

WHY SOFT LAW DOMINATES INTERNATIONAL FINANCE—AND NOT TRADE

Chris Brummer[★]

ABSTRACT

International financial law is in many ways a peculiar instrument of global economic affairs. Unlike international trade and monetary affairs, where global coordination is directed through formal international organizations, international financial law arises through inter-agency institutions with ambiguous legal status. Furthermore, the commitments made by regulatory officials participating in such forums are non-binding. This divergence is perplexing, especially when comparing international financial law to international trade. Both trade and finance comprise key areas of ‘international economic law’ and their rules have important distributive consequences for global markets and market participants. This article suggests that in order to understand soft law’s value as a coordinating mechanism, an institutional assessment of the way that law is enforced is necessary. Under close inspection, international financial law departs from traditional public international law notions of informality and can in fact be ‘harder’ than its soft-law quality suggests. This feature helps explain why international financial rules, though technically non-binding, are often relied upon. The predominance of international soft law in finance does not, however, imply that it is without flaws, and this article highlights important structural deficiencies that the World Trade Organization, a more mature legal regime, largely avoids.

International financial law is in many ways a surprising instrument for establishing a global economic order. Unlike international trade and monetary affairs, where global coordination efforts are led by formal international organizations, international financial law is promulgated by inter-agency forums with (at best) ambiguous legal status. Furthermore, the commitments made by participating regulatory agencies have no legal effect, but are instead non-binding as a matter of international law. This divergence is perplexing both from a comparative perspective and from the standpoint of

[★] Professor of Law, Georgetown University Law Center. E-mail: chris.brummer@law.georgetown.edu

international legal theory, especially when comparing international financial law to international trade. Both trade and finance are clearly key areas addressed by ‘international economic law’, and their rules have important consequences for global markets. In addition, they relate to market access, embrace non-discrimination and potentially have asymmetric distributive implications for special interests in affected jurisdictions.

Why then are most instruments used for the promulgation of international regulatory standards ‘non-binding’ and thus ‘soft’? This article suggests that in order to understand soft law’s implications as a coordinating mechanism, it is necessary to undertake an institutional assessment of the way that law is enforced. Specifically, it builds on more recent scholarship demonstrating that international financial law departs from traditional public international law notions of informality, and is in fact ‘harder’ than its soft-law quality suggests. This feature, the article suggests, helps explain why international financial rules, though soft, are often relied upon even where commitments may have steep distributional implications for parties. The predominance of international soft law in finance does not, however, imply its perfection, particularly with regard to its ‘compliance pull’, and the article highlights important structural deficiencies in the international financial regulatory system that the global trading system, as embodied by the World Trade Organization, largely avoids.

I. HARD LAW AND INTERNATIONAL ECONOMIC AFFAIRS

International treaties have long occupied a special place in global economic affairs, especially in trade matters. Part of their popularity lies in their overt democratic trappings: Unlike customary law, where international law is deducted from the consistent practice of states, treaties specifically memorialize agreement between countries and often require approval by national legislatures.¹ As a result, treaties are not only able to express commitments in more precise terms than customary international law, but they are also imbued with legitimacy and imply the ‘consent of the governed’.²

As species of ‘hard law’—that is, as recognized sources of international law—treaties are additionally viewed as especially well positioned to address what can be considered the distributive challenges inherent to international trade. Trade, like many areas of international economic law, is not always an

¹ Customary international law is, as a result, generally regarded as a vaguer and less specific form of international law. See Janet Koven Levit, ‘A Bottom-Up Approach to International Lawmaking: The Tale of Three Trade Finance Instruments’, 30 *Yale Journal of International Law* 125 (2005), at 179 (noting that customary international law norms must remain vague to ensure that they envelop enough ‘state practice’ to constitute international law).

² John O. McGinnis, ‘The Comparative Disadvantage of Customary International Law’, 30 *Harvard Journal of Law and Public Policy* 7 (2006), at 10, http://www.law.harvard.edu/students/orgs/jlpp/Vol30_No1_McGinnisonline.pdf (visited 14 June 2010).

area in which agreement can be reached between parties and sustained. To the extent to which they open barriers to goods and services, trade agreements inherently involve a redistribution of wealth or market share to more efficient industries. As a result, where markets are opened, some businesses will find themselves potentially losing market share to new, more efficient competitors and will lobby their national government to back-pedal on liberalization efforts even if consumers benefit from lower-priced goods and services.³ Trade liberalization is, as a result, an inherently fragile activity, and is difficult to achieve on a sustained level even where countries express their intent to liberalize markets and open their borders to one another's goods.

Treaties help respond to these domestic pressures both by making commitments to liberalization more credible and by developing institutions that make defections from commitments more costly. Because treaties require significant levels of governmental involvement, including leadership by heads of state and usually ratification by legislatures, states may face considerable reputational costs where they do not honor their treaty obligations. Simply put, states that tend to honor their commitments develop strong reputations that help them coordinate with parties when they need to advance their national interests.⁴ On the other hand, where countries fail to honor their commitments, they send a signal that they cannot be trusted, and thus gain reputations that hamper their future prospects for cooperation from and with others.⁵

International treaties additionally enable the creation of institutions that can enhance compliance themselves.⁶ Because of the costs involved in establishing hard legal orders, participants want to make sure signatories live up to their commitments. As a result, treaties often create or enable the creation of institutional structures that increase the transparency of parties' activities

³ The argument here stems from the fact that the political costs incurred by alienating domestic manufacturers will likely outweigh the political favor curried from domestic consumers. This is because those benefitting in the aggregate most from liberalization—namely individual domestic consumers—will often not be as effective as producers at promoting their interests. See Warren F. Schwartz and Alan O. Sykes, 'Toward a Positive Theory of the Most Favored Nation Obligation and Its Exceptions in the WTO/GATT System', 16 *International Review of Law & Economics* 27 (1996), at 28. Furthermore, the domestic political process often assigns disproportionate weight to the interests of domestic producers as compared to those of individual domestic consumers, though of course consuming industries may still wield significant political influence.

⁴ This idea has been articulated by a variety of theorists, but for a comprehensive assessment see Andrew Guzman, *How International Law Works* (Oxford: Oxford University Press, 2007) 71–111.

⁵ *Ibid.*

⁶ Gregory C. Shaffer and Mark A. Pollack, 'Hard vs. Soft Law: Alternatives, Complements, and Antagonists in International Governance', 94 *Minnesota Law Review* 706 (2010), at 718 (noting that hard law treaties create mechanisms for the interpretation and elaboration of legal commitments over time).

with regard to the issues memorialized in the treaty—and thus make it easier to identify and punish cheaters.⁷ Institutions, furthermore, often serve as the forums where disputes between members as to the terms of the agreement are elaborated and potentially solved.

The paradigmatic institution cited as evidence for such institutional evolutionary dynamics is the World Trade Organization (WTO) and its predecessor treaty, the General Agreement on Tariffs and Trade (GATT).⁸ In 1948, the USA and its principal economic partners created the GATT to promote freer and fairer trade, primarily through negotiated reductions of formal tariffs. Over time, the GATT evolved, through successive rounds of treaty negotiations spurred by the USA, to include the deeper substantive commitments assumed by its signatory countries to reduce to reduce trade barriers as well as important institutional characteristics including dispute panels and a secretariat. This evolutionary process culminated with the creation of the WTO in 1995, a true international organization with a distinct legal personality and an almost universal membership of nearly 150 countries.⁹ As well as enjoying the authority to interpret laws, it enjoys more efficient and formalized disciplinary mechanisms than the GATT, whose dispute resolution mechanisms were often delayed and altogether sidelined due to the ability of disputants to block proceedings and the frequent failure of members to implement decisions.¹⁰

Perhaps most importantly, the WTO can, through its panels, authorize states that are harmed by uncured rule violations by other states to retaliate by suspending equivalent concessions or other obligations under the covered agreements.¹¹ As a result, the WTO's enforcement strategy employs what Jide Nzelibe rightly describes as a robust tit-for-tat approach: 'if state A is found to breach its obligations to state B and state A refuses to remedy the breach, state B can suspend an equivalent measure of its market access obligations to state A.'¹² The WTO also enjoys an Appellate Body to oversee the work of the dispute panels, accept a decision of the dispute panel, and in

⁷ Kenneth W. Abbott and Duncan Snidal, 'Hard and Soft Law in International Governance', 54 *International Organization* 421 (2000), at 429 (noting that treaties establish monitoring provisions to detect noncompliance with the commitments).

⁸ For an authoritative history of the WTO, see John H. Jackson, *Sovereignty, the WTO and the Changing Fundamentals of International Law* (Cambridge: Cambridge University Press, 2006).

⁹ Joost Pauwelyn, 'The Transformation of World Trade', 104 *Michigan Law Review* 1 (2005), at 25.

¹⁰ Robert Gilpin, *Global Political Economy, Understanding the International Economic Order* (Princeton: Princeton University Press, 2001) 223.

¹¹ Jide Nzelibe, 'The Credibility Imperative: The Political Dynamics of Retaliation in the World Trade Organization's Dispute Resolution Mechanism', 6 *Theoretical Inquiries in Law* 215 (2005), at 215.

¹² *Ibid.*, at 216.

doing so permit strong monitoring and enforcement of commitments made by member states.¹³

II. THE 'SOFT' SOURCES OF INTERNATIONAL FINANCIAL LAW

Still, hard law institutions and instruments play a very limited role in the regulation of finance, especially at the global multilateral level. The International Monetary Fund (IMF) and World Bank do not generally create regulatory standards, even though they can serve as monitors of regulatory activity. Moreover, the WTO's only commitment that touches on financial services, the General Agreement on Trade and Services (GATS), is not prudential in nature. Instead, like trade agreements, it relates to the treatment of foreign investment by national authorities and does not so much coordinate specific regulatory actions as define the limits of regulatory authority. Indeed, the GATS, like most of its bilateral and regional counterparts, has explicit prudential exceptions from country commitments and permits measures 'for the protection of investors [and] depositors... or to ensure the integrity and stability of the financial system'.¹⁴ National authorities face, as a result, few limitations with regard to how they oversee their national markets. Only the European Union wields what is commonly viewed as supervisory authority in financial services—though its influence is only regional, not multilateral, and even here its power is fragmented among federal (regional) authorities and Member States.¹⁵

Instead, most of the sources of international financial law are informal, intergovernmental institutions that set agendas and standards for the global regulatory community. These institutions are generally not grounded by treaty, but instead usually operate according to consensus and non-binding by-laws.¹⁶ Furthermore, coordination is not dominated and led by heads of state, but instead by central banks, regulatory agencies and supervisors, and finance ministries.

Perhaps the best known of these groups is the G-20, the only institution where heads of state do participate directly (if somewhat irregularly) and which now largely determines the broad agenda for international standard

¹³ Susan D. Franck, 'The Legitimacy Crisis in Investment Treaty Arbitration: Privatizing Public International Law Through Inconsistent Decisions', 73 *Fordham Law Review* 1521 (2005), n 466 (discussing the mandate of the WTO Appellate Body).

¹⁴ GATS Annex on Financial Services Paragraph 2(a).

¹⁵ For a discussion of the shortcomings of the institutional framework in the European Union with regards to financial supervision and its role in the recent financial crisis, see Eilis Ferran and Kern Alexander, 'Soft Institutions and Hard-Edged Power: What Role for the European Systemic Risk Board?', at 29 (Unpublished manuscript, 3 March 2010, on file with author).

¹⁶ For a description of the soft law basis of international standard setting bodies, see generally David Zaring, 'Informal Procedure, Hard and Soft, in International Administration', 5 *Chicago Journal of International Law* 547 (2005); David Zaring, 'International Law by Other Means: The Twilight Existence of International Financial Regulatory Organizations', 33 *Texas International Law Journal* 281 (1998).

setting, and the Financial Stability Board which is charged with oversight of systemic risk. Other important bodies include the Basel Committee on Banking Supervision, the International Organization of Securities Commissions (IOSCO), and the International Association of Insurance Supervisors (IAIS), responsible for setting international standards for banking, securities regulation, and insurance, respectively. Finally, alongside these primary regulators are other important standard-setting bodies that enjoy much more limited mandates and tackle very specific domains of finance. To name a few, the International Accounting Standards Board (IASB), with participation from the International Federation of Accountants (IFAC), promulgates international guidelines on how particular types of transactions and other events should be reflected in financial statements.¹⁷ Meanwhile payment systems are addressed primarily by the Committee on Payments and Settlements Systems (CPSS),¹⁸ while the Financial Action Task Force promulgates rules to combat money laundering and terrorist financing.

III. KEY SPECIES OF (SOFT) INTERNATIONAL FINANCIAL LAW

Just as the sources of international financial law are informal, so are the legislative products that they promulgate. International financial law is, in short, legally non-binding, and as such is characterized (and analyzed) as international 'soft law'. Although the forms in which soft law arises are myriad, they can be categorized according to three basic genres.

A. Best practices

First, international financial law often takes the form of best practices that promote sound regulatory supervision through rules of thumb.¹⁹ Often, best in a softer version, 'generally accepted' practices, concern discrete issue areas, like capital adequacy, optimal disclosure rules, and due diligence

¹⁷ The first-generation set of rules, promoted under the organization's predecessor organization, The International Accounting Standards Committee, were called the international accounting standards (IAS). Later, when the organization changed its name and reorganized in 2001, the IASB incorporated the IAS but now promulgates new rules called international financial reporting standards (IFRS). These standards have gained prominence and now rival the US Generally Accepted Accounting Principles (GAAP), especially since the European Union adopted IFRS in 2001, though they are generally viewed as more flexible—and lenient—than US standards. See William W. Bratton and Lawrence A. Cunningham, 'Treatment Differences and Political Realities in the GAAP-IFRS Debate', 95 *Virginia Law Review* 989 (2009), at 997–99.

¹⁸ For further information on the CPSS, see Bank for International Settlements, 'CPSS History, Organization, Cooperation', <http://www.bis.org/cpss/cpssinfo01.htm> (visited 14 June 2010).

¹⁹ Best practices have not been much analyzed from the standpoint of international law, but have been the subject of insightful scholarly examination in the domestic US context. See David Zaring, 'Best Practices', 81 *New York University Law Review* 294 (2006), at 294–350.

techniques for preventing money laundering. They may be transmitted by coalitions of wealthy regional bodies²⁰ and even private legislatures comprising professional associations and industry groups.²¹ In other instances, best practices have broader scope, touching on the general features of sound oversight in a particular financial sector. Particularly important in this regard are the standards comprising 'core principles' of regulation promulgated by the Basel Committee, IOSCO, and IAIS.²² As opposed to focusing on one discrete area, they provide an overview of what qualities are necessary for sound supervisory and prudential oversight. Best practices can also be articulated through codes of conduct addressed directly at private parties. IOSCO in particular has issued guidance aimed at minimizing conflicts of interest among credit ratings agencies, as well as promulgating implementation advisories to boost its effectiveness.²³

B. Regulatory reports and observations

Though rarely acknowledged as such, the data collected, assessed and ultimately utilized by national regulators to craft policy serve as a second important form of international financial law. Reports create an official record of fact, as well as institutional opinions and perspectives as to financial data and their implications for the broader global economy. In doing so, reports help establish a basis for policymaking and often generate normative undercurrents that help define the appropriateness of national regulatory approaches. They also, by extension, help establish tacit commitments by national authorities. Where, for example, reports identify certain regulatory practices as deficient or ineffective, sponsors of the report are, at least tacitly, committing to not adopting such practices. In this way, reports can take on commitment-like qualities because insofar as signatories have wide discretion as to future actions, but are at least expected by one another (and often by outsiders) not to engage in behavior contrary to or conflicting with the values or norms expressed in the reports. They are, for this reason, highly debated and negotiated instruments. Reports can similarly identify alternative policies that, at

²⁰ See, for example, the G-20, which represents the economies of leading developed and emerging economies.

²¹ Perhaps the most important private legislatures include IASB and IFAC, the international standard-setters for accounting and auditing services (noted above).

²² See, e.g. Basle Committee on Banking Supervision, 'Core Principles for Effective Banking Supervision', Basle, September 1997, <http://www.bis.org/publ/bcbs30a.pdf> (visited 14 June 2010); International Association of Insurance Supervisors, 'Insurance Core Principles and Methodology' 2003, http://www.iaisweb.org/_temp/Insurance_core_principles_and_methodology.pdf (visited 14 June 2010); IOSCO, 'Objectives and Principles of Securities Organization', May 2003, <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD154.pdf> (visited 14 June 2010).

²³ The Technical Committee of the IOSCO, 'Code of Conduct Fundamentals for Credit Rating Agencies', December 2004, <http://www.treasurers.org/node/3134> (visited 14 June 2010).

least implicitly, regulators commit to following or developing in their home jurisdictions.

C. Information-sharing and enforcement cooperation

Finally, many international financial agreements spell out, often in the form of memoranda of understanding (MoUs), the procedural means by which greater information sharing and enforcement cooperation can be achieved. Information-sharing agreements address, at both regional and global levels, the reality that many financial institutions are themselves globally active, and have a span that reaches around the world. It is often difficult to gain adequate, relevant information in order to assess the risk exposures of banks, or the possibility of transnational fraud or money-laundering. Consequently, authorities of both banking and securities markets routinely enter into information-sharing agreements whereby national authorities commit to better coordination with one another to enhance their prudential oversight and monitoring at home.

Meanwhile, enforcement cooperation agreements spell out the terms by which different countries agree to provide one other with assistance with regard to the enforcement of their domestic rules and obligations abroad. Perhaps not surprisingly, securities regulators have been especially active in this space, and have enacted scores of enforcement MoUs geared toward more effective cross-border cooperation. Through such agreements, gaps arising in transnational cases are narrowed; where, for example, a Swiss conman perpetrates a fraud concerning the sale of a security against a person in the USA, the existing enforcement agreement between Switzerland and the USA would provide a formal process by which witnesses, evidence, or the proceeds of fraud can potentially be accessed by US regulators with the help of officials in Switzerland.

IV. DOMINANT EXPLANATIONS OF SOFT LAW'S POPULARITY

The ubiquity of informal agreements in international financial affairs has been noted frequently in both political science and legal literature, although few comprehensive theoretical explanations have been proffered to explain the phenomenon. Instead, it is commonly viewed as the product of power relations between countries, and usually cast as a dependent variable or signpost of power positions, as opposed to an independent variable informing the behavior of a host of regulatory and financial actors.

In many ways, this realist framing is not surprising, especially in light of the 'soft law' character of international financial regulation. The absence of any formal obligation enables a cheap exit from commitments, and by extension permits opportunism wherever it suits a country. As a result, international relations theorists do not view international financial law as an independent variable possessing any disciplining power; instead,

international financial regulation is largely posited as the product of more rudimentary forces of political or economic (and for some, military) power. Simply put, in the absence of a forceful legal regime, it is 'power', not law, which promotes the promulgation of international standards.²⁴

Nevertheless, scholars have put forward two explanations that help, to a degree, clarify soft law's popularity from the standpoint of negotiation costs. Contractarian interpretations of soft law, articulated most famously by Kenneth Abbott and Duncan Snidal, and later by Charles Lipton, view soft law's primary merits as lying in the value of lowering the costs of contracting.²⁵ States, they note, not only seek to generate credible commitments and norms to following certain policies, but they also seek to do so quickly and efficiently. From this perspective, hard law is at times unattractive. Treaty-making often entails months—if not years—of negotiation between heads of state, their representatives, and domestic legislatures. And once created, they are hard to change, increasing the risk that rules generated through treaties fall out of step with practice.²⁶

Soft law, by contrast, provides a decisively cheaper means of agreement-making.²⁷ It carries what can be thought of as low bargaining costs due to its informal status. Perhaps most important, it does not necessarily require extensive participation by heads of state or lengthy ratification procedures. Instead, agreements can be entered into between administrative agencies and technocrats—with relatively little interference by outsiders. As a result, the universe of interests becomes more finite, easing negotiation. Parties can also, because of the flexibility afforded by soft law, amend accords relatively easily, so long as agreement among parties exists.²⁸

Soft law additionally involves far fewer 'sovereignty costs' or constraints that may limit the ability of a state to follow its own national prerogatives. Sovereignty costs arise, at a most basic level, any time countries are no longer able to follow their national prerogatives.²⁹ Hard law is, as discussed above, often extremely restrictive; retaliation, reciprocal noncompliance, and reputation act as important disciplines for most countries. Together, or on

²⁴ This realist interpretation of international affairs was first articulated by Kenneth Waltz. See generally Kenneth Waltz, *Theory of International Politics* (Reading: Addison-Wesley, 1979).

²⁵ Abbott and Snidal, above n 7 at 434; Charles Lipson, 'Why Are Some International Agreements Informal?', 45 *International Organization* 495 (1991), at 518 (noting that it is less costly to abandon informal commitments).

²⁶ Levit, above n 1, at 171.

²⁷ Jacob E. Gersen and Eric A. Posner, 'Soft Law: Lessons from Congressional Practice', 61 *Stanford Law Review* 573 (2008), at 589 (discussing 'cheap talk' theories).

²⁸ Lipson, above n 25, at 500 (noting that although treaties often contain clauses permitting renegotiation, the process is slow and cumbersome).

²⁹ David Epstein and Sharyn O'Halloran, 'Sovereignty and Delegation in International Organizations', 71 *WTR Law & Contemporary Problems* 77 (2008), at 89 (defining sovereignty costs as the distance between the policy a country would implement if it were not a member of an international organization and the policy it enacts once it has joined).

their own, each of these consequences can affect a country's ability to secure its policy preferences once a treaty is signed. Treaty signatories thus find themselves more constrained with regards to the range of conduct practically available to them and their ability to secure their own policy preferences and welfare.

Sovereignty costs will be particularly steep where, as is often the case, hard law involves the acceptance by countries of an external authority over significant political or economic decisions.³⁰ International agreements may implicitly or explicitly empower international or supranational authorities—many of which are neither elected nor otherwise subject to domestic forms of accountability—to act in ways that may limit the ability of states to govern entire classes of issues.³¹ Indeed, in some cases, such delegations of authority may even inform and determine the relations between a state and its own citizens and domestic market participants, as the famous *Metalclad* case demonstrated.³²

Soft law's informal status allows parties to avoid such unexpected sovereignty costs, scholars note.³³ Where organizations are informal, no delegation of power is made to independent supranational authorities. And because agreements are not legally binding, financial regulators can choose not to adopt certain elements of the international legislation. This of course applies not only to policy suggestions proffered by reports, but also to more prescriptive terms spelled out in instruments laying out best practices. Additionally, even where they may signal intent to pursue a particular course of action, they may defect from such soft commitments if later circumstances suggest that compliance would not be in the best interests of the signatories. These defections from their commitments will not, international theorists predict, carry reputational consequences insofar as no 'legal' obligations exist. Simply put, most soft law agreements are usually framed in conditional language ('parties intend to' or 'strive to achieve') and are not legal instruments as a matter of international law; parties have thus not committed to anything that could harm or erode a state's national reputation. Regulators retain flexibility in managing their own affairs since no legal obligations are assumed and parties are given the opportunity to learn about the impact of certain policy choices over time.³⁴

³⁰ Michael C. Dorf, 'Dynamic Incorporation of Foreign Law', 157 *University of Pennsylvania Law Review* 103 (2008), at 133–38 (describing the costs arising when organizations incorporate the laws of foreign or international bodies).

³¹ Abbott and Snidal, above n 7, at 421 (defining hard law as legally binding obligations that delegate authority for interpreting and implementing the law to international actors).

³² *Metalclad Corp. v United Mexican States*, ICSID Case No ARB(AF)/97/1 (ICSID AF) (30 August 2000).

³³ *Ibid.*, at 438 (noting that hard law can lead to unanticipated costs because states cannot predict all possible contingencies); Shaffer and Pollack, above n 6, at 719 (noting that soft law allows states to limit the risk of uncertainty).

³⁴ Abbott and Snidal, above n 7, at 423.

Finally, soft law also helps facilitate agreement by lowering the risk of uncertainty that frequently pervades policy issue areas. Frequently, there is considerable skepticism or angst concerning the adoption of any particular approach. 'The underlying problems may not be well understood, so states cannot anticipate all possible consequences of a legalized arrangement.'³⁵ The wrong standard can, in principle, not only disadvantage domestic firms, but could also prove to be inefficient by either overburdening firms or not being stringent enough with regard to oversight of financial activities. There is, as a result, considerable uncertainty attached to entering into long-standing or durable agreements. This can especially be the case with regard to financial regulation which can address novel products, vehicles for investment, or investment strategies, and thus full information as to the impact of any particular rule may be unavailable.

Hard law deals with this problem by leaving contentious terms imprecise or vague.³⁶ In doing so, however, it reduces the usefulness of coordination in the sense that without a full or comprehensive agreement, uncertainty can still undergird agreements. Alternatively, treaties may incorporate reservations or, more importantly, allow signatories to exit from commitments.³⁷ However, even then, treaty exit can take decades to execute. As a result, hard law instruments frequently delegate authority to an international organization or special tribunal, which would then be charged with implementing and interpreting the agreement as circumstances unfold. This latter approach, however, not only involves high sovereignty costs, but it may also do little to assuage the basic risks of uncertainty that ultimately pervade international economic agreements.

In comparison, soft law provides an attractive alternative to these approaches by employing non-legal obligations that allow participants to avoid any unpleasant surprises.³⁸ By avoiding formal legality, parties to agreements are able to see the impact of rules in practice in order to better assess their benefits; at the same time, they retain the flexibility to avoid any unpleasant surprises the rules may hold.³⁹ Thus, from this perspective, soft law affords strategies for both individual and collective learning whereby parties can work out problems over time.⁴⁰ Especially in the

³⁵ Ibid, at 441.

³⁶ Ibid, at 442. Indeed, for some scholars, such vagaries render hard law 'soft'. Donald Langevoort notes, however, that other regulatory strategies are possible, including the targeting of new overlapping areas of interest among jurisdictions. See 'Global Securities Regulation after the Financial Crisis', *Journal of International Economic Law* (2010) (noting how the institutionalization of securities markets in both the USA and Europe creates new opportunities for international regulation).

³⁷ Laurence R. Helfer, 'Exiting Treaties', 91 *Virginia Law Review* 1579 (2005), at 1641–2 (analyzing the unilateral exit from international agreements).

³⁸ Abbott and Snidal, above n 7, at 442.

³⁹ Ibid.

⁴⁰ Ibid, at 443.

financial regulatory context, soft law allows parties to experiment, and, if necessary, change direction when new information and costs arise. Additionally, soft law serves as a communicative mechanism whereby countries can signal to one another their intention to take a particular regulatory action or to adopt a particular regulatory approach.

It is worth adding that the value of soft law has also been extolled by scholars of both international relations and international law who have come to view soft law as a power or a persuasive force in its own right. For nearly a decade, most scholars, guided by the pioneering work of Anne Marie Slaughter, have described the international financial system as consisting of collegial ‘networks’ that foster collective problem-solving and innovation through interactions of regulatory peers.⁴¹ Key to the success of networks has been the idea that within these networks, decision-making is not so much vested in the hands of uninformed political elites, but is instead guided by a stable of skilled technocrats who develop shared expectations and trust allowing them to dispense with time-consuming treaties and formal international organizations.⁴² Regulators instead execute and rely on less formal instruments that permit them to make rapid responses that keep pace with rapidly evolving financial markets.⁴³

V. FILLING THE GAPS IN EXISTING THEORY

The above theories offer welcome starting points for helping to evaluate the predominance of soft law in international affairs. But when applied to financial regulation, they overlook two important points. First, the above theories overlook perhaps the most obvious structural dynamic encouraging soft law at the international levels—the fact that administrative agencies of some variety, and not heads of state, are primarily involved in fashioning international rules. That is, because regulatory authorities are responsible for oversight in their home jurisdictions, in part due to their technical expertise, they take the lead internationally as well, often in order to fulfill domestic legislative mandates. Regulatory agencies and bureaucracies do not, however, have authority to enter into treaties by themselves, so one would and should expect a certain informality in their dealings.

⁴¹ See generally Anne-Marie Slaughter, ‘Governing the Global Economy through Government Networks’, in Michael Byers (ed), *The Role of Law in International Politics, Essays in International Relations and International Law* 202 (Oxford: Oxford University Press, 2000) 177–206.

⁴² See generally Pierre-Hugues Verdier, ‘Transnational Regulatory Networks and Their Limits’, 34 *Yale Journal of International Law* 113 (2009) (highlighting the limits of networks); see also Charles K. Whitehead, ‘What’s Your Sign?—International Norms, Signals, and Compliance’, 27 *Michigan Journal of International Law* 695 (2006), at 704.

⁴³ Kal Raustiala, ‘The Architecture of International Cooperation: Transgovernmental Networks and the Future of International Law’, 43 *Virginia Journal of International Law* 1 (2002), at 30 (exemplifying widespread use of MoUs as a cooperation tool).

Yet even this is, by itself, an ultimately inadequate explanation for soft law's predominance, as is evident from the second important shortcoming of the dominant explanatory models. Although existing theories differ considerably in terms of both their methodological and normative starting points, all ultimately assume a considerable consonance of interests between different regulatory players. For network theorists, soft law is largely envisaged as a means of power in a world animated by similarly situated, albeit decentralized parties engaged in a cooperative joint venture. Meanwhile, contractarians, though acknowledging the possibility of conflicting interests, often imply that interests are sufficiently congruent that soft law can paper over the cracks and constitute a suitably robust instrument for future coordination purposes.

Both presumptions are often difficult to support in international financial regulation. Many, if not most, coordination challenges in international finance are undergirded by significant distributive problems. One rule may have, in short, significant positive economic effects in one country, whereas in another, the implications may be far from beneficial. The possible canonical example is capital adequacy, where banks may find themselves in a less competitive position vis-à-vis their international competitors if they are required to satisfy the same capital positions as competitors. Numerous other examples are, however, available: mark-to-market rules can impact some financial institutions more negatively than others depending on their current accounting practices and balance sheet assets; money-laundering rules may make some countries less attractive destinations for capital; and even corporate governance reforms may force some countries to more dramatic reforms of firm organization than others.

This observation holds serious implications for soft law as an instrument of international financial regulation. At the most basic level, even if soft legal agreements can be achieved between parties, aided presumably by the informality of the rules, asymmetric distributional effects undermine the durability of informal international agreements as backtracking on commitments is possible. A state may, for example, recognize an opportunity to attract new business or transactions to its borders by offering less onerous disclosure requirements. Or, similarly, implementing a particular standard may be more costly (economically or politically) than what authorities expected when entering the agreement. Resources may have to be diverted to regulatory activities that are more valued by legislators or the general population, or the volume of financial transactions taking place in a country may unexpectedly suffer after entering into a particular international regime that imposes certain limitations on securities firms or banking institutions.

In such circumstances, soft law provides, at least as traditionally conceived, few disciplining mechanisms to prevent noncompliance with commitments. Indeed, the availability of cheap exit enables opportunism for parties

if circumstances change or if they identify, perhaps at a later time, more advantageous regulatory options. First, and perhaps most obvious, countries can choose not to implement any international rule. Instead, they can choose to continue on their current course, and in so doing avoid the adjustment costs of moving to a new standard. Alternatively, regulators may choose another regulatory approach that still departs from the path implied by existing international best strategies or agreements.

Alternatively, authorities can cherry-pick certain aspects of international agreements without embracing them comprehensively. If a particular global agreement, say on core standards, contains fifteen best practices, a country may choose to comply with only those that promote its own competitive position or financial market strength. In doing so, it may ultimately adopt in practice only a handful of the principles expressed in international agreements.

Finally, countries can adopt regulations in name, but can under-enforce the rules on their books, effectively leading to soft defections from commitments. This is frequently a problem where, as in the case of many regulations, commitments to international reforms involve not only the adoption of new laws, but also new domestic regulatory structures that may prove costly to domestic governments with other priorities. In such circumstances, signatories may agree in principle to certain kinds of conduct *ex ante* but may be incapable of, or institutionally incompetent with regard to, carrying out or executing the terms of the agreement *ex post*.⁴⁴

We are, therefore, left with a puzzle when integrating these options into existing cheap law theories: Why is soft law relied on so frequently to express global standards than treaties, which dominate the international trade arena? Although soft law may make agreement more likely on the front end, the availability of easy exit enables opportunism for parties when circumstances change or if they identify superior individual gains to be made by abiding to possibly (globally) suboptimal regulatory strategies. Insofar as regulatory choices and compliance with particular standards begin to resemble zero-sum games, as opposed to win-win collaborations, international legal theory predicts that international financial regulations will be unable to achieve deep and lasting convergence.

A. Stable versus unstable issue—area equilibria

At least one explanation can be found in what can be roughly acknowledged as the differing states of equilibrium states that trade and finance agreements

⁴⁴ Though not addressed specifically in this context, Howell Jackson surmises similar possibilities with regard to the under-enforcement of even domestic rules. See Howell Jackson, 'Variation in the Intensity of Financial Regulation: Preliminary Evidence and Potential Implications', 24 *Yale Journal on Regulation* 253 (2007), at 286–7 (discussing rational under-enforcement and inefficient under-enforcement).

imply. As the dominant theory predicts, informality lowers bargaining costs, not only because of presumably lower stakes, but also because of the possibility of leadership by lower-level non-political regulatory actors. This advantage can be particularly important where the underlying object of regulation is constantly evolving. The regulation of financial markets, for example, is difficult since financial markets are constantly evolving due either to innovations in the trading strategies or technological capabilities of market participants, and because of the changing macroeconomic and regulatory environment in which markets operate. As a result, 'the prudential regulation and supervision of financial markets requires continuous adaptation as markets themselves evolve'.⁴⁵ In such a reiterative bargaining context, which often requires swift regulatory responses, leadership by administrative agencies holds considerable advantages. Not only do regulators enjoy technical expertise, but rules and standards can be devised without necessarily jumping the political procedural hurdles associated with treaty ratification.⁴⁶

By comparison, trade has historically been a more stable object of regulation and it is here where treaties are more prominent. Goods are less fungible than financial products, and there are fewer means to evade core provisions of trade agreements. Instead, countries generally attempt to exploit existing (as opposed to new) loopholes to support domestic special interests such as longstanding exemptions (like agriculture) and non-tariff trade barriers (like currency manipulation). And it is particularly where trade lawyers have attempted to address those issue areas involving constant change and innovation such as intellectual property issues and services that treaties have been noticeably less robust and comprehensive.

B. Reputational disciplines

Institutional design also plays an important role in explaining the dominance of soft law in international financial regulation. Specifically, international financial law, though formally a species of soft law, is 'harder' than traditional public international law anticipates, a topic I have discussed elsewhere.⁴⁷ First, soft law, although informal, can express 'commitments' made by parties. In some cases, commitments may be relatively weak, since soft law comprises a set of observations made by members at international forums

⁴⁵ Ferran and Alexander, above n 15, at 1.

⁴⁶ See Roberta S. Karmel and Claire Kelly, 'The Hardening of Soft Law in Securities Regulation', 34 *Brooklyn Journal of International Law* 883 (2009), at 885 (noting that soft law is relied upon 'because of the need for speed, flexibility and expertise in dealing with fast-breaking developments in capital markets').

⁴⁷ Chris Brummer, 'How International Financial Law Works (and How It Doesn't)', *Georgetown Law Journal* (forthcoming January 2011), at 33 and 58, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1542829 (noting that international financial regulation is often buttressed by a range of reputational, institutional and market disciplines that render it more coercive than traditional theories of international law predict).

and, as such, may operate as way stations to a more elaborate regime or expressions of limited consensus among regulators as to the causes, and not the solutions, to emerging challenges.⁴⁸ In such cases, agreements take on qualities of broad ‘negative covenants’,⁴⁹ where signatories or sponsors of the legislation may have wide discretion as to future actions, but are at least expected not to engage in behavior contrary to or conflicting with the values or norms expressed in the agreements. In other circumstances, international financial law may express specific actions that parties to agreements intend to take, and in doing so constrain self-serving autonomy as kinds of ‘affirmative covenants’ or regulatory contracts.⁵⁰ In these circumstances, international financial law may be operationalized through bilateral or even multilateral MoUs or codes of conduct and best practices. Moreover, precise commitments may be spelled out under these agreements, along with explanatory methodologies or supporting documentation addressing the implementation of agreed-upon standards and principles.⁵¹

That the agreements are not legally binding like trade treaties does not detract from the fact that they are often made with great solemnity.⁵² International financial agreements often have important consequences for counterparties, and this makes them intrinsically important. To use a simple example, one regulator may rely on another in order to gain access to witnesses or evidences concerning a domestic violation that may be located in another jurisdiction. Where regulators fail to live up to their commitments to provide assistance, the counterparty will often internalize the costs of the defection. As a result, noncompliance with key international standards, if discovered by the parties, will cause counterparties and allies to rethink or reevaluate their expectations concerning the regulator’s future behavior, and undermine its incentives to cooperate with the regulator in the future.

C. Market disciplines

Alongside the reputational dynamics presaged by classic international law is what can be considered an array of possible market disciplines that can inform both firm preferences, and by extension, the decisions of regulators. Simply put, where capital markets are operating efficiently, they will reward a firm for its adherence to practices that are viewed by investors as making the firm more profitable.⁵³ If, for example, a firm discloses clear and useful

⁴⁸ Abbott and Snidal, above n 7, at 423.

⁴⁹ Ibid, at 425 (discussing how some international agreements are viewed as covenants).

⁵⁰ Ibid, at 424, 427 (discussing how rationalists view international agreements as expressing contractual commitments, usually between states).

⁵¹ Gersen and Posner, above n 27, at 573.

⁵² Chris Brummer, above n 47, at 13.

⁵³ This point perhaps enjoyed its most famous articulation in corporate law scholarship, especially regards to the ‘choice’ of states under domestic US corporate law. See Roberta Romano, *The Genius of American Corporate Law* (Washington, DC: AEI Press, 1993) (arguing that firms

information concerning its profits, shareholders should reward the company with higher share prices that reflect lower investment risk.⁵⁴ Similarly, where firms like banks and insurance companies set aside large capital cushions, shareholders will generally have more faith in the financial health of the company, contributing to higher valuations of the firms, just as potential counterparties to financial transactions will be more eager to transact with them.⁵⁵

What precisely constitutes 'efficient' rules or standards is, however, often debatable.⁵⁶ That said, market participants frequently perceive adherence to major international standards as a mark of good regulatory practice. The law and finance literature has long argued that some firms seek to become subject to the laws and supervision of major financial centers (and especially those in the USA) so that they can signal their strong corporate governance and disclosure for investors, and enjoy lower costs of capital.⁵⁷ Similar market reputational effects can take place with regard to international regulatory standards: Banks, for example, and even some insurance companies, often seek to adopt the Basel Committee's capital standards to signal that they are solvent and well-capitalized, as well as to signal to investors that they meet the most stringent regulatory oversight.⁵⁸ Moreover, where firms ignore or do not comply with well-regarded international standards, investment analysts will at times attempt to evaluate the risk embodied by the compliance gap—even where firms are still abiding by (less rigorous) national hard law obligations.

that choose states with inefficient corporate laws should have lower stock prices); Ralph K. Winter Jr., 'State Law, Shareholder Protection, and the Theory of the Corporation', 6 *Journal of Legal Studies* 251 (1977).

⁵⁴ See David Easley and Maureen O'Hara, 'Information and the Cost of Capital', 59 *Journal of Finance* 1553 (2004) (showing that differences in the composition of information between public and private information affect the cost of capital, with investors demanding a higher return to hold stocks with greater private information).

⁵⁵ In this case, the reverse is, not surprisingly, equally applicable. Specifically, where banks (or for that matter any financial institution embedded in financial systems as intermediaries) are viewed as having insufficient capital to meet their operational requirements or credit obligations, 'runs' on those banks are likely. For a recent description of bank runs over time, see Carmen M. Reinhart and Kenneth S. Rogoff, *This Time is Different: Eight Centuries of Financial Folly* (Princeton: Princeton University Press, 2009) 144–5.

⁵⁶ Indeed, the very concept of market efficiency is often difficult to discern. Randall S. Thomas and James F. Cotter, 'Measuring Securities Market Efficiency in the Regulatory Setting', 63 *SUM Law & Contemporary Problems* 105 (2005), at 122.

⁵⁷ See John C. Coffee Jr., 'Racing Towards the Top?: The Impact of Cross-Listings and Stock Market Competition on International Corporate Governance', 102 *Columbia Law Review* 1757 (2002), at 1763.

⁵⁸ Daniel W. Drezner, *All Politics is Global: Explaining International Regulatory Regimes* (Princeton: Princeton University Press, 2007) 147.

D. Institutional sanctions

Finally, alongside reputational and market costs, particularly egregious instances of non compliance with international standards can trigger sanctions by and from international organizations and financial institutions. Compliance with international standards is often the basis upon which loans are granted by the IMF and the World Bank.⁵⁹ If recipient countries take the loans and then renege on these commitments, they theoretically risk not being able to take out loans in the future. Moreover, where loans can be made in installments, they can be used as policy tools whereby subsequent extensions are made on the basis of steps taken to comply with the standards.

International standard-setting bodies themselves may have institutional mechanisms that make compliance more likely. Although many institutions are universal organizations, and thus open to all countries, institutions can adopt membership standards and punish those that fail to comply.⁶⁰ For more exclusive organizations that often operate as governmental ‘clubs’, organizational mechanisms may additionally provide for expulsion as the ultimate sanction for bad behavior and non compliance with the group’s standards.⁶¹

Finally, institutions can publicly signal a member’s failure to comply with particular rules or standards. Conventionally, this ‘name and shame’ strategy is associated with public international law institutions like the United Nations where states ignore widespread international law standards such as those relating to human rights or security. However, these institutional affects can also be employed in the financial regulatory arena as a means of isolating regulators both institutionally (and at times, personally) in the international community. Regulators can be viewed as second-class citizens within their own larger regulatory body.⁶² Additionally, regulators can face social opprobrium from counterparts in the relatively close-knit regulatory community for failing to deliver on the group’s regulatory program.

⁵⁹ Kern Alexander, Rahul Dhumale and John Eatwell, *Global Governance of Financial Systems: The International Regulation of Systemic Risk* (Oxford: Oxford University Press, 2006) 89; see also Joseph Stiglitz, *Globalization and Its Discontents* (New York: W. W. Norton & Company, 2002) 44 (discussing conditionality loans via the IMF); Rosa Lastra, *Legal Foundations of International Monetary Stability* (Oxford: Oxford University Press, 2006).

⁶⁰ See Abram Chayes and Antonia Handler Chayes, *The New Sovereignty: Compliance with International Regulatory Agreements* (Cambridge, MA: Harvard University Press, 2007) 70–71.

⁶¹ Drezner, above n 58, at 75–7 (discussing clubs, standards, and the possibility of expulsion); see also Chris Brummer, ‘Post-American Securities Regulation’, 98 *California Law Review* 327 (2010), at 364–72.

⁶² Embarrassment caused by deviating from network norms operates, for some, as a kind of social tax. Adhering to network-based standards may encourage praise, and deviation may cause embarrassment or shame that results in a loss of prestige or influence among peer regulators as the violation becomes known to others. See Whitehead, above n 42, at 705.

Shaming can also, importantly, carry costs beyond institutional and professional reputations. By publicly identifying jurisdictions that do not comply with their standards, institutions can create new market costs by implying or arguing that non-cooperative jurisdictions suffer from poor domestic oversight and market supervision and thus are somehow risky or dishonorable places to do business. As a result, any firm operating in a jurisdiction that is not compliant with the standards of the organization can potentially incur higher costs of capital, and targeted countries may find it more difficult to attract firms to enter their borders.

VI. WHY PREDOMINANCE IS NOT PERFECTION

For all its popularity, international financial regulation has not been without its own serious structural flaws and shortcomings, especially when compared to the law and institutions of international trade. Hard law, at least as operationalized under the WTO, allows members to police for compliance from their trading partners and fellow signatories. It then leverages the capabilities and incentives of members to enforce its decisions, thereby making its decisions (and underlying treaty commitments) directly applicable to members.

Such design innovations have not historically characterized the international financial architecture. For one, monitoring of compliance with international regulatory standards is not always robust. Although the IMF and World Bank are the primary actors tasked with the lion's share of surveillance responsibilities with regard to compliance with international regulatory standards, only those countries that are recipients of loans from the World Bank and the IMF have faced the prospect of surveillance by the two institutions. And even here, the data provided to international institutions are self-reported by national authorities—and can depend on information often provided by regulated financial entities that are themselves subject to little supervisory oversight.⁶³ Additionally, the information gained by surveillance is often published only with the permission of the country that is inspected.⁶⁴ Important changes have, however, recently been announced,⁶⁵ including commitments by G-20 countries to undertake assessments by the IMF and

⁶³ World Bank, 'Financial and Private Sector Development—Financial Sector Assessment Program', <http://lnweb90.worldbank.org/FPS/fsapcountrydb.nsf/FSAPEXTERNALcountryreports?OpenPage&count=5000> (visited 14 June 2010).

⁶⁴ International Monetary Fund, 'Factsheet: The Financial Sector Assessment Program (FSAP)', <http://www.imf.org/external/np/exr/facts/fsap.htm> (visited 14 June 2010) (noting that the voluntary nature of FSAPs is necessary for 'buy-in' among participants).

⁶⁵ IMF, 'IMF Expanding Surveillance to Require Mandatory Financial Stability Assessments of Countries with Systemically Important Financial Sectors', Press Release No 10/357, 27 September 2010, <http://www.imf.org/external/np/sec/pr/2010/pr10357.htm> (visited 18 October 2010).

World Bank, but the degree to which this will be sustainable and effective remains unclear.

Ironically, it is where soft financial law 'is' effective, and overcomes these challenges, that another second important problem arises—that of legitimacy.⁶⁶ Many international standard-setting bodies, though informal, are nonetheless 'exclusive' clubs generally constituted by wealthy countries, which effectively export their rules to the rest of the world, or 'open-membership' organizations administered by a tight policy core. Some outsiders to the policy process believe that rules and standards are devised to protect the interests of key players (especially developed countries) and in the process block legislation that is globally welfare-enhancing. As a result, international financial regulation, even where effective, can be exposed to charges of being unrepresentative (even more so than the WTO) and lacking in transparency and accountability—charges that in themselves can diminish the compliance pull of international financial regulation.⁶⁷

These observations suggest that in the long term, despite the predominance of soft law, reforms will likely have to be made as international financial law becomes an increasingly critical element of the global financial system. I have in my other writings suggested some good starting points.⁶⁸ For one, more robust monitoring of regulatory rules is necessary. Here, existing institutions can be improved—by making compliance with global inspection and surveillance processes mandatory, and by making the information gained from monitoring more useful and utilizable for investors and regulators alike.

Additionally, the legitimacy challenges facing the existing system suggest that more basic changes will likely have to be introduced at an organizational level to the existing regulatory architecture. Although it is unlikely that a 'WTO' can be created with the moral authority or mandate to supersede existing organizational arrangements, less dramatic reforms that enhance legitimacy may still be possible in existing soft law organizations. Most importantly, expanded or reformed membership in key standard-setting bodies may have to be introduced. Already, international financial institutions are beginning to adopt structural changes. The G-20 itself represents a displacement of the G7, the erstwhile and more exclusive venue of policy-making that dominated economic decision making the 1990s, and voting rules and decision-making in leading international financial institutions are

⁶⁶ Ferran and Alexander, above n 15, at 11, 18, 37–54 (discussing the legitimacy concerns regarding the Financial Stability Board, the IMF, and European Systemic Risk Board).

⁶⁷ *Ibid.*, at 12.

⁶⁸ Brummer, above n 47, at 65 (suggesting improvements in the monitoring and information utility to the existing structure of international financial system).

making ways to include leading emerging markets.⁶⁹ Similarly, emerging markets are gaining, albeit slowly, both clout and voting power in international financial institutions like the World Bank and the IMF.⁷⁰ Further institutional innovations will, however, perhaps inevitably be necessary in these and other standard-setting bodies as these countries come to wield more financial power and regulatory significance.

⁶⁹ Ibid, at 80.

⁷⁰ Ibid.