96] Critical scholars argue that international financial standards act in the material interests of transnational financial firms by harmonizing national regulatory frameworks.

### *2.6.2 The Power of Transnational Private Financial Market Actors*

Within transnational private financial market actor theories scholars provide three competing explanations of the power of private financial market actors. The first set of scholars argue that the power of transnational private financial market actors is derived from their privileged access to international financial regulatory institutions, and the shift of the regulatory policymaking process from domestic to transnational policy processes. The shift from domestic political processes to transnational policy making processes has enabled financial regulatory reform processes to escape forms of political oversight since there is little or no political oversight at the transnational level. Underhill highlights that private financial market actors retain a privileged position in the international policy making process and are consulted exclusively. Underhill and Xiaoke Zhang highlight that societal actors such as NGOs are kept out of discussions about the content of international financial standards.[97] Underhill argues that private actors' centrality in these institutions have enabled them to obtain their preference for financial market integration and market orientation in economic governance.[98] Consistent with transgovernmental network theory, transnational private financial market actor models argue that national regulatory preferences are increasingly derived from international regulatory institutions and that this empowers private transnational market actors by moving the policy making process away from the domestic realm.

A second set of scholars argues that the power of transnational private financial market actors is derived from their comparative knowledge advantage over financial market regulators. Torsten Strulik argues that financial markets are characterized by increasing complexity in financial systems. Politicians and regulators lack the "cognitive competence"

[96] Underhill 1995, p. 263
[97] Underhill and Zhang 2008
[98] Underhill and Zhang 2008.

to keep up with innovation of the economy.[99] Strulik argues that analyzing international financial standards requires an understanding of the characteristics and consequences of knowledge production within the financial system. Strulik argues that "a knowledge-based financial system requires organizations which are specialized in a knowledge-based production of system trust. With their expertise in credit assessments, rating agencies not only observe the trustworthiness of states, firms and financial instruments, they also expand the risk-processing capacity of the global financial system."[100] Important actors within the system are those that are able to provide knowledge and, through their reputations, ensure the maintenance of trust. In financial markets, these are predominantly private actors.

Strulik remains agnostic about the impact of private actors' involvement in the regulatory process. The current governance problem is characterized by the existence of ignorance defined as "unsolvable information problem". Often the information problem is unsolvable because it no longer reflects a normal risk but reflects a constellation of risks that is too difficult to be understood by decision makers.[101] Whether it is a positive development or not, transnational private financial market actors have become important actors in the creation of international and national regulatory regimes.

Eleni Tsingou's research on transnational policy networks adopts a similar theoretical approach to Strulik. Tsingou emphasizes that the power and authority of private transnational financial actors within transnational policy networks is derived from their knowledge and technical authority compared to public regulators. Tsingou's analysis of OTC derivative regulation, and the favoring of self-regulatory private regimes over direct state regulation of OTC derivatives, suggests that it was the knowledge power of the transnational policy community, which enabled them to obtain their preference for self-regulation. Under Tsingou's model, private financial firms are not the predominant actors in the policy process but their preferences are transmitted through transnational policy networks. Tsingou highlights the role of the Group of 30 (G30), which is comprised of senior public, private and academic representatives, generally considered to be market-friendly. Tsingou states that the G30's work on derivatives was influential because the G30 "produced and transmitted

[99] Strulik 2006, p. 11
[100] Strulik 2006, p. 29
[101] Strulik 2006, p. 22

crucial knowledge on OTC derivatives markets and demonstrated that the private sector had the expertise, capacity and incentive to self-regulate."[102] Tsingou also highlights the role of the ISDA, which created the Master Agreement that formed a private self-regulatory regime for OTC derivatives. In forming a Master Agreement, ISDA was able to convince regulators and policymakers that OTC derivatives markets were capable of effective self-regulation.

As discussed in the inter-state theory section, Germain's historical materialist approach straddles both an inter-state and transnational private financial market actor analytical framework. Germain's focus on the global economic and social order argues that the governance of international financial markets is driven by political, social and cultural forces, which emphasize the exercise of power by states and the nature of class relations.[103] Germain's analytical framework is consistent with transnational private financial market actor models as he argues that the governance of international financial markets favors the interests of private financial market actors over wider social interests. Germain's analysis of the pre-crisis global social and economic order argues that a coherent and consolidated "managerial class" has helped to embed liberal and neoliberal ideas in to the global financial order. This strength of the global capitalist class has led to the devolution of control away from national regulators towards private financial institutions.[104] Similar to Tsingou, the power of this managerial class is the salience and power of their ideas. Germain also agrees with Strulik in arguing that financial firms have an information and knowledge advantage over regulators.[105] Germain states that a combination of "technology, a more permissive political environment and changes in the behavioral incentives produced by their regulatory environment," has enabled financial institutions to become more innovative and to create new revenue streams.[106]

Germain's analysis of the impact of the 2007/2008 financial crisis on the governance of global financial markets concludes that the established structure of power has not yet

[102] Tsingou 2006, p. 167
[103] Germain 2009, p. 685
[104] Germain 2007, p. 81
[105] Germain 2007, p. 83
[106] Germain 2007, p. 81

changed. Germain's analysis of the extent to which the crisis shifted the balance of power concludes the following:

> "we see at best a recalibration of public and private authority that leaves intact the economic basis of global capitalism, a reconfiguration of regulatory authority that allows the state to impose its demands more fully on financial systems but which does not modify unduly the essentially private character of those systems"[107]

This is the paradox of the post-crisis financial order. Financial markets will be subject to greater regulation but regulation will continue to respect and serve the interests of financial markets rather than wider social interests. Germain's 2012 introduction to the *Review Of International Political Economy* issue re-emphasizes how the balance of power remains firmly in the hands of globally dominant financial firms and that this is a result of "their information rich position in the global financial system and their extensive ties to key national regulatory communities."[108]

### *2.6.3 Transnational Private Financial Actor Theory and IOSCO*

Geoffrey Underhill's analysis of IOSCO argues that the organization propels the transnationalization of financial markets. According to Underhill, IOSCO's main goal is "the removal of regulatory barriers and barriers to the enforcement of national standards, which necessarily involves a degree of harmonization across regulatory boundaries."[109] Underhill highlights two cases of IOSCO's policy initiatives that promulgate the transnationalization of securities markets. First, IOSCO's work on cross-border listings sought to harmonize public listing requirements, especially disclosure requirements. This reflected the preferences of transnational financial market actors by cutting the costs of financial firms operating across borders. Second, IOSCO sought to harmonize capital adequacy requirements with the lower standards in the U.K. and E.U. Underhill states that the U.S. considered lowering its capital adequacy requirements to satisfy the interests of private financial firms. Underhill concludes

[107] Germain 2009, 686
[108] Germain 2012, p. 533
[109] Underhill 1995, p. 262

that, "if the United States cannot stand up for the principles and standards it seeks for its markets in an era of increasing globalization, few others can."[110]

Zhang and Underhill explain that IOSCO keeps itself at arms-length from traditional government oversight mechanisms and is more accountable to self-regulatory organizations and private market participants.[111] Furthermore, IOSCO delegates some of its functions to private sector organizations. IOSCO delegated responsibility for accounting harmonization to the IASB and clearance and settlement issues to the G30.[112] Underhill and Zhang conclude that the nature of IOSCO's governance process, its internal institutional arrangements, and its accountability mechanisms, mean that IOSCO represents the interests of private sector participants rather than the broader public.[113] Underhill argues that the influence of IOSCO on the national regulatory framework of the U.S. and other states demonstrates the power of transgovernmental networks of IOSCO and the transmission of the regulatory preferences of transnational financial market actors to national regulatory frameworks. Tsingou's analysis of OTC derivatives market regulation touches on the role of IOSCO, as it had addressed the regulatory issue area. Tsingou's analysis of OTC derivatives market regulation highlights how transnational private financial market actors were able to avoid direct regulation through their authority at the transnational level.

Transnational financial private market actor models have identified the interests and influence of private financial market actors in the creation of international financial standards. As Underhill has demonstrated, private financial market actors benefit from regulatory harmonization. Underhill, and Underhill and Zhang demonstrate that private financial market actors benefit from preferential access to institutions such as IOSCO. Strulik and Tsingou have argued that private financial market actors benefit from their comparative information advantage.

[110] Underhill 1995, p. 271
[111] Underhill and Zhang 2008, p. 548
[112] Underhill and Zhang 2008, p. 549
[113] Underhill and Zhang 2008, p. 536

### *2.6.4 Limitations to Transnational Private Financial Market Actor Models*

Despite the important contributions of private transnational financial market actor models, there are a number of limitations to this approach that need to be addressed. International securities market standards are not harmonized as Underhill hypothesized. For instance, cross-border disclosure requirement and capital adequacy standards remain disharmonized despite Underhill's contention to the contrary. The United States maintains U.S. GAAP accounting standards, whereas the rest of the world has converted to International Financial Reporting Standards. U.S. capital adequacy standards also continue to differ from the U.K. and E.U. Interviews with senior securities regulators and senior members of IOSCO reveal that securities market regulation remains nationally distinct. Those officials also stated that the historical development of securities markets and differentiation in the level of development, sophistication, and financial products offered between national securities market means that regulatory harmonization is an unlikely prospect. Regulatory harmonization is partial.

Third, and most importantly, efforts to establish harmonized financial regulatory frameworks are driven by the ideational preferences of securities regulators. As chapter five and six of this thesis discusses, international credit rating agency and hedge fund standards were created to promote harmonized financial regulatory frameworks. In the case of credit rating agencies, IOSCO's *Principles for CRAs* and IOSCO's *Code of Conduct* were created to promote the harmonization of national regulatory frameworks amidst regulatory reform in the U.S. and E.U. Securities regulators sought harmonized national regulatory frameworks in order to ensure common assessments of credit worthiness across jurisdictions. Securities regulators were concerned that dual systems of rating regulation would create dual systems of assessing credit worthiness and believed this was not in the interests of protecting investors. In the case of hedge funds, international securities market standards were produced by IOSCO's Technical Committee at the beginning of the international financial regulatory reform process to establish common information and reporting requirements that would enable regulators to monitor the systemic risk that hedge funds posed. As Ethiopis Tafara and Robert Peterson, the former Director and current Deputy Director of the Office of International Affairs (OIA) at the U.S. SEC, discuss in a 2007 article in the *Harvard*

*International Law Journal*, regulators' preference for harmonized financial regulatory frameworks are driven by their ideational preferences, not political pressure from private financial market actors.[114] Andrew Baker concurs.[115]

## 2.7 Limitations to IPE Literature on the Politics of International Financial Regulation

There are a number of limitations to existing IPE literature that this thesis seeks to address. These limitations fall in to two categories: empirical and theoretical.

### *2.7.1 Empirical Limitations to IPE Literature*

Existing IPE literature has analyzed a number of dimensions of IOSCO and the politics of international securities market regulation. However, important international securities standards have not yet been analyzed. This includes: IOSCO's *Principles*, IOSCO's *Methodology,* IOSCO's *MMoU*, and IOSCO's *Systemic Risk Data Requirements for Hedge Funds*. These empirical cases are important institutional initiatives within IOSCO and they reveal important political dynamics in international securities market regulation. This thesis addresses this empirical gap.

The second empirical limitation is that existing IPE literature has conducted single case studies or multiple case studies in a single time period. Whilst this empirical approach is understandable, this thesis argues that it has led to a myopic view of the political dynamics of international securities market regulation. In explaining single financial regulatory standards, or regulatory standards from a single era, existing literature has attributed cause to certain political factors that were present at the time of their creation. This has caused existing literature to explain international financial standards through the role and influence of just one of three competing political arenas: inter-state, domestic, and transnational. This thesis has conducted an empirical analysis of international securities standards over the lifetime of the issue, from the genesis of securities market regulatory cooperation in 1983, through to the post-2007/2008 financial regulatory reform process. This research approach reveals that

[114] Baker 2009; Tafara and Peterson 2007
[115] Baker 2009

international financial standards are derived from different political arenas across time and across issue areas.

### *2.7.2 Theoretical Limitations to IPE Literature*

This thesis argues and demonstrates that international financial standards are derived from different political arenas and that the political arena from which they are derived depends on the historical and political context of each regulatory standard. Existing literature is unable to account for the differentiated sources of international securities standards and the differentiated sources of power in the promotion and enforcement of those standards. As Helleiner and Pagliari state, existing international financial regulatory politics literature "points to a distinct political arena – interstate, domestic, and transnational – as the source of the creation and strengthening of international financial standards."[116]

Interstate, domestic political, and transnational private financial market actor theories recognize the power and authority of regulators to create international financial standards through transgovernmental networks, such as IOSCO. However, they argue that international financial standards are not derived from the preferences of financial regulators but from the political and material interests of states, domestic political actors, or private transnational financial market actors. Existing literature correctly argues that regulators are not wholly autonomous actors and are subject to political pressure from states and their domestic legislatures. Of the international securities standards analyzed as part of this dissertation, little evidence has been found that IOSCO was subject to direct political pressure from transnational financial market actors to create international financial standards. Instead, private financial market firms have lobbied at the domestic political level to obtain their interests. This thesis argues that, although regulators have been subject to political pressure from states and domestic political actors, they have also created international securities standards at their own initiative. Those international securities standards have been created to obtain the professional interests of securities regulators, rather than their bureaucratic political interests. These international securities standards are

[116] Hellieiner and Pagliari 2011, p. 171

derived from the transnational level and the policy preferences of the network of regulators within the transgovernmental network.

The central theoretical limitation to existing IPE literature is that it is unable to account for the differentiated political sources of international financial standards. This limitation warrants theoretical innovation. In order to achieve this aim this thesis proposes the use of a revised PA analytical framework to explain the creation and strengthening of international securities market standards.

## 2.8 Principal-Agent Theory

PA theory provides an analytical tool to understand how and when IOs act autonomously. PA theory does so by establishing how and under what conditions states exercise control over IOs. PA theory in IR literature was pioneered by Mark Pollack's *International Organization* article on the European Union in 1997, which analyzed the delegation of governance tasks to supranational public bureaucracies within the EU.[117] PA theory in IO and IR literature emerged out of U.S. domestic politics literature in the U.S., which applied theories of the firm to understanding how domestic legislatures do and should control the behavior of opportunistic public bureaucracies.[118] IR literature began to apply PA theory to analyze the dynamics between states and international public bureaucracies and how states ensure that IOs act consistently with the interests of states.

David Singer pioneered the use of PA theory in IPE and, more specifically, financial regulatory politics literature. Singer analyzes the impact of PA relationships at the domestic political level on the creation of international financial regulatory standards at the transnational level. Singer argues that by threatening the autonomy, prestige and future career opportunities, domestic legislatures exercise control over regulators. As a result, when domestic financial systems suffer bouts of financial instability and threats to domestic competitiveness, securities market regulators create international financial standards. International financial standards enable domestic politicians to responding to financial

[117] Pollack 1997

[118] See Nielson and Tierney 2003, p. 245 citing Coase 1937; Alchian and Demsets 1972; Williamson 1975; Fama 1980. Also see Pollack 1997, p. 22 citing Shepsle and Weindgast 1987b; Krehbiel 1987. Also see Lavelle 2011

instability, whilst reducing the costs of adjustment by exporting domestic financial regulatory demands to foreign financial centers.

### *2.8.1 PA Theory in IO and IPE Literature*

Central to PA theory is the act of delegation. As Hawkins et al. explain, "delegation is a conditional grant of authority from a *principal* to an *agent* that empowers the latter to act on behalf of the former. This grant of authority is limited in time or scope and must be revocable by the principal."[119] The conditional grant of authority enables the principal to renegotiate the contract with the agent to define the conditions of the act of delegation, which enables the principal to exercise control over the agent.

PA theory assumes that bureaucracies are opportunistic political actors who seek to expand their mission and accumulate political and material resources.[120] As D. Roderick Kiewet and Michael Daniel McCubbins explain, "agents behave opportunistically, pursuing their own interests subject only to the constraints imposed by their relationship with the principal."[121] Through the act of delegation, principals can and often do incur agency losses defined as "costs when agents engage in undesired independent action or when they [principals] expend resources to contract with or monitor and control those agents."[122] Independent action by agents occurs through agency slack and occurs in the form of shirking and slippage. Shirking represents the minimization of the agent's efforts when acting in the principal's interests, whereas slippage occurs when the agent shifts policy away from the preferences of the principal towards its own.

The principal forms contracts, administrative procedures and other mechanisms of control that define the scope of the activity of the agent to ensure that the agent acts in the interests of the principal. PA theory adopts a 'logic of consequences' approach, in which the behavior of agents is conditioned by the expectation of the consequences of their behavior.[123] It is through the logic of consequences that principals are able to control the behavior of their

[119] Hawkins et al 2006b, p. 7
[120] Vaubel 2006; Vaubel 1986
[121] Kiewet and McCubbins 1991, p. 5
[122] Hawkins et al. 2006b, p. 9
[123] Nielson et al 2006, p. 111

agents. The formation of contracts and administrative procedures come at a cost. The rationalist tradition of PA theory contends that "principals will adopt a given control mechanism only if its cost is less than the sum of agency losses that it reduces."[124] Consistent with rational design literature, PA literature presumes that states' investment in institutions to ensure outcomes within IOs is dependent on the extent to which they expect the IO to deviate from the interests of states, and the rate of return on investing in those institutions. PA theory in its present form argues that outcomes at IOs are derived from the preferences of states who exercise control over IOs.

PA theory also utilizes the concept of discretion to discuss how IOs or transgovernmental networks exercise agency in the international system. PA theory states that within a Principal-Agent contract, principals grant agents discretion. Discretion is defined as "specifying the principal's goals but not the specific actions the agent must take to accomplish those objectives."[125] When IOs act within the zone of discretion, they are acting in the interests of the states, but act semi-autonomously by choosing the range of actions to fulfill states' specific goals. Singer's analytical framework highlights how this concept is used by existing literature. Financial regulators go to the transnational level to create an international financial standard to obtain the policy goals or interest of domestic political actors. This is an example of how the agent exercises discretion to obtain the principal's specified policy goals.

### *2.8.2 The Contributions of PA Theory to International Financial Regulatory Politics Literature*

A PA analytical framework provides important theoretical concepts that enable IPE literature to establish an integrative approach to international financial regulatory politics. PA theory's identification of mechanisms of control highlights how domestic political actors are able to exercise control over outcomes at IOSCO. As David Singer discusses, domestic political actors exercise control over outcomes at IOSCO by threatening the power, autonomy and prestige of domestic securities market regulators. This thesis also reveals that domestic legislatures exercise control by granting or withholding statutory authority to govern previously unregulated financial market actors from domestic securities regulators.

[124] Pollack 1997, p. 109
[125] Hawkins et al. 2006b, p. 8

PA theory's concept of multiple agents is also able to account for the role and influence of states in the strengthening of international securities market standards. Kenneth Arrow first introduced the concept of multiple agents in 1984. Arrow is not an IO, IR or IPE scholar, but was an economist. The concept of multiple agents helps us to account for the role and influence of states on the creation and strengthening of international securities market standards. Arrow discusses the issue of the hidden-information problem. The hidden-information problem refers to the fact that "the agent has made some observations that the principal has not made. The agent uses (and should use) this observation in making decisions; however, the principal cannot check whether the agent has used his or her information in the way that best serves the principal's interests."[126]In order to overcome this monitoring issue, the principal utilizes multiple agents that also represent and act in the interests of the principal. This accounts for the role of states in the strengthening of IOSCO's international financial standards. Finance ministries also oversee the outcomes of international financial regulatory organizations, particularly after financial crises. When finance ministries are unhappy with the outcomes of these institutions and feel they need to improve their financial regulatory frameworks, they exercise control over these institutions. In the case of IOSCO's *Methodology*, financial ministries exercised control over IOSCO through their influence over relatively senior international financial institutions: the IMF and World Bank.

PA theory's concept of discretion provides an important theoretical concept to describe the role and influence of the transgovernmental network of securities regulators through IOSCO's Technical Committee. The concept of discretion recognizes that the semi-autonomous actions of the agent are still consistent with the specific interests of the principal. Discretion sits in contrast to agency shirking or slippage. When exercising discretion, the agent is not pursuing its own interests at the cost of the principal. The agent acts in the interests of the principal by exercising the discretion granted to them by the principal. The interests of the principal and the agent must be aligned. When agents are acting consistently with the preferences of the principal whilst exercising discretion, agents are operating within the "zone of discretion". However, when agents, or in this case

[126] Arrow 1984, p. 5

securities regulators, exercise discretion, they demonstrate initiative and create governance regimes that are important to the governance of international financial markets. The concept of discretion helps to establish how and under what conditions international financial regulatory standards are derived from the preferences of the community of regulators within IOSCO. International regulatory standards must serve the interests of regulators, domestic legislatures and states. A PA analytical approach makes two important insights in to the role and function of securities market regulators in the creation of international securities market standards.

A PA analytical approach establishes that the transgovernmental network of securities regulators demonstrate agency in the governance of international financial markets and that this agency is derived from the domestic political context. The authority of securities regulators' is derived from their domestic institutional environment. The agency of securities regulators is acquired through the discretion granted to them to create international financial standards. This has led to the creation of governance mechanisms to address threats to the integrity and stability of the domestic securities market system that they regulate. When financial regulators create international financial standards to address threats to the integrity and stability of domestic securities market systems, they are acting in their principled professional interests. As Chapter 3 and Chapter 4 discusses, the creation of IOSCO's *Principles for MOUs*, IOSCO's MMoUs, IOSCO's *Principles*, and IOSCO's *Methodology* were driven by the preferences and influence of the transgovernmental network of securities regulators within IOSCO.

### *2.8.3 Limitations to PA Theory*

The first limitation to PA theory is that it has not yet incorporated an analysis of transgovernmental networks in the chain of delegation. PA theory in IO literature has analyzed the principal-agent relationship between states and international organizations. Existing PA theory analyzes a simple delegation chain between states and IOs as demonstrated in Figure 2.1 below:

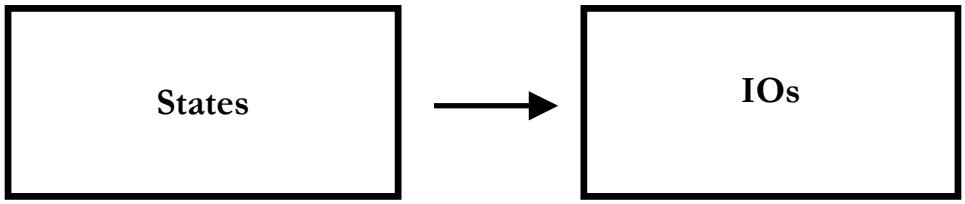



**Figure 2.1 Delegation Chain within Existing IO literature**

David Singer's PA theory incorporates an analysis of transgovernmental networks. However, Singer's PA model does not consider transgovernmental networks to be an important explanatory variable in the creation of international financial standards. Singer states,

> "[transgovernmental regulatory networks] are not constituted by treaty and are not granted agency – legal or otherwise – to act in international affairs… ultimately, a compelling explanation of regulator behavior must be grounded in domestic politics (including domestic institutions) and the domestic ramifications of globalization."[127]

Singer argues that transgovernmental networks are epiphenomenal and, therefore, focuses on what domestic political factors lead regulators to create international financial standards. This thesis argues and demonstrates that transgovernmental networks are an important explanatory variable in explaining the creation and strengthening of international financial standards and turns its focus on to what leads the community of securities market regulators to create and strengthen international financial standards.

PA theory does analyze a number of alternate chains of delegation ranging from multiple principals to multiple acts of delegation. PA theory has not yet encapsulated the nature of the delegation chain that this thesis highlights. The PA relationship highlighted by this thesis involves the delegation of authority from domestic legislatures to domestic securities regulators. Securities regulators use the considerable autonomy and discretion granted to them by domestic legislatures to establish international regulatory standards at the transnational level, through transgovernmental networks. Furthermore, multiple agents are

[127] Singer 2007, p. 34

used to monitor the creation and strengthening of international financial standards including finance ministries. This chain of delegation is represented below in Figure 2.2 below:

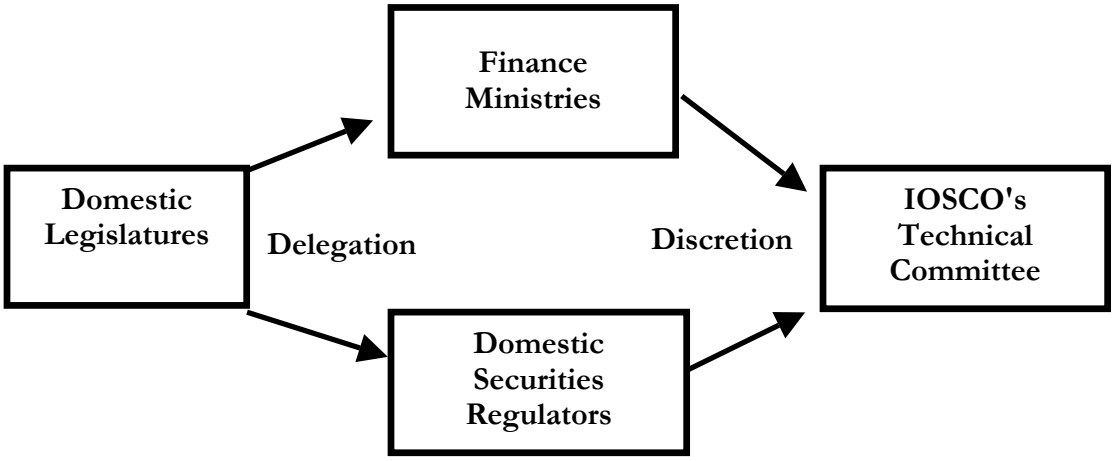



**Figure 2.2 Delegation Chain in International Securities Market Regulation**

The second limitation of existing PA theory is that it underemphasizes the role of IOs or transgovernmental networks in the international system. PA theory underemphasizes the role of IOs and transgovernmental networks because it establishes an incomplete model of IO preferences. PA theory assumes that IO preferences are derived from rationalist, material and bureaucratic political interests. PA theory presumes that ideational factors are exogenous to explanations of outcomes or changes in international financial regulatory organizations. This thesis highlights that this provides a limited view of the preferences of financial regulators by demonstrating that than pursuing international securities market standards based on rationalist, material or bureaucratic political interests, securities regulators have created international financial standards to obtain their principled professional interests. This highlights that the ideational interests of securities market regulators are an important explanatory factor in the creation of international financial standards.

PA theory recognizes the role of IOs in outcomes in the international system through concepts such as agency slack and discretion. However, PA theory claims that states overcome agency slack through systems of monitoring and mechanisms of control over IO

outcomes.[128] PA theory's discussion of discretion emphasizes how states benefit from the agency of IOs and transgovernmental networks, rather than emphasizing the role of IOs or transgovernmental networks in governing the international system. This is because existing PA theory assumes that the preferences of transgovernmental networks are bureaucratic and material, thereby discounting or dismissing the ideational preferences of transgovernmental networks. As Stephen Nelson and Catherine Weaver argue, ""PA models largely conform to economistic analysis by assuming IOs to be self-interested, rational actors who have predefined (and unchanging) preferences centered on the expansion of staff, their missions and resources. [What's] missing is a persuasive theory of IO identity and interests that goes beyond this blanket assumption to understand the constitution of IO preferences"[129] PA theory overlooks the internal cultural values or ideational beliefs of IOs or transgovernmental networks. It is necessary to better account for and theorize the role and influence of transgovernmental networks (or agents more generally) within PA theory.

In order to better account for the role and influence of transgovernmental networks it is necessary for PA theory to open the "black box" of regulators' interests. As Catherine Weaver explains, "the PA model assumes, rather than explains, IO preferences. More often than not PA analysis tends to "black box" the IO in a manner that obscures a clear sense of the internal "social life" and dynamics of bureaucratic politics."[130] In opening the "black box" of regulators' preferences, a PA model that incorporates analysis of regulators' preferences or bureaucratic culture can better account for outcomes at international financial regulatory outcomes. This work builds on the emerging literature set within IO literature that identifies bureaucratic culture as an important explanatory variable in explaining outcomes at IOs.[131]

PA theory has not shed enough light on to what happens within the "zone of discretion" and what explains international financial regulatory organizations' creation of international financial standards. Securities market regulators have created international financial regulatory standards that export national financial regulatory frameworks to foreign financial

[128] This work is in the traditional of rational design literature. See Koremenos et al. 2001
[129] Nelson and Weaver 2013, p. 9 – 10
[130] Weaver 2006, p. 3
[131] Momani 2010; Momani 2007; Weaver 2006; Weaver 2008

centers and established cooperative regulatory mechanisms. The creation of these standards reflects the preferences of their domestic legislatures as they are created to fulfill their domestic regulatory responsibilities and reflect domestic regulatory frameworks. These standards, therefore, are reflective of the transgovernmental network acting within the "zone of discretion". This thesis argues that the principled professional interests of the transgovernmental securities market regulators is an important explanatory variable in the creation of this set of international financial standards.

The third limitation of PA theory is that it has not yet analyzed the role of multiple agents over outcomes in the international system. This thesis argues that the role of multiple agents can account for the role of the state in international financial standards. The role of multiple agents highlights that, whilst securities regulators are responsible for international securities market standards, finance ministries retain overarching responsibilities for the economy as a whole. These departments have historically been involved in international financial regulation and the international financial architecture through the G7/G20 in the wake of financial crises. Their role has been historically focused on coordinating financial regulatory reform processes by committing themselves and other members to implementing international financial standards.

The role of finance ministries in international financial regulation proves that there is a degree of agent overlap and that there are multiple agents. Finance ministries and treasury departments within the G7 or G20 traditionally view international financial standards through an inter-state lens, focusing on the costs of non-compliance by peripheral financial centers and/or competing financial centers. This is why their role is focused on implementation of international financial standards after domestic policy preferences are established. If these actors perceive that international financial standards are not sufficiently implemented, they will place pressure on their regulatory counter-parts to improve implementation; as is the case in IOSCO's *Methodology*. These actors have placed pressure on their regulatory counter-parts through the IMF and World Bank, within which they are powerful political actors.

## 2.9 Conclusion: Contributions to PA Theory and IPE literature

IPE literature has made an important contribution to the study of international financial regulatory politics. IPE literature has identified the different political sources of international financial standards and the interests of the relevant political actors in creating them. IPE literature has also identified the source of power of each political actor in creating, promoting and enforcing international financial standards. Furthermore, IPE literature has conducted important but limited empirical studies of international securities standards including: MOUs, cross-border disclosure requirements for public listings, capital adequacy requirements, hedge funds, OTC derivatives, and credit rating agencies. There are a number of limitations to existing literature that this thesis will seek to address.

There are important empirical gaps in the IPE literature's analysis of international securities market regulation. First, there are three important international financial standards that have not been analyzed by IPE literature. Those standards are IOSCO's *Principles*, IOSCO's *Methodology*, IOSCO's *MMoU*, and IOSCO's *Systemic Risk Data Requirements for Hedge Funds*. These international securities standards have been important in the governance of international securities markets. They also reveal important political dynamics that further our understanding of international financial regulatory politics. Second, existing empirical studies have also overlooked a number of important aspects in the creation of international securities standards. Accounts of post-crisis regulatory reforms have focused on shifts in domestic political preferences and contexts in causing the creation of international financial standards. With the exception of Eric Helleiner,[132] these accounts have overlooked the preferences of the community of regulators. Finally, IPE literature has limited its empirical analysis to single financial regulatory standards or an analysis of limited time periods. This thesis argues that this has led scholars to overlook the differentiated political sources of international securities market standards across the lifetime of IOSCO.

The results of this research project conclude that international securities standards were derived from different political arenas at different times in the history of IOSCO. The first

[132] Helleiner *Forthcoming*

category of standards was created by the transgovernmental network, driven by the principled professional interests of securities market regulators. These standards were created to address threats to the integrity and stability of domestic financial markets by under-regulated or ineffectively regulated jurisdictions. This includes IOSCO's *Principles*, IOSCO's *Principles for MoUs* and IOSCO's *MMoU*. IOSCO's *Principles* was created to improve national regulatory frameworks in peripheral jurisdictions to improve financial instability after a series of financial crises impacted the stability of dominant financial centers. IOSCO's *Principles for MoUs* was created to address the threat of under regulated jurisdictions in foreign financial centers – predominantly Switzerland at the time. IOSCO's *MMoU* was created to raise financial regulatory standards and to promote cooperation with foreign regulators.

The second category of international financial standards was driven by the preferences of domestic legislatures and the transgovernmental network. IOSCO's *Principles for CRAs* and *Code of Conduct* was created in response to domestic legislatures indication that strengthening the regulation of rating agencies was a priority after rating agencies' heavily publicized failure to warn investors of the impending collapse of large, publicly-listed companies. IOSCO's international credit rating agency standards were created after domestic legislatures' policy preferences had changed. At the same time, the transgovernmental network of securities market regulators exercised their discretion in creating international securities market standards to promote the creation of harmonized national financial regulatory frameworks. IOSCO's *Code of Conduct* created an internationally consistent regulatory regime that was applied in different jurisdictions. The implementation of IOSCO's *Principles for CRAs* and IOSCO's *Code of Conduct* was strengthened when domestic legislatures from developed financial markets began to favor the direct regulation of rating agencies after widespread instances of conflicts of interest and rating shopping in the securitized debt market. This highlights the role of domestic legislatures in the strengthening of international financial standards.

IOSCO's *Principles for Hedge Funds* and IOSCO's *Systemic Risk Data Requirements for Hedge Funds* were created once domestic political contexts in the U.S. and E.U. shifted to favor the direct regulation of hedge funds. Despite the majority of securities regulators favoring the direct regulation of hedge funds in the years before the crisis, the U.S. domestic legislature was

unwilling to grant the U.S. SEC the statutory authority to do so. After the crisis, the domestic political context shifted in favor of directly regulating hedge funds. Once the domestic political context had shifted in favor of regulating hedge funds, the transgovernmental network of securities market regulators created international financial standards to promote common regulatory frameworks that would enable securities regulators to monitor the systemic risk posed by internationally active hedge funds.

Finally, IOSCO's *Methodology* was driven by the preferences of powerful states. States placed pressure on securities regulators to create a methodology through the IMF and World Bank. States with dominant financial centers did so because of the perceived costs of under regulated jurisdictions had changed. This led finance ministers and world leaders within the G7 to establish and promote the international financial standards project, investing in international financial institutions to raise financial standards in foreign jurisdictions.

This thesis argues that a PA analytical framework can account for when and under what conditions international securities standards are derived from the community of regulators within the transgovernmental network, from domestic political actors or states. PA theory recognizes that regulators are subject to the exercise of control by their domestic legislature through public oversight and through the granting or withholding of statutory authority. This thesis also highlights the role of discretion in granting agency to securities market regulators. The "zone of discretion" granted to regulators enables them to create international financial standards so long as they act consistently with the preferences of the domestic legislature. When securities markets in developed financial centers face threats to their integrity and stability from more peripheral financial centers, regulators demonstrate agency in the creation of international securities market standards. PA theory provides important analytical tools to help understand the role and influence of states. The concept of multiple agents can account for the role of finance ministries in placing pressure on IOSCO to improve the implementation of IOSCO's *Principles* through the creation of IOSCO's *Methodology*.

A PA approach seeks to make an important contribution to IPE literature by proposing an analytical framework that integrates the insights of currently competing analytical

frameworks. A PA approach can better account for the nature of domestic political actors, states, and transgovernmental networks' preferences and influence in the governance of international financial markets.

PA theory also has some important theoretical limitations that this thesis seeks to address. PA theory has not yet analyzed the nature of the PA relationship within transgovernmental networks. As this chapter has discussed, this thesis highlights how securities regulators create transgovernmental networks and international financial standards by exercising the considerable autonomy and discretion granted to them by domestic legislatures. Also, PA theory currently presumes that ideational factors are exogenous to outcomes in the international system because outcomes at IOs are ultimately derived from the preferences of states. This thesis argues that it is necessary to shine a light on what happens within the "zone of discretion" by analyzing the source of regulators preferences in the creation of international financial standards. By analyzing what occurs within the "zone of discretion", and recognizing the importance and influence of ideational factors in the creation of international securities market standards, this thesis overcomes an important theoretical limitation of existing PA theory.

# Chapter 3

# The Creation and Strengthening of International Securities Standards for Memoranda of Understanding

## 3.1 Introduction

This chapter will seek to explain the creation and strengthening of international securities standards for MoUs. In the 1980s, securities regulators faced increasing threats to their ability to protect the integrity of their respective securities markets. Securities market regulators faced difficulties in prosecuting cases of financial crime, predominantly in the form of insider trading, because they originated in foreign jurisdictions. In response to this, securities regulators created MoUs, which established information sharing and mutual legal assistance mechanisms that would assist regulators in investigating and prosecuting cases of financial crime. MoUs assisted regulators in overcoming legal barriers to sharing information with foreign regulators, and enabled regulators to utilize information obtained from foreign regulators during prosecution.

MoUs were pioneered by the U.S. SEC's Michael Mann as an effective regulatory response to the first two successful prosecutions of cross-border financial crime involving Swiss financial entities in 1981. IOSCO was created in 1983, in part, to help regulators identify common solutions to address the threat of cross-border financial crime. IOSCO's first Working Group was created to address the issue of cross-border financial crime. In 1991 IOSCO produced its first international securities market standard, IOSCO's *Principles for MoUs*. IOSCO's *Principles for MoUs* was created to promote the adoption of cooperative mechanisms to assist in the prosecution of financial crime and to identify how securities market regulators, from both developed and emerging markets, could more effectively prosecute cases of cross-border financial crime.

From their creation in 1991 until 2001, IOSCO's *Principles for MoUs* was promoted through the diplomacy and encouragement of securities market regulators from predominantly developed securities markets. IOSCO's Technical Committee encouraged IOSCO members to sign MoUs with foreign counterparts by drafting a number of resolutions and reports. These resolutions and reports served to identify non-cooperative jurisdictions that had failed to establish information sharing mechanisms or provide assistance in the prosecution of financial crime. This led to the formation of a network of bilateral MoUs, which left critical gaps in the international securities market system. These critical gaps were revealed in the wake of September 11 terrorist attacks. Securities regulators realized that if securities regulators were required to assist federal investigators in identifying the perpetrators of the attacks, their efforts to identify the perpetrators would have been limited by gaps in the international system of MoUs.

The September 11 terrorist attacks established a new tenor in regulatory cooperation, as foreign regulators were more willing to provide assistance, and realized the costs of an ineffective regulatory regime for the prosecution of cross-border financial crime. In response, IOSCO created the *MMoU*. IOSCO, led by former Chairman of the Executive Committee Jane Diplock, sought to have all of its members as signatories by January 1, 2013. As of 2013, 92 of IOSCO's members are signatories to IOSCO's *MMoU* and 26 members have committed themselves to gaining the legal authority to becoming full signatories to IOSCO's *MMoU*.[1]

The creation and strengthening of international standards for MoUs is best explained through a transgovernmental network perspective. Securities regulators initiated the creation of MoUs as a novel form of governance in the early 1980s to enable regulators to fulfill their regulatory responsibilities delegated to them by their domestic legislature. IOSCO's *Principles for MoUs* was established in response to threats to the integrity of domestic securities markets by financial globalization and technological innovation.

[1] IOSCO 2013

Regulators demonstrated agency in four ways. First, the U.S. SEC's Michael Mann created an MoU with foreign regulators that established a cooperative regulatory mechanism that would enable regulators to prosecute cases of cross-border financial crime. Second, regulators created IOSCO to establish a cooperative governance solution to the issue of cross-border financial crime, and identify common barriers to information sharing and mutual legal assistance. Third, regulators proposed the creation of international financial standards for MoUs in the form of IOSCO's *Principles for MoUs*, which established common systems of governance to deal with the issue of cross-border financial crime. Finally, the transgovernmental network of securities market regulators acted independently of domestic political pressure. As Michael Mann explained, "the only "pressure" I recall was to do the right thing."[2] IOSCO's *Principles for MoUs* was created to enable securities regulators to fulfill the regulatory responsibilities delegated to them by domestic legislatures. This demonstrates the validity of a PA analytical approach, as securities regulators were acting within the "zone of discretion" in the creation of MoUs and IOSCO's *Principles for MoUs*. IOSCO's *Prnciples for MoUs* was created by securities regulators at the transnational level to enable securities regulators to fulfill the regulatory responsibilities delegated to them at the domestic level. Regulators exercised their discretion in establishing an international regulatory regime to govern cross-border financial crime.

IOSCO's *Principles for MoUs* influenced the domestic regulatory and legislative frameworks of states. The recommendations of the report formed the basis of regulators' lobbying efforts of their respective legislatures. This granted them the necessary statutory powers that enabled them to share information and provide legal assistance to foreign regulators, as well as allowing the use of information obtained from foreign regulators to be used in domestic courts of law. The case of IOSCO's cross-border financial crime regime demonstrates the influence of the preferences of the transgovernmental network on the policy preferences of states.

The strengthening of IOSCO's *Principles for MoUs* through the creation IOSCO's *MMoU* in May 2002 is best explained through a transgovernmental network perspective. Securities market regulators exercised the discretion granted to them by domestic legislatures. The

[2] Mann 2012

creation of IOSCO's *MMoU*, and its correlation with the events of September 11, suggests that it was created to pre-empt domestic political pressure and to address traditional foreign policy concerns. The idea of creating IOSCO's *MMoU* was proposed at the first meeting of the Technical Committee after September 11 in October 2001. However, an interview with a regulator who attended the meeting revealed that U.S. regulators did not propose the idea. Regulators had also expressed concerns about the limitations of the existing network of MoUs prior to September 11. Securities regulators within IOSCO's Technical Committee created IOSCO's *MMoU* to address limitations to IOSCO's cross-border financial crime regime by standardizing MoUs and by centralizing and multilateralizing the MoU process through IOSCO. IOSCO's Technical Committee demonstrated initiative in creating IOSCO's *MMoU*, and demonstrated that the *MMoU* was created to address concerns about the effective regulation of international securities markets.

## 3.2 The Creation of Memoranda of Understanding

The U.S. SEC's investigation of suspected insider trading during the takeover of St Joe Minerals by Seagrams, and of Santa Fe International by the Kuwaiti Foreign Investment office, led to the creation of the first MoU. Both cases were illustrative of the challenges that securities regulators faced in the era of financial globalization and technological innovation. This was the first case in which securities regulators conducted foreign policy on behalf of their respective states and securities regulators negotiated a cooperative governance solution that enabled them to fulfill their domestic regulatory responsibilities.

### *3.2.1 St Joe Minerals and Santa Fe International*

In March 1981, the U.S. SEC began an investigation of the takeover of St Joe Minerals by Seagrams. The U.S. SEC was investigating a high volume of trading in the purchasing of options in St Joe Minerals prior to the announcement of the takeover under the Swiss-based accounts of Banca della Svizzera Italiana (BSI) and its principal advisor Giuseppe Tome.[3] The U.S. SEC successfully sued BSI and was granted a court order to freeze the BSI's New

[3] See *SEC v Banca della Svizerra Italiana* 92 FRD 111 (SDNY 1981) as discussed in Lowenfeld 1996, p. 166 – 179

York-based assets by Judge Polack. The U.S. SEC also filed and won a motion to compel discovery of the identities of BSI's customers.

Soon after the investigation of St Joe Minerals (and as the case proceeded) in October 1981, the U.S. SEC began investigating high volume trading in the purchase of options of Santa Fe International prior to the announcement by the Kuwaiti Investment Office of its takeover bid. Five of the largest Swiss Banks were under investigation. Judge Polack's decision was monumental in both cases, as it would determine whether Swiss banks could shield the identity of their clients from discovery by the U.S. SEC. As Michael Mann recounts:

> "At this time, the SEC had an enormous weapon -- the Swiss banks were looking down the barrel of Judge Pollock's judgment in which he ordered a fine of $50,000 against BSI for each day it failed to comply with his order to identify its client."[4]

Swiss government regulators could not compel BSI to comply with Judge Pollack's orders, and Swiss banks were unable to reveal the identity of their clients due to the nature of Switzerland's bank secrecy laws. As Michael Mann explains:

> "What grew out of that confrontation were approaches to the SEC by the Swiss government and the Swiss banks. In sum, they argued that they wanted to cooperate but they had to respect their bank secrecy laws. In the end they agreed to develop a mechanism pursuant to which they could legally respect those laws and still provide the information."[5]

The St Joe's Mineral case established an important legal precedent and revealed the unique legal barriers that regulators faced in effectively prosecuting cases of financial crime. Although foreign regulators were not resistant to sharing information and providing mutual legal assistance, they were legally hamstrung by domestic legislation that restricted their ability to assist foreign regulators.

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[4] Mann 2011
[5] Mann 2011

### *3.2.2 The Discovery of Legal Barriers to the Prosecution of Cross-border Financial Crime*

U.S. regulators faced significant legal barriers in obtaining information and mutual legal assistance from foreign regulators. Swiss banking secrecy laws prohibited regulators from providing information to foreign regulators. Swiss courts allow regulators to provide assistance only when the crime fulfils the criteria of criminal duality. As David Chaikin explains, "the dual criminality principle requires that the relevant conduct alleged in the foreign request amounts to a crime not only in the requesting State but also in Switzerland, assuming hypothetically it was committed there."[6] At the time, insider trading was not a crime in Switzerland. This was problematic because nobody wanted to "spend their career litigating the agreement after the fact at the Hague, or litigating at the Hague for enforceability"[7] to establish legal precedent that would allow regulators to cooperate with their foreign counterparts. Regulators needed to establish a mechanism that would allow regulators to exchange information and provide legal assistance without circumventing Swiss law, and without being overly cumbersome to negotiate. It was from these legal barriers to cooperation that the idea of an MoU was born.

### *3.2.3 The Legal and Regulatory Benefits to MoUs*

U.S. and Swiss regulators proposed the use of an MoU after a series of discussions that were aimed at identifying how U.S. regulators could obtain the information necessary for the prosecution of cross-border financial crime whilst respecting the legal constraints on Swiss regulators and Swiss banks. A non-binding MoU was used for three reasons. First, an MoU helped regulators avoid the legal barriers that regulators faced in sharing information and providing mutual legal assistance by obtaining the consent of customers to turn documents over to the U.S. SEC to assist in their investigation.[8] The MoU achieved this by establishing a non-binding agreement with Swiss-based banks called *Convention XVI*. *Convention XVI* "was a private agreement among the bankers that provided, if certain circumstances were met, that the banks would have in their hands waivers of Swiss bank secrecy that would allow them to comply with the SEC's request that would be made through inter-

[6] Chaikin 2006, p. 201
[7] The Securities and Exchange Commission Historical Society 2005, p. 9
[8] Mann 2011

governmental channels."[9] Rather than requiring regulatory harmonization, the U.S. SEC's MoU established a statement of intent that committed banks to provide information necessary for the prosecution of cross-border financial crime. This enabled Swiss banks to maintain banking secrecy laws whilst providing assistance in instances of suspected cross-border financial crime.[10]

Second, MoUs established a non-binding, voluntary agreement between the U.S. SEC and its designated counterparts (sometimes a securities regulator and sometimes a government department or agency), outlining how cooperation would occur and how information requests would be handled. By utilizing an MoU, the U.S. SEC was able to avoid overly cumbersome treaty-based negotiations and was able to lead negotiations rather than involve the State Department. The MoU established a common understanding between regulators to address common concerns, rather than forming an agreement that bound two states and be confined to the specific terms of the agreement. This enabled regulators to avoid the constraints of wider foreign policy concerns. MoUs were built on the principle of trust because it was in the common interests of both parties. The flexible approach also enabled regulators to adapt to rapid developments in international markets.[11]

Third, the creation of an MoU reflected the legal status and statutory authority of the U.S. SEC. The U.S. SEC was an independent regulatory agency of the U.S. government and was unable to negotiate treaty-based agreements with foreign governments. The U.S. State Department has a formal process for negotiated agreements with foreign states and this is why MoUs were explicitly written as documents of intention rather than formal, negotiated agreements. In creating an MoU, the U.S. SEC was able to overcome limitations to its authority, whilst achieving the ultimate goal: enforcing domestic securities laws and addressing the governance dilemma that multi-jurisdictional crimes presented.

[9] The Securities and Exchange Commission Historical Society 2005, p. 5
[10] Mann 2011
[11] Mann 2011

### *3.2.4 The Agency of Regulators in the Governance of Cross-Border Financial Crime*

The creation of an MoU with the Swiss government was the first instance where the U.S. SEC conducted foreign policy and established a foreign regulatory agreement with a foreign regulator and/or government. As Michael Mann states in his interview with the U.S. SEC Historical Society, this "was a change in terms of looking at the outside world, where the U.S. SEC really was able to lead the negotiation with the support of Justice and the State Department; and work out something that was a memorandum of understanding."[12] The issue of cross-border financial crime and the negotiation of an MoU with the Swiss government propelled securities regulators in to playing an integral role in the governance of the international financial system.

The creation of a cooperative governance solution for the prosecution of financial crime was created at the initiative of U.S. securities regulators. U.S. regulators did not face the same domestic political pressure to respond to threats against the integrity of U.S. securities markets. As Michael Mann explains, "there was definitely criticism from Congress that this was a priority but I do not regard that as pressure… the only "pressure" I recall was to do the right thing."[13] The U.S. Congress was aware of the threat that under-regulated foreign jurisdictions, such as Switzerland, posed to the integrity of domestic securities markets and had expressed its concerns to the U.S. SEC. The U.S. SEC created MoUs in order to establish an effective response to the threat of cross-border financial crime and the legal and regulatory barriers faced in prosecuting multijurisdictional cases of financial crime and insider trading in the 1990s. Securities regulators were driven to create MoUs by their principled professional interests in maintaining the integrity and stability of the domestic securities market they are responsible for regulating.

## 3.3 Cross-Border Financial Crime and the Creation of IOSCO

IOSCO was established in 1984 after regulators from the Inter-American Association of Securities Commissions (IASC) agreed to transform the organization into a global

[12] The Securities and Exchange Commission Historical Society 2005, p. 10
[13] Mann 2012

cooperative body in 1983.[14] The creation of IOSCO was primarily driven by regulators' interest in establishing a global cooperative body to help govern cross-border financial crime and in facilitating the development of emerging securities markets.[15] European regulators were particularly interested in turning the regional body of securities regulators in the Americas in to an international financial regulatory institution.

At the time of IOSCO's creation, France was becoming frustrated by the U.S. SEC's extra-territorial application of U.S. law. As Marie-Claude Robert Hawes, former Head of the Service of International Matters at France's COB said, "[the U.S. SEC] wanted to conduct investigations in other countries and other countries didn't want them to. Instead, they offered to launch their own investigation and cooperate with the SEC."[16] European regulators, therefore, wished to establish a cooperative mechanism to address the issue, and to allay the concerns of U.S. regulators, in order to restrict the extraterritorial application of U.S. law.

European regulators sought to resolve their own issues of cross-border financial crime. According to Marie-Claude Robert Hawes, the chief problem facing French markets was that French investors were executing trades using inside information from Swiss-based investors. This meant that financial fraudsters were able to conduct their business with impunity as they hid behind Switzerland's banking secrecy laws. France's COB, headed by Yves Le Portz, sought to establish effective diplomatic ties with Switzerland to ensure their cooperation on the escalating problem of cross-border financial crime that originated in Switzerland. France's COB believed that bringing Switzerland into a global organization to negotiate a solution to cross-border financial crime enforcement would be the most effective way to deal with the problems that Switzerland posed and to effectively deal with cross-border financial crime.[17]

[14] Sommer Jr. 1995/1996, p. 15 "IOSCO: Its Mission and Achievement," *Northwest Journal of International Law and Business* 17 (1995 – 1996): 15; also see IOSCO 2012a
[15] The Securities and Exchange Commission Historical Society 2005, p. 23; Robert Hawes 2012
[16] Marie-Claude Robert Hawes. Interview.
[17] Robert Hawes 2012

France took a leadership role in creating IOSCO. Yves Le Portz who headed France's Commission des Opérations de Bourse (COB) at the time, hosted the first meeting of IASC outside of the Americas and spent considerable time gaining support for a global cooperative regulatory institution in Europe.[18] At the time, there were many proponents of the idea of establishing a global cooperative regulatory institution in order to establish a cooperative solution to the issue of cross-border financial crime, including the U.S. SEC.

Domestic and inter-state politics approaches in IPE literature often presume that the U.S. and/or the U.K. were critical actors in the creation of international financial standards. They argue that because of the relative market size of these two dominant financial centers, they are the only states that have the power to initiate, create and enforce international financial standards. The creation of IOSCO and the use of MoUs is a more nuanced narrative. The U.S. SEC did negotiate the first MoU but the U.S. SEC was not the only national securities market regulator who was interested in utilizing MoUs to help govern cross-border financial crime. Furthermore, the U.S. SEC did not force MoUs on other national regulators. Instead, there was a community of regulators who were interested and motivated to improve the use of MoUs to tackle the emerging governance issue that national securities regulators faced. IOSCO was created in response to the issue of cross-border financial crime. The community of national securities regulators began cooperating for the first time through IOSCO in order to effectively to this issue.

### 3.4 IOSCO and the Creation of Principles for Memoranda of Understanding

IOSCO's creation of *Principles for MoUs* in 1991 through Working Group No. 4 (the Working Group on Enforcement and Exchange of Information) demonstrates the influence and agency of the community of regulators within IOSCO's Technical Committee. In response to threats to the integrity of their domestic securities markets, the community of regulators gathered within Working Group No.4 to identify a cooperative solution to the threat posed by cross-border financial crime. Securities regulators created a global cooperative body to address the issue and to establish international regulatory principles to govern the issue at

[18] Robert Hawes 2012.

their own initiative. Securities market regulators were not driven to create IOSCO's *Principles for MoUs* by domestic political pressure.

Securities regulators utilized the recommendations of IOSCO's Working Group No.4 to successfully lobby their domestic legislatures for new forms of statutory authority and reforms of existing legislative frameworks. Securities regulators, working through IOSCO, were critical in establishing effective governance mechanisms to assist in the prosecution of cross-border financial crime. Furthermore, regulators demonstrated the influence of transgovernmental networks through domestic regulatory reforms, which were secured through the recommendations of the community of regulators.

### *3.4.1 Working Group No. 4 and the Creation of Principles for Memoranda of Understanding*

IOSCO's Working Group 4 was comprised of mostly European securities regulators, many of whom still resided within finance ministries, foreign affairs, and trade departments. IOSCO's Working Group 4 included the Swiss Banking Commission, the industry organization of Swiss financial firms, and the Swiss Department of Foreign Affairs, further highlighting the centrality of Switzerland to the issue of cross-border financial crime. Working Group No.4 worked over the next six years to establish regulatory principles for MoUs to govern cross-border financial crime. Working Group No. 4 identified common barriers to the exchange of information and provision of mutual legal assistance, both from Requesting Authorities (or home jurisdiction) and the Requested Authority (the foreign jurisdiction that holds evidence relating to a case of financial fraud that occurred within the home jurisdiction). Interactions between regulators were critical in identifying a policy package that should be incorporated in domestic regulatory regimes.

Working Group No. 4 illuminated a number of critical issues for regulators in order to establish effective agreements with foreign regulators, and to utilize the benefits that MoUs provided. Regulators identified three critical issues that needed to be addressed, including: a) the ability to investigate cases of financial crime on behalf of foreign regulators; b)

maintaining the confidentiality of investigations; and c) the admissibility of evidence in domestic courts.[19]

In 1990 Working Group No. 4 produced a report in November 1990 titled, *Report Addressing the Difficulties Encountered while Negotiating and Implementing Memoranda of Understanding (MOUs)*, which identified the critical issues in the creation of MoUs.[20] IOSCO's *Principles for MoUs* arose from the work of Working Group No.4 and the issues identified in the 1990 report. It was hoped that IOSCO's *Principles for MoUs* would "provide a blueprint for use by securities and futures regulatory authorities in developing MoUs with their foreign counterparts."[21] The intention of IOSCO was "to develop a consensus among regulators about provisions that should be included in MoUs in order to develop effective tools for fighting fraud and other abuses in the securities and futures markets."[22]

IOSCO's *Principles for MoUs* highlighted the issues that need to be addressed within MoUs including: subject matter included in the agreement, confidentiality policies, implementation procedures, rights of persons subject to an MoU request, consultation between regulators, public policy exceptions, participation by the requesting authority, and cost sharing.[23] One of the critical issues that the principles identified was that MoUs should include a provision that requires regulators to provide reciprocal assistance "without regard to whether the type of conduct under investigation would be a violation of the laws of the Requested Authority unless the Requested Authority is not permitted to provide assistance where the type of conduct under investigation would not be a violation of the laws of the Requested Authority."[24] Furthermore, IOSCO's *Principles for MoUs* state that MoUs should outline the types of assistance that Requested Authorities are able to provide under existing statutes and internal capacity.

After Working Group No. 4 identified the critical regulatory issue areas, the use of MoUs expanded. The U.S. SEC established an MoU with Canadian and Brazilian regulatory

[19] Mann 2011
[20] Technical Committee of IOSCO 1991
[21] Ibid.
[22] Ibid.
[23] Ibid.
[24] Ibid.

authorities and began negotiations that would craft a common approach to the issues raised by domestic limitations to mutual legal assistance. The U.S. SEC utilized MoUs to outline how and when cooperation would be granted, as defined by the evidence gathered by the Requesting Authority. Furthermore, regulators developed confidentiality policies to ensure that the information provided by securities regulators remained confidential until a case was established. Through the work of Working Group No. 4, IOSCO's *Principles for MoUs* established an international standard for bilateral MoUs between securities market regulators. IOSCO's *Principles for MoUs* was intended to establish and identify effective mechanisms of cooperation to facilitate the prosecution of cross-border financial crime.

### *3.4.2 The Influence of Transgovernmental Networks on Domestic Legislative and Regulatory Frameworks*

Regulators obtained the necessary statutory authority and subsequent legislative reforms by lobbying their domestic legislatures.[25] The flexibility of MoUs meant that regulators would first develop internal policies that outlined what regulatory powers were necessary before seeking the "organic authority"[26] from domestic legislatures. Regulators still required the statutory authority from domestic legislatures to enable them to comply with the conditions of the MoU signed with foreign regulators.

In the United States, confidential information obtained from foreign authorities was covered under the Freedom of Information (FOI) Act. The FOI Act allowed information that had been obtained during information exchange procedures to be made publicly available. This made foreign regulators unwilling to provide information to U.S. authorities, due to both policy and legal concerns. It was necessary for the U.S. SEC to seek legislative reforms, ensuring that confidential information obtained from foreign regulators was not subject to the FOI. Furthermore, under Section 21(a) of the *United States Securities and Exchange Act of 1934*, the U.S. was only able to provide assistance to foreign regulators if the relevant investigation related to a violation of U.S. law; not foreign law. The U.S. SEC lobbied Congress from around 1987[27] and had convinced Congressman John D. Dingell to propose

[25] Robert Hawes 2012
[26] The Securities and Exchange Commission Historical Society 2005, p. 17
[27] Ibid., p. 17

legislation titled, *The International Securities Enforcement Cooperation Act of 1988*.[28] This bill was passed as part of a larger securities market reform act, H.R. 1396, *Securities Act Amendments of 1990* and was passed in to law on the 15th of November 1990.[29] After the U.S. SEC lobbied Congress, regarding the authority to cooperate with foreign regulators and the right to maintain the confidentiality of information obtained through an MoU, Congress passed a package of legislation in 1990.

The U.S. SEC lobbied its domestic legislature to obtain the necessary statutory authority to provide assistance to foreign regulators, and to obtain the rights and powers to prosecute multijurisdictional cases of financial crime. A number of securities regulators obtained the necessary domestic legislative reforms to enable them to agree to and execute MoUs with foreign regulators.[30] IOSCO's *Principles for MoUs* formed the basis of domestic legislative reforms in a number of member states, demonstrating the influence of securities regulators' recommendations on domestic legislative and regulatory frameworks.

### 3.5 Explaining the Creation of International Standards for Memoranda of Understanding

International regulatory standards for MoUs were created after regulators' ability to investigate and prosecute cases of financial crime were threatened by globalization and technological innovation. As Ethiopis Tafara and Robert Peterson (former Director and current Deputy Director of the OIA at the U.S. SEC respectively) explain, "technology and globalization have [also] created new opportunities for securities fraud. It is well recognized that the technology that allows for cross-border markets also allows for cross-border fraud."[31] Regulators from developed financial market centers created international financial standards for MoUs through IOSCO's Technical Committee to enable regulators to fulfill their domestic regulatory responsibilities delegated to them by their respective legislatures. Regulators demonstrate agency in pursuing international financial regulatory standards that enable them to foster financial stability and to protect the integrity of their respective national securities markets. IOSCO's *Principles for MoUs* are derived from the

[28] United States 100th Congress 1988
[29] United States 101st Congress 1990
[30] Mann 2011
[31] Tafara and Peterson 2007, p. 35

transgovernmental network of securities regulators and were created in the pursuit of their principled professional interests.

### 3.6 IOSCO's Early Efforts to Promote the Adoption of MoUs

Since the creation of IOSCO in 1983, IOSCO established a number of institutional initiatives aimed at promoting the adoption of MoUs to facilitate the prosecution of financial crime. First, IOSCO passed the Resolution Concerning Mutual Assistance in 1986.[32] IOSCO's resolution, or the Rio Declaration as it became known, encouraged regulators to become signatories to the Rio Declaration, indicating their commitment "to provid[ing] assistance on a reciprocal basis to the extent permitted by law to all securities authorities who accede to the Resolution of the Executive Committee of the International Organization of Securities Commissions dated November 7, 1986."[33] The Rio Declaration accumulated 66 signatories from 1987 until 1997.[34] The Rio Declaration was replaced in 1998 by the creation of IOSCO's *Principles*, which included recommendations that securities regulators adopt information sharing and mutual legal assistance mechanisms with foreign regulators.

IOSCO expressed concerns about the lack of cooperation between regulators on enforcement issues in the early 1990s. In 1994, IOSCO began to place pressure on non-cooperative and under-regulated jurisdictions for their failure to establish bilateral MoUs with other jurisdictions. A 1994 report, *Issues Raised for Securities and Futures Regulators by Under regulated and Uncooperative Jurisdictions*,[35] found "that obstacles continue to exist for securities and futures authorities in obtaining necessary information from under regulated and uncooperative jurisdictions."[36] IOSCO's resolutions resolved that current members must undertake a self-evaluation of their ability to provide assistance to foreign regulators and that new members would not be admitted unless they agree to undertake self-evaluations.[37] IOSCO monitored the level of cooperation and consultation between securities supervisors with particular focus on non-cooperative jurisdictions. In July 1996 and September 1998

[32] IOSCO 1986
[33] Ibid.
[34] From 1997 onwards IOSCO's 1998 *Objectives and Principles of Securities Regulation* replaced the Rio Declaration.
[35] IOSCO 1994a
[36] IOSCO 1994b, p. 1
[37] Ibid.

IOSCO produced the *Report on Implementation of IOSCO's Resolutions* and in November 1997 the *Report on the Self-Evaluation Conducted by IOSCO Members Pursuant to the 1994 IOSCO Resolution on "Commitment to Basic IOSCO Principles of High Regulatory Standards and Mutual Cooperation and Assistance".*[38] These reports monitored the level of participation in the system of bilateral MoUs, and the level of cooperation by jurisdictions on issues of mutual legal assistance; raising concerns about the level of participation and cooperation by some members.

IOSCO's encouragement, combined with the independent actions of interested regulators within the organization, led to the creation of a network of bilateral MoUs. The U.S. SEC signed enforcement assistance MoUs with regulators from 20 different countries between 1988 and 2002.[39] The U.S. SEC often signed more than one MoU with individual jurisdictions in order to address different regulatory issues that arose over time.[40] France's COB, and subsequently the Autorité des Marchés Financiers (AMF), signed enforcement assistance MoUs with regulators from 34 different countries. Through the diplomatic efforts of regulators from large, developed financial centers, a network of bilateral MoUs was created. Although IOSCO placed pressure on its members to sign bilateral enforcement MoUs with foreign regulators, the network of bilateral MoUs remained incomplete and had important gaps.

### 3.7 September 11 and the Creation of IOSCO's MMoU

September 11 was critical to securities regulators realizing the importance of strengthening the existing network of bilateral MoUs. It was originally feared that al Qaeda financially benefited from their act of terrorism by purchasing options on U.S. Airline stocks, expecting that stock prices would fall after the terrorist attacks.[41] Immediately after the attacks, U.S. regulators received phone calls from a number of securities regulators from developed and emerging securities markets. Securities regulators extended their support and let the U.S.

[38] IOSCO 1996; IOSCO 1997a; IOSCO 1998a
[39] U.S. Securities and Exchange Commission 2012
[40] The US SEC also formed MOUs to help provide assistance in investigations in to market participants and market vulnerabilities. For instance, the SEC signed an MOU with the Bank of England in 1997 after concerns that securities firms had exposures to Barings Bank in the wake of its collapse.
[41] Veitch 2010

SEC know that they willing to provide any assistance necessary in order to investigate any incidents of financial crime that occurred around the time of the September 11 terrorist attacks.[42] Although it turned out that suspicions of insider trading were unfounded, the event still drew regulators' attention to the importance of establishing an effective governance regime to combat cross-border financial crime.

### *3.7.1 The First Meeting of the Technical Committee of IOSCO after September 11*

The Technical Committee was scheduled to meet in Rome in mid-October, hosted by Italy's Commissione Nazionale per la Societa e la Boursa (CONSOB).[43] During that meeting, Felice Friedman, the U.S. SEC's acting Director of the Office of International Affairs, recalls that a non-US member of the Technical Committee suggested the idea of forming an *MMoU* that would create a single global standard for MoUs.[44]

IOSCO's *MMoU* was not created to primarily address states' concerns about terrorist financing. Instead, the events of September 11 made it clear that the bilateral network of MoUs had some important limitations, and that it was necessary to establish a more effective system to govern cross-border financial crime. As Greg Tanzer, former Secretary General of IOSCO, explains:

> "When September 11 happened we understood that it was a pretty big web with pretty big holes in it with not many interconnecting lines in it. We found the MoUs were not sufficient or binding enough for cooperation when we needed it. We undertook an initiative at the time to create a special group headed by Michel Prada…There were concerns [about the existing system of bilateral MoUs] but they were a bit muted. But people felt that with the bilateral MoUs we were getting at the principles of promoting cooperation where we could. The truth is that September 11 highlighted the truth; the fact

[42] Friedman 2011 Peterson 2011; IOSCO 2001a
[43] Corcoran 2012
[44] The U.S. SEC's acting Director of International Affairs, Felice Friedman, did not attend the meeting herself but attended the meeting via conference call. Felice Friedman was unable to recall who proposed the idea of creating an MMoU but recalls that it was proposed by a non-U.S. member of IOSCO's Technical Committee. Friedman 2011

> that we moved on it so quickly after September 11 demonstrates that there were concerns but it hadn't reached such a level to produce an official response."[45]

Furthermore as David Brown, former Chair of IOSCO's Technical Committee and Chairman of the Ontario Securities Commission, explains:

> "The trigger for the change was the September 11 terrorist attacks in the United States. We had a meeting scheduled 10 days after that attack. We recognized that there was a role for securities regulators to play in response to those terrorist attacks, particularly in response to the possibility that the terrorists were using the world's capital markets to conduct terrorism. That's when he hatched the plans for the *MMoU*. We had an emergency meeting of the Technical Committee in Rome in mid-October. We decided that we as securities regulators should be harnessing the enforcement branches of all the members of IOSCO, particularly the members of the Technical Committee to start with, to coordinate their efforts to counteract securities fraud with a particular focus on counteracting terrorism."[46]

The creation of an MMoU would standardize MoU requests to ensure that common barriers to cooperation in the execution of information requests and mutual legal assistance were removed. An MMoU would also fill the gaps that existed within the bilateral system of MoUs by standardizing MoUs and expanding their global reach. On October 12, 2001, IOSCO announced the creation of a Special Project Team. IOSCO's Special Project Team respond to the events of September 11, by forming contingency plans in response to "disorderly conditions"; strengthen client identification in line with the Financial Action Task Force's recommendations; and to expand regulatory cooperation and information sharing. Michel Prada, then President of France's COB, chaired the Special Project Team created to respond to these events. David Brown, Chair of IOSCO's Technical Committee stated in IOSCO's Press Release:

[45] Tanzer 2011
[46] Brown 2012

> "IOSCO has created this new project team to build on our experiences. Regardless of the outcome of any investigations relating to the events of 11 September, we are doubling our efforts to ensure the preparedness of the securities community and the ability of regulators to combat financial crime involving securities markets."[47]

The Special Task Force drew on the 1999 report *Principles for MoUs*[48] outlining what should be emulated in bilateral MoUs. IOSCO's *MMoU* created international regulatory standards that ensured that regulatory authorities had:

- The adequate statutory authority to provide mutual legal assistance and to undertake information exchanges with foreign regulators;

- the regulatory authority had adequate confidentiality policies in place that ensured that the information being exchanged was kept confidential; and

- the regulatory authority to provide mutual legal assistance and information exchange when requested by a foreign regulatory authority.[49]

### *3.7.2 IOSCO's Verification Process*

As part of the *MMoU*, IOSCO designed a verification process to ensure that an applicant to the *MMoU* had the adequate legal authority to become a signatory, or had at least demonstrated its intentions to obtain the necessary legal authority. The verification process was integral to the success of the *MMoU*, because it was necessary that regulators' and their states' participation was substantive rather than simply symbolic. The U.S. SEC expressed concerns from the outset that the *MMoU* could unintentionally weaken regulatory cooperation and assistance if it provided an international seal of approval to signatories even if they were relatively uncooperative. The United States and other regulators stressed the

[47] IOSCO 2001b
[48] Technical Committee of IOSCO 1991
[49] Anonymous Interview A.

need for the *MMoU* to have teeth.[50] IOSCO designed a verification process that sought to ensure that applicants were compliant with the *MMoU*'s requirements or, where further steps were needed, provided assistance to applicants to enable them to become compliant.

IOSCO's screening process seeks to ensure the legal authority of the regulators is accurately reflected in the legislative authority of the regulator, as encompassed in its domestic laws. Applicants provide comprehensive answers to the questionnaire and provide the supporting documents to IOSCO's Secretariat. Once received, the verification case is handed to one of seven verification teams. Each verification team, where possible, has representatives from each region to ensure a diversity of legal traditions from different jurisdictions. Where possible, the lead regulator conducting the verification process will be based in a similar time zone and be familiar with the language and jurisprudential traditions of the applicant.[51]

Each verification team assesses compliance with the *MMoU*'s demands. The *MMoU* states:

> "The verification of the questionnaire responses will be limited to verification that the responses accurately reflect the legal authority of members to comply with the specific MOU provisions cited in the questionnaire based on the laws, rules and regulations cited in the responses."[52]

This process is a paper-only process and does not involve interviews with the regulators or industry members who are regulated. The verification team outlines its recommendations on the applicants' compliance with each of the *MMoU* provisions to the screening group. If the screening group provides recommendations to the decision-making group comprised of the Technical, Emerging Markets and Executive Committee regarding verification of the *MMoU* provisions and the applicants' laws. Given any negative recommendations, the applicant is allowed the chance to meet with assessors upon request. The decision-making group then decides if the member becomes a signatory to the *MMoU*. The *MMoU* clearly and directly outlines the obligations of signatories to the *MMoU*.[53]

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[50] Friedman 2011
[51] Davies 2011
[52] IOSCO 2002
[53] See IOSCO 2002

The *MMoU* would have two forms of signatories, known as Appendix A and Appendix B signatories. Appendix A signatories are members who have been assessed to have the appropriate legal authority to be compliant with the demands of the *MMoU*, allowing them to be full signatories to it. Appendix B signatories are those members who may not have the full and sufficient legal authority to be compliant with the demands of the IOSCO's *MMoU*, but who "have committed to seeking the legal authority necessary to enable them to become full signatories to the IOSCO *MMoU* (Appendix A)."[54]

### 3.8 Post-2002: IOSCO's Promotion and Enforcement of MMOU Signatories

IOSCO's *MMoU* was endorsed in May 2002 at the Annual Conference in Istanbul, Turkey. Once formed, IOSCO's Executive Committee turned its focus to how to accumulate signatories. The Executive Committee decided that rather than forcing its members to become signatories immediately, IOSCO would wait three years from the creation of IOSCO's *MMoU* before more forcefully encouraging its members to become signatories in 2005.[55] IOSCO's Executive Committee decided it was important to discover how realistic it was to get IOSCO members to become signatories, and to identify what barriers there were to members becoming signatories. From 2003 to 2005, IOSCO, led by the Executive Committee, sought to accumulate the greatest number of signatories possible.

In 2003, 24 members became signatories to IOSCO's *MMoU*. The first 24 signatories were predominantly from large and highly respected markets. As Jane Diplock, former Chair of IOSCO's Executive Committee described:

> "As most of the large jurisdictions became able to sign the *MMoU* it developed its own momentum and became a badge of good corporate citizenship. The waiting period and the accumulation of political momentum placed greater pressure on non-signatories to undertake the necessary reforms in order to become signatories."[56]

[54] IOSCO 2013
[55] IOSCO 2005a
[56] Diplock 2011

As Michel Prada discussed,

> "This created a virtuous circle whereby those who had been pushing in this direction convinced their governments to sign immediately so that those who were not signatories became uncomfortable. They said, "We are out of the game therefore our credibility is at stake and please allow us to sign. Let us make the credible changes to allow us to sign." This rapidly helped bring together the most significant members of the major markets."[57]

In 2005, years after the *MMoU* was endorsed, IOSCO announced that it would seek for all of its members to become signatories of IOSCO's *MMoU* by 2010. IOSCO stated in its Final Communiqué:

> "At this Annual Conference, IOSCO has adopted a timetable by which all member regulators, which are not already signatories to the MoU, will be asked to meet this benchmark by 1 January, 2010. By this time all members should have applied for and been accepted as signatories under Appendix A of the IOSCO MoU or have expressed (via Appendix B), a commitment to seek legal authority to enable them to become signatories."[58]

In order to assist members in becoming signatories, IOSCO created the *IOSCO MoU Assistance Program*. In its 2004 Annual Report, Jane Diplock explains,

> "This Program assists members to become signatories to the MoU. It provides expert assistance for completing the application questionnaire, and in planning and implementing actions that an applicant may need to take to meet the requirements of the MoU. IOSCO also launched, through its Technical

[57] Prada 2011
[58] IOSCO 2005b

> Committee, an initiative to address issues relating to off-shore financial centers."[59]

In parallel to this, IOSCO raised its annual dues to expand the resources available to the General Secretariat in Madrid in order to fund programs such as the *MoU Assistance Program*. Annual dues rose from €8,300 to €10,100 from 2004 to 2005.[60]

In addition to the technical assistance and training provided by IOSCO, the leadership of IOSCO's Executive Committee aggressively pursued the initiative. In particular, Jane Diplock, was intensely focused on the success of the *MMoU* and the accumulation of signatories. As Felice Friedman states,

> "Jane Diplock was very interested in the MOU. She quickly saw the benefits of it for many reasons but also for IOSCO as an institution. She very much took interest in the MoU and gave it publicity. She saw the MoU as the centerpiece of IOSCO… She came to IOSCO meetings and would push to have half the organization signed on the MoU by a certain year. There was real pressure on the organization to do that."[61]

The initiative was largely successful. By September 2010 there were 71 Appendix A signatories and 43 Appendix B signatories.

In July 2010, IOSCO agreed to a resolution, requiring the unanimous support of the President's Committee, which intensified efforts to accumulate signatories and to enforce the adoption of the *MMoU* on all of its members. For non-applicant members, "the Executive Committee is asked to intensify efforts to provide technical assistance to the non-applicants to encourage them to apply as well as to comply with the requirements; and the Executive Committee is asked to create a watch list of non-applicant members which should be maintained and disclosed in the public area of the IOSCO website."[62] Furthermore,

[59] IOSCO 2004
[60] IOSCO 2011c
[61] Friedman 2011
[62] IOSCO 2010b

Appendix B signatories "are asked to apply to become full signatories to the IOSCO MoU by 1 January 2013," IOSCO's Executive Committee was also asked to make technical assistance programs and advice available to Appendix B signatories. The 2010 resolution agreed to create a 'watch list' after 1 January 2013 for members who fail to make an application to advance to Appendix A of the IOSCO MoU."[63] The list has come to be known as the '2013 list', referring to countries that are not Appendix A countries by the January 1 2013 deadline.[64] As Georgina Philippou, Chair of IOSCO's Standing Committee 4 and Co-Chair of IOSCO's Screening Group, explains:

> "we published the list because we think it is an important part of our strategy to raise international standards of cooperation among member jurisdictions and we think that it is important to highlight the fact that certain jurisdictions do not have the legislative standards which we think are required to facilitate effective enforcement cooperation in market misconduct cases. Publishing the list was the logical outcome of the work we have done in recent years to encourage all IOSCO members to reach the standards of the MMoU. The idea for the list was developed by Committee 4 and the Screening Group working closely with the IOSCO Secretariat and it was signed off by the IOSCO Board."[65]

This demonstrates that IOSCO's '2013 list' was created by IOSCO's Standing Committee 4 and driven by IOSCO and regulators' interests in strengthening implementation of IOSCO's *MMoU* rather than from outside pressure from the G20 and the FSF.

The creation of IOSCO's watch list or "2013 list" has been effective in encouraging members to become signatories to IOSCO's *MMoU*. In an article in the *Antigua Observer* entitled "Trinidad Moves to Avoid Being Blacklisted by International Regulatory Group," Finance Minister of Trinidad and Tobago, Larry Howai is cited as saying the following:

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[63] IOSCO 2010b
[64] Philippou 2013
[65] Philippou 2013

> "this Bill seeks to address deficiencies in the previous Bill relating to regulator access to records of market participants, sharing information with other regulators, record-keeping and confidentiality provisions… Failure to enact this Bill into law this year will result in Trinidad and Tobago being blacklisted by IOSCO… We cannot afford to find ourselves in such a situation in which we are unable to comply with these international standards, as the consequence for our securities market in such an event would indeed be dire."[66]

The threat of being included on IOSCO's watch list or '2013 list' has been influential in enforcing the adoption of IOSCO's *MMoU*.

### 3.9 Explaining the Strengthening of IOSCO's International Standards for Memoranda of Understanding

In IOSCO's early years, the promotion of IOSCO's *Principles for MoUs* was comparatively weak. Despite the Rio Declaration and the series of reports assessing and identifying non-compliant jurisdictions, IOSCO's Technical Committee remained mostly content with the bilateral network of MoUs. This dramatically changed with the events of September 11. The September 11 terrorist attacks were important for two reasons. First, they revealed the costs of an ineffective and comparatively weak international regulatory regime for cross-border financial crime. Second, they changed the tenor of cooperation between securities market regulators. Securities regulators were suddenly more willing to cooperate as a result of September 11 and the costs of regulators' failure to cooperate prior to the terrorist attacks on the United States.

The events of September 11, and the subsequent strengthening of domestic and international regulatory institutions to identify and investigate terrorist financing might suggest that regulators created IOSCO's *MMoU* as an *ex ante* response to domestic political pressure, and pressure from domestic foreign affairs and state departments. There are, however, two important aspects of the decision to create IOSCO's *MMoU* that negates that perspective. Firstly, a U.S. regulator did not propose the idea. Secondly, regulators had previously

[66] *Antigua Observer* 2012

expressed concerns about the limitations to the pre-existing bilateral network of MoUs Although regulators were keen to addresses these issues, the concerns had not reached a critical point until the September 11 terrorist attacks and the implications of terrorist financing revealed. The decision of IOSCO's Technical Committee to create the *MMoU* was driven by the preferences of the transgovernmental network and concerns about their ability to identify and prosecute cases of financial crime in an increasingly global securities market system.

### 3.10 Conclusion

This chapter has analyzed the creation of international securities market standards for MoUs. An investigation into the history and political context of IOSCO's creation of international standards for MoUs in 1990, and the strengthening of those international standards through the creation of IOSCO's *MMoU* in 2002, reveals important political dynamics. These political dynamics are best explained through a transgovernmental perspective.

The establishment of MoUs as a result of the first prosecuted cases of cross-border financial crime highlights how Michael Mann of the U.S. SEC created the first international regulatory agreement between supervisors in order to allow the U.S. SEC to fulfill their domestic regulatory responsibilities. Regulators initiated negotiations between Swiss and U.S. regulators to address the unique legal barriers faced by regulators in the prosecution of cross-border financial crime, made possible by globalization and technological innovation. As interviews with U.S. SEC's Michael Mann reveal, securities regulators were not subject to domestic political pressure. Instead, regulators proactively responded to issues because it was necessary to "do the right thing."[67] The principled professional interests of regulators, therefore, drove the creation of the first MoU with Switzerland.

IOSCO was created in 1983, in part, to address the issue of cross-border financial crime. European regulators, led by France, approached the United States to transform the regional organization of American securities regulators into a global regulatory body to establish a forum to negotiate a cooperative solution for cross-border financial crime. European

[67] Mann 2012

securities regulators sought to push back against the extraterritorial application of U.S. law and to establish a diplomatic solution to Switzerland's threat to the integrity of European securities markets. IOSCO was created to enable regulators to obtain their professional interests by enabling them to effectively investigate and prosecute cross-border financial crimes. The recommendations of Working Group No.4, and IOSCO's 1991 *Principles for MoUs,* was also driven by these issues and these concerns.

IOSCO's *Principles for MoUs* was initially promoted through the individual work and efforts of IOSCO's Technical Committee members. This comparatively weak system was strengthened through the creation of IOSCO's *MMoU* in October 2002. In the immediate aftermath of the September 11 terrorist attacks on the U.S., IOSCO's Technical Committee proposed the creation of IOSCO's *MMoU* because securities regulators sought to address the costs of having incomplete global coverage of MoUs between securities regulators. Regulators recognized the limitations to the current network of bilateral MoUs prior to the crisis, but it had not reached a critical point where securities regulators were willing to do something to address it. September 11 was that critical point. IOSCO's Technical Committee created the *MMoU* in 2002 to address threats to the integrity of domestic securities markets after realizing the costs of failing to establish an effective global regulatory regime.

The political dynamics of the creation and strengthening of international securities standards for MoUs highlight the validity of a PA analytical framework in explaining international securities market regulation. The creation and strengthening of MoUs to facilitate the prosecution of cross-border financial crime was driven by the transgovernmental network of securities market regulators within IOSCO's Technical Committee. IOSCO's Technical Committee created these standards to obtain their own principled professional interests. Therefore, domestic political actors did not need to place substantive political pressure on securities market regulators, because regulators were willing to create these standards of their own volition. The creation of IOSCO's *Principles for MoUs* was created to obtain the policy goals delegated to securities regulators by the domestic legislature. The creation and strengthening of IOSCO's *Principles for MoUs* reflects regulators' exercise of agency within the

"zone of discretion", by forming an international cooperative policy solution to address domestic policy problems.

# Chapter 4

# The Creation and Strengthening of IOSCO's Objectives and Principles of Securities Market Regulation

## 4.1 Introduction

This chapter will analyze the creation of IOSCO's *Principles* and the strengthening of IOSCO's *Principles* through the creation of IOSCO's *Methodology*. IOSCO's *Principles* was created in 1997 under the leadership of Tony Neoh, Chairman of the Securities and Futures Commission (SFC) of Hong Kong and Chairman of IOSCO's Technical Committee. IOSCO's *Principles* was created in the midst of the creation of the New International Financial Architecture (NIFA), an institutional initiative led by the G7, which saw the creation of the *Twelve Key Standards and Codes of for Sound Financial Systems* to assess compliance with international financial standards. This suggests that IOSCO's *Principles* was created after pressure from powerful states. However, IOSCO's *Principles* was first proposed in 1995 after Nick Leeson was found to have caused the collapse of Barings Bank, due to a series of risky bets executed at Barings' Singapore offices. Furthermore, in 1994, Mexico suffered a financial crisis that brought financial systemic interdependence to the forefront of regulators' minds. Finally, IOSCO's *Principles* was proposed at a meeting of IOSCO's Technical Committee in May 1997, before the collapse of the Thai Baht that marked the beginning of the Asian Financial Crisis.

IOSCO's *Methodology* was proposed in October 2001 at the first meeting of IOSCO's Technical Committee following the September 11 terrorist attacks on the United States – the same meeting in which IOSCO's *MMoU* was proposed. The creation of IOSCO's *Methodology* was driven by two political factors. First, IOSCO was being pressured by the IMF and World Bank to create a more comprehensive international securities standard. Doing so would enable the IMF and World Bank to conduct objective assessments of compliance with

international financial standards under the IMF's Financial Stability Assessment Program (FSAP) and the IMF's Reports on the Observance of Standards and Codes (ROSCs). The creation of IOSCO's *Methodolgoy* was driven by the preferences of states with dominant financial centers. After the Asian Financial Crisis, these states' perception of the costs of under-regulated jurisdictions had changed. As such, those states promoted and enforced an international financial regulatory regime based on the assessment of the *Twelve Key Standards and Codes for Sound Financial Systems*. Second, IOSCO made the decision to create IOSCO's *Methodology* in the wake of the September 11 terrorist attacks after resisting pressure from the IMF and World Bank, three years since the creation of IOSCO's *Principles*. IOSCO's *Methodology* was created after securities regulators[2] recognized the importance of strengthening the implementation of international securities market regulation in the wake of September 11.

The creation of IOSCO's *Principles* is explained by a transgovernmental network perspective. IOSCO's *Principles* was created by regulators through IOSCO's Technical Committee in response to threats to the stability of developed financial centers by under-regulated jurisdictions. IOSCO's *Principles* was created in the principled professional interests of securities market regulators. The strengthening of IOSCO's *Principles* through the creation of IOSCO's *Methodology* is explained through an inter-state and a transgovernmental perspective. The creation of IOSCO's *Methodology* was driven by the preferences of states and by the principled professional interests of securities regulators. Securities regulators were subject to political pressure from the IMF and World Bank, which were acting on behalf of states with dominant financial centers. But the decision to relent to that pressure was driven by regulators' interest to improve national regulatory frameworks in more peripheral jurisdictions.

The political dynamics of the creation and strengthening of IOSCO's *Principles* highlights the validity of a PA analytical model. First, the creation of IOSCO's *Principles* was driven by the preferences of the transgovernmental network of securities market regulators. Securities regulators' independent pursuit of international financial regulatory standards reflects regulators' exercise of discretion to fulfill the regulatory responsibilities delegated to them by the domestic legislature. The creation of IOSCO's *Methodology* highlights the role of multiple

agents. Securities market regulators and finance ministries have overlapping responsibilities for financial regulation. The role and function of finance ministries is to represent the interests of the state, viewing issues through the material interests of the state as a whole. Finance ministries were unsatisfied by the enforcement and adoption of international securities market standards, and placed pressure on IOSCO's Technical Committee, through the IMF and World Bank, to create more effective international financial standards. This accounts for the influence of the inter-state political arena in the creation of IOSCO's *Methodology*.

## 4.2 The Creation of IOSCO's *Principles*: From 1995 to the post-Asian Financial Crisis Regulatory Reform Process

The transgovernmental network of securities market regulators within IOSCO's Technical Committee created IOSCO's *Principles* in recognition of the increasing integration of national securities markets and threat of under-regulated foreign financial centers. IOSCO's *Principles* was created amidst a series of financial crises and the collapse of Barings Bank in 1995. This section tracks the creation of IOSCO's *Principles* and seeks to contextualize its creation. This section concludes that IOSCO's *Principles* was derived from the preferences of securities regulators who sought to respond to the impact of increasingly integrated national securities markets, and the effects of under-regulated peripheral jurisdictions.

### *4.2.1 The Barings Crisis, IOSCO's Strategic Review and the Initiation of IOSCO's Principles*

Securities regulators first proposed creating international securities market principles in a meeting of the Executive Committee on March 14, 1995 in Sydney, Australia.[1] The Executive Committee proposed an organizational review, which included the idea of creating international financial standards. The review was introduced by the Chairman of the Executive Committee, who "proposed a review (the Organizational Review) of IOSCO's structure and range of activities." The Review's purpose was to fine-tune IOSCO's structure and activities so that the Organization can more effectively implement its important international objectives."[2] Around the same time as the organizational review, IOSCO

[1] IOSCO 1995
[2] IOSCO 2009

proposed to create an international securities market standard.[3] At the meeting, the Executive Committee decided:

> "it may be an appropriate occasion to consider the following issues:
>
> 1) the importance of not wasting resources within IOSCO notably by duplicating work on international standards and principles;
>
> 2) the necessity of establishing, in an increasingly global financial environment, a unique set of international standards and principles and the resulting need of having within IOSCO only one committee responsible for this important task; and
>
> 3) the importance of enabling all the members of the Organization to somehow participate in the elaboration and in the implementation of those international standards and principles."[4]

The idea of creating international securities principles was proposed at a time of increased recognition of the importance of established international financial regulatory standards in order to guide national securities standards, and to improve financial regulatory frameworks in peripheral jurisdictions.

Barings Bank collapsed in February 1995 after Nick Leeson took large speculative positions on future prices on the Singaporean Stock Market. Those large speculative positions became unmanageable by February 1995, and Barings Bank collapsed.[5] Second, in December 1994, Mexico suffered a devastating financial crisis, widely known as the Peso or Tequila Crisis. These twin crises highlighted the impact of under-regulated peripheral jurisdictions on dominant financial centers. Moreover, this provided regulators the opportunity to raise financial standards. As Ed Waitzer, Chairman of IOSCO's Technical Committee in 1995 and Chairman of the Ontario Securities Commission, explains, "we took it [the Barings Crisis] as

[3] Waitzer 2012
[4] IOSCO 1995
[5] Brown and Steenbeek 2001, p. 83 – 99

an opportunity to raise [regulatory] standards and create common standards."[6] Securities regulators were already beginning to think about seeking to raise regulatory standards before these events and the Barings Crisis provided regulators that opportunity.

The collapse of Barings Bank and the Tequila crisis of 1994 brought the interdependence of national financial markets and financial globalization to the forefront of regulators' and world leaders' minds. The 1995 G7 Summit in Halifax, Canada on June 16 1995 placed improving the governance of international financial markets at the top of the agenda. The G7 Communiqué from the Halifax Summit stated the following:

> "The growth and integration of global capital markets have created both enormous opportunities and new risks. We have a shared interest in ensuring the international community remains able to manage the risks inherent in the growth of private capital flows, the increased integration of domestic capital markets, and the accelerating pace of financial innovation."[7]

By the time of the G7 Summit, the work of IOSCO had already begun. The G7 Halifax Summit Communiqué recognized this as demonstrated by the following:

> "Continued strengthening of these efforts has the full support of G-7 Finance Ministers and Central Bank Governors. We look forward to the development and further enhancement of concrete international understandings, where necessary and appropriate, to the safeguards, standards, transparency, and systems necessary to reduce potential risks. In this context, we recognize the important initiatives being undertaken separately and jointly by various committees under the aegis of the BIS and the International Organization of Securities Commissions as well as by national authorities."[8]

[6] Waitzer 2012
[7] G7 1995a
[8] G7 1995b

Furthermore, as Ed Waitzer explains:

> "the Objectives and Principles Initiative was not a top down initiative but a bottom up initiative. We began work on the issue and the G7 knew about it because we [IOSCO's Technical Committee] had informed our domestic political counterparts of what we were doing at the time. The G7 Communiqué, which was written in advance by finance ministry bureaucrats who were aware of the work we were doing."[9]

Although the idea to create a regulatory framework identifying minimum standards for securities regulation was proposed in 1995, it took two years for the project to materialize. A number of issues contributed to IOSCO's eventual development of IOSCO's *Principles* in 1997 and its eventual endorsement in 1998.

### *4.2.2 The 1997 Asian Financial Crisis and The New International Financial Architecture*

IOSCO's Technical Committee met in May 1997 in Cape Town, South Africa. At the meeting, IOSCO's Technical Committee "agreed to recommend to the Executive Committee to set up an IOSCO Principles Task Force jointly chaired by the Chairmen of the Executive, Technical and Emerging Markets Committee." The task force would "draft a reference document drawing together the statements of intention, recommendations, desirable regulatory practices and advice set out in the various Resolutions and reports, which have been adopted by the Organization."[10]

IOSCO's taskforce that created IOSCO's *Principles* was established at the same time as the Asian Financial Crisis and was endorsed in 1998. IOSCO's *Principles* was created amidst efforts by the G7, the IMF and the World Bank to improve financial regulatory standards in more peripheral financial centers. This suggests that IOSCO's *Principles* was created in response to the Asian Financial Crisis and in response to pressure from the G7 and the world's dominant financial powers. However, as the previous section has already identified, the idea of creating IOSCO's *Principles* was proposed in 1995 and IOSCO's task force was

[9] Waitzer 2012; Martin 2011
[10] IOSCO 1997b

established before the Asian Financial Crisis began. In May 1997, Thailand, with the assistance of Singapore, spent billions of dollars defending the value of the Thai Baht against speculative attacks on its currency. In July 1997, the Thai Baht collapsed and the Asian Financial Crisis unfolded.[11] As Michel Prada, former Chairman of the AMF and Chairman of the Technical Committee, explains, the creation of IOSCO's *Principles* "started a little earlier to the [Asian financial] crisis and was sped up by the crisis."[12]

Improving financial regulation had emerged as an important policy issue out of the 1994 Mexican Peso Crisis and, in the minds of securities regulators, the collapse of Barings Bank in 1995. The interests of central bankers, finance ministers, treasury bureaucrats, and financial regulators in the creation of an international financial regulatory regime was driven by the increasingly encompassing nature of financial markets, both between countries and between financial sectors. As Tony Neoh, Head of the Technical Committee and Head of the Hong Kong Securities and Futures Commission between 1996 and 1998 during the creation of IOSCO's *Principles*, explains:

> "There was a realization in governments and finance ministers that markets were becoming increasingly interconnected. Even before my time as chairman there were essentially three strands of work. The first strand was that banking and securities markets were converging through the European Universal Bank model and, although Glass-Steagall separations were not full dismantled until 2000, separations between commercial banks and investment banks were already beginning to crumble."[13]

International standard-setters, the G7, IMF, and World Bank were also concerned about how to effectively resolve the unwinding of financial firms. There was a joint effort by these organizations to have greater information sharing between markets and regulators to stay better informed of the assumption of risk by all financial firms across borders.[14] Securities

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[11] *PBS.org*, "Timeline of the Panic." Accessed online at http://www.pbs.org/wgbh/pages/frontline/shows/crash/etc/cron.html as of 25 February 2012.
[12] Prada 2011
[13] Neoh 2011
[14] Ibid.

regulators recognized emerging issues within their own regulatory perimeter.[15] Bond and equity markets were becoming increasingly integrated in the rise of cross-border listings. The integration between national markets raised the necessity of creating an international financial standard for securities markets.[16] Securities regulators were aware of the changing dynamics in international securities markets, and were interested in creating a set of international securities standards that would help raise financial standards in more peripheral jurisdictions.

As noted above, the idea to create IOSCO's *Principles* was proposed in 1995. IOSCO's Technical Committee began work on the standard in May 1997. Neoh, then head of the Technical Committee and the first to suggest the idea of creating IOSCO's *Principles* at a 1996 Technical Committee meeting, notes the following:

> "We were not lent on as such. It is really a question of voluntary engagement by both sides. The Halifax declaration was the start of it all. The BCBS, IOSCO and IAIS were connected by efforts by the IMF and World Bank. They were proponents of regulatory standards. We were caught up in the ferment where there was tremendous consensus that there should be as much as possible consensus on international standards. There was a wind that was blowing that caught all of us. We were pushed along."[17]

Furthermore, as Prada noted earlier, the idea of creating IOSCO's *Principles* was proposed prior to the crisis and sped up by the crisis.[18] Finally, domestic politicians and legislatures were largely unaware of what their securities regulators were creating. When asked if regulators were being subjected to domestic political pressure, Andrea Corcoran, then Director of International Affairs at the U.S. Commodities and Futures Trading Commission (CFTC), said:

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[15] Ibid.
[16] Ibid.
[17] Ibid.
[18] Prada 2011.

> "Under U.S. law, the SEC and CFTC are considered to be independent agencies, that is they report to Congress not to the Executive. They are empowered to undertake day-to-day business without interference or direction (beyond their enabling statutes) from the government as a whole. In that the markets are global, most global interactions related to the implementation of national mandates are operational. The State Department makes foreign policy, but agencies at many levels (environmental, commercial, legal) undertake day-to-day global operations."[19]

This demonstrates that IOSCO's Technical Committee's pursuit of international financial standards, through the creation of IOSCO's *Principles,* was driven by its members and not from external political pressure.

### *4.2.3 The Leadership of IOSCO's Technical Committee Members*

IOSCO's *Principles* was driven by the leadership of members of IOSCO's Technical Committee. Tomasso Pado-Schioppa of Italy had participated in the BCBS' process of creating the *Core Principles for Effective Banking Supervision* on behalf of the Bank of Italy. Pado-Schioppa was recently transferred to Italy's securities market supervisor, CONSOB, and was now a member of IOSCO's Technical Committee. Neoh, of the Hong Kong SFC, suggested the idea of creating an international securities market standard to the Technical Committee, because he believed it was necessary to do so in response to the changing dynamics of global securities markets. Furthermore, some members, such as the AMF's Prada, believed that it would give the organization strategic direction. Here is how Prada explains the situation:

> "There were a few people who were committed to giving a better strategic direction for IOSCO. The organization had delivered a few interesting standards in the past but failed to deliver some real objectives and principles. Together we considered that it was key for this organization to have an agreement between its members about the strategic direction we should aim towards."[20]

[19] Corcoran 2012
[20] Prada 2011

The new international climate provided IOSCO the opportunity to create IOSCO's *Principles,* as it was effectively endorsed by the world's leading economic powers and international institutions.

IOSCO's *Principles* was also driven by the desire to raise the visibility, international presence, and reputation of IOSCO at a time when international financial standard setters were given visibility and the political capital to produce a regulatory initiative of substance. Prada described the motivations:

> "We were rather seeking recognition and support from the governments. At that time insurance regulators and securities regulators didn't have the same visibility and credibility as banking regulators. Before 1999, the establishment of the FSF, Central Bankers and prudential regulators had long been recognized internationally and had been working together for many years. We had Basel I and Basel II, the national governments were fairly aware at the global level of banking regulators. They didn't have the same sensitivity and same interest in securities regulation."[21]

Neoh agrees, saying that they hoped to "raise the level of visibility of IOSCO so that we could be taken seriously as an international organization promulgating standards."[22]

Policy leaders within IOSCO, such as Neoh, Prada, and Pado-Schioppa, were well aware of the reputation that IOSCO had in the international system. IOSCO was considered to be a relatively weak international financial regulatory organization, especially in comparison to the BCBS. The BCBS had already created an international financial regulatory standard through the creation of the *Core Principles for Effective Banking Supervision* in September 1997.

Furthermore, a group of securities lawyers in the U.S. had compiled a set of financial regulatory principles for securities markets that would guide regulators in emerging securities markets, particularly Eastern European securities markets, to facilitate capital market

[21] Ibid.
[22] Neoh 2011

development. Bill Williams Jr., the initiator and Co-leader of the project with Michael Mann of the U.S. SEC, proposed to other established securities market lawyers that they create a document that would outline "what the issues are and what they should be considering."[23] The group created *Developing Securities Markets: Key Elements of a Legal Regime* to set forth regulatory recommendations to foreign jurisdictions. The document was largely completed by 1996, and a final version was produced in February of 1997.[24] The document gained prominence when the U.S. SEC effectively endorsed it by using it as part of its annual, month-long technical assistance programs.[25]

IOSCO's *Principles* was created by IOSCO's Technical Committee in an effort to raise financial regulatory standards and in order to raise the profile of IOSCO. IOSCO's Technical Committee members wanted to raise the profile of IOSCO to ensure that IOSCO's *Principles* demonstrated to its members its commitment to improving states' securities market regulatory frameworks.

#### *4.2.4 The Creation of IOSCO's Principles*

Once the decision to create IOSCO's *Principles* was made, IOSCO's Technical Committee established a working group to oversee its production. The project was led by Andrew Procter, who was deputy to Neoh at the SFC of Hong Kong. Procter was asked to produce a draft of IOSCO's *Principles* in 1997 and an arbitrary timeline for the next Annual Meeting that was set for Nairobi in September 1998. Meetings occurred almost monthly at the AMF in Paris, hosted by Fabrice Demarine. The working group was predominantly comprised of the second-in-command of the members of the Technical Committee who were predominantly heads of international affairs departments at national securities regulators.[26]

When interviewed, Procter identified the two crucial issues that IOSCO faced. First, securities regulators face a diverse range of regulatory issues unique to each securities market jurisdiction. Securities markets are characterized by financial innovation and diversification in the range of investment products and services offered within each market. As a result,

[23] Williams Jr. 2012
[24] Sarah Ackerson et al. 1997
[25] Williams Jr 2012
[26] Procter 2011

securities markets have developed unique characteristics through their historic development, which has occurred in isolation of other domestic markets. This meant that creating an international standard that would be applicable to all domestic jurisdictions was harder for securities supervisors than banking supervisors.

Interviews with former senior members of IOSCO constantly revealed that the extent of regulatory coverage, and responsibility assigned to IOSCO and national securities regulators was significantly larger than that facing the BCBS and national banking regulators. As Neoh explains:

> "The differences between the BCBS principles is that it is directed at institutional supervision whereas ours are directed at market supervision… IOSCO has to deal with institutions, fund managers, hedge funds but at the same time they deal with stock markets, clearing systems and public firms. So they deal with a much larger canvas, which is incapable of being put in to a single regulatory framework. It is too difficult to coordinate all of the regulatory policies. All legal systems are different. The ways that they are regulated are very distinct."[27]

The consequence was that the creation of a comprehensive international regulatory standard was a complex task, because it was difficult to cover all necessary aspects of securities markets whilst not punishing those that failed to implement regulatory standards that did not apply to them.

The second issue was the diversity of IOSCO's membership. IOSCO had over 100 members at the time and its members had wide ranging degrees of sophistication and levels of market development. As Andrew Procter described, "you had a broad system of market supervisors from developed markets, such as the United States and the United Kingdom, to emerging markets, and everything in between regulating intermediaries, products, market infrastructure and conduct. There was a much broader spectrum of markets [than banking regulators faced]. That meant it was a lot more difficult making the membership more comfortable.

[27] Neoh 2011

You also needed to produce a document that IOSCO's members would be comfortable in signing."[28] Because IOSCO was a consensus-based organization, due to the voting rights of IOSCO's President's Committee (comprised of all of IOSCO's members), IOSCO's *Principles* needed to be inclusive enough of all of IOSCO's members whilst creating a regulatory standard that was comprehensive and effective.

In order to overcome these twin difficulties, Procter decided to pursue two governance strategies. When constructing the draft, Procter defined the limitations of IOSCO's *Principles* by reading all of IOSCO's reports, dated from its inception in 1983 through to 1997. This helped construct the specific areas relevant to an international securities regulatory standard upon which agreement had already been reached. After reading the reports, Procter proposed that IOSCO's *Principles* would consist of three objectives and thirty principles. Procter did so because "it made a good harmonious number"[29] and fell within the parameters of regulation that IOSCO's work had defined as relevant to national securities regulators. IOSCO's *Principles* were "copied and pasted from existing IOSCO documents"[30] and were then updated and reformed to reflect changes over time. In deriving the principles from existing regulatory work, they reflected regulatory issues that securities regulators had already agreed to as being important and necessary for effective regulation. As Procter put it, "because I had taken the thirty principles from the IOSCO reports nobody could say that it was outrageous."[31] This strategy helped reduce resistance to their creation.

Discussing the *Principles* as aspirational was a key governance strategy that Procter utilized to ensure that IOSCO's *Principles* were agreed to by the President's Committee, and to obtain the support of key members such as the U.S. SEC. Procter explained the strategy in the following way:

> "No IOSCO members meet all of these principles and they should, therefore, should be treated as aspirational. That's because I knew the Americans, for example would not sign on to something that was not consistent with their

[28] Procter 2011
[29] Ibid.
[30] Ibid.
[31] Ibid.

> existing framework. That's why we talked about it as aspirational. This was all about making sure that the document wasn't working against them. We asserted at the time that we did most of these things but we could all do better."[32]

IOSCO also sought to keep key members onside. Therefore, Procter chaired the Committee that drafted IOSCO's *Principles* alongside Marisa Lago, then head of the OIA at the U.S. SEC, who edited the *Principles* in order to maintain the support of the United States. The core concern for regulators was reputational. They feared that their securities regulatory system, which was designed for a particular domestic economic and market context, would be held up against an international standard that may or may not effectively apply to them. As Procter noted, "there was a fear that IOSCO would publish something and, in a domestic context someone would say "this is the international standard and you don't comply with it."'[33]

Procter's political strategy was proving successful until the IMF, G7 and the newly-established Financial Stability Forum (FSF) began discussing the formation of an external assessment regime that would measure countries' compliance with IOSCO's *Principles*. Originally, in 1998, IOSCO's *Principles* provided a statement regarding the objectives of securities regulation, before listing the 30 principles of securities regulation and a brief description of the issues related to each. IOSCO's *Principles* was not intended to be externally assessed by other institutions, but was supposed to provide guidance to self-assessments and for peer-assessments in association with IOSCO. This process spooked countries but IOSCO's *Principles* was passed by all parties except for New Zealand.[34]

In September 1998, IOSCO's *Principles* was formally adopted through *A Resolution of the President's Committee on IOSCO Adoption of the Objectives and Principles of Securities Regulation*.[35]

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[32] Ibid.
[33] Ibid.
[34] New Zealand objected because IOSCO's *Principles* required a registration regime for securities firms and New Zealand's regulatory policy was not to demand registration. In spite of New Zealand's dissenting vote, IOSCO claimed the *Principles* were passed by the President's Committee, which required a consensus vote to pass resolutions. Cameron 2011
[35] IOSCO 1998b

Once passed, IOSCO spent the next four years resisting pressure from the IMF and World Bank to produce a methodology for assessment of compliance, turning the high-level principles into operational principles that could be objectively and consistently assessed by the IMF through its newly-established FSAP program.

## 4.3 Explaining the Creation of IOSCO's Objectives and Principles of Securities Regulation

The creation of IOSCO's *Principles* correlated with increased efforts by world economic leaders, through the G7, to improve the governance of international financial markets by strengthening international financial regulatory institutions and international financial standards. However, securities regulators had already begun work on international securities market standards. Securities regulators believed that it was necessary to raise financial regulatory standards in foreign jurisdictions, because of threats to the integrity of their domestic markets. IOSCO's *Principles* was first proposed in 1995 in response to the collapse of Barings Bank, and in the wake of the 1994 Mexican Peso Crisis. Securities regulators created IOSCO's *Principles* in 1997 in response to the threats posed by under-regulated jurisdictions to the stability of dominant financial centers.

Financial globalization, characterized by intensified integration between domestic securities markets, facilitated by technological innovation, drew regulators and world economic policy leaders' attention to the task of improving the governance of international financial markets. Financial integration caused regulators to seek an international cooperative solution to the problems, and potential problems that regulators faced at home. International securities standards would help achieve this in two ways. First, international securities market regulatory standards would help raise financial standards in foreign jurisdictions and, it was hoped, would help reduce the frequency of financial instability in domestic securities markets caused by instability in foreign jurisdictions. Creating international securities market standards also helped raise the profile of IOSCO, which would help regulators from developed financial centers to promote and encourage the adoption of IOSCO's *Principles*. Creating IOSCO's *Principles* demonstrated that securities regulators were committed to raising the financial regulatory standards of its members.

The creation of IOSCO's *Principles* is best explained by a transgovernmental network perspective. Interviews with senior securities regulators highlight that they were motivated to create IOSCO's *Principles* in the interests of enabling securities market regulators from developed financial centers to more effectively govern their respective securities markets. Securities regulators faced a globalization dilemma, as their ability to govern domestic securities markets hinged on the ability of foreign regulators to effectively govern theirs, due to the integration of national securities markets. Unable to overcome this dilemma through domestic regulatory reforms, securities market regulators sought a governance solution through IOSCO's Technical Committee. IOSCO's Technical Committee created an international financial regulatory standard to establish an identifiable financial regulatory framework that reflected best-practice principles. This also demonstrates the validity of a PA analytical framework. Securities regulators were exercising the discretion granted to them by domestic legislatures to define how to effectively regulate domestic securities markets. IOSCO's *Principles* was created to fulfill their domestic regulatory responsibilities delegated to them by their domestic legislature. Furthermore, securities regulators made sure that IOSCO's *Principles* reflected their respective domestic regulatory frameworks.

### 4.4 The Creation of IOSCO's Methodology – October 2003

IOSCO's *Methodology* was passed in October 2003 by IOSCO's members at the organization's annual conference in Seoul, South Korea. IOSCO's *Methodology* was "intended to provide guidance on the conduct of a self-assessment or third party assessment of the level of implementation of IOSCO's *Principles*. IOSCO intended for the *Methodology* to illustrate IOSCO's interpretation of its *Principles*."[36] IOSCO's *Methodology* strengthened IOSCO's *Principles* in two ways. First, IOSCO's *Methodology* provided a more fine-grained analysis of IOSCO's *Principles* that would provide further guidance to foreign regulators. Second, IOSCO's *Methodology* provided an objective system of analysis to enable the IMF and World Bank to conduct assessments of compliance with IOSCO's financial regulatory standards, as part of the post-Asian Financial Crisis NIFA led by members of the G7.

[36] IOSCO 2003, p. 1

IOSCO's *Methodology* was created by IOSCO's Implementation Task Force. The Implementation Task Force was proposed at a meeting of IOSCO's Technical Committee in Paris, France in December 1998[37] and was established at an Executive Committee Meeting in London in February 1999.[38] The Implementation Task Force was comprised of members of IOSCO's Technical Committee, Emerging Markets Committee, a representative from each Regional Committee, and the General Secretariat.[39] IOSCO's Implementation Task Force was the first to incorporate a complete cross-section of IOSCO's decision-making organs and IOSCO's membership. IOSCO's Implementation Taskforce was created to assist its members in conducting self-assessments to establish a practical mechanism to assist the IMF and World Bank in their use of IOSCO's *Principles*.[40] The Task Force was originally limited to discussions of how to achieve these aims. However, it became strengthened after the September 11 terrorist attacks on the United States. At the first meeting of the Technical Committee after September 11, Andrea Corcoran, then Director of International Affairs at the U.S. CFTC, was asked to chair the Implementation Task Force by David Brown and Michel Prada, and began work on establishing IOSCO's *Methodology*.[41]

IOSCO had long-resisted pressure from the IMF and World Bank to create a *Methodology* for two reasons. First, IOSCO's Technical Committee believed in establishing - international securities market standards that reflected the unique market and historical context of national securities markets. Securities regulators feared that the creation of a more precise international securities market standard would be too detailed to allow for differentiation between national contexts. Second, the diffusion of power within IOSCO and its internal governance mechanisms made it difficult for IOSCO to establish internal agreement.

IOSCO's long-held resistance to the creation of a *Methodology* was overcome after the events of September 11. September 11 caused regulators to see the benefits of the strengthened implementation of IOSCO's *Principles,* and helped overcome internal disagreement over the necessity of creating a more comprehensive set of international financial standards. The

[37] IOSCO 1998c
[38] IOSCO 1999
[39] IOSCO 1998c
[40] IOSCO 1998c; IOSCO 1999
[41] Corcoran 2012

creation of IOSCO's *Methodology* is best explained through an inter-state and transgovernmental network perspective.

### *4.4.1 External Political Pressure*

IOSCO's *Principles* was a relatively brief document that established what national regulatory frameworks should seek to achieve in their design and through statutory powers and national legislation. IOSCO's *Principles* was not created to enable the IMF and World Bank to conduct external assessments of compliance with IOSCO's international securities standards. In the years after the creation of IOSCO's *Principles,* IOSCO was subject to increasing pressure to enable the IMF and World Bank to conduct objective and comprehensive external assessments of compliance with IOSCO's *Principles,* as part of its FSAP program. As Jennifer Elliot, a senior member of the IMF's FSAP team discusses, "we were under additional pressure after the Asian Financial Crisis and we needed to build up capacity."[42] The IMF was subject to pressure after the Asian Financial Crisis by the IMF's dominant member states, including members of the G7. Leading economic powers sought to place pressure on more peripheral jurisdictions, in order to improve financial supervisory standards. Leading economic powers began investing in international economic institutions, because the Asian Financial Crisis revealed the costs of under-regulated jurisdictions to the stability and profitability of their domestic financial centers.

In the wake of the Asian Financial Crisis, world economic leaders placed increased emphasis on the need for effective global financial regulatory oversight. Felice Friedman, former Member of the U.S. SEC's OIA, notes, "the G7 finance ministers increased their interest in financial regulation during that time. A number of crises had led to governments recognizing the importance of financial market oversight to financial stability."[43] Paul Martin, former Finance Minister of Canada during the Asian Financial Crisis and the former Prime Minster of Canada, explains that prior to the Asian Financial Crisis there was "a lot more smoke than fire. It was really the Asian Financial Crisis that gave impetus to the creation of a global financial supervisory regime."[44] It was perceived that ineffective regulatory oversight was

[42] Elliot 2011
[43] Friedman 2011
[44] Martin 2011

contributing to greater global financial market volatility and was a contributing factor to a series of financial crises throughout the 1990s. In response, these leading economic powers focused their attention on strengthening the international financial regulatory regime, which sought to raise the financial supervision and regulatory standards of regulatory jurisdictions around the world.[45]

The work of world economic leaders was muted prior to the crisis because the costs of under-regulated peripheral jurisdictions were not as apparent as they were after the Asian Financial Crisis. It was only after the Asian Financial Crisis that leaders forged an international supervisory regime comprised of the FSF, the IMF, and financial standard setting bodies such as IOSCO, the BCBS and the International Association of Insurance Supervisors (IAIS). This became known as the NIFA.

The NIFA was driven by the desire for transparency within financial markets in the wake of the Mexican Peso and Asian Financial Crises. As Paul Martin explains, "in the minds of the IMF transparency had been the mantra of the IMF for as long as I can remember. The Mexican Peso Crisis was caused by a lack of transparency [in the minds of the IMF and its staff]… What you're talking about [the creation of international financial standards] is essentially a reaction to what was deemed as a lack of transparency… What you're talking about [the creation of international financial standards] is essentially a reaction to what was deemed as a lack of transparency of the Mexicans i.e. reserves."[46] The G7 and the IMF created momentum for the formation of a series of financial standards and codes and the empowerment of the IMF to assess the level of compliance with those standards and codes. The regime sought to raise regulatory standards and ensure effective national financial regulatory supervision by promoting the formation of international regulatory standards and an assessment of compliance with those standards to be conducted by the IMF.

As a result of pressure from the G7, the IMF and World Bank placed significant pressure on IOSCO to create a methodology. These institutions had made it clear that they were facing significant pressure to make good quality, consistent external assessments of compliance

[45] Ibid.
[46] Ibid.

with international regulatory standards, and that this drove them to create their own methodology if IOSCO failed to do so. In addition to the IMF and World Bank, IOSCO faced pressure from the newly established FSF. As David Brown, former Chairman of the Ontario Securities Commission and Chair of IOSCO's Technical Committee from 2001 – 2002, stated, "IOSCO started to review in a very serious way the principles of securities regulation to modernize them, to improve the quality of them and ultimately to enforce them in the ways that the FSF was looking for."[47] IOSCO faced external pressure from a range of institutions to create more effective financial regulatory standards.

Furthermore, IOSCO's participation in the newly-established FSF made it clear that members of the international regulatory community were concerned about IOSCO's failure to create clear, consistent, and assessable standards that would raise regulatory standards in the securities sector. Brown stated that the OECD threatened to takeover IOSCO's role as the international financial standard-setter for securities markets:

> "As Chairman of the Technical Committee I also sat on the FSF and I was quite conscious of the fact that if IOSCO didn't step forward and assume control for setting international standards that somebody else would do it. The OECD was talking openly about developing international securities standards. So one way that I got IOSCO members that were reticent or reluctant at first was saying that if we don't produce it somebody else will."[48]

The external threat to IOSCO was real, and was a critical factor in IOSCO's creation of the *Methodology* at the time. As a consequence of the Asian Financial Crisis, and the creation of the FSF, and the NIFA, the demands and pressure placed on international financial standard-setters were immense. This was central to the creation of IOSCO's *Methodology,* and the increased capacity that it created for IOSCO as an institution.

In spite of this, IOSCO initially resisted efforts to create a more comprehensive international securities market standard. As Jennifer Elliot said, "[IOSCO] didn't want to do a

[47] Brown 2012
[48] Ibid.

methodology at all."[49] Tanis MacLaren, former member of the Ontario Securities Commission, also noted that IOSCO ignored the reality that IOSCO's *Principles* was going to be used as an objective standard to assess compliance with international standards of best practice. Their initial resistance to creating a clear methodology reflected this.[50] This was likely due to the fact that IOSCO's Technical Committee had reiterated throughout the drafting of IOSCO's *Principles* that they were aspirational standards. Procter confirmed this.[51] IOSCO's Technical Committee intended to create high level principles to assist in the self-assessment, or guided peer assessment of a country's regulatory framework, for IOSCO members that would be translated into operational standards and principles in order to reflect local circumstances with different legal and market contexts. In the interim, IOSCO created a self-assessment questionnaire that provided a guided and structured assessment methodology, which could be conducted by securities regulators, in order to ensure that they are adequately compliant with IOSCO's *Principles,* and to help identify areas of regulatory concern. IOSCO initially believed that it would facilitate compliance with IOSCO's *Principles* with an internal self-assessment mechanism.

The self-assessment process did not last long, as IOSCO eventually gave way to demands by the IMF, and World Bank in 2001. At a meeting at the World Bank in Washington DC with the IMF, World Bank, and the Implementation Task Force, IOSCO stated that it did not feel they needed an external assessment methodology. It was then that Tanis MacLaren recalls saying, "well, we have two choices, this has to be done, the G7 the FSF, is looking to the IMF and World Bank to do these assessments, they need an assessment methodology to know what the criteria is to be marked on, the choice is very simple. Either we do it, and if we don't then they do it, and frankly if they do it they will do a fine job."[52] After a long period of resistance, it was the pressure of external events that led to the formation of a task force to create a methodology for assessing IOSCO's *Principles*.

[49] Elliot 2011
[50] MacLaren 2011
[51] Procter 2011
[52] MacLaren 2011

### *4.4.2 Explaining IOSCO's Resistance to the Creation of IOSCO's Methodology*

Why did IOSCO resist the creation of IOSCO's *Methodology* from 1998 – 2001? Firstly, IOSCO's resistance is explained by the culture of securities market regulators and their belief in the importance of establishing nationally distinct financial regulatory frameworks that reflect distinct local market, legal, and national circumstances. Securities regulators resisted efforts to create IOSCO's *Methodology* because it would create clearly defined regulatory standards, at odds with the differentiated, diverse and complex nature of local securities market and their regulators. Neoh, a leader in the policy process explained the thinking at the time:

> "They [*IOSCO's Principles*] seek to provide guidance, these are principles that should underpin certain regulations in certain jurisdictions in certain areas. We are not here to write regulation but to write basic philosophies… The subsequent frameworks on various matters came out of regulatory guidance in subsequent papers. IOSCO does not follow the same format as the BCBS as they have one set of guidance for banking principles."[53]

Securities regulators truly believed that differentiation between securities markets necessitated high-level principles that could be differentially applied to different national contexts to reflect local circumstances. Alan Cameron, former head of the Australian Securities and Investments Commission (ASIC) and member of the Technical Committee, explains, "they were written at a high level to reflect that there was and should be differences in different countries to reflect different historical and legal contexts. If they were written prescriptively it would become a problem."[54] Thus, IOSCO resisted efforts to turn its high level principles into clear, objective principles through the *Methodology* with the belief that its principles should not become prescriptive. Tanis MacLaren, who is more critical of IOSCO's pursuit of differentiated implementation of national financial regulatory principles, said, "there was a general trend of exceptionalism, a belief that every country's securities market is

[53] Neoh 2011
[54] Cameron 2011

different. It's not like plain vanilla banking where one size fits all. While there's some truth to that, it's not as much as IOSCO likes to portray."[55]

IOSCO resisted granting responsibility to external assessors like the World Bank or IMF. It was believed that the process of turning IOSCO's *Principles* from high-level principles into operational principles would misinterpret them and make them too prescriptive. As Prada stated, "there was the issue of whether the implementation should be in the hands of IOSCO only or whether it should be something the IMF and World Bank would participate in. There were a few of us who were slightly upset that people from outside would look in to the way securities regulators behaved."[56] Cameron noted that "we believed that they were going to be written for us by a bunch of bureaucrats and would be prescriptive in a way that a government officials make them."[57] Thus, IOSCO initially resisted turning its *Principles* in to clear operational principles to be externally assessed by the IMF.

Secondly, securities regulators resisted the creation of IOSCO's *Methodology* because of reputational concerns. As has been previously discussed, IOSCO's *Principles* were not originally created in 1998 with the intention that they would form the basis of external assessments by international financial institutions like the IMF and World Bank. At the outset IOSCO's *Principles* were intended to be aspirational benchmarks rather than a fixed standard by which countries could be graded for their level of compliance. As Corcoran, Chair of the Implementation Task Force of IOSCO Principles, explains, "originally the assessment methodology was intended as a means for individual jurisdictions to test national implementation against an external view of what constituted effective implementation of what were very high level principles. Initially, the methodology was not developed to be a public rating system. It was supposed to provide assistance to people who were trying to design changes to their legislation and operations."[58] The idea that a methodology was to be created, placing the regulatory regime of its members under greater scrutiny, caused IOSCO's members to become resistant.

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[55] MacLaren 2011
[56] Prada 2011. It is important to note that Michel Prada did not hold this view as he believed that IOSCO lacked the legal authority to effectively demand its members to be evaluated and believed that the IMF was best placed to undertake the task.
[57] Cameron 2011
[58] Corcoran 2012

Thirdly, IOSCO had difficulty convincing its broad and diverse membership. IOSCO's difficulty stemmed from the fact that it is a consensus-based institution, which normally acts through the President's Committee. This slows down the decision-making process necessitating regulatory initiatives that attract broad agreement. As Friedman, former Acting Director of the OIA at the U.S. SEC, explains, "to create something we created, resolutions that had to be agreed with by the President's Committtee. To get [the resolutions] passed you had to get them past the President's Committtee… It [the President's Committee] is difficult and cumbersome but it is rather extraordinary."[59] The diffusion of power and the differentiation of markets made the process of achieving consensus difficult. As Procter highlighted, the issue for jurisdictions is that they sought to avoid the reputational embarrassment of failing to comply with international standards.[60] Clear, objective assessment criteria that endorsed certain systems of regulation would embarrass jurisdictions or force adjustments on the jurisdictions even if they were considered unnecessary.

The diffusion of decision-making power, the power of the United States, and the differentiation in the regulatory systems of its member countries meant that IOSCO, unlike the BCBS, was less conducive to the formation of a specific, clear and objective methodology to assess implementation.

### *4.4.3 September 11*

IOSCO began negotiations on IOSCO's *Methodology* from October 12, 2001, in the wake of the terrorist attacks on the United States. September 11 was a critical juncture because it caused IOSCO's Technical Committee to recognize the importance of raising securities market regulatory standards by ensuring the effective implementation of IOSCO's *Principles* by its members.[61] The group determined to energize the ongoing work to develop guidance on implementation of IOSCO's *Principles*, with the purpose of working toward more resilient financial systems globally. As Corcoran explains, regulators reinvigorated the vision of a *Methodology* against which to test implementation of IOSCO's *Principles* after September 11

[59] Friedman 2011
[60] Procter 2011
[61] Corcoran 2012

"because national regulators wanted to reinforce the strength of the global financial system and to have a process for robust and cooperative responses to events that could create financial turmoil. Leaders of IOSCO wanted to put a lot more pressure on urging compliance with the Principles." September 11 reminded regulators of the fragility of our system and of the importance of the ability to develop strong cooperative measures to address sometimes unknown risks in the increasingly interconnected global economy.

September 11 also raised the importance of securities market supervision in the increasingly interconnected global economy. As Brown puts it, September 11 was an important trigger for change in IOSCO, from a "meet and greet" organization, to an effective international standard-setter. Brown states that critical to the creation of IOSCO's *Methodology* "was the September 11 terrorist attacks in the United States. We had a meeting scheduled 10 days after that attack. [After September 11] [w]e recognized that there was a role for securities regulators to play in response to those terrorist attacks, particularly in response to the possibility that the terrorists were using the world's capital markets to conduct terrorism."[62]

IOSCO had long resisted the creation of a *Methodology,* because of securities regulators' belief in the necessity of nationally differentiated financial regulatory standards to reflect distinct national contexts. IOSCO also resisted the creation of a *Methodology* because of the diffusion of power within IOSCO, the reputational concerns of IOSCO members, and because the U.S. SEC didn't want to see the creation of a comprehensive international securities market standard. These factors were overcome after the events of September 11. September 11 was a critical event in the creation of IOSCO's *Methodology* because it highlighted the costs of failing to improve securities market regulation in foreign jurisdictions, and further demonstrated the dangers posed by under regulated peripheral jurisdictions.

### *4.4.4 The Policy Process of Creating IOSCO's Methodology*

The task force to create *IOSCO's Methodology* was established at the first meeting of the Technical Committee after the September 11 terrorist attacks, in mid-October in Rome.[63] Corcoran, then Director of the OIA at the United States' CFTC, was asked by the three

[62] Brown 2012
[63] IOSCO 2011b

chairs of IOSCO (the Executive, Technical and Emerging Markets Committees) to head the taskforce to create the *Methodology*. Once the taskforce was established, Corcoran oversaw a long and arduous project to create a methodology that was considered acceptable to IOSCO's members, and would be passed by the President's Committee. The taskforce had representation from all committees within IOSCO (the Executive, Technical, Emerging Markets, Regional Committees, and the Self Regulatory Organization Consultative Committee). Once established, the taskforce took stock of existing regulatory principles by other international institutions, such as the OECD and the BCBS' methodologies, to understand how principles could be explicated into operational principles. [64]

The taskforce, Chaired by Corcoran and staffed by representatives from jurisdictions sitting on each of the relevant IOSCO committees, established teams dealing with different sections of the principles. Once drafted, there was a two-part comment process that involved input from the expert committees of IOSCO and comments from all IOSCO members. More than 400 comments were received and processed. Those comments were considered and informed the final draft. IOSCO's *Methodology* was endorsed by the full membership of IOSCO at the 2003 Annual Conference in Seoul, Korea in October. The overall process of creating IOSCO's *Methodology* took two years.

In contrast to the BCBS, IOSCO's process was a bottom-up process involving all members in all states of development. Corcoran described how the BCBS principles were drafted by the Group of 10 (G10) for the G10 and then disseminated initially on a voluntary basis to banking supervisors around the world. "The IOSCO requirements were not top-down requirements. They were articulated by the institution as a whole with the idea that they should be aspirational commitments for all countries."[65] The drafting process was very long and very difficult. Corcoran said, "at every moment it wasn't clear that "consensus" was going to happen,"[66] highlighting the difficulties that such an involved, bottom-up negotiation process would have.

[64] Corcoran 2012
[65] Ibid.
[66] Ibid.

The difficulties faced by the taskforce were two-fold. First, securities markets are characterized by extraordinary diversity in terms of overall structure, level of development and sophistication, and types of products that are sold or offered. As Corcoran put it:

> "it was difficult to craft appropriate common denominators and it was difficult to take into account the different circumstances of different jurisdictions [in *IOSCO's Methodology*]. We had to deal with the differences in how markets are constituted… some were very old, some had rules that preceded the rules of regulators, some were private mutual companies, some were organs of the governments who created them… it was a very complex situation."[67]

The second difficulty faced by IOSCO was the pressure that the *Methodology* and the newly-established NIFA created for IOSCO's members. Originally, IOSCO's *Principles* aimed to provide assistance to countries that were seeking to improve their regulatory structure, and to raise the standards of regulation of IOSCO members. National jurisdictions had developed different approaches to accounting, capital adequacy, and other issues that meant that they were not ready to commit to a common approach even though they were willing to commit to common objectives. Through the creation of strict grading regimes after the Asian Financial Crisis, securities regulators became concerned about getting a good grade.[68]

Thus, IOSCO members' comments were driven by reputational concerns, and an effort to craft the document in a way that would not endanger their reputation through the external assessment of their system by the World Bank and IMF. Corcoran argues that this was not solely based on self-interest but driven by the fact that there were real differences between markets and regulatory systems. This problem was exacerbated by a feeling that external assessments were going to be unnecessarily prescriptive and that they would fail to incorporate real differences between jurisdictions.[69]

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[67] Ibid.
[68] Ibid.
[69] Ibid.

Once completed, IOSCO's *Methodology* works through Principles 1 – 30, providing an outline of the principle, key issues, and key questions regarding the regulatory powers and authority of the regulator, before providing three categories of benchmarks to be assessed against: Fully, Broadly or Partly Implemented. The level of implementation is determined by the extent to which the assessor (the IMF or World Bank) answers affirmatively to the key questions related to the principle.[70] As stated previously, IOSCO's *Methodology* doesn't define accepted systems or methods of securities regulation; instead, it provides an assessment of whether the regulator has the adequate regulatory power to cover the demands of the regulatory principle.

Similar to the creation of IOSCO's *Principles*, IOSCO's *Methodology* was critical for the evolution of IOSCO, not only for the obligations it placed on its members, but for how it increased the institutional capacity. As a result, IOSCO would assess the level of compliance of its members and would roll out its *IOSCO Principles Assessment and Implementation Program,* which would assist in members' self-assessments of compliance*,* and technical assistance programs to enable members to comply. Furthermore, IOSCO's *Methodology,* in concert with other institutional initiatives, led to an expanded secretariat, strengthened institutional financing, a formal communication strategy, and a new consultation policy. Thus, IOSCO's *Methodology* played a critical role in strengthening the institutional capacity of IOSCO.

### *4.4.5 The Nature of IOSCO's Methodology*

IOSCO's *Methodology* is still relatively non-prescriptive. IOSCO chose to define the regulatory goals rather than defining technical rules as to how those goals are implemented. This differs from the approach of the BCBS, who specifically define how capital adequacy requirements are calculated. IOSCO's *Methodology* was created in a manner that allows for nationally differentiated implementation of international financial regulatory principles. IOSCO's *Methodology* did not seek to push powerful regulators' own regulatory model or system of regulation, but provided basic regulatory principles that would be incorporated within national financial regulatory frameworks. When asked if the development process was about an effort by individual jurisdictions to push their own regulatory model or system of

[70] IOSCO 2003

regulation, Corcoran stated the following:

> "there was no consensus on a single structure or model for regulation. National jurisdictions did not want the Principles to impose a structure provided the objectives of the Principles were served. National differences were accommodated in many cases to reflect that jurisdictions in practice offered different types of financial services and faced different legal, political, and other circumstances."[71]

At the same time IOSCO members wanted to be good regulatory citizens of the world—to be able to combat financial crime and to cooperate in an emergency as well as on a day to day basis as effectively as possible—and therefore were prepared to invest in lengthy discussions to provide more guidance to members overall on how to do that. The nature of IOSCO's *Methodology* reflected the ideational preferences of the community of securities regulators. Predominantly, this meant that international financial regulatory standards should allow for substantive variation between national regulatory frameworks.

The U.S. SEC had begun a technical assistance program called the International Institute for Securities Market Development. The U.S. SEC offered technical assistance and training programs to the barrage of securities market supervisors who emerged in the wake of the fall of the Berlin Wall and the rise of securities markets throughout Western Europe. The U.S. SEC sought to improve regulatory regimes in securities markets through its technical assistance program. The program recognized the impact that differentiated stages of development, sophistication and the type of product offerings had on whether different regulatory frameworks were appropriate for each national market context. The securities market project pursued by Bill Williams Jr. and the community of securities lawyers also endorsed this approach. During the process of creation the document, *Developing Securities Markets: Key Elements of a Legal Regime*, Williams became aware of flaws in the U.S. securities market regulatory regime and began work to promote reforms of U.S. securities law.[72] U.S. securities regulators did not seek to export its regulatory regime to foreign markets because

[71] Corcoran 2012
[72] Williams Jr. 2012

they believed it was inappropriate to do so. As Michael Mann, the first Director of the U.S. SEC's OIA, explains,

> "the SEC was interested in identifying what made a good securities market and what was critical to it. There was a huge tension within the SEC at the time. We believed we had the best markets and we wanted markets to emulate our style. But nobody in their right mind would have just passed those securities laws in to their law. Those laws were instituted in 1930s and evolved over time. It was a donkey that worked well but wasn't elegantly created."[73]

Therefore, the nature of IOSCO's *Methodology* was not driven by the pursuit of self-interest by its most powerful members. Instead, it was driven by the recognition that narrowly defining appropriate systems of securities regulation was ineffective and potentially dangerous.

### 4.5 Explaining the Creation of *IOSCO's Methodology*

IOSCO's *Methodology* was created to obtain both the preferences of powerful states and the preferences of the community of regulators within IOSCO's Technical Committee. This chapter has identified that IOSCO resisted creating a *Methodology* from the establishment of IOSCO's *Principles* in 1998 until October 2001. During this period, IOSCO was subject to political pressure from the World Bank and IMF. These institutions wanted IOSCO to create a more comprehensive methodology to enable them to conduct objective assessments of compliance with international financial standards as part of the NIFA after the Asian Financial Crisis. The NIFA was characterized by a strengthened surveillance program, assessing countries' compliance with international financial standards. This program was created through the IMF but was pursued by the world's leading economic powers through the G7. G7 member states pursued a strengthened international financial regulatory regime through the IMF and World Bank because they perceived that the costs of under-regulated jurisdictions necessitated investment in strengthened financial regulatory institutions in the global economy.

[73] Mann 2011

September 11 was critical in the creation of IOSCO's *Methodology*. September 11 helped to overcome regulators' internal disagreement over whether it was appropriate to establish a more comprehensive international securities standards. As interviews with senior national securities regulators reveal, September 11 caused securities regulators to perceive the necessity of strengthening implementation of international securities standards. This shift cannot be accounted by a purely inter-state approach that focuses on the preferences of states. This points to the role of ideas and the impact of external events in shifting the policy preferences of the community of regulators.

## 4.6 Conclusion

This chapter has summarized the creation and strengthening of international securities market standards through the creation of IOSCO's *Principles* in 1998 and IOSCO's *Methodology* in 2003. A review of the historical and political context of these two standards' creation reveals some interesting and important political dynamics that are important in our understanding of international financial regulatory politics.

First, the creation of IOSCO's *Principles* was driven by the impact of intensified integration between national securities markets and the transmission of financial instability between national jurisdictions. This is demonstrated by the fact that the creation of IOSCO's *Principles* was inspired by the 1994 Mexican Financial Crisis, the 1995 Barings Crisis and the 1997 Asian Financial Crisis. The influence of these crises highlights that international financial standards are created to address negative spillovers caused by under regulated peripheral jurisdictions. Second, IOSCO's *Principles* was created by the agency of securities market regulators, and not domestic political pressure or political pressure from states. This is demonstrated by the fact that interviews with regulators confirmed that regulators independently pursued IOSCO's *Principles*. Regulators proactively created IOSCO's *Principles*. Their primary motivation was to enable regulators to more effectively regulate their domestic securities markets and obtain their interest in fostering financial stability. Third, regulators within IOSCO's Technical Committee demonstrated through the policy-making process that they were interested in assuring that IOSCO's standards reflected their domestic regulatory

frameworks. Regulators, therefore, were conscious of the preferences of their domestic legislatures.

An analysis of the creation of IOSCO's *Methodology* highlights two further issues. First, international securities market standards were not solely driven by the preferences of securities regulators. Instead, securities regulators were subject to pressure from powerful states. Powerful states placed pressure on regulators through institutions within which they exercised greater control. Second, whilst IOSCO was subject to substantive pressure from the IMF and World Bank, the critical issue that caused regulators to create IOSCO's *Methodology* was the events of September 11. The events of September 11 shifted the policy preferences of securities regulators, causing regulators to overcome any internal disagreement and to creating a more comprehensive international standard. September 11 demonstrated to regulators the dangers and costs of under-regulated peripheral jurisdictions.

This analysis demonstrates the validity of a PA approach to international securities standards. IOSCO's *Principles* and IOSCO's *Methodology* were created to obtain the policy goals delegated to securities market regulators by domestic legislatures. When securities regulators were unable to obtain these aims through domestic financial regulatory reforms, securities regulators from developed financial centers pursued international financial standards at the transnational level. Furthermore, securities regulators were conscious of creating international securities standards that reflected these domestic policy goals by ensuring that the international standard reflected domestic policy frameworks. The creation of IOSCO's *Principles* highlights the influence and agency of the community of securities regulators in creating international standards that reflect their legislatures' policy preferences The creation of IOSCO's *Methodology* highlights the influence and power of national treasury departments and finance ministries, acting on behalf of the state, on outcomes at IOSCO. This demonstrates the role of multiple agents in the creation of institutional initiatives to strengthen implementation of IOSCO's *Principles*.

# Chapter 5

# The Creation and Strengthening of International Credit Rating Agency Standards

## 5.1 Introduction

This chapter analyzes the creation and strengthening of international credit rating agency standards. IOSCO's Technical Committee created two international credit rating agency standards, including: IOSCO's *Principles for CRAs* in September 2003[1] and IOSCO's *Code of Conduct* in December 2004.[2] IOSCO created IOSCO's *Principles for CRAs* after domestic legislatures in the U.S. and E.U. had indicated that improving the regulation of rating agencies was a domestic policy priority. U.S. indicated that it sought to improve the regulation of rating agencies after the collapse of Enron and WorldCom in 2001 and 2002 respectively. The E.U. indicated that it sought to improve the regulation of rating agencies after the politicization of rating agencies in the wake of the collapse of Parmalat in late 2003 and after rating agencies downgraded German public banks during the same period. Domestic legislatures in the U.S. and E.U. had indicated that improving the regulation of rating agencies was a priority through a series of public initiatives including: public statements by domestic politicians, public hearings, the creation of committees reviewing the regulation of rating agencies, the drafting of public reports, and legislation requesting further technical advice from securities market regulators.

Domestic legislatures had also indicated that they were unwilling to subject rating agencies to a direct regulatory regime. U.S. Congress (Congress hereafter) was unwilling to regulate rating agencies because rating agencies were afforded First Amendment, free speech protections by the U.S. courts.[3] This strengthened the hand of rating agencies in their lobbying efforts of U.S. lawmakers. Consequently, Congress chose not to directly regulate

[1] Technical Committee of IOSCO 2003b
[2] Technical Committee of IOSCO 2004
[3] See Sinclair 2005; Bruner and Abdelal 2005

rating agencies until 2006. E.U. Parliament chose not to regulate rating agencies despite the recommendations of the European Commission to create an E.U. rating agency regulator. E.U. Parliament chose not to directly regulate rating agencies due to resistance by the U.K. and financial market interest groups and because it questioned the efficacy of a stand-alone E.U. regime. The U.S.' decision not to regulate rating agencies would have weakened the effectiveness of an E.U. regime and could have proved costly to E.U. investors and E.U. publicly listed companies and issuers.

IOSCO's *Principles for CRAs* was created by IOSCO's Technical Committee to promote the adoption of common regulatory regimes for rating agencies. Securities regulators believed that competing systems of rating agency regulation were not in the interests of investor safety. Competing regulatory regimes would have led to competing systems of assessment of the creditworthiness of obligors across jurisdictions. IOSCO's Technical Committee created IOSCO's *Principles for CRAs* to establish common principles for upcoming U.S. and E.U. regulatory reforms. IOSCO's Technical Committee created IOSCO's *Code of Conduct*, a voluntary self-regulatory framework for rating agencies, in order to establish a regulatory response to the policy problems posed by rating agencies whilst respecting the domestic political constraints in the U.S. and E.U. IOSCO's *Code of Conduct* was also created to promote the adoption of an internationally consistent regulatory regime for rating agencies across jurisdictions in the interests of investor safety. The effort was successful as both the U.S. and E.U. adopted regulatory regimes that were consistent with IOSCO's *Code of Conduct*.

The creation of IOSCO's international credit rating agency standards is explained by both a domestic politics and transgovernmental network perspective. A domestic politics perspective explains the creation of IOSCO's *Principles for CRAs* and IOSCO's *Code of Conduct* because they were created in response to shifts in the policy preferences of domestic legislatures and their expressed policy preference for the improved regulation of rating agencies. The creation of IOSCO's standards for rating agencies was contingent on shifts in the policy preferences of domestic legislatures and their decision to improve the regulation of previously unregulated financial market actors. The creation of IOSCO's international credit rating agency standards is also explained by a transgovernmental network perspective. Securities market regulators exercised agency by creating international rating agency

standards that established and promoted common regulatory approaches to rating agencies. Domestic legislatures did not express a preference for common regulatory regimes. Instead, these standards were created to obtain the principled professional interests of securities market regulators who sought to ensure consistent systems of assessment of creditworthiness across jurisdictions in the interests of investor safety.

The political dynamics of international credit rating agency standards is best explained by a PA analytical framework. Securities market regulators responded to the domestic legislatures' expressed policy preferences for improving the regulation of rating agencies. After domestic legislatures had expressed their preferences, securities market regulators exercise their discretion by creating an international securities market standard to promote the coordination of national regulatory frameworks by establishing common regulatory principles.

IOSCO's international credit rating agency standards were strengthened by the decision of domestic legislatures in the U.S. and E.U. to create a direct regulatory regime for rating agencies. The U.S.' decision to directly regulate rating agencies in 2006 is explained by the policy preferences of domestic political actors. The initial impetus for a direct regulatory regime in the U.S. was the narrow political interests of two Pennsylvanian Congressmen, Paul Kanjorski and Michael Fitzpatrick. Fitzpatrick and Kanjorski's 2006 Credit Rating Agency Duopoly Relief was proposed to facilitate market access for Egan-Jones, a Pennsylvania-based rating agency. The 2006 Credit Rating Agency Reform Act also reflected a strengthening consensus of the need for the direct regulatory regime to reduce conflict of interest issues and to improve disclosure practices. Despite this, the regulatory regime remained weak because of resistance by members of Congress and continuing judicial constraints on the U.S. SEC's rule-making authority. It took the 2007/2008 financial crisis to substantively shift the domestic political context to favor the direct regulation of rating agencies and to enable the Congress and the U.S. SEC to establish a comprehensive regulatory regime under the existing 2006 act and under the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank hereafter), which was signed in to law in July 2010.

The E.U.'s decision to directly regulate rating agencies is also explained by change in the policy preferences of domestic political actors due to shifts in the E.U. domestic political context. The E.U. chose not to regulate rating agencies after its review of rating agencies from 2002 – 2005. It took the 2007/2008 financial crisis to create a direct regulatory regime for rating agencies, because it shifted the domestic political context in favor of subjecting rating agencies to a comprehensive direct regulatory regime. The 2007/2008 financial crisis changed the domestic political incentives of U.S and E.U. politicians.[4]

The strengthening of IOSCO's *Principles for CRAs* and IOSCO's *Code of Conduct* is explained by a domestic politics perspective. The strengthened implementation of IOSCO's international standards for rating agencies was dependent on shifts in the domestic political context and the preferences of domestic political actors.

## 5.2 The U.S. and E.U.'s Review of Rating Agency Regulation

This section summarizes the U.S. and E.U.'s review of rating agency regulation after the politicization of rating agency regulation in the U.S. and E.U. from 2001 – 2003. This section will demonstrate that U.S. and E.U. domestic legislatures expressed a preference for improving the regulation of rating agencies. At the same time, U.S. and E.U. domestic legislatures indicated that they were unwilling to directly regulate rating agencies due to domestic political and judicial constraints.

### 5.2.1 *The United States' Regulatory Review of Rating Agencies after Enron and WorldCom*

Congress indicated that improving the regulation of rating agencies was a policy priority after the collapse of Enron and WorldCom in 2001 and 2002 respectively. Congress conducted hearings, drafted reports and requested technical advice from the U.S. SEC on the issue of rating agencies oversight. U.S. lawmakers heavily criticized rating agencies for their failure to warn investors of the impending collapse of Enron and WorldCom and the maintenance of investment grade ratings of Enron up to four days before its collapse. Senators suggested that it was time to regulate rating agencies. In March 2002, Senator Libermann stated that, "I think it's appropriate, as we try to learn the lessons of Enron, to ask if the agencies should

[4] Stefano Pagliari 2013.

have some sense of accountability, some oversight, from the SEC perhaps, to ensure they properly perform their function as watchdogs."[5] The Senate Committee on Governmental Affairs held hearings on Enron and the Ratings Agencies in March 2002[6] and Senate Staff compiled a report called, "Financial Oversight of Enron: The SEC and Private-Market Watchdogs," in October 2002.

The Senate Staff report recognized that Enron provided insufficient quality information to rating agencies and that this was the primary cause of rating agencies' failure to accurately assess the creditworthiness of Enron. This was rating agencies' main argument in Senate hearings. For instance, Ronald Barone of Standard & Poors stated, "Senator, this was not a ratings problem. This was a fraud problem."[7] The Senate Staff Report concludes that, in spite of this, the primary problem was that rating agencies' failure to undertake effective duty of care. The report states the following:

> "the credit rating agencies' approach to Enron fell short of what the public had a right to expect, having placed its trust in these firms to assess corporate creditworthiness for the purpose of federal and state standards. It is difficult to wonder whether the lack of accountability – the agencies' practical immunity to lawsuits and non-existent regulatory oversight – is a major problem."[8]

The report concludes that this shouldn't preclude greater accountability[9] and recommended that the SEC set specific conditions for the designation of credit rating agencies as Nationally Recognized Statistical Rating Organizations (NRSROs). The report states that it should be dependent on whether rating agencies adopt appropriate standards and considerations when reaching ratings, that their staff be adequately trained and that the U.S. SEC be responsible for monitoring rating agencies' ongoing compliance with these

[5] Liebermann 2002
[6] U.S. Senate Committee on Governmental Affairs 2002
[7] Staff of the Senate Committee on Governmental Affairs 2002, p. 121
[8] Ibid., p. 116
[9] Ibid., p. 123 – 124

standards.[10] The Senate report highlights that U.S. Senators and their staff felt that rating agencies' failure was, in part, due to the lack of regulatory oversight.

On July 30 2002, the Sarbanes-Oxley Act was signed in to law. The law reformed financial industry 'gatekeepers' including accountants and auditors for publicly listed stocks. Credit rating agencies were not included in the bill. Instead, Congress requested the U.S. SEC to report back to Congress with recommendations on the regulatory environment for rating agencies. The SEC produced a report on rating agency oversight to fulfill Congress' request under Section 702 (b) of the 2002 Sarbanes-Oxley Act in January 2003.[11] The U.S. SEC's report was designed to address "the role of credit rating agencies and their importance to the securities markets, impediments faced by credit rating agencies in performing that role, measures to improve information flow to the market from rating agencies, barriers to entry into the credit rating business, and conflicts of interest faced by rating agencies."[12]

The staff report stated that rating agencies lacked appropriately skilled staff, but that rating agencies believed that reputational concerns were adequate for rating agencies to maintain a high level of staff training.[13] The report also reflected the views of buy-side firms and market analysts who sought greater transparency in the ratings process including disclosure of the basis of ratings decisions.[14] The report highlights that there are concerns over the exemption of rating agencies from disclosing material, nonpublic information. The U.S. SEC previously had sought to subject rating agencies to the 1940 Investment Advisers Act that would require rating agencies to disclose material, nonpublic information. Rating agencies, however, were granted an exemption by U.S. courts because they were considered 'publishers' and were therefore not subject to the act. Rating agencies took part voluntarily but the U.S. SEC did not have statutory authority on this issue.[15] Some U.S. securities regulators were concerned that requiring rating agencies to disclose a rating change to issuers ahead of time created an opportunity for insider trading by issuer insiders.[16] Finally, the

[10] U.S. Securities and Exchange Commission 2003a, p. 18
[11] U.S. Securities and Exchange Commission 2003a
[12] Ibid., p. 1
[13] Ibid., p. 32
[14] Ibid., p. 33
[15] Staff of the Senate Committee on Governmental Affairs 2002, p. 124
[16] Anonymous Interview B

report highlights that the issuer-pays system used by rating agencies produces potential and alleged conflicts of interest issues in the industry but that the rating industry believed that it demonstrated its ability to effectively manage these issues in the past.[17]

Five months later on June 4 2003, the U.S. SEC produced a Concept Release, entitled *Concept Release: Rating Agencies and the Use of Credit Ratings under the Federal Securities Law*.[18] This was intended to establish what appropriate regulatory actions could be taken to address the concerns raised in the staff report. The 2003 concept release sought comment from industry members and the public on the issues that were raised in the 2003 report, and provided potential regulatory actions in this issue area. The 2003 concept release echoed that of previous concept releases in 1992 and 1997 in that it proposed three alternative systems of regulatory reform: direct oversight, elimination of the NRSRO designation, and a review of designation policies to establish standards for the designation of NRSROs to ensure that they maintain adequate internal organizational standards to deserve the designation.[19]

The report identified the core issues regarding the function and regulation of rating agencies. The primary concern was the flow of information available from issuers that rating agencies were responsible for assessing and that inadequate disclosure requirements reduced the effectiveness of the ratings process.[20] The U.S. SEC noted that a number of reforms had already been undertaken to address these concerns through Sarbanes-Oxley.[21]

The U.S. SEC's concept release identified the core issues relating to the regulation of rating agencies and what should be incorporated in a regulatory framework to govern rating agencies. When the concept release was published in June 2003, staff at the U.S. SEC had not established a clear position on whether it was necessary or appropriate to directly or indirectly regulate rating agencies.[22] Furthermore, the U.S. SEC was conscious that despite Congress' public support for the direct regulation of rating agencies, Congress was unlikely to grant the U.S. SEC the statutory authority to do so. The U.S. SEC was awaiting clear

[17] U.S. Securities and Exchange Commission 2003a, p. 42
[18] U.S. Securities and Exchange Commission 2003b
[19] U.S. Securities and Exchange Commission 2003b
[20] U.S. Securities and Exchange Commission 2003a, p. 20
[21] U.S. Securities and Exchange Commission 2003a, p. 30
[22] Anonymous Interview B

Congressional leadership on the issue before stating a public view of what form of regulation the U.S. SEC supported.

### *5.2.2 Explaining the U.S.' Decision Not to Directly Regulate Rating Agencies*

After the collapse of Enron and WorldCom, Congress publicly appeared to seek legislative reforms that would subject rating agencies to direct regulation. Instead, Congress chose not to directly regulate rating agencies and delegated the task of determining whether and/or how rating agencies would be regulated to the U.S. SEC. What explains the Congress' unwillingness to directly regulate rating agencies? Three factors explain the failure of the U.S. to legislate a direct regulatory regime for rating agencies, including: rating agencies being afforded First Amendment Right protections, traditional lobbying efforts by the rating agency industry, and a lack of consensus between legislators and regulators on the necessity of directly regulating rating agencies.

First, Congress failed to regulate rating agencies in the wake of Enron and WorldCom because Congress faced important judicial constraints, which limited their ability to create an effective regulatory regime for rating agencies through legislative reform. Rating agencies were afforded First Amendment right protections by the U.S. courts. U.S. Courts had effectively shielded rating agencies from liability and accountability because rating agencies had successfully made the argument that ratings are "the world's shortest editorials"[23] and should be afforded similar protection from liability as journalists.

The rating industry had hired Floyd Abrams, Senior Partner at Cahill Gordon & Reindel, who had become the first authority on First Amendment, freedom of speech rights in the U.S., and had been involved in the most definitive Supreme Court cases in the United States.[24] Annette Nazareth, former U.S. SEC Commissioner responsible for rating agency regulation from 2005, explained that Floyd Abrams, acting as counsel for U.S. credit rating agencies, strategically chose which cases to settle with claimants and which cases to contest to build a set of legal precedents. As Annette Nazareth explains, this "ensured that credit

[23] Liebermann 2002
[24] Nazareth 2012

ratings were opinions and were therefore above reproach."[25] A key reservation of Congress was that they could be accused of constitutional and congressional overreach if legislative reforms were struck down by the U.S. court system.

Second, rating agencies lobbied Congress to protect against the creation of a direct regulatory regime. Rating agencies' claim to First Amendment right protections were a crucial part of the rating agencies' lobbying efforts. As the *Huffington Post's* Ben Protess and Lagan Sebert discuss, rating agencies have repeatedly "quashed or watered down potential government rules by arguing that, much like a newspaper editorial, ratings are protected by the constitutional right to free speech, according to a Huffington Post Investigative Fund review of congressional testimony, SEC documents and lobbying reports."[26] Rating agencies were able to convince legislators and regulators that regulatory regimes for rating agencies would be rendered ineffective if they trampled on their First Amendment rights. Congressman Paul Kanjorski, argued that Congress must be "very sensitive to the First Amendment issue posed in these debates."[27]

Third, there was not a clear consensus on the necessity of creating a direct regulatory regime for rating agencies. As the U.S. SEC's Concept Release makes clear, the U.S. SEC did not take a public position or endorse one of the three regulatory options it had identified. As Howard Davies (former Chairman of the United Kingdom Financial Services Authority) and David Green state, "Majority opinion among the regulators was that the [rating] agencies should themselves be responsible for policing conflicts of interest and ensuring the integrity of their analysis."[28] In 2005, Annette Nazareth stated in public testimony to Congress that the U.S. SEC "believed a strong and effective industry-led regime could prove to be a constructive and reasonable approach to address a number of concerns involving the credit rating industry that have been raised in recent years by Congress, the Commission, and others, such as the International Organization of Securities Commissions."[29] Some securities regulators favored the continuation of the self-regulatory regime.

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[25] Ibid.
[26] Protess and Sebert 2010
[27] Ibid.
[28] Davies and Green 2008, p. 70
[29] Nazareth 2005

An interview with a senior U.S. SEC regulator reveals two reasons why some U.S. securities regulators favored a self-regulatory regime for rating agencies. First, the U.S. SEC already retained a lot of power over ratings agencies, which enabled the U.S. SEC to address regulatory concerns without being given direct authority by Congress. The interviewee stated that the Trading and Markets Division at the U.S. SEC dealt with rating agencies and communicated the regulatory concerns of the SEC for rating agencies. The interviewee stated, "there was no formal regulation but that doesn't mean that we didn't have a lot of power… There was a lot of informal power, which, for regulators, was good because it was concentrated within the SEC."[30]

Second, some U.S. securities regulators believed that oligopolistic rating agencies had some important policy benefits. The interviewee stated that for public bond issues and stock listings, "when it's an oligopoly you don't get to chose. If you don't have a choice on which rating agencies you hire you don't have the same conflict of interest." The real regulatory concern "was monopolistic slacking but [we felt there was] no real conflict of interest with issuers."[31] Some staff in the U.S. SEC reached the conclusion that Enron was a unique case caused by rating agencies' failure to adequately investigate the statement of accounts and financial position of the firm due to monopolistic slacking rather than inherent conflicts of interest.[32] Monopolistic slacking refers to the fact that firms who have a monopolistic position in the market do not invest sufficient resources or do not effectively monitor the quality of its product. In the case of rating agencies, monopolistic slacking impacts the quality of rating agencies' assessments and can impact the quality of information investors receive.

After both the U.S. Congress and U.S. SEC began to review the regulation of rating agencies until the creation of the 2006 Credit Rating Agency Reform Act, the U.S. continued to favor the regulatory status quo and did not legislate credit rating agency reform. In response, the U.S. SEC created a domestic Code of Conduct as a measure to fill the regulatory void left by

[30] Anonymous Interview B
[31] Anonymous Interview B
[32] Anonymous Interview B

Congress' unwillingness to legislate rating agency measure whilst addressing some of the core concerns that regulators and domestic politicians had expressed. The U.S. SEC proposed the idea in March 2004.[33]

As discussed previously, bills were introduced to regulate rating agencies but were defeated. As previous scholarship has noted, rating agencies were able to forestall Congressional action by successfully making the case that they were afforded First Amendment right protections by the U.S. courts and that legislative reforms could impinge on these rights.[34] Finally, securities regulators were not entirely convinced of the necessity for the direct regulation of rating agencies.

### *5.2.3 The European Union Rating Agency Regulatory Reform Process*

The European Union began investigating the regulation of rating agencies in April 2002. In April 2002, European finance ministers requested a report on the regulation of rating agencies through the informal Oviedo EcoFin council.[35] The impetus for reform was the collapse of Enron and WorldCom in the U.S., the FSF's concerns, policy developments in the United States and IOSCO's work on rating agencies during this time.[36] The issue was given greater impetus by two other events that brought the regulation of rating agencies to the E.U.'s attention. First, Parmalat, Italy's dairy giant, collapsed in late 2003 with no effective warning by rating agencies. Second, Germany began lobbying for the regulation of rating agencies after Standard & Poors downgraded Germany's public banks due to their future pension obligations.[37] As Klaus C. Englen explains, "The German government, faced with a domestic revolt against damaging rating decisions by Standard & Poor's, is under mounting pressure to control what is perceived as an excessive level of American rating power."[38] Furthermore, as Christopher Bruner and Rawi Abdelal state, "European parliamentarians have grown resentful of the perceived lack of understanding that the U.S.-based agencies have shown toward different accounting standards and corporate financing

[33] Protess and Sebert 2010
[34] Sinclair 2005; Bruner and Abdelal 2005
[35] European Commission 2004; European Commission 2005
[36] European Parliament 2004
[37] Engelen 2004, p. 66; Anonymous Interview B
[38] Engelen 2004, p. 65

customs"[39] and "increasingly complained about industry concentration, the U.S.-centric orientation of the major agencies, [and] the 'protectionist overtones' of the NRSRO system."[40] The E.U. also appeared ready to regulate rating agencies in the wake of public scandal and growing resentment of rating agencies.

In June 2003, the European Parliament granted the Committee on Economic and Monetary Affairs' request that a report be produced for regulatory recommendations regarding credit rating agencies. The report was to be chaired Giorgos Katiforis. In November 2003, two months before the final draft of the Katiforis report, U.S. based credit rating agencies downgraded German state banks to junk status because of their future pension obligations. As Engelen states, "to large segments of Germany's political and financial establishment, Standard & Poor's rating action amounted to a declaration of war."[41] The European Parliament's proposal to require rating agencies to register with an E.U. authority was driven, in part by, Germany's concerns about U.S. rating agencies and in an effort to counter the Anglo-Saxon ratings of American-based rating agencies.[42] The final draft of the Committee's report was produced in January 2004 and its recommendations were put forth in a resolution on the role and methods of rating agencies in February 2004. In the final report, the Committee recommended the following:

> "Registration with a European authority would help redress the imbalance between Europe and the US… Registration would imply accountability, implemented by periodic reporting to the European ratings authority and supervision over the conditions of effectiveness of rating activity, implemented by an active dialogue between the management of the agencies and the regulator."[43]

The European parliament did not act on the recommendations of the Katiforis report. Instead, as Bruner and Abdelal summarize, "the European Parliament has directed the

[39] Bruner and Abdelal 2005, p. 192
[40] Bruner and Abdelal 2005, p. 204
[41] Engelen 2004, p. 67
[42] Anonymous Interview B
[43] European Parliament 2005, p. 204

European Commission to report back by July 2005 with its view on regulation of the agencies. The Commission, in turn, looked to the Committee of European Securities Regulators for advice."[44] The Committee of European Securities Regulators (CESR) didn't produce its final recommendations until March 2005 in a report, *CESR's Technical Advice to the European Commission on Possible Measures Concerning Credit Rating Agencies*.[45]

### 5.2.4 *Explaining the E.U.'s Decision Not to Regulate Rating Agencies*

As this chapter has established, Congress chose not to legislate rating agency regulation and instead chose to establish an industry-led, voluntary Code of Conduct initiative in March 2004. The E.U. Parliament was presented with the Katiforis report in early 2004, which recommended that the E.U. establish an European credit agency oversight body. The E.U. Parliament chose to delay a decision on whether to regulate rating agencies in early 2004, requesting a report from CESR instead.

The E.U. parliament chose to not to legislate rating agencies in early 2004, despite the recommendations of the Katiforis report, for two reasons. First, the domestic political balance of power did not support Germany's efforts to regulate rating agencies. The European financial industry opposed the direct regulation of rating agencies at the time of the initial regulatory review and had expressed these concerns during the drafting of the Katiforis report.[46] The U.K. opposed the direct regulation of rating agencies and, at the time, the U.K. had more influence than Germany in European financial regulatory affairs.[47]

Second, although there is no clear evidence that the E.U.'s decision not to legislate rating agency regulation in early 2004 was because of the U.S.' decision not to legislate rating agency regulation; it was likely influential in the E.U.'s decision. A formal regulatory regime would have led to differentiated assessments of creditworthiness between jurisdictions. E.U. policymakers could have inadvertently put E.U.-based issuers at a disadvantage as investors questioned the transparency and accuracy of European-based ratings due to fears of government intervention in the ratings process. In 2004, a report by France's AMF stated

[44] Bruner and Rawi Abdelal 2005, p. 204
[45] Council of European Securities Regulators 2005
[46] Abdelal 2007, p. 190
[47] Anonymous Interview B

the following: "the only forum for dealing effectively with these issues is the upcoming international talks between regulators. The agencies' organisational structures… do not lend themselves easily to analysis from a strictly domestic viewpoint."[48] This was also indicated by CESR when, during their recommendations to the European Commission, they argued that a direct regulatory oversight regime "poses a danger, if it is different from regulatory initiatives taken in other systems, that ratings from EU CRAs would be viewed differently from those produced by non-EU CRAs, thereby creating an un-level playing field."[49] This indicates that the E.U. had concerns about establishing a differentiated regulatory regime.

## 5.3 The Creation of IOSCO's Principles for CRAs and IOSCO's Code of Conduct

IOSCO's *Principles for CRAs* was created in September 2003 to establish a common policy platform for regulatory reforms in light of the U.S. and E.U.'s review of the regulation of rating agencies. IOSCO's Technical Committee was driven to create IOSCO's *Principles for CRAs* by their principled professional interests. Securities regulators believed competing systems of rating agency regulation was not in the interests of investor safety. IOSCO's *Code of Conduct* was created in December 2004 to establish an effective and internationally consistent regulatory response to the policy problems posed by rating agencies whilst respecting the domestic political constraints in the U.S. and E.U.

### *5.3.1 IOSCO's Principles for CRAs*

IOSCO's *Principles for CRAs* was created in September 2003 to promote the creation of common regulatory regimes for rating agencies across jurisdictions. Securities regulators were concerned about the threat of differentiated regulatory regimes for rating agencies. As one regulator involved in the creation of IOSCO's *Principles for CRAs* and IOSCO's *Code of Conduct* stated, "it's pretty fair to say that the impetus for [the credit rating agency] task force was to get in the way of contradictory global approaches to the regulation of rating agencies… We didn't want jurisdictions to go out and do whatever."[50]

[48] Autorité des Marchés Financiers 2005, p. 35 as cited in Abdelal 2007, p. 191
[49] Council of European Securities Regulators 2005, p. 46
[50] Anonymous Interview B

IOSCO's *Principles for CRAs* was derived from the work of IOSCO's Task Force for CRAs, which was established in response to the U.S. and E.U.'s decision to review the regulation of rating agencies. IOSCO's *Principles for CRAs* reflect the outcomes and recommendations of IOSCO's *Report on the Activities of Credit Rating Agencies* that was released at the same time as IOSCO's *Principles for CRAs* in September 2003.[51] IOSCO's *Report on the Activities of Credit Rating Agencies* states that the two core issues that rating agencies face is conflicts of interests and disclosure practices.[52] IOSCO's *Report on the Activities of Credit Rating Agencies* states the following:

> "Perhaps the single greatest concern facing CRAs is identifying and addressing potential and actual conflicts of interest that may inappropriately influence the rating process… Securities regulators, CRAs and other market participants should be aware of the nature of these conflicts and consider mechanisms by which the effects of potential and actual conflicts may be eliminated or mitigated."[53]

The report also states that the rating agencies rely on the information provided from the issuer itself, and that "sufficient and accurate information from issuers" is critical to the ratings decision and that information deficits will be to "the detriment of market transparency."[54]

IOSCO's *Principles for CRAs* was created to establish "high-level objectives for which rating agencies, regulators, issuers and other market participants should strive in order to improve investor protection and the fairness, efficiency and transparency of the securities markets and reduce systemic risk."[55] E.U. and U.S. regulators, as members of the Technical Committee, created IOSCO's *Principles for CRAs* to coordinate regulatory approaches. IOSCO's *Principles for CRAs* identified what regulatory frameworks should be addressed but remained non-committal on how those principles should be implemented. IOSCO's

[51] Technical Committee of IOSCO 2003b
[52] Ibid., p. 12
[53] Ibid., p. 12
[54] Ibid., p. 12
[55] Technical Committee of IOSCO 2003c

*Principles* states, "The Technical Committee proposes to await future consideration of these alternatives in the *major jurisdictions* and take account of preferences of other sector supervisors before considering its preferred method of implementation. The Technical Committee proposes to review these developments within 18 months."[56] IOSCO's Technical Committee established four principles to improve rating agency oversight including: principles for the quality and integrity of the rating process, independence and conflicts of interest, transparency and timeliness of rating disclosure, and confidential information.[57]

At the heart of IOSCO's *Principles for CRAs* were the principles regarding the management conflicts of interest. IOSCO's *Principles for CRAs* also states the following:

> "CRAs should adopt written internal procedures and mechanisms to (1) identify, and (2) eliminate, or manage and disclose, as appropriate, any actual or potential conflicts of interest that may influence the opinions and analyses CRAs make or the judgment and analyses of the individuals the CRAs employ who have an influence on ratings decisions. CRAs are encouraged to disclose such conflict avoidance and management measures."[58]

IOSCO's *Principles for CRAs* also states, "CRA ratings decisions should be independent and free from political or economic pressures and from conflicts of interest arising due to the CRA's ownership structure, business or financial activities, or the financial interests of the CRA's employees."[59] Securities regulators created and endorsed these principles to ensure that rating agencies monitor and improve their regulation of conflicts of interest. They were also created and endorsed to ensure that rating agency regulation did not subject rating agencies to regulation that placed political pressure to grant sovereigns favorable ratings. This principle was explicitly included in order to endorse a non-interventionist approach to rating agencies.[60] German lawmakers had historically favored bond issuers and publicly listed

[56] Technical Committee of IOSCO 2003c *emphasis added.*
[57] Ibid.
[58] Ibid.
[59] Technical Committee of IOSCO 2003c
[60] Anonymous Interview B

companies to have the right of review when rating agencies issued their credit ratings and wanted issuers to have time to prepare markets for impending rating downgrades.[61]

IOSCO's *Principles for CRAs* also encouraged greater transparency of the ratings process. First, IOSCO's *Principles for CRAs* stated that "CRAs should adopt and implement written procedures and methodologies to ensure that the opinions they issue are based on a fair and thorough analysis of all relevant information available to the CRA."[62] Second IOSCO's *Principles for CRAs* states that "CRAs should publish sufficient information about their procedures and methodologies so that outside parties can understand how a rating was arrived at by the CRA" and "publish historical default rates of CRA rating categories and whether the default rates of these categories have changed over time."[63] These principles were included to promote greater disclosure practices by rating agencies to improve transparency of the ratings process. It would also appear that these principles were included to respond to Germany and the Katiforis report's criticism that rating agencies were insensitive and demonstrated a lack of understanding of European accounting standards and corporate financing customs.[64] By disclosing how rating agencies reached their ratings, it was left to the markets to judge whether the information utilized to reach each rating was effective in assessing the creditworthiness of obligors.

IOSCO's *Principles for CRAs* established a common platform for national regulatory regimes amidst the review of the regulation of rating agencies in the U.S. and E.U. IOSCO's *Principles for CRAs* achieved this by identifying the core issues that should be addressed in designing effective regulatory regimes for rating agencies. This was driven by regulators' interest in promoting common regulatory regimes and common assessments of creditworthiness across jurisdictions.

### *5.3.2 The Creation of IOSCO's Code of Conduct*

IOSCO's Technical Committee created IOSCO's *Code of Conduct* in December 2004 after a consultation document was produced in October 2004. IOSCO's *Code of Conduct* produced a

[61] Anonymous Interview B Engelen 2004, p. 64 – 71
[62] Technical Committee of IOSCO 2003c
[63] Ibid.
[64] See Bruner and Abdelal 2005, p. 192

set of measures that "should be included in individual CRA codes of conduct, and the elements contained in the Code Fundamentals should receive the full support of CRA management and be backed by thorough compliance and enforcement mechanisms."[65] IOSCO's *Code of Conduct*, a voluntary self-regulatory framework for rating agencies, was created in order to establish an effective and internationally consistent regulatory response to the policy problems posed by rating agencies whilst respecting the domestic political constraints in the U.S. and E.U.

The creation of IOSCO's *Code of Conduct* can be understood within the context of the U.S. and E.U.'s regulatory review process. IOSCO's *Code of Conduct* was created after the U.S. SEC chose to create a domestic Code of Conduct for credit rating agencies from March 2004[66] because Congress appeared to be unwilling to legislate rating agency regulation.[67] In the E.U., the European Parliament rejected the recommendation of the Katiforis Report to establish a European credit rating agency oversight body, around the same time that the U.S. SEC chose to create an industry-led voluntary Code of Conduct framework. The European Parliament chose to delay the decision on whether and/or how to regulate rating agencies by asking CESR to report back by July 2005 with their recommendations. The European Parliament likely chose to delay the decision because an E.U.-based regulatory oversight regime "poses a danger, if it is different from regulatory initiatives taken in other systems, [because] ratings from EU CRAs would be viewed differently from those produced by non-EU CRAs, thereby creating an un-level playing field."[68] The community of securities market regulators created IOSCO's *Code of Conduc*t within IOSCO's Technical Committee to establish a globally consistent regulatory regime for rating agencies whilst taking account of U.S. and E.U. domestic political constraints.

IOSCO's *Code of Conduct* reflected the recommendations of the September 2003 *Report on the Activities of Credit Rating Agencies* and IOSCO's *Principles for CRAs*. IOSCO's *Code of Conduct* established what aspects of the rating agency business that rating agencies should address through internal codes of conduct that were backed by senior management. IOSCO's *Code of*

[65] Technical Committee of IOSCO 2004, p. 2
[66] Protess and Sebert 2010
[67] Annette Nazareth 2012
[68] Council of European Securities Regulators 2005, p. 46

*Conduct* identifies four areas of interest that internal codes of conduct should address including: rating agency independence and conflicts of interest, the ratings process and information provided by the issuer, public dissemination of ratings and timing, preferential access to rating agencies by subscribers, barriers to entry for new CRAs, and unsolicited ratings.[69] IOSCO's *Code of Conduct* was intended to form the basis of internal codes of conduct implemented by rating agencies themselves but the *Code of Conduct* left the option of formal regulation open. The *Code of Conduct* stated the following:

> "CRAs and regulators should consider whether or not additional measures may be necessary to properly implement the Principles in a specific jurisdiction, and the Technical Committee may revisit the Code Fundamentals in the future should experience dictate that modifications are necessary."[70]

Regulators were keenly aware that direct regulation could be forthcoming at some point in the future.[71]

### 5.3.3 *The E.U.'s Rating Agency Regulatory Regime: CESR and IOSCO's Code of Conduct*

When CESR reported back to the E.U. Parliament, CESR recommended that the implementation of IOSCO's *Code of Conduct* matched with CESR's monitoring of its implementation by rating agencies operating within the E.U. would be sufficient to deal with the regulatory issues raised by rating agencies. This demonstrates the effectiveness of IOSCO's *Code of Conduct* in coordinating regulatory regimes for rating agencies across the U.S. and E.U.

CESR's March 2005 report analyzed a number of regulatory issues surrounding rating agencies. CESR's report and its recommendations are consistent with IOSCO's *Principles for CRAs*, highlighting the same regulatory issues that IOSCO's *Report on the Activities of Rating Agencies* address. The report utilized a survey of industry members and regulators in concert

[69] Technical Committee of IOSCO 2004, p. 2
[70] Ibid., p. 2
[71] Anonymous Interview B

with its own analysis to highlight critical issues regarding the regulation of rating agencies and potential regulatory solutions.[72]

First, the report highlights that the issuer pays system in the credit rating industry may give rise to real or perceived conflicts of interest. As such, it recommends that rating agencies disclose conflicts of interest, establish internal policies and procedures to protect against conflicts of interests and to look to the existing *Markets in Financial Instruments Directive* and emulate the conflict of interest policies of investment firms.[73] Second, CESR recommends that rating agency methodologies be clearly stated, accurately disclosed and strongly applied to allow investors to judge the accuracy of rating agencies' assessments of debt worthiness.[74] CESR believes it is necessary that sufficient information about the methodology be disclosed to investors.[75] The report states,

> "CESR believes that there is no need or opportunity of explicitly regulating the content of methodologies used by credit rating agencies in elaborating credit rating, since this kind of regulation would seriously risk to erode individual quality and independence of the credit rating agencies analysis, and consequently to harm the quality of information flow in securities market, like it is suggested also by almost an unanimity of responses in this sense by market operators to the CESR's consultation."[76]

Third, the report highlights problems associated with the use of inside information. However, the report states that the Market Abuse Directive (MAD) covers the use of all forms of inside information. The report recommends that the MAD should provide greater clarity with special interest in the use of inside information in rating agencies, that legal harmonization be facilitated in this area, and that rating agencies disclose potential uses of inside information.[77] The report also recommends that smaller rating agencies be provided access to common pools of information to create a level playing field between smaller and

[72] Technical Committee of IOSCO 2003b
[73] Council of European Securities Regulators 2005, p. 14 - 20
[74] Ibid., p. 24
[75] Ibid., p. 25
[76] Ibid., p. 25 – 26
[77] Ibid., p. 29

larger rating agencies.[78] Fourth, on the issue of publishing misleading or inaccurate information, CESR concluded the MAD makes it an offence to publish misleading or inaccurate information and that rating agencies have sufficient market incentives to not do so.[79]

The report is littered with references to IOSCO's *Code of Conduct* and repeatedly states that IOSCO's *Code of Conduct* addresses most of the regulatory issues identified in the report. When discussing a formal regulatory system for monitoring rating agencies, CESR expresses concerns that doing so may create barriers to entry (even though smaller rating agencies favored this approach) and increase the costs of ratings. CESR also believed that formal regulatory oversight could grant rating agencies an unfair level of creditability by granting credit ratings a seal of approval. The report states that the majority of industry participants did not support the idea of creating a direct regulatory regime. Finally, the report states that an E.U. regime could create a dual system of ratings for E.U. listed firms and other rated products.[80] The report concludes the following:

> "When it comes to the enforcement issue, a clear majority of CESR members is of the view that there is an argument for the wait and see approach, where no recognition system is set up at present, and the effects of the Code are let to work. The introduction of the IOSCO Code states that the IOSCO Technical Committee may revisit the Code in the future should experience dictate that modifications are necessary. Overall, this is the preferred option by the respondents to the consultation."[81]

In January 2006, the Commission concluded that existing financial services directives, and implementation of IOSCO's *Code of Conduct* would be sufficient at the time.[82] The European Commission endorsed CESR's approach to CRAs in a letter to the Director General of CESR, Docters van Leuwen, in March 2006.[83] The E.U.'s adoption of IOSCO's *Code of*

[78] Ibid., p. 32
[79] Ibid., p. 35
[80] Ibid., p. 46
[81] Ibid., p. 52
[82] Council of European Securities Regulators 2006
[83] European Commission 2005b

*Conduct* demonstrates the influence of IOSCO's policymaking process in effectively coordinating the regulatory framework for rating agencies in the two dominant financial centers.

### 5.4 The Strengthening of IOSCO's International Credit Rating Agency Standards

IOSCO's *Principles for CRAs* was initially implemented through voluntary self-regulatory codes of conduct. IOSCO's *Code of Conduct* established a template for national and regional self-regulatory initiatives and began to be implemented by rating agencies around the world. IOSCO's international credit rating agency standards began to be strengthened in 2006 when the United States established the first direct regulatory regime of rating agencies under the Credit Rating Agency Reform Act. The 2006 Act remained limited because of the continued threat that rating agencies' First Amendment right protections would limit the applicability of U.S. SEC rules.

The implementation of IOSCO's international standards for rating agencies was substantively strengthened after the 2007/2008 crisis when the U.S. and E.U. chose to subject rating agencies to direct regulation. It became clear early in the crisis that the domestic political context of the U.S. and E.U. had shifted to favor the direct regulation of rating agencies. The first indication was in November 2008 at the G20 Summit in Washington D.C. At the summit, G20 leaders agreed to "exercise strong oversight over credit rating agencies, consistent with the agreed and strengthened international code of conduct."[84] The G20 reaffirmed their commitment at the London G20 Summit in April 2009 when the G20 agreed "to extend regulatory oversight and registration to Credit Rating Agencies to ensure they meet the international code of good practice, particularly to prevent unacceptable conflicts of interest."[85] The U.S. regulated rating agencies under Section C of the 2010 Dodd-Frank Act. The European Union regulated rating agencies under a series of laws passed through the European Parliament, culminating in CRAIII.

The strengthening of IOSCO's international standards for credit rating agencies can be explained by shifts in the domestic political context of the U.S. and E.U. In the U.S. the

[84] G20 2008a
[85] G20 2009

creation of a direct regulatory regime in 2006 is partly explained by the narrow political interests of a U.S. Congressman. The creation of the 2006 direct regulatory regime is also explained by the gradual acceptance by Congress of the necessity of regulating rating agencies. In the wake of the 2007/2008 financial crisis, the U.S. and E.U. domestic legislatures faced a different set of political incentives after widespread reports of conflict of interest issues in securitized debt markets and rating agencies' systemic under valuation of risk. After the strengthened implementation of IOSCO's international standards for rating agencies, securities regulators endorsed the direct regulation of rating agencies in March 2009 and assessed the compliance of national regulatory reforms for rating agencies with IOSCO's *Principles for CRAs* in February 2011.

The strengthening of IOSCO's *Principles for CRAs* and IOSCO's *Code of Conduct* is best explained through a domestic politics framework. Although securities market regulators created international rating agency standards to promote the continued harmonization of national regulatory frameworks, the decision to regulate agencies was driven by shifts in the domestic political context and changes in the policy preferences of domestic political actors.

### *5.4.1 The United States' Pre-Crisis Direct Regulatory Regime*

The U.S. governed rating agencies through voluntary codes of conduct until 2006. In 2006, the U.S. SEC was given formal statutory authority to govern rating agencies under the Credit Rating Agency Reform Act. The Congress' decision to directly regulate rating agencies is largely explained by the narrow domestic political interests of two U.S. Congressmen from Pennsylvania: Paul Kanjorski and Michael Fitzpatrick.

The 2006 Credit Rating Agency Reform Act emerged out of a bill introduced by Pennsylvanian Rep. Fitzpatrick.[86] The 2006 Credit Rating Agency Reform Act was originally called the Credit Rating Agency Duopoly Relief Act.[87] Rep. Fitzpatrick introduced the bill in the interests of Egan-Jones Ratings Company, a Pennsylvania-based ratings firm that sought to gain entry and expand their market share in the U.S. ratings market. The central aim of Rep. Fitzpatrick's bill was to encourage competition in the ratings industry by redefining the

[86] United States 109th Congress House of Representatives 2006a
[87] Ibid.

definition of NRSROs. The bill encouraged increased competition by removing the U.S. SEC's requirement that they be "nationally recognized" and considered by financial markets to be "an issuer of credible ratings."[88] The 2006 bill defined NRSROs as a credit rating agency that: "(A) has been in business for at least the 3 consecutive years and is (B) registered under section 15E."[89] The 2006 Act slightly strengthened the requirements by adding that an NRSRO is defined as: "(A) has been in business as a credit rating agency for at least the 3 consecutive years immediately preceding the date of its application for registration under section 15E; (B) issues credit ratings certified by qualified institutional buyers."[90] The 2006 bill was originally motivated by Congress' wish to remove regulatory barriers to rating agencies become NRSROs and to promote competition in the rating agency market.

The 2006 Credit Rating Agency Reform Act also strengthened the regulation of rating agencies by requiring NRSROs to register with the U.S. SEC. As the report on the original draft of the legislation states, the bill sought to "enhance transparency of the ratings industry by mandating that NRSROs disclose in their registration applications… the methodologies it uses… and the conflicts its business model raises and the manner in which it manages those conflicts."[91] Registration required rating agencies to submit a report outlining their procedures and methodologies, policies and procedures to prevent the misuse of material, nonpublic information, its organizational structure, whether they maintain a code of ethics (to identify any conflicts of interest for rating issuance), a list of the 20 largest issuers and subscribers and to submit credit rating performance statistics.[92]

The Act required NRSROs to maintain written policies to prevent the misuse of material, nonpublic information and to protect against conflicts of interest. The 2006 Act required the U.S. SEC to assess them by their implementation of internal conflict of interest policies and credit rating performance statistics. The Act also prohibits anticompetitive practices such as

[88] Ibid., p. 2
[89] Ibid., p. 2
[90] United States 109th Congress 2006b, p. 29
[91] United States 109th Congress House of Representatives 2006a, p. 8
[92] United States 109th Congress 2006b

threatening to lower ratings if the issuer didn't obtain other CRA services.[93] The Act specifically prohibits the U.S. SEC from regulating the substance of credit ratings or the procedures and methodologies that the rating agencies use to reach a rating.[94] The 2006 Credit Rating Agency Reform Act essentially granted the U.S. SEC the statutory authority to monitor compliance with rating agencies' written codes of conduct and take actions against rating agencies or NRSROs if they failed to monitor and implement those codes of conduct. The measures to strengthen regulatory oversight caused Rep. Kanjorski to vote against the bill that he was integral in creating.[95]

The 2006 Credit Rating Reform Act granted the U.S. SEC some authority to regulate rating agencies. A number of issues remained outside the regulatory purview of the U.S. SEC. Rating agencies were still exempt from any liability for ratings decisions and the U.S. SEC was unable to intervene in how ratings decisions were arrived at. When the bill was originally proposed, it met resistance when the U.S. SEC sought to implement it in 2006. The U.S. SEC's efforts to create final rules to enact the law were published on June 5 2007.[96] Throughout the process, the rating agency industry's allies in Congress tightly circumscribed the SEC's final rules. A coalition of Senators, led by Chuck Schumer of New York, again expressed concern over the U.S. SEC's rules. Schumer stated: "the law required the SEC to enforce "narrowly tailored" regulations."[97] Senate members Chuck Schumer, Mitch McConnell and Rep. Paul Kanjorski repeatedly warned that the legislation must not breach rating agencies' First Amendment rights.[98] The 2006 Credit Rating Agency Reform Act was relatively weak and would soon be surpassed by Subtitle C of Dodd-Frank that was signed in to law on July 21st 2010.

### *5.4.2 Post-Crisis Credit Rating Agency Regulatory Reform: The United States*

The 2008 financial crisis and rating agencies' failure to adequately assess the creditworthiness of underlying borrowers within the securitized debt market led to the creation of a

[93] Ibid.
[94] GovTrack 2006; Duane Morris (*Law Firm*) 2010
[95] *Vote Smart* 2008
[96] U.S. Securities and Exchange Commission 2007
[97] Protess and Sebert 2010
[98] Ibid.

comprehensive direct regulatory regime under Subtitle C of Dodd-Frank. Dodd-Frank differed from the 2006 Credit Rating Agency Reform Act because it placed statutory obligations on rating agencies to fulfill certain regulatory requirements, rather than requiring rating agencies to adopt internal policies to address regulatory concerns.

Dodd-Frank establishes a number of requirements for rating agencies' methodologies:

- Ratings methodologies must be approved by the rating agency's Board of Directors,

- They disclose any underlying assumptions used in reaching a final rating decision, any data used in the rating assessment process, the use of third party diligence services, and any change in its methodologies and;

- Rating agencies are required to disclose the quality and reliability of information used during the ratings process

Dodd-Frank requires rating agencies to publish the ratings performance of its ratings in each asset class and establishes the Office of Credit Ratings within the U.S. SEC to oversee the rating agency industry.

After Dodd-Frank passed, the U.S. SEC has since published a number of rules, including the requirement of rating agencies to establish standards, training and experience relative to the complexity of the securities they analyze, test its credit analysts on credit rating procedures and that one individual with three or more years experience participate in ratings.[99] The U.S. SEC has established rules requiring rating agencies to publish performance statistics for 1, 3 and 10 years, to disclose how often credit ratings are reviewed and to make historical performance statistics for all ratings to be made publicly available. CRAs are also required to publish, on a six-month delayed basis, rating action histories for a randomly selected sample of 10% of its issuer-paid credit ratings in each of the following five rating classes.[100] The U.S. SEC requires that rating agencies disclose quantitative and qualitative information in a

[99] U.S. Securities and Exchange Commission 2011a
[100] U.S. Securities and Exchange Commission 2010b

standardized form that would identify potential limitations of the rating, the five main assumptions underlying the methodology, and identify the probability that an issuer will default.[101] Finally, the U.S. SEC requires that rating agencies publish a 100% history of its credit ratings in order to identify any changes from initial ratings.[102]

The domestic political context of the U.S. substantively shifted after the 2008 financial crisis. The systemic failure of rating agencies to adequately assess the creditworthiness of obligors, particularly in securitized debt markets, meant that judicial and legislative preferences had shifted in favor of creating a comprehensive regulatory regime for rating agencies. Dodd-Frank explicitly states that rating agencies are financial "gatekeepers." Dodd-Frank states the following:

> "Because credit rating agencies perform evaluative and analytical services on behalf of clients, much as other financial "gatekeepers" do, the activities of credit rating agencies are fundamentally commercial in character and should be subject to the same liability and oversight as apply to auditors, securities analysts, and investment bankers."[103]

George Miller, Executive Director of the American Securitization Forum noted in his testimony to the SEC during the CRA Roundtable Discussions in 2009 that rating agencies were no longer defending their First Amendment protections in their 2009 testimony.[104] In the wake of the 2007/2008 financial crisis, U.S. courts began disassembling rating agencies' First Amendment protections. In a 2009 ruling, the U.S. District Court ruled in the case of Abu Dhabi Commercial Bank v. Morgan Stanley & Co., "the First Amendment does not apply when a rating agency disseminates ratings to a select group of investors and not the public at large."[105]

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[101] Ramsay 2011; Darbellay and Partnoy 2012, p. 8
[102] Duane Morris (*Law Firm*) 2011
[103] United States 111th Congress 2010
[104] U.S. Securities and Exchange Commission 2009, p. 78
[105] Simpson Thatcher (*Law Firm*) 2011, p. 8. The U.S. District Court's ruling and opinion is available at United States District Court 2009

Due to the removal of First Amendment rights protections, Dodd-Frank removed the liability shield granted to rating agencies. The enforcement and penalty provisions of Dodd-Frank "shall apply to statements made by a credit rating agency in the same manner and to the same extent as such provisions apply to statements made by a registered public accounting firm or a securities analyst under the securities laws."[106] Furthermore, Dodd-Frank states that individuals can seek damages when a credit rating agency "knowingly or recklessly failed – (i) to conduct a reasonable investigation of the rated security with respect to the factual elements relied upon by its own methodology for evaluating credit risk; or (ii) to obtain reasonable verification of such factual elements (which verification may be based on a sampling technique that does not amount to an audit) from other sources that the credit rating agency considered to be competent and that were independent of the issuer and underwriter."[107]

This highlights how the crisis facilitated an ideational shift in the perspective and policy preferences of U.S. legislators and the judiciary, leading to the creation of a credible and substantive direct regulatory regime for rating agencies.

### 5.4.3 *Post-Crisis Credit Rating Agency Regulatory Reform: The European Union*

Prior to the 2008 financial crisis, the E.U.'s Commission on Internal Markets and Services willingly accepted the recommendation of CESR to regulate agencies by monitoring their compliance with IOSCO's *Code of Conduct*. In May 2008, E.U. securities regulators were asked to review rating agency regulation in light of the events in U.S. financial markets in late 2007, and produced its final review of CRA regulation in May 2008. CESR concluded the following: "there is no evidence that regulation of the credit rating industry would have had an effect on the issues which emerged with ratings of US subprime backed securities and hence continues to support market driven improvement." The European Securities Market Experts (ESME) committee, comprised of private financial market actors, reached the same conclusion in March 2008. ESME concluded the following: "Given the global nature of the business of CRAs and the existing U.S. law, we have doubts as to whether the development

[106] United States 111th Congress 2010 Kramer Levin (*Law Firm*) 2010
[107] United States 111th Congress; Kramer Levin (*Law Firm*) 2010; Duane Morris (*Law Firm*) 2010

of a separate E.U. law would produce any particular benefits."[108] ESME's report concludes that the costs of stronger regulation outweigh the costs but supports stronger implementation of IOSCO's *Code of Conduct*.[109]

The European Commission rejected the conclusions of its experts in November of 2008 and decided that strong, effective legislated supervision was necessary to correct deficiencies in the operation and conduct of credit rating agencies. After receiving advice from CESR and ESME, the Commission concluded the following: "Self-regulation based on voluntary compliance with the IOSCO code does not appear to offer an adequate, reliable solution to the structural deficiencies of the business."[110] Commissioner of Internal Markets and Services at the time, Charles McCreevy, said the following:

> "I am flabbergasted at the naivety of anyone who thinks these same credit rating agencies should be trusted to abide by a non-legally enforceable voluntary code of conduct drawn up under palm trees – A code that has proven itself to be toothless, useless, and worthless time and time again. Fool me once shame on you, fool me twice shame on me."[111]

The European Parliament was no longer willing to accept a self-regulatory approach to rating agencies even after its own European regulators sought to continue the previous regime. In November 2011, the E.U. Parliament proposed what has become known as CRA III after a series of E.U. Commission proposals from November 2008.[112]

The Commission proposed a regulatory framework requiring rating agencies to be registered with CESR and the competent authority of the Home state in which the credit rating agency is registered, to tackle conflicts of interest, rating agencies' internal governance structure and staffing demands.[113] In May 2011, the European parliament granted European Securities Market Authority (the replacement organization for CESR) the authority to regulate, oversee

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[108] European Securities Markets Experts 2008, p. 8
[109] European Securities Markets Experts 2008, p. 22
[110] European Commission 2008, p. 3
[111] McCreevy 2008
[112] European Commission 2012a
[113] European Commission 2008

and require the registration of rating agencies within the Union. Under the legislation, rating agencies are required to register with European Securities Market Authority (ESMA). Rating agencies registered are subject to on-site inspections and requests for information. ESMA is empowered to revoke the registration of, and impose fines on, the rating agencies it regulates. Rating agencies are required to establish internal control systems to guard against conflicts of interest, periodically review its methodologies, and supply information to a central repository. This aims to facilitate unsolicited ratings to spur rating agency market competition and to provide information on historical performance through default incidence and rating change data.[114] Rating agencies are also required to provide an inventory of existing and potential conflicts of interest for their rating services and for ancillary services to rating agencies.[115]

Under the legislation rating agencies must be registered for three classes of credit ratings: sovereign and public financing ratings, structured finance ratings, and corporate ratings.[116] The rating methodologies of rating agencies are subject to review and approval by ESMA.[117] Rating agencies are required to disclose their rating methodologies including the qualitative and quantitative factors that are key variables in determining credit ratings. ESMA assesses whether that methodology is being applied consistently and systematically. As Germany's national securities regulator, The Federal Financial Supervisory Authority (BaFin), explains, "the legislation states that ESMA as the competent supervisory authority may not interfere with the content of credit ratings or methodologies. While there is a certain contradiction in the provisions named above, it is clear that ESMA only has the authority to control rating methodologies within extremely narrow bounds."[118] Finally, similar to the United States, E.U. legislation will "expose credit rating agencies to potentially unlimited liability where they breach the regulation intentionally or with gross negligence."[119]

The E.U. originally proposed that bond issuers would be required to rotate rating agencies every three to six years but was forced to back down from its position due to a strong

[114] European Commission 2011a European Commission 2012b; EUbusiness 2011 Standard & Poor's 2012
[115] European Commission 2012b
[116] European Commission 2012b
[117] European Commission 2012b
[118] BaFin 2013
[119] *Reuters* 2012

backlash by members of the financial industry and by some members of the European Parliament.[120] Rating agencies such as Standard & Poors argued that this would lead to less stable ratings, confidentiality issues and a disruption in capital raising.[121] It appears that E.U. and U.K. politicians agreed.[122] In 2008, the E.U. also backed down from a proposal that required analysts to be rotated to ensure that individuals didn't rate the same entity for four years.[123] The rule was only applied to securitized debt products and not to government issued bonds or for publicly listed issuers. The E.U. was also forced to back down from a proposal that rating agencies would be subject to blackouts during bailouts. The E.U. did agree to require rating agencies to establish a calendar for when ratings decisions will be reached and published. Furthermore, rating agencies would be required to "publish ratings only after close of business and at least one hour before the opening of trading in the EU," explains Reuters.[124]

Similar to the U.S., the E.U.'s domestic political context shifted after the 2008 financial crisis. As Stefano Pagliari argues, the continued political salience of the issue of rating agency regulation created new incentives for domestic politicians, which led to the creation of direct regulatory regimes for rating agencies.[125] This led the E.U. to establish a comprehensive direct regulatory regime that established statutory obligations requiring rating agencies to adequately disclose information relating to conflicts of interest, to ensure that conflicts of interest were dealt with, and to ensure the integrity of ratings decisions.

### 5.5 IOSCO After the Crisis: Promoting Continued Cooperation and Coordination

During and after the 2007/2008 financial crisis, IOSCO promoted the continued cooperation and coordination of national regulatory frameworks. IOSCO promoted continued cooperation and cooperation by updating IOSCO's *Code of Conduct* in May 2008,[126] producing a note titled *International Cooperation in Oversight of Credit Rating Agencies* in March

[120] Leftly 2012
[121] Standard & Poor's 2012
[122] Leftly 2012
[123] European Securities Markets Experts 2008, p. 21
[124] *Reuters* 2011.
[125] Pagliari 2013 p. 223 – 224
[126] Technical Committee of IOSCO 2008a

2009,[127] and generating a report titled *Regulatory Implementation of the Statement of Principles Regarding the Activity of Credit Rating Agencies* in January 2011.[128]

IOSCO updated its *Code of Conduct* in May 2008[129] amidst a wider regulatory review process. In October 2007, G7 finance ministers and central bank governors requested the FSF to conduct a review of the causes of the financial market crisis and to propose a set of recommendations. This review included a review of the regulation of rating agencies.[130] IOSCO's Technical Committee updated its *Code of Conduct* for two reasons. First, IOSCO likely responded to pressure from the G7 to review its *Code of Conduct* to ensure that it responded to the regulatory issues that arose during the 2007/2008 financial crisis. Securities regulators sought to remain relevant and appear to be on top of the regulatory issues that emerged during the financial crisis.[131] This is demonstrated by IOSCO's focus on the unique regulatory issues raised by securitized debt products. IOSCO's *Code of Conduct* took aim at the core practices of rating agencies that caused inaccurate assessments of creditworthiness during the crisis. IOSCO's *Code of Conduct* states that "A CRA and its employees should not, either implicitly or explicitly, give any assurance or guarantee of a particular rating prior to a rating assessment. This does not preclude a CRA from developing prospective assessments used in structured finance and similar transactions."[132] Furthermore, "A CRA should prohibit its analysts from making proposals or recommendations regarding the design of structured finance products that a CRA rates."[133]

Second, IOSCO's Technical Committee sought to respond to turmoil in the securitized debt market. IOSCO's *Code of Conduct* was reviewed and updated after the Technical Committee reviewed the role of rating agencies in structured finance markets.[134] The revised *Code of Conduct* urged rating agencies to disclose ratings methodologies and the historic performance of their ratings. The updated *Code of Conduct* also urged rating agencies to indicate the limitations of its ratings and to publish its cash flow and loss analysis so that investors could

[127] Technical Committee of IOSCO 2009b
[128] Technical Committee of IOSCO 2011a
[129] Technical Committee of IOSC 2008a
[130] G7 Finance Ministers 2007; Financial Stability Forum 2007
[131] Anonymous Interview B
[132] Technical Committee of IOSCO 2008a, p. 6
[133] Ibid., p. 6
[134] Technical Committee of IOSCO 2008b

better understand the risk profile of their investment portfolio.[135] IOSCO's *Code of Conduct* was updated in an effort to improve transparency in the notoriously opaque securitized debt market with the hope that it would improve confidence in securitized debt markets to calm market volatility at the time.

Paul Blustein contends that IOSCO was given direction by the FSF during the 2007/2008 financial crisis throughout the FSF's review of financial regulation and through the FSF's *Report of the Financial Stability Forum on Enhancing Market and Institutional Resilience.*[136] An analysis of the FSF's preliminary report,[137] the interim report,[138] and the final report[139] in combination with an interview with a senior U.S. regulator[140] does not provide clear evidence of this. Blustein highlights the FSF recommended that structured financial "products should be rated using a different system than the one used on corporate bonds. This went considerably further than IOSCO's own taskforce, which had only recommended that credit rating agencies "study" whether to change their systems."[141] IOSCO's updated *Code of Conduct* does not include a recommendation that rating agencies establish differentiated rating symbols, but instead proposes the following:

> "A CRA should assess whether existing methodologies and models for determining credit ratings of structured products are appropriate when the risk characteristics of the assets underlying a structured product change materially. In cases where the complexity or structure of a new type of structured product or the lack of robust data about the assets underlying the structured product raise serious questions as to whether the CRA can determine a credible credit rating for the security, CRA should refrain from issuing a credit rating."[142]

This indicates that IOSCO resisted pressure from the FSF and continued to endorse rating agency regulation on the basis of promoting transparency through disclosure.

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[135] Technical Committee of IOSCO 2008b, p. 16
[136] Paul Blustein 2012, p. 20; Financial Stability Forum 2008
[137] Financial Stability Forum 2007
[138] Financial Stability Forum, 2008
[139] Financial Stability Forum 2008
[140] Anonymous Interview B
[141] Blustein 2012
[142] Technical Committee of IOSCO, 2008a p. 5

In March 2009, IOSCO's Technical Committee produced a note called *International Cooperation in Oversight of Credit Rating Agencies*.[143] The note stated the following:

> "Given that CRAs played such a prominent role in the recent financial market crisis, many jurisdictions are now considering ways to regulate CRAs. However, as jurisdictions adopt regulations for the oversight of CRAs, the issue of regulatory fragmentation becomes a concern for CRAs, investors and regulators. Because the IOSCO CRA Code is viewed as the international consensus regarding the regulatory issues stemming from the activities of CRAs and the processes by which CRAs develop credit ratings, the IOSCO CRA Code can serve (and is serving) as a template for regulation of CRAs."[144]

After it was clear that rating agencies would be subject to direct regulatory regimes, the Technical Committee focused on ensuring that regulatory regimes were effectively coordinated. IOSCO's Technical Committee promoted the use of IOSCO's *Code of Conduct* and *IOSCO's Principles for CRAs* to form the basis of national regulatory frameworks. IOSCO promoted cooperation between its members through the Standing Committee on Credit Rating Agencies, which was established in February 2009.[145] Within the new Standing Committee, as Commissioner Ellisse B. Walter of the U.S. SEC revealed, IOSCO members were investigating how they could "better coordinate their oversight efforts, given that the largest CRAs operate in multiple jurisdictions and frequently use analysts and resources based in different offices when making a rating, and how IOSCO can facilitate this coordination and information sharing."[146] Through the Technical Committee, IOSCO's members were kept aware of developments in the major regulatory reform processes in the U.S., E.U, Australia, Japan and Brazil.

In February 2011, IOSCO produced a report titled, *Regulatory Implementation of the Statement of Principles Regarding the Activities of Credit Rating Agencies*. The report discussed regulatory

[143] Technical Committee of IOSCO, 2009b
[144] Ibid., p. 3
[145] Ibid., p 5
[146] Walter 2009

implementation of the four objectives of rating agency regulation that IOSCO's 2003 *Principles for CRAs* had identified.[147] The report stated that securities regulators recognized that formal regulatory oversight of rating agencies was needed to supplement IOSCO's *Code of Conduct*.[148] The report reviews regulatory reforms after the crisis in many jurisdictions including the U.S., E.U., Japan, Mexico and Australia, and concludes by stating the following: "Despite the differences among the jurisdictions, however, in each jurisdiction reviewed, the IOSCO CRA Principles appear to be the building blocks upon which CRA regulatory programs have been constructed."[149] The report indicates that direct regulatory regimes for credit rating agencies in the jurisdictions assessed were created consistent with IOSCO's 2003 *Principles for CRAs*.

IOSCO's *Principles for CRAs* were strengthened after the 2008 financial crisis through the creation of direct regulatory regimes in systemically important jurisdictions. IOSCO's Technical Committee responded to shifts in the domestic political context of the U.S. and E.U. by promoting cooperation and coordination in the regulation of rating agencies. IOSCO's Technical Committee promoted regulatory coordination through IOSCO's newly established Standing Committee on Credit Rating Agencies and by encouraging countries to establish regulatory reforms that were consistent with IOSCO's *Principles for CRAs* and IOSCO's *Code of Conduct*.

## 5.6 Conclusion

This chapter analyzed the creation and strengthening of IOSCO's *Principles for CRAs* in September 2003 and IOSCO's *Code of Conduct* in December 2004. This chapter has demonstrated that IOSCO's international rating agency standards came about after the U.S. and E.U. chose to review the regulation of rating agencies. These international rating agency standards were created in order to promote the continued harmonization of national regulatory frameworks in the U.S. and E.U. IOSCO's Technical Committee believed it was in the interests of investors to maintain common regulatory regimes for rating agencies because it would ensure common assessments of creditworthiness across jurisdictions.

[147] Technical Committee of IOSCO 2011a, p. 1
[148] Ibid.
[149] Ibid., p. 38

IOSCO's Technical Committee responded to the regulatory review process in the U.S. and E.U. by working together at the transnational level to create common regulatory principles for rating agencies.

IOSCO's *Code of Conduct* was created in December 2004 to establish a common regulatory regime for rating agencies that took account of domestic political constraints in the U.S. and E.U. IOSCO's *Code of Conduct* established an internationally consistent regulatory regime that addressed the core regulatory issues cited in the U.S. and E.U. review process and the regulatory issues identified by IOSCO's *Principles for CRAs*. IOSCO's *Code of Conduct* filled the regulatory void left by the U.S. and E.U.'s decision not to regulate rating agencies around 2004.

The creation of IOSCO's *Principles for CRAs* and IOSCO's *Code of Conduct* is explained by a domestic politics and transgovernmental network perspective. The creation of IOSCO's international credit rating agency standards is explained by a domestic politics perspective because their creation was contingent on shifts in the policy preferences of domestic legislatures. Furthermore, IOSCO's Technical Committee created international credit rating agency standards after domestic legislatures indicated that they sought to improve the regulation of rating agencies. The U.S. sought to improve the regulation of rating agencies after the politicization of rating agencies after the collapse of Enron and WorldCom in 2001 and 2002 respectively. At the same time, Congress indicated that they were unwilling to directly regulate rating agencies due to domestic political and judicial constraints. The E.U. sought to improve the regulation of rating agencies in response to U.S. regulatory reforms, the collapse of Enron and WorldCom, the collapse of Parmalat in late-2003 and due to the lobbying efforts of Germany after rating agencies downgraded German state banks in late-2003. The E.U. also indicated that they were unwilling to regulate rating agencies directly.

The creation of IOSCO's international credit rating agency standards is also explained by a transgovernmental network perspective. IOSCO's Technical Committee created IOSCO's *Principles for CRAs* and IOSCO's *Code of Conduct* to promote the coordination of common regulatory frameworks for rating agencies. IOSCO's Technical Committee was motivated to promote the coordination of national regulatory frameworks because securities market

regulators believed that competing systems of rating agency regulation was not in the interests of protecting investors. Competing systems of regulation would create dual systems of assessing the creditworthiness of obligors. The influence of the transgovernmental network of securities market regulators is demonstrated by the E.U.'s adoption of IOSCO's *Code of Conduct* as the basis for regulating rating agencies from 2005.

The political dynamics of the creation of international credit rating agency standards is consistent with a PA analytical framework. The creation of international credit rating agency standards was contingent on domestic legislatures decision to favor the regulation of rating agencies. Furthermore, IOSCO's international credit rating agency standards reflected the domestic political constraints of legislatures in dominant financial centers. Once domestic legislatures in the U.S. and E.U. indicated that improving the regulation of rating agencies was a domestic policy priority, domestic securities market regulators exercised their discretion and created an international regulatory standard that coordinated and established an internationally consistent regulatory framework for rating agencies.

The implementation of IOSCO's *Principles for CRAs* was strengthened by the decision of the U.S. and E.U. to create direct regulatory regimes for rating agencies. The U.S. created a direct regulatory regime in 2006 under the Credit Rating Agency Reform Act. The initial impetus for the act was to promote competition in the rating agency industry by removing the requirement that NRSROs be "nationally recognized". The bill was driven by the narrow domestic political preferences of two Pennsylvanian Congressmen, Rep. Fitzpatrick and Rep. Kanjorski. These Congressmen were acting in the interests of Egan Jones (a Pennsylvania-based rating agencies). The bill also included provisions to subject rating agencies to greater accountability, but the application of these rules were limited by continued Congressional resistance and the continued protection of rating agencies under First Amendment right protections. It took the 2007/2008 financial crisis to shift the U.S. domestic political context to support the creation of a comprehensive direct regulatory regime. Widespread reports of conflicts of interest and the systemic undervaluation of risk by ratings shifted the policy preferences of U.S. politicians and the U.S. judiciary to improve the accountability and oversight of rating agencies under the 2010 Dodd-Frank Act. The E.U. echoes the U.S.

domestic political context. It took the 2007/2008 financial crisis to shift E.U. domestic policy preferences in favor of the direct regulation of rating agencies.

The strengthened implementation of IOSCO's *Principles for CRAs* and IOSCO's *Code of Conduct* is explained by a domestic politics perspective. The creation of direct regulatory regimes was in response to domestic political imperatives. IOSCO's *Principles for CRAs* and IOSCO's *Code of Conduct* were strengthened by the creation of direct regulatory regimes for rating agencies in the U.S. and E.U. In the U.S., the creation of a direct regulatory regime was driven by the narrow political interests of two Pennsylvanian Congressmen. A comprehensive direct regulatory regime was driven by substantive shifts in the preferences of the U.S. domestic legislature and judiciary due to the centrality of rating agencies to the 2007/2008 financial crisis. The E.U. chose to regulate rating agencies after it became apparent that rating agencies were central actors in the build up of systemic risk in the global financial system.

# Chapter 6

# The Creation of IOSCO's Hedge Fund Standards

## 6.1 Introduction

This chapter analyzes the creation of IOSCO's *Principles for Hedge Funds* in June 2009 and IOSCO's *Systemic Risk Data Requirements for Hedge Funds* in February 2010. The creation of IOSCO's international hedge fund standards was made possible by shifts in the policy preferences of domestic legislatures in dominant financial centers after the 2007/2008 financial crisis.

Before the 2007/2008 financial crisis, the majority of IOSCO's Technical Committee either regulated or sought to regulate hedge funds. IOSCO's Technical Committee members were responding to the increased exposure of retail investors to hedge funds, known as the 'retailization' of hedge fund investment. IOSCO's Technical Committee was unable to establish international hedge fund standards because domestic legislatures in dominant hedge fund jurisdictions were unwilling to directly regulate hedge funds. The U.S. SEC sought to require hedge fund advisers to be registered, but was unable to under existing statutory authority and Congress was unwilling to grant securities regulators the statutory authority to do so. The U.S. SEC's failure to gain domestic statutory authority and the U.K. Financial Services Authority's (FSA's) opposition to hedge fund regulation meant that IOSCO's Technical Committee was restricted to creating reports and regulatory principles that related to investment funds that securities regulators had pre-existing statutory authority to regulate including: a report titled *Regulatory and Investor Protection Issues Arising from the Participation by Retail investors in (Funds-of) Hedge Funds*,[1] *Principles for the Valuation of Hedge Fund Portfolios*,[2] and a report titled *The Regulatory Environment for Hedge Funds: A Survey and Comparison*, which

[1] Technical Committee of IOSCO, 2003a
[2] Technical Committee of IOSCO 2007

analyzed the current regulatory environment of hedge funds in different jurisdictions.[3] The failure of IOSCO's Technical Committee to create international financial standards for hedge funds before the crisis demonstrates the exercise of control by domestic legislatures.

IOSCO's *Principles for Hedge Funds* and *Systemic Risk Data Requirements for Hedge Funds* were created after domestic legislatures in the U.S. and E.U. indicated that they were willing to subject hedge funds to direct regulation in the wake of the 2007/2008 financial crisis. The U.S. was willing to regulate hedge funds after the crisis because of the symbolism of Bear Stearns' hedge funds triggering the financial crisis in 2007, the highly publicized arrest of Bernie Madoff and Madoff's hedge fund-based Ponzi scheme, and because of a shift in the domestic balance of power in favor of institutional investor groups over the alternative investment fund industry.[4] The E.U. was willing to regulate hedge funds, and expend significant political capital to subject the U.K. hedge fund industry to E.U. regulation, because a growing coalition of European states favored the direct regulation of hedge funds in the wake of the crisis.

IOSCO's Technical Committee, through IOSCO's Task Force on Unregulated Entities, created IOSCO's *Principles for Hedge Funds* and IOSCO's *Systemic Risk Data Requirements for Hedge Funds* to coordinate national regulatory frameworks before the upcoming legislative and rule-making process. IOSCO's *Principles for Hedge Funds* agreed to require hedge funds or hedge fund managers to register with the national regulator and subject hedge funds or hedge fund managers to ongoing supervisory requirements including conflict of interest and business conduct rules, disclosure to investors, and prudential regulation. IOSCO's Task Force on Unregulated Entities also took the opportunity to identify common regulatory requirements that were necessary to effectively regulate hedge funds. IOSCO's *Systemic Risk Data Requirements for Hedge Funds* was created to identify common data requirements that would enable regulators to monitor the systemic risk posed by hedge funds and hedge fund managers. The common data requirements were intended to assist regulators when cooperating with foreign regulators in monitoring globally active hedge funds. After the creation of IOSCO's *Principles for Hedge Funds* and IOSCO's *Systemic Risk Data Requirements for*

[3] Technical Committee of IOSCO 2006
[4] Helleiner and Pagliari 2010; Fioretos 2010; Quaglia 2011

*Hedge Funds*, U.S. and E.U. incorporated the recommendations from IOSCO's Task Force on Unregulated Entities in their respective legislative and rulemaking process. IOSCO's *Principles for Hedge Funds* and IOSCO's *Systemic Risk Data Requirements for Hedge Funds* coordinated the aspects of the U.S. and E.U.'s legislative frameworks for hedge funds that were necessary to enable regulators to fulfill their domestic regulatory responsibilities.

The E.U.'s legislative process resulted in the creation of a regionally differentiated regulatory regime for hedge funds, which many consider to be discriminatory to U.S.-based hedge funds. The regime also establishes higher regulatory requirements for E.U. hedge fund managers and foreign hedge fund managers marketing to E.U. investors. The E.U.'s hedge fund regime acts against the interests of U.S. hedge fund managers, E.U. hedge fund managers, and the profitability and competitiveness of the E.U. hedge fund industry. It does not threaten the ability of domestic securities regulators' ability to fulfill their domestic regulatory responsibilities because securities regulators are able to monitor the systemic risk posed by hedge funds through information sharing regimes and common reporting requirements. This exemplifies a case what Helleiner and Pagliari call "cooperative decentralization".[5] The creation of a regionally distinct regulatory regime highlights the different roles, and sources of influence, of domestic legislatures and the transgovernmental network of securities market regulators.

The creation of IOSCO's *Principles for Hedge Funds* and IOSCO's *Systemic Risk Data Requirements* is explained by both a domestic politics and transgovernmental network perspective. The creation of IOSCO's international hedge fund standards was contingent on shifts in the policy preferences of domestic legislatures in dominant financial centers. IOSCO's Technical Committee only created international regulatory principles once domestic legislatures had indicated that they were willing to regulate hedge funds after the 2007/2008 financial crisis. IOSCO was unable to establish international hedge fund standards before the crisis because domestic legislatures from dominant hedge fund jurisdictions were unwilling to subject hedge funds to a direct regulatory regime. In the U.S., this was in spite of the U.S. SEC's preference for regulating hedge funds due to the increased exposure of retail investors to hedge fund investment. Globally, a majority of securities

[5] Helleiner and Pagliari 2010, p. 193; Helleiner *Forthcoming*

regulators favored the direct regulation of hedge funds. It took the 2007/2008 financial crisis to shift the policy preferences of U.S. and E.U. domestic legislatures due to the politicization and highly public role of hedge funds in the financial crisis.

IOSCO's international hedge fund standards are also explained by a transgovernmental network perspective. Technical Committee exercised their discretion in creating international regulatory principles. Through the Task Force on Unregulated Entities, national securities market regulators identified common regulatory principles that were incorporated in national regulatory frameworks that would enable them to effectively regulate globally active hedge funds. Common disclosure and information requirements would enable regulators to more effectively monitor hedge funds and facilitate information exchange between national securities market regulators.

This is consistent with a PA analytical framework. Domestic legislatures exercise control over securities market regulators by withholding and creating new forms of statutory authority, thereby restricting outcomes at IOSCO's Technical Committee. As demonstrated in the case of the E.U.'s regulatory framework for hedge funds this may result in different legislative frameworks as domestic politicians respond to domestic political imperatives. When domestic legislatures delegate domestic securities market regulators new forms of statutory authority, securities market regulators exercise their discretion to create new international financial standards to coordinate national regulatory frameworks to enable securities market regulators to more effectively fulfill their domestic regulatory responsibilities.

## 6.2 International Hedge Fund Regulation: 1998 - 2001

Hedge fund regulation drew the attention of world economic leaders, policy makers and regulators in the wake of the 1997 Asian Financial Crisis and a year later in 1998 after the collapse of Long Term Capital Management (LTCM). In response to the Asian Financial Crisis, the G7 and the IMF concluded that hedge funds were not a central actor in the Asian Financial Crisis and that the central problem was East Asia's mismanaged currencies and economies. The issue re-emerged a year later in the U.S. when the CFTC sought to regulate

OTC derivative markets and require hedge funds to disclose their positions. Six months later, the CFTC's concerns were realized when LTCM collapsed in September 1998.

Following LTCM's collapse, policymakers and regulators recommended improvements to counterparty risk management by hedge funds and regulated firms. Regulators also recommended that hedge funds improve disclosure practices to allow regulators to identify the systemic risk they posed to regulated firms. Despite the recommendations of domestic regulators and the conclusions of international standard setting bodies, Congress failed to pass legislation to require greater disclosure practices by hedge funds. Hedge funds, banks and securities firms effectively responded to the concerns of regulators and Congress by establishing self-regulatory regimes. This succeeded in holding off direct regulatory regimes. As a result, the international regulatory landscape reflected the policy preferences of the U.S. domestic legislature and the domestic balance of power.

*6.2.1 The East Asian Financial Crisis, the CFTC's Concept Release and the Collapse of LTCM*

World leaders and policymakers began investigating the regulation of hedge funds in the wake of the 1997/1998 Asian Financial Crisis and the collapse of LTCM in the U.S. After the Asian Financial Crisis, East Asian leaders, other policymakers from the developing world, France and Germany, all began lobbying for the creation of direct regulatory regimes for hedge funds.[6] East Asian governments blamed the collapse of their domestic currencies squarely at hedge funds. In response to pressure from East Asian countries, the IMF produced a report titled *Hedge Funds and Financial Market Dynamics*. The report concluded the following: "the analysis…does not suggest a strong case for supervisory and regulatory measures such as these targeted specifically at hedge funds."[7] As Pagliari discusses, the IMF's interpretation of hedge funds' role in the crisis reflected the preferences of the U.S., where the largest hedge fund industry is domiciled. The U.S. and other industrialized countries concluded that the issue wasn't with hedge funds but the economic and financial supervisory policies of East Asian Economies.[8]

[6] Fioretos 2010, p. 708; also see Barry Eichengreen 2003
[7] Cited in Stefano Pagliari 2013; Eichengreen et al 1998, p. 4
[8] Stefano Pagliari 2013, p. 229 citing Eichengreen 2003

In the U.S., proposals for hedge fund regulation emerged when the U.S.' CFTC issued a Concept Release on 7 May 1998. The concept release was aimed at exploring ways to improve management controls of hedge fund lenders, appropriate oversight mechanisms for OTC derivatives markets, and disclosure mechanisms that would provide greater transparency to the positions of hedge funds in derivatives markets.[9] The CFTC's proposal to create regulation for OTC derivatives markets was famously pioneered by CFTC Chairperson Brooksley Born and was infamously crushed by Federal Reserve Chairman Alan Greenspan, the U.S. Treasury's Larry Summers,[10] and the U.S. SEC's Arthur Levitt.[11] Larry Summers' testimony to the Senate Committee on Agriculture, Nutrition and Forestry in July 1998 argued that the CFTC didn't have the statutory authority to introduce these rules.[12]

Four months after the CFTC's concept release, the concerns of CFTC and CFTC Chairperson Brooksley Born came true when the U.S.-based hedge fund, LTCM, collapsed in September 1998. This caused U.S. policymakers to begin investigating the regulation of hedge funds. The U.S. President's Working Group (PWG) was requested to investigate the regulatory issues posed by hedge funds after the collapse of LTCM.[13] The PWG was a multi-agency taskforce that included the Treasury Department, the Board of Governors of the Federal Reserve System, the U.S. SEC, and the CFTC. During the drafting of the report, Brooksley Born announced her intention not to be nominated for a second term as Chairperson of the U.S. CFTC.[14] After clearing any resistance from the U.S. CFTC, the PWG produced its report in April 1999.

The PWG's report concluded that LTCM's collapse was due to LTCM's failure to manage counterparty risk and not due to the use of trading strategies common to the hedge fund industry.[15] This led the PWG to recommend that the hedge fund industry review and reform internal risk and counterparty risk management practices. The report noted that banking

[9] U.S. Commodities and Futures Trading Commission 1998
[10] Summers 1998; see PBS 2009
[11] Levitt 1998; also see PBS 2009
[12] Summers 1998. The harsh response to Brooksely Born's efforts to further regulate OTC derivatives markets is well documented, as was the efforts of senior Clinton Administration officials and other financial regulators to push Brooksley Born out from the CFTC. See PBS 2009
[13] President's Working Group on Financial Markets 1999
[14] U.S. Commodities and Futures Trading Commission 1999
[15] President's Working Group on Financial Markets 1999

regulators had issued guidance to address banks' funding and counterparty risk exposure to hedge funds.[16] The U.S. SEC had issued a non-public report to broker-dealers "addressing the strengths and weaknesses of their particular credit risk management, structure, credit control procedures, and implementation of credit and other policies."[17] The PWG report also states the following: "currently, the scope and timeliness of information made available about the financial activities of hedge funds are limited. Hedge funds should be required to disclose additional, and more up-to-date, information to the public."[18]

The United States and United Kingdom then approved an international study of the risks posed by Highly Leveraged Institutions (HLIs) and potential policy recommendations by the FSF. The FSF's report was released in April 2000 and provided three policy recommendations:

1. Hedge funds should review and reform their counterparty risk management and ensure they are in line with internationally promulgated standards by IOSCO and the BCBS

2. Regulators should improve the quality and quantity of disclosure practices by ensuring that the exposure of regulated funds and public companies to HLIs be adequately disclosed;

3. Regulators should enhance oversight of investment funds providing credit to hedge funds in order to mitigate the systemic risk HLIs posed to the wider financial system.[19]

The FSF's report echoed the policy recommendations of the PWG report. The FSF's report endorsed internal self-regulatory responses by HLIs to address the issues raised by the collapse of LTCM and a review of the regulatory environment of regulated firms' exposure to HLIs. The BCBS produced a report in January 1999 that reviewed "deficiencies identified

[16] Ibid.
[17] Ibid., p. 35 – 36
[18] Ibid., p. 32
[19] Financial Stability Forum 2000

in the internal controls and risk management practices of the banks that were counterparties to LTCM."[20] The Basel Committee's report identified ways in which banks could improve its risk management practices "when dealing with HLIs as counterparties."[21] As Pagliari highlights, France and Germany, long-time supporters of hedge fund regulation,[22] had proposed the creation of a central information repository on banks' exposure to hedge funds. The proposal was rejected by the FSF.[23]

IOSCO's Technical Committee's response to the issues raised by the collapse of LTCM was to create a special taskforce addressing the regulatory issues posed by HLIs. The special taskforce produced a single report in November 1999 called, *Hedge Funds and Other Highly Leveraged Institutions*.[24] The report highlighted the existing work of the PWG, the FSF, and the BCBS' January 1999 report analyzing bank interactions with HLIs.[25] Mirroring the work of existing domestic and international regulatory reports, IOSCO's report on hedge fund regulation focused its analysis on the "exposure of organized markets."[26] The report states the following: "the overall risk exposures of market participants, such as HLIs, can adversely affect the ability of such participants to meet their obligations to their counterparties. If large enough, these risks may adversely affect the market itself."[27] The report, therefore, encouraged securities supervisors to review prudential risk management measures across the whole regulated sector.[28] The report also encouraged improved disclosure by HLIs but noted that regulators faced difficulties in improving disclosure practices. Disclosure requirements were established for public companies but hedge funds were private entities. Because hedge funds were private entities, there were some unique legal and regulatory barriers to establishing disclosure requirements for the hedge fund industry. IOSCO's report drew the same conclusions as existing reports by the U.S.' PWG, the FSF and work by the BCBS. IOSCO's report also reflected the policy preferences of the U.S. and U.K.

[20] Technical Committee of IOSCO 1999, p. 1
[21] Technical Committee of IOSCO 1999, p. 1
[22] See Fioretos 2010
[23] Stefano Pagliari 2013, p. 233
[24] Technical Committee of IOSCO 1999
[25] Ibid.
[26] Ibid., p. 8
[27] Ibid., p. 8
[28] Ibid., p. 37

Despite the recommendations of the PWG, the FSF and IOSCO, that domestic legislatures should improve disclosure practices by HLIs or hedge funds, efforts to improve disclosure practices were defeated by Congress. Two bills were introduced in 1999. The *Hedge Fund Disclosure Act* was introduced by Rep. Richard Baker and the *Derivatives Market Reform Act* was introduced by Congressman Edward Markey. Both bills were never passed during the 106th Congress.[29] As Pagliari identifies, the defeat of derivatives disclosure bills was assisted by the private self-regulatory initiatives of the hedge fund and wider financial industry. The financial industry effectively responded to regulators and policymakers' concerns about limitations to their current counterparty risk model by establishing the Counterparty Risk Management Policy Group (CRMPG), comprised of twelve major banks and securities firms.[30] IOSCO's Technical Committee was critical of CRMPG's concerns about the PWG's recommendation that HLIs be subject to stronger disclosure requirements.[31] The private financial sector also participated in the *Multidisciplinary Working Group on Enhanced Disclosure* and worked towards establishing a voluntary framework for hedge funds to improve disclosure.[32] These self-regulatory regimes helped to stave off new statutory powers to require hedge funds to disclose information about their positions and counterparty risk exposures to domestic regulators.

After the Asian Financial Crisis and the collapse of LTCM, the recommendations of the FSF, BCBS and IOSCO reflected the recommendations of the U.S.' PWG. The main focus of these reports was on improving counterparty risk management by regulated banks and securities firms. After the PWG endorsed improved disclosure practices by HLIs or hedge funds, IOSCO also endorsed this effort. However, due to the effective self-regulatory response by banks and hedge funds through the CRMPG and *Multidisciplinary Working Group on Enhanced Disclosure,* hedge funds managed to evade direct regulation and statutory disclosure requirements. IOSCO fell silent on the issue for two years until 2001.

[29] Stefano Pagliari 2013, p. 236 citing Robotti, 2007
[30] Technical Committee of IOSCO, 1999, p. 2
[31] Technical Committee of IOSCO 1999, p. 23 – 24
[32] Pagliari 2013, p. 236 citing Robotti, 2006; Eichengreen 2003

## 6.3 The Re-Emergence of Hedge Fund Regulatory Reform: 2001 – 2008

Hedge fund regulatory reform re-emerged in 2001 due to two key issues: terrorist financing and the "retailization" of hedge fund investment. September 11 and concerns over terrorist financing meant hedge funds were subject to greater scrutiny. However, it was the "retailization" of hedge fund investment that caused the U.S. SEC and IOSCO to investigate the issue of hedge fund regulation. During this period, the U.S. SEC sought the authority to require hedge funds to be registered to improve regulatory oversight. Congress was unwilling to grant them clear statutory authority and the U.S. Court of Appeals struck their efforts down. In the U.K., the FSA sought to expand retail investors' exposure to hedge funds rather than limit them. Because domestic legislatures were unwilling to grant regulators the statutory authority to regulate hedge funds, IOSCO was limited to producing reports on the exposure of retail investors to hedge funds, and a survey of hedge fund regulation in the jurisdictions of IOSCO members. This time period highlights the role and exercise of control of domestic legislatures over the preferences of securities regulators in IOSCO's Technical Committee.

### *6.3.1 U.S. and U.K. Hedge Fund Regulatory Preferences: 2001 – 2008*

Hedge funds returned to the front of policymakers' minds in the wake of the September 11 terrorist attacks and the issue of terrorist financing. The 2001 Patriot Act aimed to reduce the use of financial institutions for the purposes of terrorist financing and money laundering. This goal subjected hedge funds to further regulatory scrutiny. All financial institutions, including hedge funds, were required to maintain accurate identification records of investors and report any suspicious activity. The Patriot Act strengthened the U.S. SEC's market surveillance powers and helped to protect against financial crime and fraud in the hedge fund industry, which was previously subject to little regulatory oversight.[33]

Hedge fund regulation also returned to the spotlight from 2001 onwards due to the "retailization" of hedge funds. The "retailization" of hedge funds refers to the increased exposure of retail investor funds, or Collective Investment Schemes (CIS) as they are known, to hedge funds. CIS' investment in hedge funds rose from around US$100 billion to around

[33] Santangelo 2012

US$600 billion in 2007 and hedge funds' assets under management rose from around US$600 billion to around US$1500 billion.[34] Some regulators were concerned that hedge fund investors were no longer restricted to high net worth individuals but included pension funds, small investors and institutional investors.

The U.S. SEC responded to the changing dynamics in the hedge fund industry by proposing a Final Rule in December 2004 that would overturn an existing loophole in the 1940 Investment Advisers Act, enabling hedge fund managers to escape registration with the U.S. SEC.[35] The rule would require hedge fund managers, not hedge funds, to register with the U.S. SEC. The hedge fund industry was outraged by the U.S. SEC's effort to subject hedge fund managers to registration requirements. In response, Bulldog Investors, led by Philip Goldstein, challenged the statutory authority of the U.S. SEC and their right to require the registration of hedge fund managers. Judge Randolph, from the U.S. Court of Appeals, struck down the U.S. SEC's hedge fund registration powers in June 2006, citing the U.S. SEC's lack of statutory authority in the decision.[36]

In 2007, the U.S.' PWG requested two private sector committees, the Asset Managers' Committee and Investors' Committee, to produce a report providing a set of recommendations focusing on disclosure, valuation, risk management, operations and business practices and conflict of interest issues for hedge funds. The report was released in January 2009 after the crisis. The private sector committees created non-binding recommendations for the industry to emulate in these policy issue areas.[37] Despite the U.S. SEC's concerns, the U.S. continued to favor the use of private self-regulatory regimes to govern hedge funds. The absence of clear Congressional statutory authority on the issue meant hedge funds remained unregulated before the crisis.

In contrast to the U.S., U.K. hedge fund managers were registered under the 1986 Financial Services Act. Hedge funds themselves were not regulated under existing legislation. Hedge

[34] Authorité des Marchés Financiers 2007, p. 7
[35] U.S. Securities and Exchange Commission 2004a
[36] Fioretos 2010, p. 708; also see Rappeport 2007; For a summary of the case and judgment see U.S. Court of Appeals for the District of Columbia 2006
[37] Morphy 2009

fund managers, however, were not subject to ongoing prudential supervisory requirements regarding the current exposure or systemic risk posed by hedge funds. Rather than expressing concerns about the "retailization" of hedge fund investment, the U.K. FSA was more interested in allowing retail investors to have greater exposure to hedge funds. In March 2007, the U.K. FSA proposed to bring alternative investment funds under the category of well-regulated collective investment funds, thus allowing investments to increase from 20 – 100% of assets under management.[38] The plan was delayed due to complications surrounding tax treatment of funds of hedge funds.[39] The plan was scrapped as the financial crisis began and as details of the Bernie Madoff fraud scandal became public.[40]

From 2001, hedge fund regulatory reform re-emerged as an issue for policymakers due to the "retailization" of hedge funds; the exposure of retail investors to the risk posed by highly leveraged hedge funds. The U.S. SEC moved to require hedge funds to register with the U.S. SEC but was defeated by the U.S. Court of Appeals' Judge Randolph. Congress and the PWG continued to favor the use of indirect self-regulatory initiatives to regulate hedge funds and the exposure of retail investors to hedge funds. In the U.K., both the U.K. FSA and the U.K. Parliament showed no interest in strengthening regulatory oversight of hedge funds. The U.K. FSA sought to allow retail investors to increase their exposure to hedge funds. Members of the alternative asset management industry effectively responded to the concerns of regulators and policymakers by establishing industry standards that covered most aspects of hedge fund management and operations.[41]

### *6.3.2 IOSCO's Pre-Crisis Hedge Fund Regulatory Reports and Principles*

IOSCO began conducting research into the regulatory environment of hedge funds and retail investors' exposure to hedge funds in the early 2000s. In 2001, IOSCO established a special taskforce and produced its first report in 2003, titled *Regulatory and Investor Protection Issues Arising from the Participation by Retail investors in (Funds-of) Hedge Funds.* The 2003 report analyzed the emerging regulatory issues created by increased retail participation in hedge

[38] U.K. Financial Services Authority 2007a
[39] U.K. Financial Services Authority 2007b
[40] U.K. Financial Services Authority 2010
[41] See Hedge Fund Matrix 2012

funds.[42] The report questioned whether the risks posed by CIS funds' investment in hedge funds necessitated tighter regulation including the regulation and authorization of hedge funds and their managers.[43] IOSCO stated that it was crucial that hedge funds adequately disclosed their trading strategies and practices so that investors would be aware if their fund's investment in hedge funds met their investing needs. The report went on to identify further risks including the valuation of hedge fund portfolios and liquidity risks posed by investment in hedge funds due to the lock-in period that hedge funds routinely utilize to enable them to execute their trading strategies.[44] IOSCO's report was not taken further and did not result in regulatory principles.

In 2005, IOSCO's Standing Committee on Investment Funds or Standing Committee 5 (SC5) to update the 2003 report by producing a report that mapped the regulatory approaches of taken by the different members of IOSCO's SC5 to the regulation of hedge funds.[45] The report, *The Regulatory Environment for Hedge Funds: A Survey and Comparison*, highlights that the regulatory approaches of different jurisdictions to the regulation of hedge funds is highly differentiated. The survey does establish that the majority of SC5 members have mandatory registration requirements for hedge fund managers. The notable exception is the U.S. SEC and the U.K. FSA. Furthermore, hedge fund managers are subject to ongoing regulatory requirements including disclosure requirements, organizational and operational standards, and conflict of interest and other conduct of business rules. Finally, national regulators have established valuation requirements for funds of hedge funds.[46]

The survey noted concerns over the valuation and pricing of hedge funds causing IOSCO to publish a report and regulatory recommendations on this topic in November 2007.[47] The report, *Principles for the Valuation of Hedge Fund Portfolios,* recommended that internal governance systems be established to protect against the impact of conflicts of interest on accurate pricing models and that appropriate pricing mechanisms be established for complex

[42] Technical Committee of IOSCO 2003a
[43] Ibid.
[44] Ibid.
[45] Technical Committee of IOSCO 2006, p. 1
[46] Ibid.
[47] Technical Committee of IOSCO 2007

instruments.[48] This report was aimed at the hedge fund industry with the hope that, in the absence of meaningful regulation in the U.S. and U.K., its recommendations were heeded and emulated either in practice or through industry standards. IOSCO would later take part in an industry standards project in November 2008 with the launch of the *Hedge Fund Matrix* that listed all of the existing industry standards for each relevant issue area.[49] IOSCO's final report on funds of hedge funds also identifies the liquidity risk posed by maturity mismatches between hedge funds and the underlying funds due to their differing redemption rights.[50]

IOSCO's reports on hedge funds pushed the boundaries of the statutory authority of securities regulators in the U.S. and U.K. The 2003 report questioned whether it was necessary to regulate hedge funds and their managers in the light of the risk they posed to retail investors. In spite of questioning whether it was necessary, IOSCO restricted its international securities standards for hedge funds to the valuation of hedge fund portfolios for CIS. IOSCO's standards were restricted to financial firms that securities regulators in the U.S. and U.K. were responsible for regulating. The U.S. SEC sought authority for hedge funds but Congress was unwilling to grant it the statutory authority to do so. Furthermore, the U.K. Parliament and U.K. FSA were unwilling to regulate hedge funds. This highlights the exercise of control by domestic legislatures over outcomes at IOSCO.

### 6.4 Hedge Fund Regulation After the Crisis

During the 2007/2008 financial crisis, the policy preferences of the U.S. and E.U. shifted in favor of directly regulating hedge fund managers. The U.S. and E.U.'s shift in policy preferences culminated in the G20's announcement on April 2nd, 2009 in a communiqué that stated the following:

> "hedge funds or their managers will be registered and will be required to disclose appropriate information on an ongoing basis to supervisors or regulators, including information on their leverage and information necessary

[48] Ibid.
[49] Stefano Pagliari 2011; also see Hedge Fund Matrix 2012
[50] Technical Committee of IOSCO 2008c

> for an assessment of the systemic risks that they pose individually or collectively… They will be subject to oversight to ensure that they have adequate risk management."[51]

The G20's endorsement of direct regulation for hedge funds indicates that the policy preferences of the U.S. and E.U. had shifted after the 2007/2008 financial crisis in favor of the direct regulation of hedge funds. In response, IOSCO's Technical Committee produced its *Principles for Hedge Funds* two months later in June 2009 and IOSCO's *Systemic Risk Data Requirements for Hedge Funds* in February 2010. These principles were created to establish common regulatory principles and to inform regulators' approach to the upcoming legislative and rule-making process.

### *6.4.1 The U.S.' Preference for the Direct Regulation of Hedge Funds*

The U.S. was now willing to subject hedge funds to direct regulatory regimes because the domestic context and, subsequently, domestic policy preferences had changed. Hedge funds became politicized due to the symbolism of Bear Stearns' hedge funds triggering the financial crisis in 2007 and because of Bernie Madoff's hedge fund-based Ponzi scheme's that collapsed in late 2008. The domestic political context had also shifted to favor institutional investment firms over the alternative investment industry.

Regulatory reforms were successfully established in the United States due to the politicization of hedge funds during the crisis. The beginning of the crisis is associated with the collapse of two hedge funds managed by Bear Stearns. Hedge funds were further politicized once details of Bernie Madoff's Ponzi scheme entered the public consciousness and became symbolic of the public's perception of Wall Street excess. Congress began legislating hedge fund reform after the arrest of Bernie Madoff.[52] Members of Congress who had raised concerns about hedge fund regulation before the crisis noted how the domestic political context had substantively changed as a result of the crisis. As Senator Grassley explains, "There wasn't much of an appetite for this sort of legislation before the financial

[51] G20 2009
[52] Pagliari 2013, p. 264

crisis. I hope attitudes have changed and that Congress takes up this important legislation without delay."[53]

The U.S.' preference for the direct regulation was also caused by the increased political influence of institutional investors at the expense of the hedge fund and investment bank industry.[54] Powerful institutional investors such as CalPERS sought the full and effective implementation of U.S. financial regulatory reforms to increase the transparency of financial markets. This would enable regulators to better identify emerging risks and preserve regulatory independence.[55] Institutional investors were well positioned to take a dominant position in the post-crisis regulatory reform process because they represented the interests of a majority of household investors who suffered from the mismanagement of risk by hedge funds and investment banks, which directly led to the crisis and the loss of household savings. Changing domestic political dynamics empowered the U.S. SEC within the PWG as they had a pre-existing regulatory framework that could be applied to address the perceived regulatory shortfalls of the existing regime. The new domestic political context enabled the U.S. SEC to realize their pre-crisis policy preferences for the regulation of hedge funds.[56] This shift in the policy preferences of domestic legislatures culminated in the Obama Administration drafting legislation that required hedge funds to be registered with the U.S. SEC, which was delivered to Congress in July 2009. A final suite of legislation was passed in to law under the Dodd-Frank Act, which was passed in July 2010.

### *6.4.2 European Union Hedge Fund Reform*

In the E.U., France, Germany and a majority of E.U. members were now willing to expend political capital to ensure that the U.K.-based hedge fund industry was subject to direct market oversight and supervision. The U.K. relented, accepting hedge fund regulatory reform through the European Commission despite its protestations.

As Pagliari discusses, the E.U. Commission on Economic and Monetary Affairs and its Commissioner Charles McCreevy resisted early efforts to regulate hedge funds directly. As

[53] Grassley 2009
[54] Fioretos 2010, p. 703
[55] See calPERS 2013
[56] Fioretos 2010, p. 717

the crisis progressed, the European Parliament, led by the European Socialists, began lobbying for the regulation of hedge funds. In late 2008, Germany criticized the U.K. and U.S. for blocking Germany's efforts to improve the transparency and supervision of hedge funds before the crisis. France drew further attention to the issue stating in an October 2008 session to the European Council that, "no financial institution should escape regulation and supervision."[57] As the crisis unfolded, the European Parliament passed a measure that required the European Commission on Economic and Monetary Affairs to draft legislative proposals for the regulation of hedge funds. The measure was passed by a large majority of the European Parliament.[58]

The U.K. resisted efforts to regulate hedge funds before and during the financial crisis. The U.K. was forced to accept E.U.-wide hedge fund regulation in 2010 despite its resistance to what it considered to be draconian measures. The U.K. was defeated by the overwhelmingly pro-reform coalition within the E.U. The E.U.'s pro-reform coalition was strengthened by indications that the U.S. was willing to regulate hedge funds after the crisis. The Obama Administration was in the process of drafting legislation that would require hedge funds to be registered with the U.S. SEC in July 2009.[59] This facilitated the proposal of the Alternative Investment Fund Manager Directive (AIFMD) in April 2009,[60] the approval of the Directive in May 2010 and the passage of the legislation in June 2011.[61]

### *6.4.3 IOSCO's Principles for Hedge Fund Regulation and the Effective Coordination of U.S. and E.U. Rulemaking Processes*

IOSCO established a Task Force on Unregulated Financial Entities on November 24, 2008 "in order to support the initiatives undertaken by the G20 to… achieve needed reforms in the world's financial systems following the recent financial crisis."[62] IOSCO's Task Force on Unregulated Financial Entities produced two reports on Hedge Fund Oversight in 2009: a Consultation Document in March 2009[63] and a Final Report in June 2009. The final report

[57] Pagliari 2013, p. 250 citing Sarkozy 2008
[58] Pagliari, 2013, p. 248
[59] Price Waterhouse Coopers 2009
[60] European Parliament 2009, p. 5 – 6
[61] European Parliament 2011
[62] Technical Committee of IOSCO 2009c
[63] Ibid.

outlined IOSCO's *Principles for Hedge Funds*.[64] In February 2010, IOSCO's Technical Committee published *Systemic Risk Data Requirements for Hedge Funds*.[65] IOSCO's international hedge fund standards were created after it was clear that domestic legislatures in the U.S. and E.U. had indicated that they were willing to regulate hedge funds. IOSCO's international hedge fund standards were intended to outline common regulatory principles to be incorporated in the upcoming legislative and rulemaking processes.

IOSCO's 2009 Consultation Paper discusses the regulation of hedge funds and the threat that hedge funds pose for the stability of the global financial system in light of the 2007/2008 financial crisis. The report highlights that the risks posed by hedge funds are due to the lack of transparency, reporting and disclosure risks, compensation risks, leverage, market behavior and/or trading strategy risk.[66] The report states that in spite of the fact that hedge fund investors are often sophisticated high net worth investors, information asymmetry continues to be a problem and the lack of transparency increases the risk of market abuse and fraud.[67] The Task Force notes that the compensation structures of hedge funds can lead hedge fund managers to assume greater risks and inflate valuations of hedge fund portfolios, posing risks to the financial system and individual investors.[68]

The Task Force notes that leverage poses risk to financial stability by increasing losses to investors and lenders and by contributing to disorderly pricing of markets as funds rapidly unwind their positions.[69] Finally, the report states that hedge funds can cause market disruptions when large concentrations are forcibly unwound, and through settlement stresses caused by hedge funds' unwinding of large and complex positions.[70] Through these risks, hedge funds can have deleterious impacts on the global financial system contributing to the build-up of systemic risk and financial instability.

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[64] Technical Committee of IOSCO 2009a
[65] IOSCO 2010c
[66] Technical Committee of IOSCO 2009a, p. 10 – 20
[67] Technical Committee of IOSCO 2009c, p. 12
[68] Ibid., p. 14
[69] Ibid., p. 17
[70] Ibid., p. 19

These reports highlight a change in policy preferences in the wider policymaking community. preferences towards the direct regulation of hedge funds as institutions, rather than their investment managers. The report states,

> "[I]t seems that new trends towards a more direct regulatory oversight approach (addressed to the managers and the fund) are emerging in the international community. The recently issued G-30 Report recommends that — Managers of private pools of capital that employ substantial borrowed funds should be required to register with an appropriate national prudential regulator (....). The prudential regulator of such managers should have authority to require periodic regulatory reports and public disclosures of appropriate information regarding the size, investment style, borrowing, and performance of the funds under management." [71]

The report highlights that self-regulatory initiatives were not enough, noting that industry standards are not being applied thoroughly or consistently. The report states that 60% of hedge funds surveyed, in a November 2008 survey, supported the Hedge Fund Working Group's industry standards but that less than 10% were prepared to sign up to the standard.[72]

As a result of the March 2009 Consultation Document and the G20's endorsement of hedge fund regulation in April 2009, IOSCO produced a Final Report on the regulation of hedge funds in June 2009. IOSCO's Final Report establishes *Principles for Hedge Funds*. Those final six principles were:

1. Hedge funds and/or hedge fund managers/advisers should be subject to mandatory registration;

[71] Ibid., p. 22 citing G30 2009
[72] Technical Committee of IOSCO 2009c, p. 28 citing Kinetic Partners 2008

2. Hedge fund managers/advisers which are required to register should be subject to ongoing supervisory requirements;

    a. Organizational and operational standards;

    b. Conflicts of interest and other conduct of business rules;

    c. Disclosure to investors; and

    d. Prudential regulation

3. Funds of hedge funds be subject to mandatory registration and incorporate appropriate risk management practices;

4. Hedge fund managers/advisers should provide information to the relevant regulator information for systemic risk purposes;

5. Regulators take account of industry standards where relevant; and

6. Regulators should have the authority to cooperate and share information in order to facilitate efficient and effective oversight of globally active managers/advisers and/or funds to help identify systemic risks, market integrity and other risks arising from the activities or exposures of hedge funds.[73]

A majority of jurisdictions had already adopted or had committed to adopting Principles 1 - 5. As the 2005 survey of hedge fund regulation reveals, a majority of securities market regulators already required hedge fund managers and funds of hedge funds to be registered, and hedge fund managers and funds of hedge funds were subject to ongoing supervisory requirements.[74] The notable exception was the U.S. and U.K. However, the U.S. and E.U. had indicated that they were willing to require hedge funds and hedge fund managers to be

[73] Technical Committee of IOSCO 2009a
[74] Technical Committee of IOSCO 2006

registered and subject to ongoing supervisory requirements before June 2009. The final report notes that Congress was likely to "consider legislation in 2009."[75] As noted earlier, the E.U. had already proposed AIFMD in April 2009. After the 2007/2008 financial crisis, there was a consensus that hedge funds should provide information for systemic risk purposes as indicated by the G20's statement two months earlier.[76]

Members of IOSCO's Task Force on Unregulated Financial Entities took the opportunity to share their views on what national regulatory frameworks to govern hedge funds should incorporate and discussed how these principles could be implemented. For instance, the Task Force noted the registration requirements for hedge fund managers should be proportional and that *de minimis* exceptions be included in national regulatory frameworks.[77] *De minimis* exceptions were included in the final legislative framework of the U.S. and E.U. *De minimis* exceptions establish a level, determined by the size of assets under management, at which hedge funds are subject to regulation and registration requirements.

For instance, in the U.S., under amendments to the 1940 Private Investment Advisers under Section 403 of the Dodd-Frank Act, U.S. and foreign hedge fund managers were required to be registered with the U.S. SEC. The Private Investment Advisor Act required hedge fund managers to register with the U.S. SEC by eliminating the private adviser exemption. The Private Investment Advisers Act previously provided an exemption from registration with the SEC for any investment adviser who had fewer than 15 clients and is not considered to be an investment adviser to the general public. Each fund was previously counted as one "client". The Private Investment Advisers Act overturned this. One client related to a single investor. The Act required all U.S. investment advisers to private investment funds, with more than $150 million under management, to register with the U.S. SEC.[78] Foreign advisers were only exempt if they had no place of business in the U.S., retained fewer than 15 clients in the U.S., had less than $25 million assets under management attributable to U.S. clients, do not hold themselves out generally to the U.S. public as an investment adviser, and do not

[75] Technical Committee of IOSCO 2009a
[76] G20 2009
[77] Technical Committee of IOSCO 2009a
[78] Price Waterhouse Coopers 2009; Paul Hastings (*Law Firm*) 2009; Davis Polk (*Law Firm*) 2009

advise registered investment companies or registered business development companies.[79] By being subject to the Private Investment Advisers Act, U.S. hedge fund managers were required to prepare disclosure statements, appoint a Chief Compliance Officer, adopt a formal compliance program, adopt a written code of ethics, develop a books and records policy, ensure the compliance program is adequately resourced, and establish fundamental operating committees.[80]

Under the E.U.'s AIFMD, all alternative investment fund managers (AIFMs) will be required to register with a home national securities market authority within the E.U. The AIFMD provides a *de minimis* exemption for those funds with less than €100 million in funds or €500 million if Alternative Investment Funds (AIFs) are subject to a 5 year redemption limit and have no leverage.[81]

The report also identified what information should be disclosed to regulators as part of the registration process and what information should be included to enable regulators to assist in the monitoring of systemic risk.[82] This process was developed further and became a central focus in national regulators' development of national reporting standards for hedge funds. The process culminated in IOSCO publishing *Systemic Risk Data Requirements for Hedge Funds* in February 2010.[83] IOSCO's *Systemic Risk Data Requirements for Hedge Funds* identified common information and reporting requirements for hedge funds. Creating common information and reporting requirements for hedge fund was critical to securities regulators' ability to effectively monitor internationally active hedge funds and the systemic risk that hedge funds posed.

In the U.S., Section 404 of the Dodd-Frank Act requires hedge fund managers to disclose data to the U.S. SEC to assist the newly-established Financial Stability Oversight Council (FSOC) in their monitoring and assessment of systemic risk.[84] Hedge funds were required to disclose information to the U.S. SEC and FSOC through Form PF. This information was to

[79] DLA Piper (*Law Firm*) 2012
[80] Price Waterhouse Coopers 2009
[81] European Parliament 2009, p. 5 – 6
[82] Ibid.
[83] IOSCO, 2010c
[84] Paredes 2011 U.S. Securities and Exchange Commission 2012b; Champ, 2012

be kept confidential.[85] Large private fund advisers are required to provide more detailed information than smaller fund advisers. The U.S. SEC requires that large hedge fund advisers disclose aggregate information regarding their hedge funds, including exposures by asset class, geographical concentration of investments held by funds and the monthly value of portfolio turnover by asset class. Large private fund advisers that advise at least one "qualifying hedge fund" (a hedge fund with a net asset value of at least $500 million) must report certain information relating to that fund's exposures, leverage, risk profile and liquidity.[86] The U.S. SEC's Final Rule for Form PF states, the following:

> To this end, our staffs have consulted with the United Kingdom's [FSA], [ESMA], [IOSCO] and Hong Kong's [FSC]… IOSCO, in turn, used the guidelines established in the FSA survey [of hedge funds], together with its own report on hedge fund oversight, in coordinating a survey of hedge funds conducted by IOSCO's members (including the SEC and CFTC) as of the end of September 2010… Form PF includes many of the types of information collected through the FSA survey and proposed to be collected in the ESMA template, and a number of changes we are making from the proposal further align Form PF with these international approaches to private fund reporting.[87]

The U.S. SEC's final rules for private fund reporting highlight how the U.S., E.U. and Hong Kong had worked together to establish common reporting requirements and that IOSCO was an important institution within this process. Regulators were conscious that, because hedge funds are internationally active and are consistently engaged in cross-border investment, it was necessary to effectively coordinate their national regulatory frameworks. According to Jim Hamilton, Dan Waters of the U.K. FSA stated the following:

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[85] U.S. Securities and Exchange Commission 2011b

[86] U.S. Securities and Exchange Commission 2012b. Further disclosure requirements include unencumbered cash holdings, identification of the fund's base currency, collateral practices with significant counterparties, risk metrics, market risk, concentration of positions, and trading and financing for each such hedge fund. From Champ 2012

[87] U.S. Securities and Exchange Commission 2012b, p. 12 – 14

> "the global nature and cross-border reality of hedge fund and other market components must be kept in mind. There is a need to create a proportionate and effective regulatory approach that recognizes the global nature of the hedge fund industry and the practical realities of how alternative investment fund management, including its supporting services, inevitably involves cross-border markets and jurisdictions."[88]

Securities regulators were mindful of the importance of establishing effective forms of regulatory cooperation to monitor hedge funds.

In the E.U., the delegated regulation directive also states that the report should include an accurate "review of the activities of the AIF with a description of the principal risks and investments or economic uncertainties that it faces. That disclosure should not result in the publication of proprietary information of the AIF which would be to the detriment of the AIF and its investors."[89] The E.U.'s AIFMD seeks to calm early fears that E.U. disclosure requirements would force hedge fund managers to disclosure proprietary information. The U.S. SEC's Final Rule for Form PF also indicates that the E.U.'s information and reporting requirements were developed in concert with the U.S. SEC's rulemaking process.

### *6.4.4 E.U. Legislation and the Adoption of a Differentiated National Regulatory Framework*

Although securities regulators effectively coordinated their national regulatory frameworks in matters of common concern to securities regulators, there are a number of aspects to the E.U.'s regulatory framework for hedge funds (under AIFMD) that differs from the U.S.' legislative and regulatory framework.

First, the AIFMD requires AIFMs to disclose their use of leverage and empowers the Commission to set leverage limits restricting individual managers' leverage in exceptional circumstances.[90] Second, the E.U. AIFMD establishes capital adequacy requirements. Capital adequacy requirements are set at 25% of fixed overhead costs and €150,000 (or €300,000 for

[88] Hamilton 2010
[89] European Commission 2012c
[90] Ibid., p. 9

internally managed funds) plus 0.02% of the value of the fund that exceeds $250 million.[91] The AIFMD demands greater disclosure requirements of the hedge fund industry including the firm's investment strategy, risk management, and expenses.[92] The EU's AIFMD goes above and beyond the regulatory demands of the US' regulatory statutes and the U.S. SEC's final rules by granting securities regulators the authority to set leverage limits and by forcing AIFMs to disclose their investment strategy and expenses.

The most controversial aspect of the E.U. AIFMD is the extraterritorial application of E.U. law to non-E.U. fund managers marketing alternative investments funds in the E.U. In order for non-E.U. AIFMs to be accepted for private placement by ESMA (responsible for overseeing the implementation of the AIFMD), they must be subject to the regulatory authority of their home jurisdiction. That home jurisdiction must (a) have cooperation arrangements with the host jurisdiction of the AIFM, (b) have a cooperative tax information agreement in place with the member states into which the Alternative Investment Fund is to be marketed in line with article 26 of the OECD Model Tax Convention,[93] and (c) not be on the list of 'non-cooperative' countries on the FATF list regarding anti-money laundering or terrorist financing protections.[94] Alternative investment fund managers must be registered in a home jurisdiction by 21 July 2013. Whilst the U.S. has cooperation agreements with many of the E.U.'s jurisdictions, it had not agreed to a cooperative agreement with ESMA, as required under AIFMD, as of May 2013. Until the creation of a passport regime in 2013, non-EU alternative investment funds are required to fulfill the E.U.'s disclosure requirements.

This prompted the Alternative Investment Management Association CEO, a hedge fund industry and lobby group, Andrew Baker to state:

> "The proposed third country provisions do not appear to reflect advice the European Commission received from ESMA on implementing AIFMD. The Commission is contemplating a requirement that EU and

[91] Deloitte 2012
[92] Kamal 2012
[93] Organization for Economic Cooperation and Development 2012
[94] Gibson Dunn (*Law Firm*) 2010; Sciales, 2010

> non-EU regulators sign co-operation, agreements which are legally binding on both parties. These would be extremely problematic if not impossible to conclude if the Regulation prescribes that the cooperation agreements ensure that third country regulators enforce EU law in their territories. It could be extremely difficult for many regulators to be able to sign up to that."[95]

Consequently, in its current state, the E.U.'s mutual recognition regime demands regulatory equivalency between the home jurisdiction of the hedge fund and the E.U. E.U. hedge fund regulation is considered by most to be protectionist and will result in a loss of choice for E.U. investors.[96] The U.K.'s Treasury claimed a small victory in negotiating a measure "to ensure that managers of hedge funds and private equity providers will be regulated in an internationally consistent and non-discriminatory way, with third country fund managers able to qualify for a passport into the EU."[97] Despite the success of the U.K. in lobbying for a passport regime, E.U. regulation establishes a substantively different regulatory regime for hedge funds.

U.S.-based hedge fund managers are required to comply with E.U. transparency and disclosure requirements regarding trading strategies, expenses, remuneration, leverage and risk. U.S. hedge fund managers will also be required to report to ESMA and provide information on their current levels of leverage. The E.U.'s decision to establish a regional regulatory regime rather than a mutual recognition regime will force U.S.-based hedge funds and hedge managers to establish hedge funds for E.U. investors, rather than allowing them to market U.S.-based hedge funds to E.U. investors.

The E.U.'s differentiated financial regulatory framework for hedge funds highlights the role of domestic legislatures and limitations to the influence of securities market regulators. The E.U.'s regulatory requirements act against the interests of the mainly London-based European hedge fund industry, the interests of U.S.-based hedge funds, and the profitability of the hedge fund industry as a whole. The E.U.'s stronger regulatory requirements do not

[95] AIMA 2012
[96] Kamal 2012 Mikkelsen 2010
[97] HM Treasury 2011

affect the ability of domestic securities regulators to fulfill their domestic regulatory responsibilities.

It is unclear what the preferences of securities market regulators are. However, it is likely that U.S. securities regulators would have preferred common regulatory regimes that did not discriminate against U.S. hedge fund advisers. The U.K. FSA criticized the E.U.'s approach to the regulation of hedge funds. According to Hamilton, Dan Waters of the U.K. FSA stated that the "[E.U.] Directive must embrace a global approach that recognizes the cross-border nature of the hedge fund industry and does not restrict investor choice with unjustifiable geographic restrictions. At a hedge fund regulation forum, he called "misplaced" the Directive's restrictions on the delegation of management services, custody and depositary activity. He similarly scored the blanket prohibitions on the marketing of non-European funds to professional investors."[98] The E.U.'s decision to demand higher regulatory requirements of E.U. hedge funds and hedge fund managers and foreign hedge fund managers marketing hedge funds to E.U. investors was taken by domestic legislatures and was outside the sphere of control of securities market regulators. As indicated by the previous section, securities market regulators effectively coordinated the aspects of hedge fund regulation that would enable regulators to fulfill their domestic regulatory responsibilities under existing legislation.

As Helleiner and Pagliari discuss, the hedge fund regulatory process is characterized by "cooperative decentralization." Cooperative decentralization is "centered upon the development and promotion of broad principles-based international regulatory standards as well as activities such as information-sharing, research collaboration, international early warning systems, and capacity building."[99] Helleiner later describes cooperative decentralization as "uneven implementation across jurisdictions as well as the territorialization of new central market nodes being cultivated by the standards."[100] The E.U.'s hedge fund legislative framework highlights a case of cooperative decentralization. The E.U. has created a nationally distinct regulatory framework for hedge funds whilst securities regulators, working through IOSCO's Technical Committee have established

[98] Hamilton 2009
[99] Helleiner and Pagliari 2010, p. 193
[100] Helleiner *Forthcoming*

cooperative responses to regulatory reforms to enable them to fulfill their domestic regulatory responsibilities.

## 6.5 Conclusion

The political dynamics of IOSCO's international hedge fund standards are explained by both a domestic politics and transgovernmental network perspective. The politics of pre-crisis international hedge fund standards highlights the central role of domestic legislatures. IOSCO's failure to establish international hedge fund standards before the 2007/2008 financial crisis was because domestic legislatures in the U.S. and U.K. were unwilling to regulate hedge funds. After the collapse of LTCM, U.S. and international regulators recommended improvements to the disclosure of hedge funds to investors and financial regulators. When Congress took up the measure, the bills were defeated by the successful lobbying efforts of the financial industry. As a result, IOSCO and other international financial regulatory bodies stayed silent on the issue. The issue re-emerged in 2001 when retail investors increased their exposure to hedge funds. The U.S. SEC sought to require hedge funds to become registered with the U.S. SEC, but Congress remained unwilling and the judicial system concluded the U.S. SEC did not have the adequate statutory authority. Because Congress did not grant the U.S. SEC the statutory authority to regulate hedge funds and because the U.K. Parliament and U.K. FSA chose not regulate hedge funds, IOSCO's Technical Committee was limited to creating regulatory principles relating to regulated CIS funds including: the valuation of hedge funds,[101] a report on the risks of retail investor's investment in hedge funds,[102] and a report on the regulatory environment of hedge funds.[103]

After the crisis, the domestic political context of the U.S. and E.U. shifted causing domestic legislatures to change their policy preferences in favor of the direct regulation of hedge funds. Domestic politicians in the U.S. and E.U. faced a different set of political incentives after the 2007/2008 financial crisis. The highly publicized role of hedge funds in triggering the crisis, beginning with the collapse of Bear Stearns' hedge funds in 2007, and the arrest and prosecution of Bernie Madoff had the effect of politicizing hedge fund regulation.

[101] Technical Committee of IOSCO 2007
[102] Technical Committee of IOSCO 2003a
[103] Technical Committee of IOSCO 2006

Furthermore, the domestic political balance of power shifted in favor of institutional investors rather than the alternative investment fund industry. This shift in the domestic political balance of power favored pro-reform interests groups over status quo interests groups. As a result, Congress was willing to regulate hedge funds and the E.U. was willing to expend significant political capital to ensure the U.K. hedge fund industry was subject to direct regulation through the AIFMD. This outcome re-emphasizes the work of Pagliari, Fioretos and Quaglia, who have argued that the decision to regulate hedge funds in the U.S. and E.U. has been driven by shifts in domestic political contexts.

After domestic legislatures in the U.S. and E.U. had indicated their preference for directly regulating hedge funds in early 2009, IOSCO's Technical Committee created IOSCO's *Principles for Hedge Funds* in June 2009 and IOSCO's *Systemic Risk Data Requirements for Hedge Funds*. As this chapter has demonstrated, the creation of IOSCO's international hedge fund standards was driven by the principled professional interests of the transgovernmental network of securities market regulators. Securities market regulators sought to effectively coordinate their national regulatory frameworks before the upcoming rulemaking process to enable them to effectively monitor international active hedge funds. Common information and reporting requirements enabled securities market regulators to exchange information freely and effectively. Although the creation of IOSCO's international hedge fund standards was contingent on shifts in the policy preferences of domestic legislatures in the U.S. and E.U., securities regulators exercised the discretion granted to them by domestic legislatures to establish international hedge fund principles to promote the coordination of national regulatory frameworks.

The political dynamics of IOSCO's international hedge fund standards is consistent with a PA analytical framework. The creation of international hedge fund standards was contingent on domestic legislatures from dominant jurisdictions favoring the regulation of hedge funds. Securities market regulators exercised the discretion granted to them within the PA relationship established between domestic legislatures and securities market supervisors to create international hedge fund standards. Those international hedge fund standards were created to enable domestic securities regulators to effectively execute their domestic regulatory responsibilities.

# Chapter 7

# Conclusion: A Principal-Agent Approach to Explaining the Creation and Strengthening of International Securities Market Standards

## 7.1 Introduction

This thesis has addressed the question: what explains the creation and strengthening of IOSCO's international securities market standards? To do so, this thesis has analyzed the creation and strengthening of IOSCO's international securities market standards including:

1. IOSCO's Principles for Memoranda of Understanding (to facilitate the prosecution of cross-border financial crime) created in September 1991 and its strengthening with the creation of IOSCO's MMoU in May 2002

2. IOSCO's Objectives and Principles of Securities Market Regulation created in September 1998 and its strengthening with the creation of IOSCO's Methodology in October 2003

3. IOSCO's Principles for Credit Rating Agencies created in September 2003 and IOSCO's Code of Conduct Fundamentals for Credit Rating Agencies created in December 2004 and their strengthening through the creation of direct regulatory regimes for rating agencies in the U.S. and E.U. before and after the 2007/2008 financial crisis

4. IOSCO's Principles for the Regulation of Hedge Funds created in June 2009 and IOSCO's Systemic Risk Data Requirements for Hedge Funds in February 2010;

This chapter will review the answers to this thesis' central research question before reviewing the contribution of this thesis to existing IPE literature analyzing international financial regulatory politics. This chapter will conclude by highlighting future research agendas for the study of international securities market regulation.

## 7.2 Key Findings: Explaining the Creation and Strengthening of International Securities Market Standards

This thesis' analysis of international securities standards reveals that the creation and strengthening of international securities market standards are derived from the role and influence of the transgovernmental network of securities market regulators, domestic legislatures and states. The extent to which the creation and strengthening of international securities market standards are derived from each actor's role and influence is differentiated across issue areas and across time.

This thesis argues that international securities market standards fall into two distinct categories. The first category of international securities market standards reflects the role and influence of the transgovernmental network of securities market regulators within IOSCO's Technical Committee. This set of international securities market standards is created in response to threats to the integrity of developed financial centers from under-regulated or ineffectively regulated financial centers. IOSCO's Technical Committee is driven to create this set of standards in order to enable securities market regulators to fulfill the regulatory responsibilities of their respective domestic securities market. This set of standards was created in response to the consequences of financial globalization and the intensified integration between national financial markets. Regulators' ability to govern domestically is contingent on their ability to govern internationally by exporting domestic regulatory frameworks to foreign jurisdictions through international financial standards and by establishing cooperative information sharing and mutual legal assistance mechanisms with foreign regulators. Two of IOSCO's international financial standards fit this category:

1. IOSCO's *Principles for MoUs* in September 1991

2. IOSCO's *Principles* endorsed in September 1998

The second category of international securities market standards reflects the role and influence of both domestic legislatures and the transgovernmental network of securities market regulators. This category of international securities market standards is created to promote the coordination of national regulatory frameworks between dominant financial centers. This category of standards were created after domestic legislatures had indicated their preference in favor of regulating, or improving the regulation of, previously unregulated financial market actors. This set of standards is contingent on shifts in the policy preferences of domestic legislatures. The transgovernmental network of securities market regulators demonstrate agency in the creation of international financial standards to promote the coordination of national regulatory frameworks. The transgovernmental network of securities market regulators are driven to create these standards by principled professional interests. Two of IOSCO's international financial standards fit this category:

1. IOSCO's *Principles for CRAs* in September 2003 and IOSCO's *Code of Conduct* in December 2004.

2. IOSCO's *Principles for Hedge Funds* in June 2009.

The political dynamics of the creation of four of IOSCO's international securities market standards is summarized in Table 7.1 below:

**Table 7.1 The Political Dynamics of the Creation of four of IOSCO's International Securities Market Standards**

| Issue Areas | | | | |
|---|---|---|---|---|
| | **Cross-Border Financial Crime and Insider Trading** | **National Securities Market Regulatory Frameworks** | **Credit Rating Agencies** | **Hedge Funds** |
| **Standards and Date of Creation** | Principles for Memoranda of Understanding<br>September 1991 | Objectives and Principles of Securities Market Regulation<br>September 1998 | Principles for Credit Rating Agencies<br>September 2003 | Principles for the Regulation of Hedge Funds<br>June 2009 |
| | | | Code of Conduct Fundamentals for Credit Rating Agencies<br>December 2004 | Systemic Risk Data Requirements for Hedge Funds<br>February 2010 |
| **Explanatory Framework** | Transgovernmental Network Theory | Transgovernmental Network Theory | Domestic Politics and Transgovernmental Network Theory | Domestic Politics and Transgovernmental Network Theory |

This thesis has also identified that three of IOSCO's international securities market standards have been strengthened. Two of IOSCO's standards (IOSCO's *Principles* and IOSCO's *Principles for MoUs*) have been strengthened through the creation of institutional initiatives that were created to promote the adoption and strengthened implementation of IOSCO's standards. IOSCO's *MMoU* was created in May 2002, to strengthen the implementation of IOSCO's *Principles for MoUs* and IOSCO's *Methodology* was created in October 2003 to strengthen the implementation of IOSCO's *Principles*. IOSCO's *Principles for CRAs* and IOSCO's *Code of Conduct* was strengthened through the creation of direct

regulatory regimes for rating agencies in the U.S. and E.U. These three cases highlight the role and influences of three different political actors.

First, IOSCO's *MMoU* demonstrates the influence of the transgovernmental network of securities market regulators within IOSCO's Technical Committee. As Chapter 3 discusses, IOSCO's *MMoU* was created by IOSCO's Technical Committee in response to the September 11 terrorist attacks on the U.S. in 2001. September 11 revealed important limitations to the bilateral network of MoUs and the ability of securities regulators to identify the perpetrators of cross-border financial crime. IOSCO's *MMoU* was created to address these gaps by improving global coverage and standardizing MoU agreements between securities market regulators. IOSCO's *MMoU* was first proposed by a non-U.S. regulator at the first meeting of IOSCO's Technical Committee, after the September 11 terrorist attacks, in October 2001. IOSCO's Technical Committee's recognition of the limitations to the bilateral network of MoUs and the immediacy of their response to the events of September 11, demonstrates that the strengthening of IOSCO's *Principles for MoUs* was driven by the transgovernmental network of securities market regulators. Furthermore, IOSCO's *MMoU* was driven by regulators' concerns about the ability of individuals to commit acts of cross-border financial crime without detection. This demonstrates that IOSCO's *MMoU* was driven by the principled professional interests of the transgovernmental network of securities market regulators.

Second, IOSCO's *Methodology* was driven by the preferences of powerful states and the transgovernmental network of securities market regulators. As Chapter 4 discusses, the creation of IOSCO's *Methodology* reveals that IOSCO was subject to external political pressure to create a more comprehensive and objective international standard for securities market regulators to enable the IMF and World Bank to conduct external assessments of compliance with IOSCO's *Principles*. The IMF and World Bank were pressured by the G7 to improve compliance with international financial regulatory standards and raise financial regulatory standards, as part of the NIFA in the wake of the Asian Financial Crisis. Powerful states recognized the costs of under-regulated and ineffectively regulated financial centers on developed financial centers after the Asian Financial Crisis. This led financial ministries to play an active role in the international financial regulatory regime and caused IOSCO to

create IOSCO's *Methodology*, in spite of its reservations about creating a comprehensive, 'one-size-fits-all' model of securities market regulation. At the same time, IOSCO's *Methodology* was created as a result of September 11, causing IOSCO's Technical Committee to recognize the importance and benefits of strengthening the adoption of IOSCO's financial standards. September 11 demonstrated to securities market regulators the dangers of a comparatively weak regulatory regime for the stability and integrity of their respective securities market. IOSCO's *Methodology* was also driven by transgovernmental network of securities market regulators and their principled professional interests.

Third, the strengthened implementation of IOSCO's *Principles for CRAs* and IOSCO's *Code of Conduct* through the creation of direct regulatory regimes for rating agencies in the U.S. and E.U. demonstrates the role and influence of domestic legislatures. As Chapter 5 discusses, the creation of direct regulatory regimes in the U.S. and E.U. was driven by shifts in the domestic political context and policy preferences of domestic legislatures. The initial impetus for the U.S.' creation of a direct regulatory regime was the narrow political interests of two Pennsylvanian Congressmen, Michael Fitzpatrick and Paul Kanjorski. Fitzpatrick and Kanjorski initiated the 2006 Credit Rating Agency Reform Act to promote competition and reduce regulatory barriers to entry for rating agencies in the interests of Egan-Jones (a Pennsylvanian based rating agency). The regulatory regime remained weakened because rating agencies were still afforded First Amendment rights protections and continued Congressional resistance to substantive regulatory oversight. It took the 2007/2008 financial crisis to shift the domestic political context in favor of a comprehensive direct regulatory regime for rating agencies. Widespread reports of conflicts of interest in the securitized debt market and the under valuation of risk by rating agencies meant that domestic politicians faced a different set of incentives after the financial crisis than before. Furthermore, U.S. courts began dismantling the First Amendment Rights protections afforded to rating agencies before the crisis. The E.U. created a direct regulatory regime after the 2007/2008 financial crisis because the U.S. had established a direct regulatory regime, as a result of rating agencies' central role in the financial crisis.

The political dynamics of the strengthening of three of IOSCO's international securities market standards are summarized in Table 7.2 below:

**Table 7.2 The Political Dynamics of the Strengthening of IOSCO's International Securities Market Standards**

| Issue Areas | | | | |
|---|---|---|---|---|
| | **Cross-Border Financial Crime and Insider Trading** | **National Securities Market Regulatory Frameworks** | **Credit Rating Agencies** | **Hedge Funds** |
| **Strengthening of International Securities Market Standard** | Multilateral Memorandum of Understanding<br><br>May 2002 | Methodology for Assessing Implementation of IOSCO's Objectives and Principles of Securities Market Regulation<br><br>October 2003 | The creation of direct regulatory regimes in the U.S. and E.U. before and after the 2007/2008 financial crisis | N/A |
| **Explanatory Framework** | Transgovernmental Network Theory | Inter-State and Transgovernmental Network Theory | Domestic Politics Theory | N/A |

This thesis' analysis concludes that the role and influence of political actors in the creation and strengthening of international securities market standards is differentiated across issues and across time. This thesis has argued that a Principal-Agent analytical framework is able to account for the role and influence of different political actors. A Principal-Agent relationship exists between securities market regulators and domestic legislatures. Domestic legislatures delegate domestic securities market regulators the task of regulating domestic securities markets within the current legislative framework and existing statutory authority. Domestic legislatures exercise control over securities market regulators through public statements by domestic politicians, public hearings, the drafting of public reports, and the creation or withholding of statutory authority. Domestic legislatures also grant regulators' discretion to establish international securities market standards in order to fulfill the regulatory responsibilities they are delegated. Securities regulators exercise this discretion by creating

international regulatory standards that reflect their statutory authority domestically and export those regulatory frameworks to foreign jurisdictions. Finally, domestic legislatures use multiple agents to monitor outcomes. Multiple agents are created to overcome the hidden-information problem and ensure that all agents are acting consistently with their preferences. Finance ministries act as another agent, monitoring the actions of securities market regulators at IOSCO. When finance ministries feel securities market regulators need to strengthen the implementation of international securities market standards, finance ministries place pressure on securities market regulators through international financial institutions that they exercise control over. The nature of the delegation chain is represented in Figure 7.1 below:

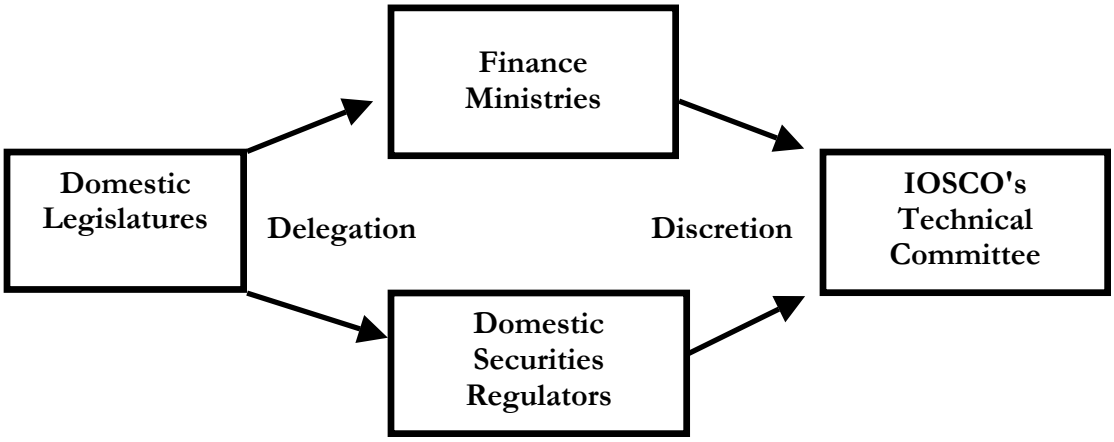



**Figure 7.1 The Delegation Chain in International Securities Market Regulation**

A PA analytical framework accounts for the differentiated sources of international securities standards. A PA analytical framework also establishes when and under what conditions international securities standards are derived from domestic legislatures, states, and the transgovernmental network of securities regulators acting through IOSCO's Technical Committee. The transgovernmental network of securities market regulators are influential in the creation and strengthening of international securities market standards, when those standards are intended to enable securities market regulators to fulfill their domestic regulatory responsibilities, as defined by their pre-existing statutory authority and their principled professional interests. Domestic legislatures are influential when international securities standards are created to address the regulation of previously unregulated financial

market actors. Domestic legislatures define the perimeter of international financial standards through the granting or withholding of statutory authority from domestic securities market regulators and by indicating their interest in improving the regulation of previously unregulated financial market actors. Finally, states are influential when they perceive that the costs of under-regulated or ineffectively regulated financial centers are higher than the current level of institutional enforcement.

### 7.3 Contributions to IPE and IR Literature

This thesis makes a number of important contributions to IPE and IR literature. This thesis addresses three empirical gaps in existing IPE literature, analyzing international financial regulatory politics. First, although IPE scholars have analyzed IOSCO's *Principles for MOUs*, IOSCO's *Code of Conduct*, and IOSCO's *Principles for Hedge Funds*, they have not yet analyzed IOSCO's *Principles*, IOSCO's *Methodology*, IOSCO's *MMoU,* and IOSCO's *Systemic Risk Data Requirements for Hedge Funds*. These international securities standards are important international financial standards and reveal significant political dynamics in international securities market regulation.

As Chapter 3 highlights in its analysis of IOSCO's *MMoU*, the institutional initiative was created immediately after September 11, and the idea of creating IOSCO's *MMoU* was proposed by a non-U.S. regulator at the first meeting of IOSCO's Technical Committee in October 2001. This demonstrates that the transgovernmental network of securities market regulators drove the strengthening of IOSCO's *Principles for MoUs*. This counters Beth Simmons' hypothesis that IOSCO would establish a multilateral information sharing agreement in response to U.S. interests, reducing the costs of under-regulated financial centers due to its impact on the stability and profitability of U.S. financial markets. Simmons states that IOSCO's information sharing regime will be strengthened, "primarily to facilitate the detection of systemic risks that pose potentially far greater negative externalities for the dominant financial center."[1] Instead, IOSCO's *Principles for MoUs* was strengthened in response to the threat of cross-border financial crime and was not driven by the preferences

[1] Simmons 2001, p. 614

of the U.S., acting as a unitary actor, but by the transgovernmental network of securities market regulators.

As Chapter 4 discusses, an analysis of IOSCO's *Principles* highlights the central role of the transgovernmental network of securities market regulators. Chapter 4 highlights that IOSCO's Technical Committee created these standards in response to the increasing integration of national securities markets, and the threats that under-regulated jurisdictions posed to the stability of their respective domestic securities market. From the interviews with securities regulators involved in the creation of IOSCO's *Principles*, it is apparent that this international standards was not created as a reaction to the Asian Financial Crisis, and that the financial standards project at IOSCO had begun before the crisis. An analysis of the creation of IOSCO's *Methodology* reveals that IOSCO was subject to external political pressure from the World Bank and IMF in the creation of IOSCO's *Methodology*. At the same time, the creation of IOSCO's *Methodology* was tied to the events of September 11 and was part of IOSCO's effort to improve the adoption and implementation of IOSCO's standards.

As Chapter 6 discuses, an analysis of IOSCO's *Principles for Hedge Funds* and IOSCO's *Systemic Risk Data Requirements for Hedge Funds* reveals that the transgovernmental network of securities market regulators worked through the Task Force on Unregulated Entities to establish common data requirements that would enable regulators to monitor the systemic risk posed by hedge funds. Given that hedge funds are internationally active, it is useful for securities regulators to establish common reporting requirements that would enable regulators to exchange for information freely and easily in order to monitor systemic risk. Existing analysis by Pagliari, Fioretos, and Quaglia focus on the role and influence of shifts in the domestic political context in explaining the creation of international hedge fund standards and overlooks the role of the transnational policy making process.[2] This thesis recognizes that shifts in the domestic political context of dominant jurisdictions was a necessary condition for the creation of international hedge fund standards. This is further demonstrated by the fact that a majority of securities regulators in IOSCO's Technical Committee preferred the direct regulation of hedge funds before the crisis. However, IOSCO's Task Force on Unregulated Financial Entities played an important role in the post-

[2] Fioretos 2010; Pagliari 2013; Pagliari 2011; Quaglia 2011

crisis regulatory reform process by establishing common reporting requirements. The coordination of information and reporting requirements between securities market regulators had a recognizable and marked impact on national rulemaking process in the U.S. and E.U., which implemented national regulatory reforms.

Second, of the international securities standards analyzed by existing literature, this thesis reveals new and important outcomes and political drivers in the creation of international securities market standards. As Chapter 3 discusses, the creation of a cooperative solution to the issue of cross-border financial crime through the creation of IOSCO's' Working Group No.4, and IOSCO's *Principles for MoUs*, was driven by the transgovernmental network of securities market regulators rather than the U.S. SEC alone as Bach and Newman portray. Bach and Newman state that the U.S. SEC pioneered the idea of using MoUs to combat insider trading. Bach and Newman stated the following:

> "Beginning in the mid-1980s, the SEC promoted transgovernmental cooperation among the world's securities regulators as a solution to growing arbitrage opportunities in global financial markets. A series of high-profile cross-border cases of insider trading originating in jurisdictions lacking comprehensive regulation exposed the growing vulnerability of US markets. The SEC confronted the challenge by negotiating a series of MoUs with regulators from major markets."[3]

This thesis has demonstrated that the actual story is more nuanced. The U.S. SEC did pioneer the concept of using an MoU to combat cross-border financial crime and the U.S. SEC did negotiate MoUs with foreign regulators. At the same time, European regulators were also interested in using MoUs and negotiating international regulatory principles for MoUs to combat cross-border financial crime. Furthermore, in discussing international regulatory principles, the community of securities market regulators within Working Group No. 4 identified common barriers to the effective use of information sharing and mutual legal assistance mechanisms for the prosecution of cross-border financial crime. This contradicts Bach and Newman's argument that the U.S. SEC was responsible for the

[3] Bach and Newman 2010, p. 510

adoption of insider trading laws and the use of MoUs. European securities market regulators were important actors in establishing an international regulatory regime that centered on the use of MoUs to combat cross-border financial crime. The story is not as U.S.-centric as Bach and Newman originally portray.

As Chapter 5 discusses, IOSCO's *Code of Conduct* was created because of the unwillingness of U.S. and E.U. legislatures to establish a direct regulatory regime for rating agencies. IOSCO's *Code of Conduct* was created to establish an internationally consistent regulatory regime for rating agencies that took in to account U.S. and E.U. domestic political constraints. This differs from Stefano Pagliari's account of the creation of IOSCO's *Code of Conduct*. Pagliari argues that IOSCO's *Code of Conduct* was created because securities market regulators favored the use of self-regulatory regimes to govern rating agencies.[4] This is true. But, regulators' primary concern was in creating an internationally consistent regulatory regime for rating agencies because of regulators' fears that competing systems of regulation would create dual systems of assessment of creditworthiness. Securities regulators did not believe that this was in the interests of protecting investors. Existing literature analyzing rating agency regulation has also overlooked the fact that the direct regulation of rating agencies in the U.S. under the 2006 Credit Rating Agency Reform Act was driven by the narrow political interests of Pennsylvanian Congressmen Fitzpatrick and Kanjorski. As Chapter 5 highlights, the first direct regulatory regime in the U.S. was created to promote competition in rating agency markets. Fitzpatrick and Kanjorski were acting in the interests of Egan-Jones. Continued resistance from Congress and rating agencies, and the looming threat of being struck down by the U.S. court system weakened the bill.

The third empirical limitation that this thesis addresses is that IPE studies of international securities market standards have tended to analyze single empirical case studies or multiple cases studies in a single time period. This approach has led to IPE scholars to focus on the influence of a single political arena in the creation of international financial standards, because that political arena exercised influence during that singular time period. This has led existing literature to explain international financial standards through the role and influence of one of three competing political arenas: inter-state, domestic, and transnational. This

[4] See Pagliari 2013; Pagliari 2011

thesis' analysis of international securities market standards over the lifetime of the issue, from the genesis of securities market regulatory cooperation in 1983 through to the post-2007/2008 financial regulatory reform process, reveals that international financial standards are derived from different political contexts across time.

This thesis' analysis of four of IOSCO's international securities market standards highlights some important theoretical limitations to existing literature. Existing theoretical frameworks are unable to account for the fact that the creation and strengthening of international securities market standards is derived from different political arenas and driven by different political actors. It is, therefore, necessary to establish an integrative approach that can account for the role and influence of different political actors in the creation and strengthening of international financial standards. This thesis has argued that a PA analytical framework is able to account for the differentiated sources of international securities market standards. PA theory does so by establishing when and under what conditions the creation and strengthening of international securities market standards are derived from the transgovernmental network of securities market regulators, domestic legislatures, or states.

In establishing when and under what conditions each political actor plays a role in the creation and strengthening of international securities market standards, a PA analytical framework can provide a basis to better account for the role of each actor in these processes. This thesis reveals that the transgovernmental network of securities market regulators creates international securities market standards to export the national regulatory frameworks of developed financial centers to under-regulated or ineffectively regulated financial markets. Securities regulators are driven to do this because of the increased integration of national financial markets and their interests in fulfilling their domestic regulatory responsibilities. Securities market regulators do not create these standards because of the threat of legislative intervention, or increased oversight by the domestic legislature, but because it was the right thing to do.[5] Securities market regulators also create international securities market standards to promote the coordination of national regulatory frameworks between developed financial

[5] Communicated by Michael Mann who stated, "there was definitely criticism from Congress that this was a priority but I do not regard that as pressure. The only pressure I recall was to do the right thing." Michael Mann, 2012

centers. Securities market regulators do so because differentiated national regulatory frameworks threaten the interests of investor protection (as was the case in the creation of IOSCO's international credit rating agency standards) and the stability of developed securities markets (as was the case in the creation of IOSCO's international hedge fund standards). This highlights that securities market regulators create international standards because it is in their principled professional interests.

Domestic legislatures play an important role in establishing the perimeter of international financial standards. This thesis has highlighted the importance of pre-existing statutory authority in creating international financial standards. The decision to regulate previously unregulated financial market actors rests in the hands of domestic legislatures who are responding to domestic political pressures. In the case of IOSCO's international credit rating agency standards, IOSCO's Technical Committee created IOSCO's *Code of Conduct* to establish an internationally consistent regulatory regime for rating agencies that took in to account the U.S. and E.U.'s preference for the indirect regulation of rating agencies. IOSCO's international hedge fund standards were only created after dominant hedge fund jurisdictions had indicated their willingness to directly regulate hedge funds. This has been highlighted by a number of domestic scholars.[6] This thesis provides further evidence for this perspective within domestic politics literature. Furthermore, this thesis highlights the role of statutory authority in acting as a mechanism of control over securities market regulators and draws greater attention to how securities regulators are constrained by their domestic counterparts.

This thesis also reveals that states become involved in international securities market standards when they feel that the international financial regulatory institution is not doing enough to promote the implementation of international securities market standards. Consistent with Simmons' argument,[7] states strengthen the international regulatory regime when they perceive that the costs of under-regulated financial markets outweigh the costs of establishing stronger institutions to promote compliance with international financial standards. This thesis also draws attention to the fact that states use other, more senior

[6] Pagliari 2013; Fioretos 2010; Quaglia 2011
[7] Simmons 2001

international financial institutions – within which they exercise greater control – to achieve this.[8]

This thesis also makes two important contributions to PA theory within IO literature. First, this thesis analyzes the "black box" of regulators' preferences when regulators are acting within the zone of discretion. As Chapter 2 discussed, existing PA theory presumes, rather than analyzes, the preferences of regulators within international financial regulatory institutions. This thesis has analyzed what caused regulators to create international financial regulatory standards whilst acting with the "zone of discretion" granted to them by domestic legislatures. In doing so, this thesis reveals that regulators are acting in their principled professional interests when they create international financial standards. Furthermore, as Chapter 4 highlights, securities market regulators resisted creating IOSCO's *Methodology*, even though doing so would increase the authority of IOSCO. This counters the hypothesis of existing PA theory that IOs or securities market regulators are driven by their bureaucratic and material interests. This demonstrates that the transgovernmental network of securities market regulators is driven by their principled professional interests to create and strengthen international securities market standards.

Second, this thesis has re-introduced the concept of multiple agents in PA theory. Kenneth Arrow first introduced the concept in the 1980s. Arrow's analytical concept states that multiple agents are used to overcome hidden-information problems and to ensure agents act consistent with the principal's interests. This thesis has used the concept to explain how IOSCO's Technical Committee was subject to pressure from the finance ministries of the G7 to create IOSCO's *Methodology* to improve the adoption of IOSCO's *Principles*.

## 7.4 Conclusion: Future Research Agendas

This project also suggests a number of research agendas. First, this thesis has limited its empirical analysis to four international securities market standards. There are a number of

[8] This does not provide an exhaustive list of what role each political actor plays or their interests in the creation and strengthening of international financial standards or international securities market standards. Instead, it provides a list of some of the roles and motivations of each political in the creation and strengthening of the four international securities market standards this thesis has analyzed, and provides a basis to understand other international financial standards.

important international securities market standards that this thesis has not analyzed. An analysis of these financial standards, which fell outside the scope of this thesis, may reveal new and important political dynamics. For instance, IOSCO has produced a number of reports and international standards for OTC and non-OTC derivatives markets including: IOSCO's *Report on Unregulated Financial Markets and Products* that analyzed how to improve the regulation of OTC derivatives,[9] *Principles for the Regulation and Supervision of Commodity Derivative Markets*,[10] IOSCO's *Report on Trading of OTC Derivatives*,[11] *International Standards for Derivative Market Intermediary Regulation*,[12] and *Requirements for Mandatory Clearing*,[13] amongst others. Helleiner's analysis concludes that OTC derivative market standards have been driven by the domestic competitiveness concerns of U.S. and E.U. politicians following unilateral increases in financial regulatory demands.[14] This highlights new domestic political drivers in the creation of international financial regulatory standards. Similarly, these international standards have been monitored and overseen by the Financial Stability Board (FSB) and written in concert with the BCBS and Committee on Payment Settlement Systems (CPSS). This highlights that there is likely to be (at least to some extent) a multiple-agent relationship between securities market regulators, banking regulators, the FSB and the G20 process.

Second, this thesis has made an initial step towards defining the "bureaucratic culture"[15] of securities market regulators to explain the creation and strengthening of international financial standards. This thesis has focused on the principled professional interests that securities regulators pursue, in order to promote financial stability and integrity in their respective domestic securities markets. This does not encapsulate the entirety of the "bureaucratic culture" of the transgovernmental network of securities market regulators.

Although it is outside the scope of the thesis, the research project revealed that an important part of the "bureaucratic culture" of securities market regulators is that they are traditionally trained in law. In comparison, banking regulators and central bank governors are

[9] Technical Committee of IOSCO 2009d
[10] Technical Committee of IOSCO 2011b
[11] Technical Committee of IOSCO 2011c
[12] Technical Committee of IOSCO 2012a
[13] Technical Committee of IOSCO 2012b
[14] Helleiner *Forthcoming*
[15] Nelson and Weaver 2013, p. 9 – 10

traditionally trained in macro-economics. Securities market regulators have viewed the regulation of securities markets through the lens of contractual relationships between parties to ensure the stability and integrity of domestic securities markets. By their own admission, this may have led securities market regulators to overlook systemic risk in securities markets prior to the 2007/2008 financial crisis. IOSCO's Technical Committee produced a report titled, *Mitigating Systemic Risk: A Role for Securities Regulators*. The report states the following:

> "The primary emphasis of the Principles is on comprehensive disclosure and market discipline, backed by regulatory oversight, to protect investors and enhance confidence. They also emphasized the role of business conduct regulation and corporate governance in protecting investors and addressing any misalignment in the interests of managers and investors. The Principles recognized the importance of systemic risk and the role of securities regulators in preventing and mitigating such risks. Nonetheless, one of the lessons of the crisis is that securities regulators, among others, generally paid insufficient attention to systemic risk."[16]

Future research could further analyze and conceptualize the impact of this and other aspects of securities market regulators' "bureaucratic culture" on the creation and strengthening, and nature of international securities market standards.

[16] Technical Committee of IOSCO 2011d, p. 8

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Alan Cameron – former Chairman of the Australian Securities and Investment Commission, Interviewed by the Author, 28 November 2011.

Andrea Corcoran – former Director of the Office of International Affairs at the U.S. Commodities and Futures Trading Commission, Interviewed by the Author, 25 January 2012.

Andrew Procter – former member of the Securities and Futures Commission of Hong Kong, Interviewed by the Author, 7 December 2011.

Annette Nazareth – former Commissioner at the U.S. Securities and Exchange Commission, Interviewed by the Author, 18 July 2012.

Anonymous Interview A.

Anonymous Interview B.

Ed Waitzer – former Chairman of the Ontario Securities Commission, Interviewed by the Author, 27 January 2012.

David Brown – former Chairman of the Ontario Securities Commission, Interviewed by the Author, 25 January 2012.

Felice Friedman – former Acting Director of the Office of International Affairs at the U.S. Securities and Exchange Commission, Interviewed by the Author, 28 October 2011.

Georgina Philippou – Head of Retail Enforcment at the U.K. Finanical Services Auhtority, Interviewed by the Author, 20 October 2011.

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Ros Davies – Deputy of Retail Enforcement at the U.K. FSA – Interviewed by the Author, 6 September 2011.

Susan Bergstraesser and Barbara Kunz – Securities Supervision/Asset Management for BaFin the Federal Financial Supervisory Authority of Germany, Interview by the Author, 9 September 2011.

Tony Neoh – former Chairman of the Securities and Futures Commission of Hong Kong, Interviewed by the Author, 26 November 2011.

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