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THE POLITICS OF COMPETITION IN INTERNATIONAL FINANCIAL REGULATION

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The Politics of Competition in International Financial Regulation

Stavros Gadinis

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ABSTRACT: Policy coordination between diverse regulatory regimes in financial services ranks highly on the international political agenda, because regulatory differences create impediments to growing financial activity. Efficiency-oriented theories fail to explain why coordination was achieved in some domains but not in others, while arguments linking coordination to similarities or differences in states' substantive policy goals cannot account for coordination progress in spite of vast differences in prior domestic regimes. I argue that coordination success or failure depends on the interaction of two variables: whether strong competitors to U.S. firms and markets challenge U.S. dominance and whether activity is centralized at a main facility in a single jurisdiction, such as a stock exchange, or diffused around many separate jurisdictions. Strong U.S. dominance attracts more foreigners to U.S. centralized markets, who voluntarily adopt U.S. laws and lobby their governments for policy coordination; yet in dispersed markets, policy coordination offers limited benefits to either the United States or to foreign countries when U.S. dominance is strong. When a competitor challenges U.S. dominance in a centralized market, U.S. policymakers will maintain regulatory barriers to prevent U.S. investors from migrating to competitors. In dispersed markets, on the other hand, the United States will promote policy coordination because it can eliminate its competitors' advantages across all national markets. Four case studies in areas with varying degrees of U.S. dominance and market centralization support this theoretical framework: the accounting standards (U.S. GAAP – IFRS) convergence, the SEC's refusal to authorize the establishment of European exchanges' trading screens in the United States, the regulation of audit firms under the U.S. Sarbanes-Oxley Act, and the 1988 Basel Accord. This paper makes two contributions: it generalizes across cases to draw broad conclusions about the field of finance as a whole, and it highlights the role of politics in financial regulation, refining the concept of power, clarifying mechanisms, and providing a theory of how increased competition might shape diverse fields.

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Stavros Gadinis*

I. Introduction

International financial activity has expanded dramatically in recent years.¹ Propelled by the forces of globalization, ever-increasing cross-border capital flows boost the financial industry's turnover and create new opportunities for firms and investors. For example, the New York Stock Exchange ("NYSE") logo boasts that "the world puts its stock in us," referring to the 421 foreign companies it lists, with a market value of \$11.4 trillion (NYSE's aggregate market capitalization amounts to \$27.1 trillion).² Total cross-border claims of internationally active commercial banks in 2007 reached a staggering \$30 trillion,³ almost three times as much as in 2001.⁴ Large financial institutions have expanded globally to an impressive scale: Deutsche Bank's operations span seventy-three

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¹ See JEFFREY A. FRIEDEN, *GLOBAL CAPITALISM* 396 (2006); DANIEL W. DREZNER, *ALL POLITICS IS GLOBAL* 119 (2007).

² NYSE Listed Company Directory, <http://www.nyse.com/about/listed/listed.html?ListedComp=NONUS> (last visited March 24, 2008).

³ Ryan Stever, Christian Upper & Goetz von Peter, *Highlights of International Banking and Financial Market Activity*, BIS Q. REV. 26 (Dec. 2007), available at http://www.bis.org/publ/qtrpdf/r_qt0712.pdf.

⁴ Total cross-border claims for internationally active commercial banks in 2001 stood at \$10.9 trillion. Philip D. Wooldridge, *The International Banking Market*, BIS Q. REV. 13 (Dec. 2001), available at http://www.bis.org/publ/r_qt0112b.pdf.

different jurisdictions and include 1276 separate subsidiary firms⁵ with varying business objectives. Few other industries were able to benefit to this extent from links between previously distinct and geographically distant national markets brought about by improvements in communications technology.

Yet national laws still regulate crucial aspects of financial activity:⁶ they determine the creation of financial products, the rights of investors acquiring these products, and the licensing and conduct of firms offering these products to the public. Regulatory differences between various jurisdictions raise cross-border transaction costs and thus create significant impediments to international financial activity. Countries can lower these barriers by coordinating their regulatory policies; they can adopt a set of internationally harmonized regulatory standards,⁷ recognize the effectiveness of each other's oversight regime so as to eliminate dual compliance requirements, or both.⁸ Some states participate in regional integration programs that provide strong institutional mechanisms for policy coordination not only among member states,⁹ but also vis-à-vis third parties.¹⁰ Thus, reducing barriers to international financial activity provides a strong

⁵ Dagmar Linder, Director, Reg'l Mgmt., Central and Eastern Europe, Deutsche Bank AG, Supervision of Cross-Border Activities of Banks and Insurance Companies, Panel Session at the Symposium on Building the Financial System of the 21st Century: An Agenda for Europe & the United States (Mar. 11, 2006).

⁶ See Hal S. Scott, *International Finance*, in RESEARCH HANDBOOK IN INTERNATIONAL ECONOMIC LAW 363 (Andrew T. Guzman & Alan O. Sykes eds., 2006) [hereinafter Scott, *International Finance*].

⁷ For example, states agreed to harmonize capital adequacy rules for banks. See *infra* text accompanying notes 101–11.

⁸ In mutual recognition regimes, countries agree to a common set of substantive rules and administrative certification procedures as a condition for waiving proof of compliance with host country laws for cross-border activities. See Kalypso Nicolaidis & Gregory Shaffer, *Transnational Mutual Recognition Regimes: Governance without Global Government*, 68:3-4 LAW & CONTEMP. PROBS., Summer/Autumn, at 263, 265 (2005).

⁹ The most famous regional program of financial integration is the European Union's Financial Services Action Plan. See *Financial Services: Implementing the Framework for Financial Markets: Action Plan*, COM (1999) 232 (Nov. 5, 1999).

¹⁰ Financial integration across the European Union as a result of the Financial Services Action Plan permitted E.U. officials, on behalf of E.U. member states, to engage in a direct dialogue with U.S. authorities on transatlantic regulatory issues. For more information on this dialogue, see Kern Alexander et

efficiency justification for international policy coordination, which international law and international relations theorists have long identified.¹¹

Not only is coordination theoretically optimal, but a mechanism already exists to realize this goal. Capital mobility lies at the heart of traditional accounts of globalization, which highlight that countries have sacrificed policy autonomy to international market forces.¹² If states do not adjust their policies so as to offer the best possible regulatory framework for market participants, they risk an outflow of capital from their markets, as a second group of scholars argues.¹³ Therefore, as states compete with each other to attract capital, they amend their national laws along parallel lines. Overall, both the efficiency-oriented theories and the regulatory competition theories outlined above predict that structural constraints associated with financial globalization will lead to policy uniformity across national borders.

Yet, countries' financial laws remain characteristically heterogeneous, despite exponential growth in international financial activity. While coordination efforts have succeeded in some regulatory areas, they have stalled in others, despite strong efficiency arguments for a coordinated regime.¹⁴ Competition among financial centers has peaked, and calls for regulatory reform abound, but states insist on following very different

al., *A Report on the Transatlantic Financial Services Regulatory Dialogue* (Harvard Law & Econ. Discussion Paper No. 576, 2007), available at <http://ssrn.com/abstract=961269>.

¹¹ See Anne-Marie Slaughter, *Sovereignty and Power in a Networked World Order*, 40 STAN. J. INT'L L. 283, 290 (2004); Alan O. Sykes, *The (Limited) Role of Regulatory Harmonization in International Goods and Services Markets*, 2 J. INT'L ECON. L. 49, 52 (1999).

¹² The literature on globalization is extremely broad. For an overview of this literature with regard to policy coordination, see Geoffrey Garrett, *Global Markets and National Politics: Collision Course or Virtuous Circle?*, 52 INT'L ORG. 787, 788 (1998).

¹³ See Philip G. Cerny, *The Dynamics of Financial Globalization: Technology, Market Structure, and Policy Response*, 27 POL'Y. SCI. 319 (1994).

¹⁴ See, e.g., *infra* Parts IV.b.2, IV.b.4, V.b, V.d, VI.

regulatory approaches.¹⁵ Existing theories cannot explain why states have agreed to coordinate some areas of financial regulation but have maintained divergent laws in others.

To better address this puzzle, this Article examines a previously overlooked interaction: the link between domestic politics and states' responses to international coordination.¹⁶ In finance, as in other fields, governments adopt regulatory reforms to satisfy the demands of their constituencies. Domestic constituents will favor or oppose policy coordination depending on whether it promotes or hurts their interests. This paper argues that domestic interest groups' preferences toward international coordination depend on two factors: first, how much competition they are facing in global markets, and second, how important access to a leading foreign market is for them. Below, I explain in further detail which domestic constituents affect policymaking in finance, how regulation can impact their competitive position, and under which conditions access to a leading foreign market is crucial.

¹⁵ The U.S. financial industry is concerned that New York's primacy in global finance is threatened by London's success in attracting international securities issuers and nurturing innovation in derivatives contracts. See John Willman, *The City v. Wall Street: The Smart Money is on (and in) London*, FIN. TIMES, Jan. 27, 2007 at 11. London's flexible regulatory regime provides fertile ground for financial services professionals and investors, who have been discouraged by strict U.S. requirements. The Committee on Capital Markets Regulation, a group of prominent academics and experienced practitioners directed by Harvard Law School Professor Hal S. Scott, and co-chaired by Glenn Hubbard, dean of Columbia Business School, and John Thornton, chairman of the Brookings Institution, issued a report on November 30, 2006, on the competitiveness of U.S. public securities markets. See Committee on Capital Markets Regulation, <http://www.capmksreg.org> (last visited Mar. 19, 2008). The Committee included a number of other prominent economists and lawyers. Its findings were endorsed by Treasury Secretary Henry Paulson. See Editorial, *Hot Topic: Is Wall Street Losing Its Competitive Edge?*, WALL ST. J., Dec. 2, 2006, at A6; see also Greg Ip, Kara Scannell & Deborah Solomon, *Panel Urges Relaxing Rules For Oversight; Report Seeks Shift to 'Principles' to Ease a Financial Burden; Protection for Auditors, Directors*, WALL ST. J., Nov. 30, 2006, at C1. Politicians who have thrown their weight behind the calls for reform include New York City Mayor Michael C. Bloomberg (Republican), New York Senator Charles Schumer (Democrat), and former New York Governor Eliot Spitzer (Democrat).

¹⁶ The argument that domestic actors shape governments' international policy preferences is well-established in international relations theory. See Andrew Moravcsik, *Taking Preferences Seriously: A Liberal Theory of IR*, 51 INT'L ORG. 513 (1997); Jeffrey Legro, *Culture and Preferences in the International Cooperation Two-Step*, 90 AM. POL. SCI. REV. 118 (1996).

Two types of domestic constituents are most directly affected by policy changes in financial regulation:¹⁷ investors¹⁸ and financial firms.¹⁹ While investors are numerous, they vary greatly in terms of size and goals and are relatively disorganized. Financial firms, on the other hand, are organized into industry associations, often have self-regulatory powers, and are extremely well-resourced. In cases where financial firms' and investors' goals conflict, financial firms' positions are more likely to be coherently articulated, actively pursued through lobbying, and ultimately reflected in government policy.²⁰

Financial firms and investors are concerned with international policy coordination because they may obtain gains or suffer disadvantages due to cross-border regulatory differences. Even simple regulatory mismatches raise the costs of international financial activity. Moreover, regulatory differences can serve protectionist goals, as they impede market access for foreigners and thus preserve local players' turfs. From a substantive

¹⁷ In political economy models, governments' choices are largely influenced by the interests and lobbying power of their domestic constituents. For a characteristic political economy account of domestic politics' impact on international finance, see Jeffrey A. Frieden, *The Politics of National Economic Policies in a World of Global Finance*, 45 INT'L ORG. 425 (1991).

¹⁸ Investors enter the financial markets to pursue profitable investment opportunities. Some hold surplus capital that they seek to place, while others search for external financing to complement their own resources. Clearly, if investors with surplus capital could channel funds to those in search of financing, they would both be better off. Investors conclude mutually beneficial transactions through financial markets. For example, a corporation collecting funds from the issue of new stock and the numerous individuals buying it are investors on the opposite ends of a mutually beneficial transaction. Investors have varying resources, financial goals, risk profiles, and familiarity with financial markets: a small depositor and a large private equity fund both seek to invest additional capital, while a credit-card holder and a corporation issuing stock are both using external financing. As this diversity of investor profiles illustrates, concluding a mutually beneficial financial transaction is not always straightforward.

¹⁹ Financial firms are market professionals that aid investors in identifying opportunities that match their profiles and achieve their financial goals by reducing transaction costs and information asymmetries between different types of investors in financial markets. Firms such as commercial banks, investment houses, brokers, and mutual funds identify and negotiate the allocation of resources from capital pools to promising investment projects, while accounting firms and securities lawyers guarantee the flow of accurate information between contracting parties and formulate specific terms for each transaction. Alternative theories of intermediation portray financial firms as facilitating risk transfers among investors and creating additional investment options as they repackaging simple financial assets into more synthetic products at low cost. See Franklin Allen & Anthony M. Santomero, *The Theory of Financial Intermediation*, 21 J. BANKING & FIN. 1461 (1998).

²⁰ See generally MANCUR OLSON, *THE LOGIC OF COLLECTIVE ACTION* (1965).

perspective, some jurisdictions may subject financial activity to more burdensome regulation than others. Firms and investors often denounce stringent regimes as anti-competitive, although in some cases, stricter rules may attract foreigners who seek to signal their superior quality to the market.²¹ In all these cases, regulation can significantly impact firms' and investors' positions in global markets. Thus, as levels of competition in international markets rise, domestic constituents will increase pressure on their governments either in favor of or against policy coordination, depending on their interests.

This article examines how domestic interest-group preferences vary according to levels of competition in a market by distinguishing between *strong dominance* and *contested dominance* markets.²² A state's dominance in a market is strong when it meets two separate conditions: first, its national financial industry maintains the largest market share globally, and second, the wealth available for investment within that state's borders is significantly larger than that of other states. In contrast, a state's dominance in a market is contested when foreign competitors threaten the global market share of its national financial industry, although the wealth available for investment within the formerly dominant state's borders remains significantly larger in comparison to the wealth available in other states. The distinction between strong and contested dominance reflects recent developments in financial markets. In many markets, the United States enjoys a strong dominant position, as U.S. firms control a significant market share and U.S.

²¹ See John C. Coffee, Jr., *The Future as History: The Prospect of Global Governance in Corporate Governance and Its Implications*, 93 NW. U. L. REV. 641 (1999); Rene Stultz, *Globalization of Equity Markets and the Cost of Capital*, 12 J. APPLIED CORP. FIN. 8 (1999).

²² Theoretically, a situation in which no player is dominant could occur, but this is not a relevant empirical scenario in international finance because the United States has been the dominant power in finance since the end of World War II.

investment pools are uniquely large. U.S. dominance, however, is not uniform across markets; in some cases, competitors have been able to challenge U.S. preeminence. Still, as long as the U.S. government regulates access to large pools of investment wealth, it will maintain a significant policy tool against its competitors.

The dominant state's jurisdictional powers over large pools of investment wealth will be more effective in these coordination scenarios where these pools are particularly valuable for foreign firms and investors. In these cases, the benefits of coordination will outweigh the regulatory costs of adjustment to a new regime. In international finance, access to the dominant center's investment pools is more valuable for foreign firms and investors in certain types of markets. In particular, foreign firms and investors are more likely to cross the dominant center's borders if they seek to participate in a *centralized market*, i.e., a market that aggregates the supply side and the demand side in a single location.²³ The iconic example of a centralized market is a stock exchange because it combines all buy and sell orders in a single facility. To list their stock on the dominant center's exchange, foreign firms must comply with the dominant center's laws on publicly traded companies, thus creating strong incentives for those firms to advocate for regulatory harmonization at home.

In other markets, however, financial firms need to establish branches in local communities around the world to access investors. Banks and audit firms are characteristic cases of such *dispersed market* structures.²⁴ Distinguishing between centralized and dispersed markets is critical to analyzing the impact of regulatory mismatches on cross-border financial activity because of the territorial nature of

²³ See *infra* text accompanying notes 88-92.

²⁴ See *infra* text accompanying notes 114-116.

jurisdiction. Dispersion of financial activity in multiple territorial and jurisdictional units presents proponents of coordination with different challenges and requires different policy tools in comparison to aggregating firms and investors in a single territorial unit.

The remainder of this Article examines the effects of strong and contested dominance in both centralized and dispersed markets. In each case, it identifies specific mechanisms through which governments use and react to state power to further the interests of their constituents, and provides case study evidence to supplement its theoretical claims. Table 1 below summarizes the Article's main argument.

Table 1. Expected Policy Coordination Given Dominance and Market Structure Features

	CENTRALIZED MARKETS	DISPERSED MARKETS
STRONG DOMINANCE	Coordination – Dominant center standards prevail <i>Example: US GAAP – IFRS</i> Quadrant 1	No Coordination – Accommodation by special rules <i>Example: Auditor Regulation</i> Quadrant 2
CONTESTED DOMINANCE	No Coordination – Regulatory competition <i>Example: Trading Screens</i> Quadrant 3	Coordination – Leveling playing field for dominant firms <i>Example: Basel I</i> Quadrant 4

Quadrant One (Strong Dominance/Centralized Market):

In a market dominated by a single state, firms and investors from the dominant market are insensitive to regulatory differences due to their success in the global marketplace. In contrast, investors and firms from other countries may incur significant costs if they wish to access the dominant center's market because they will be required to comply with the dominant center's laws. As foreign firms and investors in centralized markets can achieve their investment goals only by accessing the dominant center, they face high compliance costs and redundant regulatory oversight. Thus, they will lobby their governments to coordinate their policies with the dominant center. For example, the United States and the European Union have recently reached an agreement for convergence on accounting standards that will likely signal global convergence on common principles.²⁵

Quadrant Two (Strong Dominance/Dispersed Market):

In contrast, there is little demand for coordination in dominant state markets where market activity is dispersed in many jurisdictions around the world. Dominant-center firms have already succeeded in expanding abroad, and local constituents have few incentives to move beyond their borders. Thus, policy coordination is unlikely. For example, the market for audit services is dispersed around the world and dominated by four firms for which the United States is the single largest revenue source. However, the

²⁵ See *infra* Part IV.b.2.

United States' decision to subject audit firms to tight government regulation under the 2002 Sarbanes-Oxley Act did not spark global harmonization.²⁶

Quadrant Three (Contested Dominance/Centralized Market):

The predictions for policy coordination change dramatically when a serious competitor emerges, altering the costs and benefits of coordination for dominant and foreign interest groups alike. As financial firms from the dominant center lose ground to their competitors, they will lobby their government for support. The dominant-center government can use regulatory policy to assist financial firms in various ways. First, it can relax substantive requirements for financial transactions so as to undercut its competitors. Second, the dominant center can use regulatory differences to prevent competitors from entering its markets or participants in its markets from abandoning it in favor of its competitors. Finally, the dominant center can pursue a policy coordination agreement, so as to ensure that financial firms, regardless of origin, are competing internationally under equivalent terms (i.e., to “level the playing field” for its financial firms). The dominant center's ultimate course will depend, as before, on its ability to impose its choices on foreign financial firms and investors who seek to cross its borders in order to conduct business in its jurisdiction.

However, the preferences of foreign firms and investors in centralized and dispersed markets are now reversed in comparison to the dominant-market setting. In centralized markets, a competitor offers a viable alternative to the dominant center's market, attracting an increasing number of international market participants and thus hurting the dominant center's appeal. As fewer firms and investors prefer the dominant

²⁶ See *infra* Part IV.b.4.

center, its ability to impose its policy choices on other governments diminishes. Moreover, it is unclear whether policy coordination and market openness would reverse the fortunes of a declining market. On the other hand, the dominant center could entice more international business by relaxing regulatory standards and could limit the outflow of investment wealth to its competitors by imposing barriers to trade. Thus, divergence, rather than coordination, seems a more promising strategy for a dominant government facing a competitor in a centralized market. In the empirical case discussed below, when the preeminence of U.S. stock exchanges was threatened by their European competitors, the United States did not reach an agreement with the European Union on a common set of rules that would have allowed European stock exchanges to establish a direct presence in the United States through. Instead, the United States insisted on requiring foreign exchanges to comply with U.S. standards before operating trading screens in its jurisdiction.²⁷

Quadrant Four (Contested Dominance/Dispersed Market):

While a competitor in centralized markets seeks to *attract* as many international firms and investors as possible in its market center, a competitor in dispersed markets seeks to *expand* outside of its market to as many foreign jurisdictions as possible. In this situation, even as the dominant market's firms lose their competitive edge, the dominant center still has an advantage: its jurisdiction encompasses large pools of wealth available for investment. To access these pools, financial firms must comply with the dominant government's laws. Thus, the dominant government can use regulatory policy to "level the playing field" with its competitors by entering into a policy coordination agreement.

²⁷ See *infra* Part V.b.

When Japanese banks challenged U.S. dominance in the dispersed banking market, the United States threatened to exclude Japanese institutions that failed to comply with its capital-adequacy requirements from U.S. markets. As a result, Japan and other influential jurisdictions agreed on the 1988 Basel Accord on capital adequacy for banks.²⁸

In addition to these four detailed case studies, this Article also illustrates how the framework it proposes would explain coordination success or failure in other famous regulatory disputes between major jurisdictions in finance. In particular, it discusses briefly the positions of the United States and the E.U. with regard to supervision of financial conglomerates, and the U.S. requirement for reinsurance collateralization. Moreover, the Article demonstrates that changes in the competitive position of key jurisdictions over time can explain recent developments in the areas covered in the case studies. It examines briefly the Basel II capital adequacy framework and the proposals by SEC officials for mutual recognition of transatlantic stock exchanges.²⁹

The Article proceeds as follows. Part II highlights gaps and inconsistencies in current accounts of international policy coordination that motivate the inquiry of this Article. Part III outlines the impact of national regulatory differences on competition in financial markets and provides a definition of dominance. Part IV explores the politics of dominance, linking the success and failure of policy-coordination efforts with the preferences of interest groups in the dominant center and in foreign countries. To support its theoretical conclusions, it provides a case study for successful policy coordination (focusing on international accounting standards) and a case study for a failed effort to coordinate (focusing on audit firm regulation). Part V examines how increased

²⁸ See *infra* Part V.d.

²⁹ See *infra* Part VI.

competition alters the alignment of interest groups both within the dominant state and within its competitors. Again, two case studies confirm the theoretical predictions of the analysis: a failed attempt at coordination (exchange trading screens) and a successful case of coordination (the Basel Accord). Part VI concludes.

II. Theoretical Approaches to Policy Coordination

Legal theorists and political scientists have long puzzled over the burgeoning phenomenon of global policy coordination, struggling to explain why countries choose to adopt similar laws in some areas but not in others. The following section explains that traditional accounts of policy coordination, despite their otherwise large substantive and normative differences, share a common approach: they all view policy coordination as evidence that states have lost their policymaking autonomy to the forces of globalization. These theories focus on global factors that constrain governments' choices, either because coordination is better able to address regulatory concerns with cross-border implications, or because market dynamics dictate preferred types and levels of regulation. They are limited because they only take into account states' common constraints. More recent theories that consider states' varying powers and political behaviors, as well as their common constraints, offer more convincing explanations for global policy coordination.

II.a Regulatory Competition Theories

Drawing insights from the literature on competitive federalism in the United States,³⁰ a group of theorists seeks to explore the differences among states' laws in a globalized market from a competitiveness perspective. For some, regulatory competition provides a superior mechanism of policymaking leading to a "race to the top," as states seek to offer the most efficient regime to investors.³¹ Others predict a "race to the bottom" with lamentable consequences, arguing that states will lower their regulatory standards to attract cost-conscious enterprises or opportunistic managers.³² Regulatory race theories have been used to explain phenomena as diverse as capital controls removal,³³ welfare benefits reduction,³⁴ and corporate law evolution.³⁵ In securities

³⁰ In a seminal article on local expenditures, Charles Tiebout provided a model of taxation according to which taxpayers move to the local community that has a level of taxes closest to their preferences, driving governments to adjust accordingly. As mobility of capital and businesses has skyrocketed, a group of theorists built on Tiebout's foresight to argue that governments compete with each other to attract investors. See generally Charles M. Tiebout, *A Pure Theory of Local Expenditures*, 64 J. POL. ECON. 416 (1956).

³¹ Race-to-the-top proponents justify states' eagerness to satisfy the investing public on various grounds. For example, states benefit from greater business for the local financial industry, greater tax revenues, greater liquidity, and lower transaction costs for their domestic companies. See Stephen J. Choi & Andrew T. Guzman, *National Laws, International Money: Regulation in a Global Market*, 65 FORDHAM L. REV. 1855, 1860 (1997). Investors will avoid jurisdictions where increased compliance costs do not correspond to the additional protection ensured, as well as jurisdictions where low regulatory standards disproportionately increase investors' risks. See *id.* at 1870.

³² Firms' managers, who are ultimately responsible for choosing the regime applicable to their firms, may have an interest in limiting disclosure to investors to avoid revelations about past abusive practices. Thus, managerial opportunism may drive a race to the most efficient regime for managers, but not investors. See James C. Cox, *Rethinking U.S. Securities Laws in the Shadow of International Regulatory Competition*, 55 LAW & CONTEMP. PROBS., 157, 163-164 (1992).

³³ See Cerny, *supra* note 13, at 323-325.

³⁴ See generally Craig Volden, *The Politics of Competitive Federalism: A Race-to-the-Bottom in Welfare Benefits?*, 46 AM. J. POL. SCI. 352 (2002).

³⁵ In a seminal article, Cary argued that state competition for corporate charters had evolved into a race to the bottom. See William Cary, *Federalism and Corporate Law: Reflections upon Delaware*, 83 YALE L.J. 663, 705 (1974). Cary's article triggered a long debate among corporate law scholars, which continues to the present date. Romano supports the race-to-the-top position by providing evidence that state lawmaking is responsive to corporate needs. See Roberta Romano, *Law as Product: Some Pieces of the Incorporation Puzzle*, 1 J.L. ECON. & ORG. 225, 250-265 (1985). On the other hand, Lucian Bebchuk argues that managerial opportunism and the presence of externalities may result in suboptimal state corporate laws. See Lucian Arye Bebchuk, *Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law*, 105 HARV. L. REV. 1435, 1440 (1992).

regulation in particular, regulatory competition ideas have inspired a series of proposals for an international securities regime, sparking a long debate among academics.³⁶ According to these proposals, states should allow issuers conducting a securities offering in their territory to use the disclosure standards of a jurisdiction of their choice. Authorities from that jurisdiction should be responsible for ensuring compliance with its rules. The competitive pressures generated by issuers' abilities to choose their disclosure regimes should induce governments to provide optimal rules for firms.

While regulatory-race theories ultimately predict policy uniformity, either to the top or to the bottom, regulatory policy today remains widely heterogeneous across nations. Race-to-the-bottom fears have largely dissipated as regulatory standards have generally become more stringent over time.³⁷ However, race-to-the-top wishes have not materialized either. Strong political considerations prevent competition as direct as the theoretical models of regulatory races envision. Some governments are less exposed to competitiveness concerns than others because their national markets have greater liquidity and cater to larger investment pools. Moreover, states have many reasons to terminate or avoid a regulatory race instead of participating in it. Regulatory

³⁶ See Stephen J. Choi & Andrew T. Guzman, *Portable Reciprocity: Rethinking the International Reach of Securities Regulation*, 71 S. CAL. L. REV. 903, 922 (1998); Roberta Romano, *Empowering Investors: A Market Approach to Securities Regulation*, 107 YALE L.J. 2359, 2419 (1998). For a review of these proposals and their connections with analogous debates occurring in the fields of corporate and banking law, see generally Howell E. Jackson, *Centralization, Competition and Privatization in Financial Regulation*, 2 THEORETICAL INQUIRIES L. 649 (2001).

³⁷ See Beth A. Simmons, *The International Politics of Harmonization: The Case of Capital Market Regulation*, 55 INT'L ORG. 589, 590 (2001) [hereinafter Simmons, *The International Politics of Harmonization*]. Howell Jackson and Eric Pan provide significant evidence against race-to-the-bottom predictions in disclosure standards for international securities offerings in Europe during the 1990s. Most issuers combined a heavily regulated public offering in their domestic market with an unregulated private placement to institutional investors in other European jurisdictions. Instead of taking advantage of lower disclosure requirements in their domestic markets, they drafted their disclosures according to much more demanding U.S.-inspired standards. See Howell E. Jackson & Eric J. Pan, *Regulatory Competition in International Securities Markets: Evidence from Europe in 1999 – Part I*, 56 BUS. LAW. 653, 685-686 (2001).

bureaucracies in each state may be reluctant to abandon their clearly defined territorial powers to enter a race with other bureaucracies.³⁸ Domestic constituents may demand protection against competition from their governments, supporting restriction of market access for foreigners instead of market openness.³⁹ Overall, while competitiveness concerns affect policymakers' decisions, as regulatory race theories emphasize,⁴⁰ they cannot capture the full array of challenges and considerations that shape policymakers' choices at the international level.

II.b Functional Theories

A second group of scholars argues that policy coordination in international business regulation is spreading because it can produce superior results to unilateral action.⁴¹ Proponents of efficiency arguments emphasize that policy coordination reduces the costs of regulatory heterogeneity,⁴² such as costs resulting from dual compliance requirements or diverse regulatory regimes. Familiarizing themselves with local regimes

³⁸ See Frederick Tung, *From Monopolists to Markets?: A Political Economy of Issuer Choice in International Securities Regulation*, 2002 WIS. L. REV. 1363, 1369 (2002). This argument is an extension of a public choice critique of international cooperation, viewing harmonization as the tool through which regulators aggrandize their monopolies beyond their national borders. See Enrico Colombatto & Jonathan Macey, *A Public Choice Model of International Economic Cooperation and the Decline of the Nation State*, 18 CARDOZO L. REV. 925, 926 (1996).

³⁹ Suzanne Berger highlights this "paradox" of globalization: as global markets become integrated, domestic actors will start to exercise pressure on local governments to erect or maintain barriers to trade, rather than demolish them. See Suzanne Berger, *Globalization and Politics*, 3 ANN. REV. POL. SCI. 43, 58 (2000).

⁴⁰ See Joel P. Trachtman, *Recent Initiatives in International Financial Regulation and Goals of Competitiveness, Effectiveness, Consistency and Cooperation*, 12 NW. J. INT'L L. & BUS. 241, 246 (1991) [hereinafter Trachtman, *Recent Initiatives*].

⁴¹ See *id.* at 244 (arguing that regulatory effectiveness is one of the main goals of international regulation); see also Beth A. Simmons, *Compliance with International Agreements*, 1 ANN. REV. POL. SCI. 75, 76 (1998) [hereinafter Simmons, *Compliance with International Agreements*].

⁴² See Sykes, *supra* note 11, at 52. Sykes does not favor full harmonization. Heterogeneity, he argues, is desirable when it results from different conditions or past historical experiences in each jurisdiction. In his view, however, reasonable differences in the regulatory policies of various states should not preclude them from cooperating through systems of mutual recognition. By "agreeing to disagree," he claims, states may remove significant barriers to international activity while avoiding serious compromises to their regulatory objectives. *Id.* at 67. He believes that greater cooperation precludes domestic interest groups from "capturing" local regulators so as to utilize regulatory differences as entry barriers. *Id.* at 59–60.

is also costly for potential market entrants. Moreover, firms may lose the advantage of economies of scale if operations must be scattered across jurisdictions for regulatory reasons.⁴³ Reductions of these costs will boost international capital flows, facilitate efficient capital allocation across borders, and help governments around the world to promote business activity and aggregate growth.⁴⁴

Another strand of functional theorists views efforts for policy coordination as a result of states' inability to solve a particular problem without cooperation.⁴⁵ Political scientists have long argued that international institutions, including harmonized regimes, are tools utilized by states to achieve more efficient outcomes through cooperation, correcting information asymmetries,⁴⁶ or resolving collective-action problems.⁴⁷ Inspired by this literature, international lawyers also perceive harmonized regulatory regimes as a response to problems with cross-border ramifications, such as environmental issues, health and safety matters, or financial instability.⁴⁸ A particularly acute concern

⁴³ See *id.* at 54.

⁴⁴ See Joel P. Trachtman, *Unilateralism, Bilateralism, Regionalism, Multilateralism, and Functionalism: A Comparison with Reference to Securities Regulation*, 4 TRANSNAT'L L. & CONTEMP. PROBS. 69, 78 (1994) [hereinafter Trachtman, *Unilateralism*]. Emphasizing the importance of cost reduction for trade in services, Trachtman regards the effects of harmonization and mutual recognition strategies as the equivalent of a "customs union" in the services sector. *Id.* at 116.

⁴⁵ See Trachtman, *Recent Initiatives*, *supra* note 40, at 244 (arguing that regulatory effectiveness is one of the main goals of international regulation); see also Simmons, *Compliance with International Agreements*, *supra* note 41, at 80 (explaining that functional theories view international cooperation as a response to a perceived common need, e.g. protection of the environment, that states would find hard to address in some other way).

⁴⁶ For example, Simmons argues that the establishment of the Bank for International Settlements was aimed at alleviating information-asymmetry concerns regarding the bonds issued by the German Government to repay World War I reparations. See Beth A. Simmons, *Why Innovate? Founding the Bank for International Settlements*, 45 WORLD POL. 361, 364 (1993).

⁴⁷ See ROBERT KEOHANE, *AFTER HEGEMONY: COOPERATION AND DISCORD IN THE WORLD POLITICAL ECONOMY* 82 (1984). Anne-Marie Slaughter identifies networks of government officials targeted at resolving particular problems generated by cross-border economic activity. For example, harmonization networks allow states to promote their common interests by standardizing regulation and ensuring compliance across states, while enforcement networks assist national law enforcement authorities. See Slaughter, *supra* note 11, at 290.

⁴⁸ Anne-Marie Slaughter and William Burke-White note that, although the impact of these problems is often international, their sources are domestic. To address these issues, the international legal system must

for financial regulators is cross-border enforcement of anti-fraud laws, for which inter-state cooperation is necessary.⁴⁹ Policy coordination also constitutes an efficient response to concerns of regulatory capture because it commits domestic authorities to an international regime, precluding them from serving protectionist goals through regulation.⁵⁰ Finally, states seeking to strengthen their domestic regulatory frameworks may follow the footpath of a harmonized regime.⁵¹ To sum up, growing international activity and market interdependence give rise to a demand for uniform regulation⁵² and enforcement.⁵³

Although efficiency-based explanations of international policy coordination have an intuitive appeal, they do not align fully with the pattern of harmonization and mutual recognition measures in recent years. Many areas of law for which functionalist theories would predict an institutional solution remain without one. For example, it is unclear why significant differences persist in the law on disclosure of material information to investors upon a company's securities offering, despite coordination efforts by

be able to affect domestic law. See Anne-Marie Slaughter & William Burke-White, *The Future of International Law Is Domestic (or, the European Way of Law)*, 47 HARV. INT'L L.J. 327, 328 (2006). For Slaughter, the benefits of cooperation afforded by international agreements justify a reconceptualization of sovereignty as the ability to participate in international regimes, institutions, and government networks. See Slaughter, *supra* note 11, at 290. For another account of regulatory harmonization as a method to promote inter-state cooperation, see Andrew T. Guzman, *Introduction—International Regulatory Harmonization*, 3 CHI. J. INT'L L. 271, 272 (2002). Guzman portrays harmonization as providing solutions to problems that cannot be addressed by mere choice-of-law provisions.

⁴⁹ See Trachtman, *Unilateralism*, *supra* note 44, at 75–76.

⁵⁰ See Sykes, *supra* note 11, at 59–60; see also Guzman, *supra* note 48, at 272.

⁵¹ See Stephen J. Choi, *Law, Finance, and Path Dependence: Developing Strong Securities Markets*, 80 TEX. L. REV. 1657, 1695 (2002) (viewing harmonization as a domestic reform aiming to enhance safeguards for investors).

⁵² Barry Friedman draws a parallel between the growth of international market activity and the growth of the national securities market in the United States, which ultimately led to the establishment of the federal securities laws. He predicts that the growth of the international markets will result in further transfer of securities regulation authority away from the United States. See Barry Friedman, *Federalism's Future in the Global Village*, 47 VAND. L. REV. 1441, 1448–49 (1994).

⁵³ International agreements often develop an administrative apparatus for monitoring compliance with policy coordination measures. For example, harmonization and mutual recognition efforts within the European Union have been supported by various institutional arrangements to ensure uniform implementation. See Francesca Bignami, *Foreword*, 68 LAW & CONTEMP. PROBS., Winter, at 1 (2004).

international organizations.⁵⁴ Yet in other areas of law, where the high costs of policy coordination far exceed any presumed efficiency gains, coordination agreements abound.⁵⁵ International agreements do not offer adequate protection over regulatory capture either. In contrast, they may offer domestic interest groups more entrenchment opportunities than domestic statutes because they are hard to renegotiate and transfer policymaking powers from the legislature to the executive branch.⁵⁶ Fears of international regulatory capture have allowed theorists who favor market-based solutions for regulatory divergence to attack harmonization on normative grounds. Moreover the harmonization effort may divert resources from the regulators' main goals, such as efficient market supervision.⁵⁷

Although functional and regulatory competition theories are often regarded as conflicting, in reality the first step toward more effective regulatory competition among sovereign states is greater policy coordination. States can achieve greater mobility in capital and services supply, as regulatory competition models require, only by recognizing one another's laws and enforcement mechanisms.⁵⁸ States would plausibly seek to supplement supervision of events in their territory by distant authorities through their domestic administrative and judicial apparatuses. Arguably, states would also

⁵⁴ The International Organization of Securities Commissions ("IOSCO"), an international association of regulators with 109 members (including all major jurisdictions), has issued a set of common standards for cross-border securities offerings since 1998. See INT'L ORG. OF SEC. COMM'NS, INTERNATIONAL DISCLOSURE STANDARDS FOR CROSS-BORDER OFFERINGS AND INITIAL LISTINGS BY FOREIGN ISSUERS (1998), available at http://www.sec.gov/about/offices/oia/oia_corpfin/crossborder.pdf.

⁵⁵ See Simmons, *The International Politics of Harmonization*, *supra* note 37, at 590.

⁵⁶ See Rachel Brewster, *The Domestic Origins of International Agreements*, 44 VA. J. INT'L L. 501, 512–13 (2004). Brewster notes that interest-group entrenchment depends on the procedural difficulties and the political costs a change of policy entails. Comparing a domestic statute and an international agreement with the same substantive content, she concludes that an international agreement offers interest groups stronger protection against their domestic opponents. Below, I argue that international agreements may also offer domestic interest groups strong protection against their *international* competitors. See *infra* Parts V.c.–V.d.

⁵⁷ See Choi & Guzman, *supra* note 31, at 1890–91.

⁵⁸ See Alan O. Sykes, *Regulatory Competition or Regulatory Harmonization? A Silly Question?*, 2000 J. INT'L ECON. L. 257, 259 (2000).

require compliance with certain minimum standards from their co-participants, even if they do not insist on full homogenization.⁵⁹ These arguments rightly emphasize that policy coordination is a crucial component of regimes whose primary aim is to promote regulatory competition. However, they do not offer much guidance as to the conditions that drive states to agree on these regimes in certain cases, but not in others.

II.c Network Theories

In recent years, proponents of efficiency-based explanations for international policy coordination have focused their attention on networks of international organization officials,⁶⁰ domestic administrative officers, judges, and experts from different states.⁶¹ States across the world are increasingly following similar organizational structures and building specialized bureaucracies.⁶² Networks provide an informal setting where officials meet with their cross-border counterparts, exchange information and ideas, and

⁵⁹ See *id.* An international regime that relies partly on harmonized measures and partly on regulatory competition raises the classic question of federal systems—how to allocate regulatory authority between the harmonization sphere and the competition sphere. Trachtman suggests that the answer could lie in the European Union’s subsidiarity principle—harmonized laws should be adopted only when state laws cannot achieve the same result. He notes, however, that addressing this question would trigger negotiation among participating states that each seek to achieve their own national goals. See Joel P. Trachtman, *International Regulatory Competition, Externalization, and Jurisdiction*, 34 HARV. INT’L L.J. 47, 51 (1993).

⁶⁰ Andrew Moravcsik notes the consensus among leading lawyers and political scientists on the strong influence international bureaucrats exert over national governments. This informal power of “persuasion,” unlike formal disciplining power, is based on international bureaucrats’ ability to collect information from many states, frame the international agenda, and mobilize domestic support. Leading examples of bureaucratic network activity include negotiations on environmental protection and post-Cold War security cooperation. Moravcsik then challenges this consensus by pointing to the role of domestic factors in shaping governments’ international policy choices. See Andrew Moravcsik, *A New Statecraft? Supranational Entrepreneurs and International Cooperation*, 53 INT’L ORG. 267, 268 (1999).

⁶¹ See Anne-Marie Slaughter, *International Law in a World of Liberal States*, 6 EUR. J. INT’L L. 503 (1995).

⁶² Sociologists have long argued that the increasing regime similarity among different countries stems from the pervasiveness of certain socioeconomic models. See John W. Meyer et al., *World Society and the Nation State*, 103 AM. J. SOC. 144, 145 (1997). Global consensus in issues such as the value of human rights, education, or rationalized justice establishes worldwide models with increased legitimacy. According to this account, cultural and associational processes not only constrain nation states’ abilities to act independently of each other, but also shape the structure of local government and the powers of local actors in formulating and implementing their policies.

gradually arrive at commonly perceived solutions to regulatory problems that, although non-binding, effectively harmonize domestic laws. Other networks consist of professionals with expertise in a certain policy area, forming “epistemic communities” with a common set of beliefs and policy suggestions, which then advise governments to follow similar paths.⁶³ Thus, networks’ successes in achieving policy coordination are due both to their flexible and informal institutional structures and to the dynamics of socialization and persuasion.⁶⁴

The main focus of network theories lies in understanding a new channel of state interaction beyond traditional international law tools.⁶⁵ Therefore, these theories examine policy coordination insofar as networks can serve as a vehicle for coordination goals. Cooperation through networks can generally foster greater policy convergence, which may take the form of “regulatory exports” if there are significant power asymmetries between participating states.⁶⁶ Thus, networks may reinforce existing dynamics toward policy coordination, especially since the incentives to join a network increase as more states participate in it. As a result, network theories are more successful in explaining why less-influential countries adopt policies pioneered in more sophisticated

⁶³ See Peter M. Haas, *Introduction: Epistemic Communities and International Policy Coordination*, 46 INT’L ORG. 1, 3 (1992). Haas also argues that, even when governments do not seek the advice of such a group directly, its ability to shape scientific debates in its area of expertise will invariably influence government policy in that area. See *id.* at 4.

⁶⁴ States, just as individuals, seek to identify themselves with a “reference group” of other states perceived as “modern” or “advanced,” thus becoming acculturated to a world society. See Ryan Goodman & Derek Jinks, *How to Influence States: Socialization and International Human Rights Law*, 54 DUKE L.J. 621, 639–44 (2004). Acculturation, as understood by Goodman and Jinks, is a mechanism for diffusion of social and economic models distinct not only from coercion, but also from persuasion. Persuasion operates through a learning process, whereby states subject policy models adopted elsewhere to deliberation and argumentation and reach positive conclusions about their effects. In contrast, acculturation involves no substantial assessment of a specific policy; it stems from a government’s desire to develop a relationship with the state(s) that have adopted that policy.

⁶⁵ See Kal Raustiala, *The Architecture of International Cooperation: Transgovernmental Networks and the Future of International Law*, 43 VA. J. INT’L L. 1, 5 (2002).

⁶⁶ See *id.* at 51.

jurisdictions, rather than in understanding how countries with substantial financial centers reach coordination agreements. Therefore, network theories cannot offer a full account of the motivations that trigger policy coordination or the direction that initial policy coordination efforts will take.⁶⁷ Overall, network dynamics are complementary to the forces that drive coordination according to this Article.

II.d Dominance Theories and this Article's Contributions

The explanations of global policy coordination discussed above, whether they emphasize regulatory competition, institutional cooperation, or socialization, suggest that factors beyond governments' control determine their regulatory choices. However, constraints on state autonomy are neither as strong nor as uniform as these theories presume. Adapting domestic policies to global standards may entail significant costs for some states. Yet industries in other states may benefit from this coordination. Some states may simply imitate regulatory models developed elsewhere, either because they are convinced about their superiority or because they are eager to modernize their laws. At the same time, the states that pioneered these models now lead efforts to reform them. Finally, investors and firms may exert pressure on some governments by threatening to abandon local markets. These threats, however, are not equally valid toward states that have large national markets, expert workforces, and significant market infrastructure. In short, not only are some states more powerful than others, but also the alignment of domestic interest groups behind coordination goals is different in each state.

⁶⁷ See *id.* at 53.

This Article contributes to a growing literature that examines the impact of state power on international policy coordination in financial regulation. According to Simmons, the United States' undisputed dominance across financial markets allows it to reform its financial laws unilaterally; policy coordination depends on other states' incentives to bring their regulatory frameworks in line with U.S. initiatives.⁶⁸ The United States will employ political pressure on dissenting states to harmonize their local laws with its own rules only if opposition to U.S. initiatives presents significant negative externalities for U.S. market players. By regarding U.S. dominance as exogenous and uniform across policy areas, this framework does not discuss the effect of variations in U.S. power over harmonization outcomes. Drezner distinguishes between strong economies, which are involved in a coordination game, and less powerful states, whose preferences reflect the outcome in the strong economies' coordination efforts.⁶⁹ According to Drezner, the decision of strong states to coordinate their policies will depend on the net costs they face when seeking to adjust their policies.⁷⁰ Drezner's framework illustrates how these costs may drive states away from harmonization, but provides no further insight as to how these costs relate to power relations among strong states or to specific policy coordination efforts.

This Article makes two key contributions to understanding the interaction between dominance and international regulatory outcomes. First, it introduces variations

⁶⁸ See Simmons, *The International Politics of Harmonization*, *supra* note 37, at 595–99. Simmons' account focuses on the mechanisms of international regulatory harmonization and includes no normative assessment of the outcome of harmonization as race-to-the-bottom or race-to-the-top theories are keen to reach. Moreover, when harmonization emerges in Simmons' framework, the dominant power provides the substantive rule content for the harmonized regime.

⁶⁹ See Daniel W. Drezner, *Globalization, Harmonization, and Competition: The Different Pathways to Policy Convergence*, 12 J. EUR. PUB. POL'Y 841, 843 (2005). Drezner supports his argument with two case studies on anti-money laundering regulation and the laws on genetically modified organisms.

⁷⁰ See DANIEL W. DREZNER, *ALL POLITICS IS GLOBAL* 58–59 (2007).

in the dominant state's power as an explanatory variable in the discussion on policy-coordination outcomes in financial regulation. The starting point for my argument is an empirical observation: U.S. dominance is not uniform across markets. While U.S. firms are dominant in some areas, they face severe competition in others. Whether U.S. dominance is strong or contested will greatly affect the country's strategic choices and foreign states' reactions, since relative levels of dominance determine the position of local interest groups toward policy coordination. Thus, this Article focuses on the political economy of financial regulation in the dominant center, its competitors, and other states to shed light on the circumstances that will prompt policy-coordination efforts or maintain regulatory divergence. It illustrates that policy coordination may result from the working of market forces in some cases, but may also be a tool used to protect the dominant power's industry when it is most threatened.

The Article's second key contribution lies in its emphasis on the benefits of coordination, rather than the costs. In international finance, the benefits of cross-border activity are allocated differently in markets that are centralized in a few financial hubs and markets that are spread out in many other countries. As states' rulemaking authority is territorial in nature, regulation can affect the allocation of these benefits between domestic and foreign market participants. By examining degrees of state power and levels of jurisdictional control over markets, this article emphasizes the centrality of states as policymakers in international financial regulation. Moreover, it demonstrates that political motivations are more successful predictors of coordination than efficiency-based considerations.

III. Governments, Regulation, and Dominance

III.a Government Powers and Finance

National governments possess numerous policy tools to affect cross-border financial activity and thus play a critical role in the international competition among financial firms. Although direct barriers to capital flows are far lower today than in the past, national governments still control access to a country's financial markets indirectly through regulation. Countries regulate financial services to achieve a number of public policy objectives, such as limiting systemic risk, ensuring disclosure of appropriate information to the public, and preventing fraud against investors.⁷¹ National regulatory regimes often subject financial firms to license requirements, ongoing supervision by powerful administrative agencies, strict governance standards, and fiduciary duties to investors.⁷² National regimes often follow different policies on the same regulatory issue.⁷³ Differences between national regimes may impact cross-border activity in two ways. First, regulation may significantly raise the costs of access to a nation's market for

⁷¹ Limiting systemic risk is the main objective of capital adequacy regulation, such as the 1998 Basel Accord. *See infra* Part UV.d. **Study: The 1988 Basel Accord – Contested U.S. Dominance in the Dispersed Banking Market** While capital adequacy standards are also applicable to securities firms, their main target is to corroborate the public safety net available for banks. *See* HAL S. SCOTT, INTERNATIONAL FINANCE: TRANSACTIONS, POLICY AND REGULATION 330 (14th ed. 2007) [hereinafter SCOTT, INTERNATIONAL FINANCE]. In contrast, securities regulation is oriented toward establishing conditions that increase market efficiency, such as mandatory disclosure and anti-fraud rules. *See* Franklin Allen & Richard Herring, *Banking Regulation v. Securities Market Regulation* 1 (Wharton Fin. Inst. Center, Working Paper No. 1, 2001), available at <http://knowledge.wharton.upenn.edu/papers/1174.pdf>.

⁷² In the United States, the Securities Exchange Act of 1934 requires securities brokers or dealers to apply for registration with the SEC, and it authorizes the SEC to determine by rule the documentation necessary to evidence that granting the application is in the public interest. *See* Securities and Exchange Act § 15, 15 U.S.C. § 78-o (2000). In the European Union, a new set of rules governing the licensing and ongoing supervision of financial firms is included in art. 5-35 of Council Directive 2004/39 of 21 April 2004 on Markets in Financial Instruments, O.J. (L 145) 1.

⁷³ For an overview of the different administrative structures for securities markets supervision in various leading jurisdictions around the world, see Stavros Gadinis & Howell E. Jackson, *Markets as Regulators: A Survey*, 80 S. CAL. L. REV. 1239 (2007).

foreign firms and investors such as when they are required to comply with additional rules that are often in conflict with their home rules. In this way, regulatory differences may constitute an indirect impediment to cross-border finance.⁷⁴ Second, even if regulatory differences do not constitute a barrier to market access, they create substantive advantages or disadvantages for foreign and local competitors active in the same market. For example, if a country's rules involve lower compliance costs relative to other countries, its financial industry is in an advantageous position in international markets.

III.b Government Powers and Forms of Policy Coordination

Governments can agree to lower barriers for cross-border financial activity by coordinating their regulatory policies. In some cases, states agree to “harmonize” their laws so that identical rules apply across borders. More often, states endorse a single regulatory strategy to address a common problem but agree to tolerate minor differences in implementation among jurisdictions.⁷⁵ Once one state determines that a market participant complies fully with the coordinated regime, other states' authorities require no further proof of compliance (i.e., states agree to “mutual recognition”).⁷⁶ In mutual

⁷⁴ Regulatory differences are a well-established example of indirect, or non-tariff, barriers to international trade in services. For an overview of the literature, see Bernard Hoekman & Carlos A. Primo Braga, *Protection and Trade in Services: A Survey*, 8 OPEN. ECON. REV. 285, 288 (1997).

⁷⁵ Sometimes, policymakers adopt the term “policy convergence” to signal their agreement to amend domestic laws so that, although not fully identical, laws will be very similar to one another. However, policy convergence may result from mechanisms other than international negotiations, such as emulation. To avoid confusion as to the mechanism of increasing similarity between domestic laws, this Article uses the term policy coordination to describe common regimes that result from inter-state action.

⁷⁶ Mutual recognition has been a key principle in the establishment of the European Union's single market. Mutual recognition is traditionally associated with the European Court of Justice's landmark decision in *Cassis de Dijon*, which declared local regulations that constrained imports of goods lawfully produced in other E.U. member-states as contrary to the E.C. Treaty, because they effectively established a non-tariff barrier to trade. On the basis of the *Cassis* ruling, the European Commission developed a new trade liberalization policy based on minimum standards and mutual recognition. See Karen J. Alter & Sophie Meunier-Aitsahalia, *European Integration and the Pathbreaking Cassis de Dijon Decision*, 26 COMP. POL.

recognition regimes, each state adopts domestic rules that are either identical from a substantive standpoint, or vary from a commonly agreed framework within predetermined limits. Both harmonization and mutual recognition agreements establish arrangements that secure similarity in substantive law.

To fully dismantle regulatory barriers to cross-border financial activity, states must agree to recognize as equivalent not only each other's rules, but also each other's regulatory compliance apparatus. In an integrated market, firms or transactions authorized in one jurisdiction should be able to travel from their home state to a state with a substantively similar regime without the need for additional authorization. Thus, agreements for harmonization or mutual recognition often require local authorities to waive regulatory oversight requirements for firms or transactions originating in a participating jurisdiction and instead rely on evidence of compliance with the home country's regime.⁷⁷

This Article treats harmonization and mutual recognition as two equivalent methods to achieve policy coordination among different states.⁷⁸ States can agree to coordinate their substantive rules and regulatory processes through international negotiations that may result in formal treaties as well as less formal arrangements, as long as the commitments of the parties on the broad contours of a coordinated regime are

STUD. 535, 541 (1994). Within the European Union, mutual recognition now applies to areas as different as goods, services, taxation, and justice and home affairs (e.g., mutual recognition of arrest warrants). See Adrienne Heritier, *Mutual Recognition: Comparing Policy Areas*, 14 J. EUR. PUB. POL'Y 800, 800 (2007).

⁷⁷ Mutual-recognition regimes are central in debates regarding the emergence of a global administrative law. See Nicolaidis & Shaffer, *supra* note 8, at 264; see also Benedict Kingsbury, Nico Krisch & Richard B. Stewart, *The Emergence of Global Administrative Law*, 68 LAW & CONTEMP. PROBS., Summer/Autumn 2005, at 15, 15.

⁷⁸ Sykes also points out that once states accede to a mutual recognition regime they have few incentives to move to full harmonization. Having agreed that their regulatory differences are secondary in character and justified by conditions in local markets, they see no benefit in eliminating these differences. See Sykes, *supra* note 11, at 68. For Sykes, mutual recognition assists market openness as much as harmonization.

clear. While policy coordination involves some type of state-to-state interaction, states may arrive independently to comparable, or even identical, approaches to related regulatory challenges. In particular, states may respond similarly to a common development that affects many national markets or industries simultaneously. Moreover, countries may decide to emulate another state's policies because they regard them as superior or modern. Cases in which similarity in regimes does not involve inter-state activity, but results from states' separate decision-making processes, are outside the scope of this Article.

III.c Dominance in Financial Markets

International negotiations are a key step to cross-border policy coordination. Therefore, coordination outcomes depend on the relative influence of states participating in these negotiations. States whose financial industries dominate a market carry that weight to the negotiating table. States whose national industries are competing for global market share will focus on the impact of coordination on their financial sectors, as the benefits and costs of coordination outlined above may not be uniform across borders. To predict states' preferences toward coordination and the varying pressure they can exercise in coordination negotiations, a better understanding of states' relative power and dominance is necessary.

Dominance is a central concept in fields as diverse as market power economics, national security studies, and anti-trust law. Such a wide variety of scientific uses precludes a common definition of dominance. However, a core feature of dominance remains unaltered across scientific fields: it implies a significant imbalance between the

dominant entity and its competitors. In neoclassical economics, a firm is dominant if it possesses a large share of the market even though it competes against numerous small firms, each offering identical products.⁷⁹ For political scientists, dominance is “that situation in which the ongoing rivalry between the so-called ‘great powers’ is so unbalanced that one power is truly *primus inter pares*.”⁸⁰ To identify imbalance, some theories examine whether a state can get other states to do what they otherwise would not have done.⁸¹ However, defining dominance in terms of effects is impractical for an article that seeks to predict these effects. An alternative approach to determining dominance examines quantitative indicators of a state’s power base, such as share of world trade, gross national product, or economic resources.⁸² This approach helps to examine how resources affect policymakers’ choices, and thus serves better the goals of this Article. Since the Article focuses on financial markets, the set of parameters measuring dominance is much narrower.

⁷⁹ See DAVID A. BESANKO & RONALD R. BRAEUTIGAM, MICROECONOMICS 498–500 (2003).

⁸⁰ IMMANUEL MAURICE WALLERSTEIN, THE POLITICS OF WORLD ECONOMY: THE STATES, THE MOVEMENTS, AND THE CIVILIZATIONS 38 (1984).

⁸¹ Economic historians and political scientists have utilized the concept of dominance to explain openness to international trade, based on different structurally derived preferences of states depending on their rank in the international economic structure. The most illustrious attempt to connect dominance to trade openness is the hegemonic stability theory, which posits that a hegemon benefits from openness to international trade and thus is more likely to force other states to tear down protectionist barriers and sustain international “order.” See generally ROBERT GILPIN, THE POLITICAL ECONOMY OF INTERNATIONAL RELATIONS (1987). The validity of the theory has since been questioned. See Duncan Snidal, *The Limits of Hegemonic Stability Theory*, 39 INT’L ORG. 579 (1985). Other scholars have sought to offer more sophisticated versions of the original theory. See David A. Lake, *Leadership, Hegemony, and the International Economy: Naked Emperor or Tattered Monarch with Potential?*, 37 INT’L STUD. Q. 459 (1993). For an overview of the debate surrounding hegemonic stability theory, see Helen V. Milner, *International Trade*, in HANDBOOK OF INTERNATIONAL RELATIONS 448, 455 (Walter Carlsnaes, Thomas Risse & Beth A. Simmons eds., 2002).

⁸² See Susan Strange, *The Persistent Myth of Lost Hegemony*, 41 INT’L ORG. 551 (1987). A discussion on the two approaches to defining dominance can be found in Bruce Russett, *The Mysterious Case of Vanishing Hegemony; or, Is Mark Twain Really Dead?*, 39 INT’L ORG. 207 (1985). David Baldwin discusses the problem of measuring a state’s power and suggests that measuring the distribution of power within specified scopes and domains is more amenable to research objectives. See David Baldwin, *Power and International Relations*, in HANDBOOK OF INTERNATIONAL RELATIONS 177, 181 (Walter Carlsnaes, Thomas Risse & Beth A. Simmons eds., 2002).

I examine two parameters to determine whether a state enjoys dominance in a financial market: the size of its financial industry and the size of the investment pools in that country. The first parameter reflects imbalances in the slice of global market activity that each country's financial industry has already captured. The second parameter captures differences in the wealth directly available for investment in each jurisdiction. The size of local investment pools impacts dominance determination in various ways. If local investment pools are large, local firms, which are better placed to exploit them, have an advantage vis-à-vis their competitors.⁸³ Moreover, governments have regulatory powers over investment wealth in their jurisdiction, which they can use to deny foreigners' access to local markets and thus divert resources to local firms.

Data on the size of the local financial industry are readily available, as the turnover of local firms and the capitalization of market operators are immediately quantifiable. However, the aggregate value of local investment pools is harder to calculate. Investors may direct surplus capital to numerous uses apart from financial markets. They hold a multitude of non-financial assets, such as commodities, real estate, or private businesses. Even if the financial assets of a country's investors sufficiently indicated the size of its available investment pools, their value is difficult to measure because of their global reach. As investors place their wealth or raise capital in foreign locations, they augment the size of some national markets to the detriment of others. A

⁸³ Local firms have many advantages when seeking to attract investors from their localities. In many financial markets, relationships of trust between firms and investors are crucial. *See infra* Parts IV.b.3 & V.c. Investors may be more willing to invest in local firms because they possess better information about them. *See* Joshua D. Coval & Tobias J. Moskowitz, *Home Bias at Home: Local Equity Preference in Domestic Portfolios*, 54 J. FIN. 2045 (1999); Joshua D. Coval & Tobias J. Moskowitz, *The Geography of Investment: Informed Trading and Asset Prices*, 109 J. POL. ECON. 811 (2001). For the international dimension, see Kenneth R. French & James M. Poterba, *Investor Diversification and International Equity Markets*, 81 AM. ECON. REV. 222 (1991); Ian Cooper & Evi Kaplanis, *Home Bias in Equity Portfolios, Inflation Hedging, and International Capital Market Equilibrium*, 7 REV. FIN. STUD. 45 (1994).

measure of a country's aggregate economic resources is therefore more suitable to the task at hand. This Article assumes that the portion of global investment activity originating from a single country is proportionate to wealth, and thus uses GDP as an approximate measure for a country's share in global investment.⁸⁴

Variations along these two parameters suggest that a country's dominance may not be uniform across financial markets. A nation's dominance in a certain market is *strong* if first, the market share of local financial firms or market operators in that market far exceeds other states' market share and second, the portion of global investment activity originating in that country is far greater than **that of other countries**. Consequently, a nation's dominance is *contested* if it can no longer meet either one of these two conditions: either its competitors have attracted significant market share that approximates or exceeds the dominant state's market share, or the resources available to

Comment [SL1]: Again, other countries combined? Or individually?

⁸⁴ According to the IMF, the United States had the world's largest GDP in 2006, amounting to almost three times that of its closest competitor, Japan (Source: IMF statistics, *available at* <http://www.imf.org/external/pubs/ft/weo/2007/02/weodata/download.aspx>. Other measures of market size yield results that are highly correlated to GDP size. *See* DREZNER, *supra* note 1, at 35-36. Hal Scott also uses GDP to explain the dominance of U.S. securities markets. *See* SCOTT, *INTERNATIONAL FINANCE*, *supra* note 71, at 24. The combined E.U. member states' GDP is roughly equivalent to the United States. However, despite the European Union's efforts to establish a single integrated financial market, it is widely recognized that a lot of steps need to be taken before achieving this objective. Charlie McCreevy, European commissioner for internal market and services, acknowledged that "we are not quite there yet and . . . there is no such thing as the 'completion of the Single Market.'" Charlie McCreevy, Eur. Comm'r for Internal Mkt. and Servs., Transatlantic Co-operation and the Global Dimension of the Single Market (Feb. 26, 2008), *available at* <http://europa.eu/rapid/pressReleasesAction.do?reference=SPEECH/08/138&format=HTML&aged=0&language=EN>. As a result, none of the existing financial markets in Europe can lay claim to taking full advantage of the European Union's combined GDP as compared with the positioning of key U.S. markets over U.S. GDP. In terms of regulatory coordination within the European Union, European directives in financial services have made significant progress toward harmonizing E.U. financial-services regulation from a substantive standpoint, but they still leave wide discretion to member state authorities in key areas. For example, liability rules and enforcement for securities issues fall to member states, to be determined under their laws. *See* SCOTT, *INTERNATIONAL FINANCE*, *supra* note 71, at 220. Moreover, regulatory oversight in key areas is still carried out by national authorities. Currently, there is no European Union-wide securities or banking supervisor, although cooperation among national regulators has increased.

another jurisdiction have grown so much that limiting access to its market would threaten the preeminence of financial firms from the dominant state.⁸⁵

IV. The Politics of Strong Dominance

The existence of a strong dominant center determines the preferences of investors and firms both within the dominant center as well as in foreign jurisdictions, affecting governments' policymaking choices accordingly. This Part first analyzes theoretically the politics of the dominant center with regard to international coordination and the response of foreign jurisdictions to the dominant government's choices. Following a domestic political-economy approach, this Part argues that foreign governments' policies reflect the preferences of foreign firms and investors, who will favor policy coordination in markets that render regulatory mismatches particularly problematic. In particular, regulatory divergence impacts foreign firms and investors differently in centralized and dispersed markets. To illustrate the point, this Part includes two case studies: (1) accounting standards convergence as an example of coordination in a centralized market with a strong dominant center, and (2) the debate on the operation of foreign trading screens in the United States, which represents coordination failure in a centralized market under contested dominance.

⁸⁵ Given current international trends regarding GDP, the second condition is unlikely to materialize, as U.S. GDP far exceeds other states' GDPs. Thus, all situations of contested dominance in this Article are cases in which non-U.S. firms or markets have captured significant market share.

IV.a The Politics of the Dominant Center under Strong Dominance

Financial firms' and investors' incentives for and costs due to cross-border financial activity vary depending on their home jurisdiction and their target jurisdiction. The following paragraphs focus on the incentives of investors and financial firms from the dominant center to conduct business in other countries under an assumption of strong dominance in the market. Specifically, dominant-center firms and investors face little or no competition from abroad. The dominant center's financial industry has the largest global market share and the level of investment wealth available in its markets far exceeds that of other jurisdictions. Overall, its financial firms control the largest part of global financial activity and its markets attract considerably greater liquidity than any other foreign markets.

Under these conditions, investors and firms from the dominant center are indifferent to regulatory discrepancies between the dominant center and other markets. Investors have little incentive to move to smaller and less-liquid markets abroad.⁸⁶ Financial firms from the dominant center, which are likely to have international operations, probably incur some costs due to regulatory differences. For example, they face market-entry costs upon establishing operations in another jurisdiction, ongoing compliance costs in all jurisdictions where they are present, and additional costs arising

⁸⁶ Liquidity is the assurance that investors will be able to sell or buy stock at any time for the price offered in the market at the time. See Norman S. Poser, *The Stock Exchanges of the U.S. and Europe: Automation, Globalization, and Consolidation*, 22 U. PA. J. INT'L ECON. L. 497, 511–12 (2001). To ascertain liquidity, investors are willing to pay a commission to brokers organized in stock exchanges. See Jonathan R. Macey & David D. Haddock, *Shirking at the SEC: The Failure of the National Market System*, 1985 U. ILL. L. REV. 315, 317 (1985). Brokers charge a different price for buying versus selling a security at the same time (this is reflected in the bid-ask spread). See Harold Demsetz, *The Cost of Transacting*, 82 Q. J. ECON. 33, 35–36 (1968). As liquidity grows, i.e., as more investors are interested in buying or selling a security, the bid-ask spread narrows. See *id.*; see also Ananth Madhavan, *Market Microstructure: A Survey*, 3 J. FIN. MKTS. 205, 226 (2000). In other words, markets (or stocks) with higher trading activity will offer lower bid-ask spreads, and thus lower costs to investors.

from the need to address conflicts among the various regimes under which they conduct business. In theory, these costs could be sharply reduced if governments eliminated differences between home and host-country laws through greater policy coordination.

Gains from reduction of regulatory differences are in fact much more moderate for financial firms that already enjoy a strong dominant position. These firms have already paid market-entry costs in many jurisdictions since they control a large global market share.⁸⁷ Costs relating to ongoing compliance and regime conflict also decline over time, as international firms grow familiar with the various regimes under which they operate. Moreover, dominant firms can absorb higher levels of costs due to regulatory discrepancies, as they feel no competitive pressure to lower fees charged on investors. In reality, the costs that dominant firms incur due to regulatory discrepancies are not important for them.

Overall, both the investing community and the financial industry in the dominant center are unsympathetic to calls for policy coordination, either because they prefer to conduct business within their market, or because they can disregard the costs of regulatory differences due to their dominance. As a result, they are unlikely to promote the cause of policy coordination with their government.

⁸⁷ Most theories seeking to explain the expansion of multinational enterprises observe that entry in a foreign market involves high costs and seek to identify the advantages of a foreign subsidiary operation. *See, e.g.,* John Dunning, *Trade, Location of Economic Activity and the Multinational Enterprise: A Search for an Eclectic Approach*, in *THE THEORY OF TRANSNATIONAL CORPORATIONS* 183, 196–98 (John Dunning ed., 1992).

IV.b The Politics of Foreign Jurisdictions under Strong Dominance

The existence of a strong dominant center affects not only investors and financial firms within the dominant jurisdiction's borders, but also investors and firms located in other countries. As the dominant center's market is the single market of significant size at a global level, it is the main source of financing for large investments. In addition, its liquidity advantages are substantial: in the dominant center's market, investors are more likely to find better placement opportunities for their capital or more favorable financing terms.⁸⁸ However, while investors and firms from foreign jurisdictions could benefit from conducting financial activities in the dominant center, they face significant costs due to regulatory discrepancies when crossing the dominant center's borders. Clearly, foreign investors and firms will press their governments to coordinate their policies with the dominant center's ones when the benefits from operating within the dominant jurisdiction are significant and the costs of cross-border operations are high. The following paragraphs explore the circumstances under which the costs of cross-border activities are likely to lead to pressures on foreign governments for policy coordination agreements.

Although the dominant center's market offers apparent advantages over other markets, foreign investors and firms seeking to share in these advantages do not need to cross the dominant center's borders for all types of financial activities. However, some financial activities take place in one central location ("centralized" financial activities), thus requiring foreign participants to enter into the dominant center's territory. In other cases, financial activity takes place in the jurisdiction where the consumers of the services (usually the investors) are located ("dispersed" financial activities). This divide

⁸⁸ Financial firms in the dominant center are in an advantageous position as they know the market better. Thus, foreign firms that try to obtain a presence will look into some sort of know-how sharing arrangement, such as a merger.

has significant implications for the costs foreign interest groups incur due to regulatory differences with the dominant center. These costs run high when investors and firms need to cross the dominant center's borders in order to participate in a centralized activity. On the contrary, there are no such costs when foreign firms and investors conclude their business with dominant firms in their local jurisdictions. Consequently, firms and investors will press their governments to coordinate their policies with the dominant center with regard to centralized activities, but will be indifferent to policy coordination relating to dispersed activities.

IV.b.1 The Politics of Foreign Jurisdictions in Centralized Markets under Strong Dominance (First Quadrant)

Financial markets operate on a centralized basis when it is more efficient to aggregate the supply side and the demand side in a single location. This type of market organization finds its iconic application in exchanges. The members of an exchange, the brokers, collect all buy and sell orders from various investors in a single location, traditionally the exchange floor but now often an electronic facility, where all orders interact according to predetermined rules of priority. Exchanges and other centralized structures emerge when financial firms can reduce transaction costs for certain products through cooperation. For example, centralized markets maximize the possibility of finding a counteroffer to conclude a trade and thus provide liquidity to interested parties.⁸⁹ Economists have long established that centralized financial markets exhibit

⁸⁹ Moreover, centralized markets reduce information asymmetries because they develop standards for their products, such as listing rules or corporate governance requirements, and they often require specific due diligence and disclosure for each product. See Franklin Allen & Anthony M. Santomero, *The Theory of*

network characteristics: in short, their desirability increases as the number of market participants rises.⁹⁰ Moreover, these network externalities extend to vertically related services incidental to market operation, such as broker services, clearing and settlement services, or listing on a stock exchange.⁹¹ Centralized markets grow stronger as improved communication capabilities allow ever greater numbers of remote firms and investors to participate in their network.⁹² As a result, a handful of these markets control the largest share of global activity.⁹³ Figure 1 below illustrates the dynamics of a centralized market with a strong dominant center.

Financial Intermediation, 21 J. BANKING & FIN. 1461, 1463 (1997). In addition, they disseminate quote- and trade-price data that provide constant information about market trends. Thus, they assist market participants to overcome the “lemons” problem. See Stephen Craig Pirrong, *The Efficient Scope of Private Transactions-Costs-Reducing Institutions: The Successes and Failures of Commodity Exchanges*, 24 J. LEGAL STUD. 229, 229 (1995). Centralized markets also provide mechanisms for property-rights enforcement. For example, brokers are liable if their customers fail to perform their contractual obligations and may suffer further penalties if they themselves default. See Lester Telser, *Why There Are Organized Futures Markets*, 24 J. L. & ECON. 1, 12 (1981). Centralized markets further secure property rights enforcement through strict processes for the clearing and settlement of trades between participating firms. Furthermore, centralized markets are easier to police and thus less susceptible to fraud. Centralized market structures also offer high-quality technological infrastructures, which increase the efficiency of trading. However, centralized market structures also help financial firms to cooperate so as to extract rents from other market participants or to thwart competitors that threaten them through more cost-effective services. See Stephen Craig Pirrong, *Theory of Financial Exchange Organization*, 43 J. L. & ECON. 437, 441 (2000).

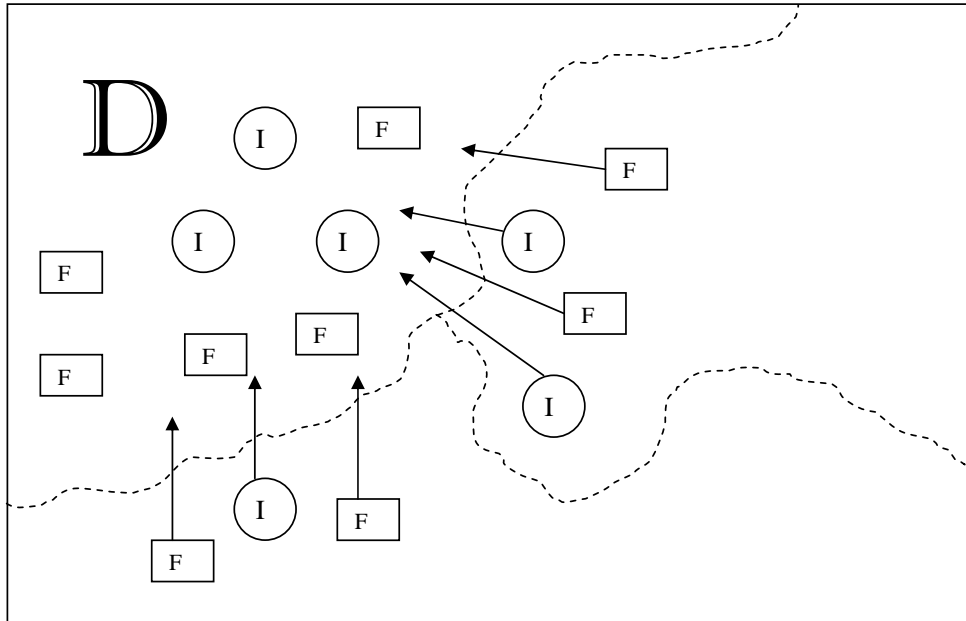
⁹⁰ See generally Nicholas Economides, *Network Economics with Application to Finance*, 2 FIN. MKTS. INSTS. & INSTRUMENTS 89 (1993) (explaining why financial markets exhibit network characteristics).

⁹¹ See Nicholas Economides, *The Economics of Networks*, 14 INT’L J. IND. ORG. 673, 679 (1996). For example, a hi-tech company will raise capital more easily if it lists its stock on a market that attracts investors accustomed to evaluating hi-tech stock. As that market lists more hi-tech companies, it will attract more investors interested in hi-tech stock.

⁹² Thus the technological advances of the past two decades have sparked a wave of consolidation among centralized markets. See Ruben Lee, *The Future of Securities Exchanges*, in BROOKINGS-WHARTON PAPERS ON FINANCIAL SERVICES 1 (Richard Herring & Robert E. Litan eds., 2002); see also Carmine Di Noia, *Competition and Integration among Stock Exchanges in Europe: Network Effects, Implicit Mergers and Remote Access*, 7 EUR. FIN. MGMT. 39, 55 (2001).

⁹³ Although the market share of the few central facilities favored by network effects is often large, the concept of a centralized market is fundamentally different than market concentration as usually perceived in antitrust cases. In particular, the U.S. Supreme Court used the concept of market concentration to indicate the market share held by the two or four largest firms in a market. See *United States v. Philadelphia Nat’l Bank*, 374 U.S. 321 (1963). The most established measure of market concentration in antitrust is the Herfindahl-Hirschman Index (HHI), according to which the market share of all firms participating in a market are squared and then added together. For a discussion of the use of the HHI index in antitrust cases, see Neil B. Cohen and Charles A. Sullivan, *The Herfindahl-Hirschman Index and the New Antitrust Guidelines: Concentrating on Concentration*, 62 TEX. L. REV. 453 (1983); Janusz A. Ordover, Alan O. Sykes & Robert D. Willig, *Herfindahl Concentration, Rivalry, and Mergers*, 95 HARV. L.

Figure 1: Cross-border Activity in a Centralized Market under Strong Dominance



In Figure 1, dotted lines represent country borders, F represents firms, and I represents investors; the area marked with D represents the dominant center's jurisdiction, and unmarked territories represent other jurisdictions. As Figure 1 shows, a dominant centralized market is extremely appealing for foreign firms and investors who seek access to larger investment pools and greater liquidity. However, foreign firms and investors can access the dominant center's market only if they comply with its regulatory regime. As foreign market actors are also subject to regulatory oversight in their home jurisdictions, they will likely face conflicts between overlapping regulatory obligations

REV. 1857 (1982). The concepts of concentrated and centralized markets are distinct; while centralized markets are characterized by structuring trading activity to take place in a single trading venue, concentrated markets in antitrust are any markets dominated by a few firms. Thus, a dispersed market could also be concentrated for antitrust purposes if a few firms prevailed over all others.

and incur higher costs as they try to comply with both regimes simultaneously.⁹⁴ Thus, foreign firms and investors will exert pressure on the dominant center's government and on their local governments to eliminate costly differences between their regulatory regimes through policy coordination.

Foreign firms' and investors' lobbying efforts toward the dominant center's government are not likely to succeed. They cannot credibly threaten it with exit as, individually, they are too small to matter to the dominant center. Even if they overcame their collective action problems, and threatened to leave collectively, they would have to bear the costs of exclusion from the largest global market. Thus, market mechanisms are unlikely to assist foreign firms and investors. Moreover, from a political perspective, foreign firms and investors are not the primary constituency of the dominant center's government; the dominant center's own firms and investors represent that primary constituency, and they are indifferent to policy coordination. These domestic firms and investors would probably like to avoid changes in the dominant center's regulatory framework that would result from policy-coordination efforts. At most, then, foreign market actors can get the dominant center's government to adopt minor adjustments to its regulatory regime with limited impact for domestic firms and investors; they cannot expect great support from the dominant center's government.

On the other hand, foreign firms and investors are more likely to succeed in their efforts for greater policy coordination if they direct pressure for regulatory reform at their local governments. They enjoy a direct link with local governments through voting and political influence. Foreign market actors often play an important role in local politics;

⁹⁴ For example, issuers seeking financing from the public markets will undoubtedly face problems of this sort, as modern states often maintain a strict and detailed legal regime for offers to retail investors.

some are large firms with a significant contribution to the country's economy and labor force. From a politician's perspective, facilitating his or her constituents' access to the largest international market is beneficial because it will lower the cost of capital for all local firms and provide a boost to the local economy. As a result, local governments that wish to minimize compliance costs for their constituents are more likely to accept "coordination" with a set of rules very close, if not identical, to the dominant center's regime. Policy coordination emerges from *necessity*; firms are compelled by market dynamics to comply with the dominant center's rules and simultaneously push their local governments toward convergence with these rules.

To sum up, strong dominance allows the dominant center to ignore foreign market actors and design its regulatory regime unilaterally. However, the centralized nature of the market structure pushes foreign market actors to comply with the dominant center's regime, so as to participate in the largest international market. As foreign market actors press their governments to relieve them of the costs associated with dual regulatory compliance, foreign states gradually coordinate their rules and regulations with those of the dominant center.

IV.b.2 Case Study: International Accounting Standards Harmonization – Strong U.S. Dominance in the Centralized Primary Offerings Market

Activity in the primary securities markets is centralized. Companies seek to raise capital by issuing stock to investors and then listing their stock on an exchange. Issuers and investors purchase financial intermediation services from a handful of investment

banks.⁹⁵ Issuers hire investment banks to prepare them for the public market as underwriters, to identify investors willing to obtain a position in their stock, and to manage the stock-transfer process. Investors obtain from these underwriters a guarantee of the accuracy of information disclosed in the offering documents. Initial public offerings (“IPOs”) are offerings of stock where the issuer addresses the public market for the first time. Listing on a stock exchange ensures investors that there will be an active market for the stock issued through an IPO when they wish to sell, either to capitalize on profits or to limit their losses. The liquidity that stock exchanges offer is essential to the success of an offering. As a result, stock exchanges display network characteristics: the larger they are, the more liquidity they offer to issuers and investors and hence the more they can attract issuers and investors.

Up to the early 2000s, U.S. dominance in the primary securities markets was strong.⁹⁶ Foreign companies gravitated toward U.S. markets to take advantage of their deeper liquidity and lower cost of capital,⁹⁷ often combining a public offering with a

⁹⁵ The 1990s was a decade of intense consolidation for the investment-banking industry, and thus calculating each bank’s market share in initial public offering (“IPO”) volume throughout the period included in this case study is challenging. For an overview of the structure of the IPO industry from 1988 to 2002, see Alexander Ljungqvist, Felicia Marston & William J. Wilhelm, Jr., *Competing for Securities Underwriting Mandates: Banking Relationships and Analyst Recommendations*, 61 J. FIN. 301, 310–11 (2006). According to their data, the top five investment banks controlled on average 64.1% of the equity IPO market throughout this period; the market share of the top ten investment banks amounted to 85.5% on average. The role of prestigious underwriters in IPOs has long been the focus of economic research. For an overview of the literature and an explanation of the role of underwriters in general, see Stephen P. Ferris et al., *An Analysis and Recommendation for Prestigious Underwriter Participation in IPOs*, 17 J. CORP. L. 581 (1992).

⁹⁶ There are clear indications that the United States is currently losing its strong dominant position in the international IPO market. After the recession that followed the “Internet bubble” of the late 1990s and the collapse of Enron and Worldcom, the IPO market is booming again. Yet, data from 2005 and 2006 indicate that foreign issuers are showing signs of preferring other markets to New York. For more information, see COMMITTEE ON CAPITAL MARKETS REGULATION, INTERIM REPORT OF THE COMMITTEE ON CAPITAL MARKETS REGULATION 29–34 (2006), available at http://www.capmktreg.org/pdfs/11.30Committee_Interim_ReportREV2.pdf.

⁹⁷ See, e.g., Sara Calian, *Heard on the Street: Foreign IPOs Lured to Riches of U.S. Markets*, WALL ST. J., June 12, 1996, at C1 (reporting that the trend for public offerings of foreign issuers’ stock was strong in 1994, 1995, and 1996); Raymond Hennessey, *Deals & Deal Makers – IPO Outlook: Foreign Firms Flock*

listing on a U.S. stock exchange. Data on stock exchange listings by foreign firms confirm the strength of the U.S. markets. Looking at foreign listings in various stock exchanges between 1986 and 1997, Pagano, Röell, and Zechner conclude that the attractiveness of U.S. markets increased dramatically as the number of European companies listing in U.S. markets nearly quadrupled in this period, from 52 in 1986 to 206 in 1997, while their main competitors, European exchanges, experienced a reduction in the number of U.S. companies listing in Europe from 284 in 1986 to 184 in 1997.⁹⁸ From 1999 to 2000, U.S. markets provided half of the capital raised in IPOs conducted outside the issuer's country of origin.⁹⁹ As Table 2 illustrates, the United States attracted the largest number of foreign companies seeking to list outside their jurisdiction between 2000 and 2004, while all other important jurisdictions maintained considerably smaller market shares.¹⁰⁰

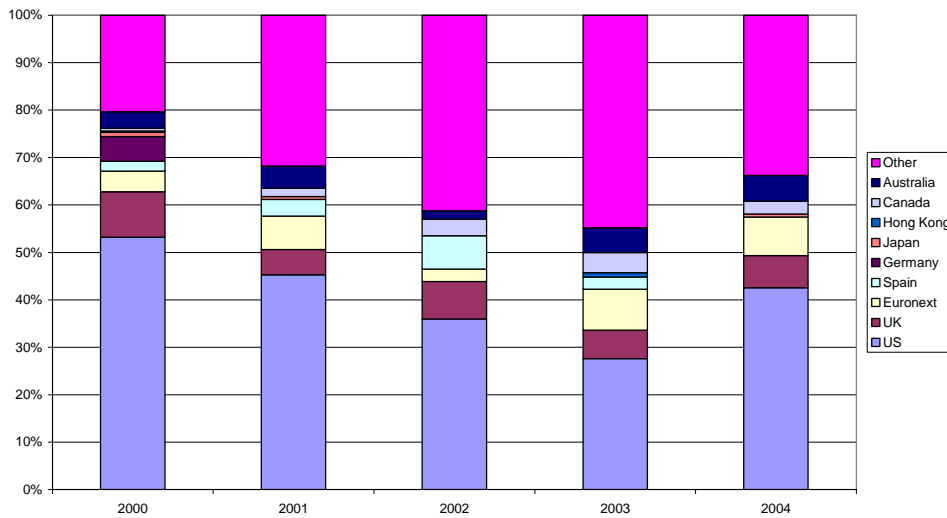
to Join U.S.'s IPO Fray, WALL ST. J., June 26, 2000, at C1 (providing evidence that this trend remained strong through 2000).

⁹⁸ See Marco Pagano, Alisa Röell & Josef Zechner, *The Geography of Equity Listing: Why Do Companies List Abroad?*, 57 J. FIN. 2651, 2661–65 (2002). The study comprised nine European exchanges, including London, Paris, Frankfurt, Spain, Vienna, Italy, Amsterdam, Brussels, and Stockholm.

⁹⁹ See COMMITTEE ON CAPITAL MARKETS REGULATION, *supra* note 96, at 30.

¹⁰⁰ See WORLD FED'N OF EXCHS., ANNUAL REPORTS (2000–2004), available at <http://www.world-exchanges.org/WFE/home.asp?action=document&menu=61>. NASDAQ did not report the new foreign companies it listed in 2002 and 2003, and thus percentages reported in Table 2 are biased against the United States for these years. As this table demonstrates, the size of the U.S. market share is many times bigger than that of the second largest national market, the United Kingdom.*****Stavros, you should be more specific about which Annual Reports he's citing, and which page #s you're referring to for the specific statement he makes.*****

Table 2: Newly Listed Foreign Companies (%)

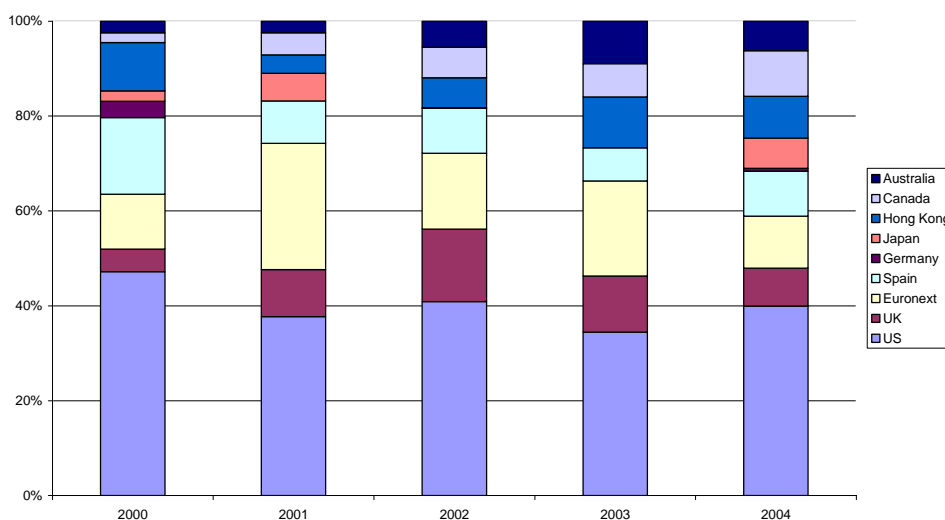


*Source: World Federation of Exchanges

As Table 3 shows, during the same period, the U.S. market was the largest supplier of capital for companies seeking financing from the public markets, either through a new listing or through a secondary offering of stock.¹⁰¹ Table 3 compares the capital raised in the U.S. markets with capital raised in the largest stock exchanges in the world.

¹⁰¹ See *id.*

Table 3: Capital Raised in the 10 Largest Stock Exchanges (%)



*Source: World Federation of Exchanges

U.S. investment banks also maintained a leading position in this market. Out of the eight top investment banks, five are based in New York, two are based in Switzerland, and one is based in Germany.¹⁰² To sum up, both the size of the U.S. markets and the market share of U.S. investment banks point to strong U.S. dominance in the primary securities markets.

Since the United States requires foreign issuers who enter its markets to comply with U.S. laws, conflicts between the U.S. regime and each issuer's home laws are hard to avoid and costly to resolve, triggering calls for harmonization. In particular, the United States requires foreign issuers to provide investors with financial statements prepared in

¹⁰² Based on 2002 data, these are: Citigroup (United States), J.P. Morgan Chase (United States), Morgan Stanley (United States), UBS (Switzerland), Merrill Lynch (United States), Goldman Sachs (United States), Deutsche Bank (Germany), Credit Suisse First Boston (Switzerland). See *The Price of Atonement*, ECONOMIST, Nov. 14, 2002, at []. [if you log in through "Miscellaneous e-journals" from the e-resources page, you'll see the chart]

accordance with the U.S. Generally Accepted Accounting Principles (“U.S. GAAP”).¹⁰³ The laws of their incorporation, however, require foreign issuers to draft their financial statements in accordance with local accounting principles, often in conflict with U.S. rules. As a result, foreign issuers seeking to access U.S. public markets must engage in a costly and time-consuming reconciliation of local accounting rules and U.S. GAAP. Given the importance of U.S. primary markets, however, increasing numbers of European companies have had to prepare U.S. GAAP-compliant financial statements.¹⁰⁴ In some cases, post-reconciliation financial statements revealed significant differences in the operating results of the issuer, confusing investors and thus raising the cost of capital. In order to attract issuers interested in cross-listing in more international financial centers, some European exchanges amended their listing requirements to accept financial statements drafted under U.S. GAAP.¹⁰⁵ Thus, U.S. GAAP looked set to become the dominant accounting regime and to gradually uproot its local competitors. Centralized market dynamics were steering market participants’ preferences to a de facto harmonization to U.S. standards.

Political efforts to intervene in the harmonization process and ascertain a role for foreign interests in formulating global accounting standards were only moderately

¹⁰³ See SCOTT, INTERNATIONAL FINANCE, *supra* note 71, at 117.

¹⁰⁴ Between 1986 and 1997, the number of European companies with a U.S. listing increased by 61%. See Pagano, Röell & Zechner, *supra* note 98, at 2661. All these companies were required to reconcile their financial statements with U.S. GAAP. The reconciliation process often revealed impressive discrepancies between IFRS and U.S. GAAP results. See John Flower, *The Future Shape of Harmonization: The EU versus the IASC versus the SEC*, 6 EUR. ACCT. REV. 281, 284 (1997).

¹⁰⁵ In response to mounting pressure from issuers that were eager to adopt either IFRS or U.S. GAAP, various E.U. member states (including Germany, France, Italy, Austria, and Belgium) introduced legislation that allowed companies to draft either all or some of their financial statements in accordance with an internationally recognized set of standards (i.e., either IFRS or U.S. GAAP). See Axel Haller, *Financial Accounting Developments in the European Union: Past Events and Future Prospects*, 11 EUR. ACCT. REV. 153, 169 (2002). This development weakened the negotiating power of the European Commission. See David Cairns, *The Future Shape of Harmonization: A Reply*, 6 EUR. ACCT. REV. 305, 309 (1997).

successful. In particular, the European Commission endorsed another set of accounting standards, the International Financial Reporting Standards (“IFRS”), as the mandatory accounting rules for all European-listed companies.¹⁰⁶ The European Union then pressed the United States to allow issuers with IFRS-compliant financial statements to access the U.S. public markets without reconciliation with U.S. GAAP, recognizing that IFRS and U.S. GAAP offer equivalent information to investors.¹⁰⁷ Developed by the International Accounting Standards Board (“IASB”),¹⁰⁸ a not-for-profit body without formal attachment to a particular jurisdiction, IFRS enjoyed wide acceptance as “a common international language of accounting to serve capital markets.”¹⁰⁹ IFRS were popular among issuers who conducted limited private international offerings, but not public offerings.¹¹⁰ In practice, IFRS belongs to the same accounting tradition as U.S. GAAP, and the two share many similarities.¹¹¹ As such, the IASB and the Financial Accounting

¹⁰⁶ Regulation 1606/2002 requires companies incorporated under the laws of an E.U. member state and whose securities are publicly traded within the European Union to prepare their consolidated financial statements for each financial year starting on or after January 1, 2005, on the basis of accounting standards issued by the IASB. Commission Regulation 1606/2002, On the Application of International Accounting Standards, 2002 O.J. (L 243) 1. As opposed to more commonly used directives, which require member-state legislative action to be incorporated into national legal orders, regulations are directly applicable in member states.

¹⁰⁷ See, e.g., Alexander Schaub, Director General for the Internal Mkt. of the Eur. Comm’n, Testimony before the Committee on Financial Services, U.S. House of Representatives 13 (May 13, 2004), available at http://ec.europa.eu/internal_market/finances/docs/general/2004-05-13-testimony_en.pdf.

¹⁰⁸ IASB is the successor of the International Accounting Standards Committee, restructured in 2001. All standards issued prior to 2001 are called International Accounting Standards (“IAS”); all standards issued after 2001 are called International Financial Reporting Standards (“IFRS”). IFRS and IAS are a single body of standards. See Ann Tarca, *International Convergence of Accounting Practices: Choosing between IAS and US GAAP*, 15 J. INT’L FIN. MGMT. & ACCT. 60, 87 (2004).

¹⁰⁹ See Geoffrey Whittington, *The Adoption of International Accounting Standards in the European Union*, 14 EUR. ACCT. REV. 127, 128 (2005). According to competing accounts, professional bodies from the U.K. and other Anglo-Saxon countries created IASC (the predecessor to IASB) to promote the advantages of Anglo-Saxon accounting to the international community. They were thus hoping to raise a barrier to the expansion of continental accounting, which they viewed as inflexible and state-controlled. See Flower, *supra* note 103, at 288.

¹¹⁰ See Tarca, *supra* note [].

¹¹¹ Most commentators, either academics or practitioners, agree that Anglo-Saxon accounting principles, and U.S. GAAP in particular, have largely influenced the drafting and final form of IAS and IFRS. Some commentators argue that for the first twenty years of its existence, IASC (later renamed IASB) “did not issue a single standard that was in fundamental opposition to U.S. GAAP.” See Flower, *supra* note 103, at

Standards Board (“FASB”, the U.S. standard-setter) had agreed in 2002 to cooperate to reduce any differences that remained between the two sets of standards.¹¹² The European Commission hoped that under the political weight of twenty-five jurisdictions, the IASB would be able to push for accounting solutions preferable to European companies otherwise disadvantaged by U.S. GAAP.¹¹³ Eventually, the United States did not yield in its insistence that the differences between U.S. GAAP and IFRS be reduced to a minimum (i.e., that IFRS obtain virtually the same content as U.S. GAAP) before the reconciliation requirement could be dropped. As Donald Nicolaisen, then SEC’s chief accountant, stated, IFRS and U.S. GAAP requirements and disclosures should be closely aligned before companies with IFRS financial statements can access the U.S. capital markets: “Convergence is the enabler that will allow IFRS and U.S. GAAP to coexist.”¹¹⁴ In 2005, the United States agreed to recognize the equivalence of IFRS to U.S. GAAP by 2009 provided, among other things, that the two sets of standards have substantially

289. IASC regularly participated in a series of meetings that took place between 1992 and 2001 among the standard-setters of the United States, the United Kingdom, Canada, Australia, and New Zealand, discussing current topics of accounting interest. See Christopher Nobes, *On the Myth of “Anglo-Saxon” Financial Accounting: A Comment*, 38 INT’L J. ACCT. 95, 98 (2003). Accounting in some European (mostly continental) jurisdictions has remained closely associated with the tax treatment and the distributable income of the issuer, whereas in other jurisdictions, such as the United Kingdom, accounting is largely oriented toward providing accurate information to investors, focusing on greater disclosure and avoiding hidden or secret reserves. See Haller, *supra* note 105, at 155–56. In addition, Anglo-Saxon accounting is allegedly less concerned about “prudence,” and is more inclined to look to substance, ignoring “superficial” legal form. See Nobes, *supra*, at 111. As Geoffrey Whittington, a member of IASB, has stated that FASB is “the world’s most prolific and well-resourced standard-setter” and it is therefore no surprise that IASB’s efforts are largely focused on convergence with the United States. See Whittington, *supra* note 108, at 133 (2005).

¹¹² In September 2002, in a meeting in Norwalk, Connecticut, IASB and FASB reiterated their commitment to “the development of high-quality, compatible accounting standards that could be used for both domestic and cross-border financial reporting.” As a result of that meeting, IASB and FASB concluded a Memorandum of Understanding, often referred to as the “Norwalk Agreement,” under which they pledged to use their best efforts to make their existing financial reporting standards fully compatible as soon as practicable and to coordinate their future work programs to ensure that once achieved, compatibility is maintained. Memorandum of Understanding between FASB and IASB, “The Norwalk Agreement” (Sept. 18, 2002), available at <http://www.fasb.org/news/memorandum.pdf>.

¹¹³ See Flower, *supra* note 109, at 290–291.

¹¹⁴ See Donald T. Nicolaisen, *A Securities Regulator Looks at Convergence*, (Address at the Symposium on the Convergence of Accounting Standards) 25 NW. J. INT’L L. & BUS. 661, 671 (2005).

converged and that E.U. member-states have put in place adequate enforcement mechanisms.¹¹⁵ The SEC has agreed with European regulators to a work plan that ensures smooth progress towards convergence.¹¹⁶

Convergence between IFRS and U.S. GAAP signals a move toward harmonization at the formal rules level, reflecting developments at the market level. The dynamics of a centralized market led an ever-growing number of market participants to comply with the rules of the dominant center. While other jurisdictions attempted to intervene in formulating final harmonized rules, the United States, as the dominant center, only agreed to minimal concessions. Global harmonization in the field of accounting standards is clearly on track, but with harmonized rules approximating the rules of the dominant center.

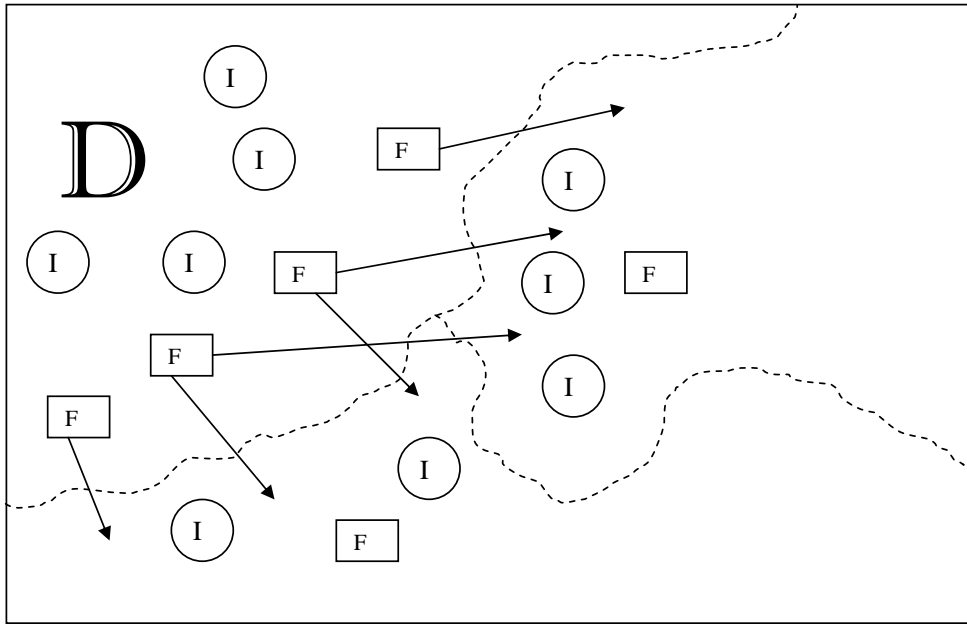
IV.b.3 The Politics of Foreign Jurisdictions in Dispersed Markets under Strong Dominance (Second Quadrant)

In dispersed markets, financial firms operate through a chain of local outputs serving the needs of a community within a limited geographic area (e.g., a person who wants a loan walks into a local bank branch).

Figure 2: Cross-border Activity in Dispersed Markets under Strong Dominance

¹¹⁵ See *id.*

¹¹⁶ See Press Release No. 2006-130, SEC, SEC and CESR Launch Work Plan Focused on Financial Reporting (Aug. 2, 2006), available at <http://www.sec.gov/news/press/2006/2006-130.htm>.



A financial firm that targets foreign investors in a dispersed market must establish a place of business in foreign countries similar to the outputs it maintains in its own jurisdiction. As international financial activity in a dispersed market grows, each country will be host to financial firms from other countries that will compete with domestic firms. Puzzled by why some financial services are better offered on a local level, economists have focused on the firm-client relationship. Financial firms with a local presence can easily overcome information asymmetries inherent in the extension of credit.¹¹⁷ Physical proximity assists firms in building relationships of mutual trust and confidentiality with investors.¹¹⁸ The dispersed character of some financial markets, where branches serve

¹¹⁷ Firms often must assess the financial condition of small customers, either individuals or businesses, who are less transparent than large corporations. However, local branches can rely on privately developed information (e.g., their bank deposits offer information about the service of future loans). See Robert N. Collender & Sherrill Shaffer, *Local Bank Office Ownership, Deposit Control, Market Structure, and Economic Growth*, 27 J. BANKING & FIN. 27, 29 (2003).

¹¹⁸ See Lambertus J. R. Scholtens, *On the Theory of International Financial Intermediation*, 140 DE ECONOMIST 470, 474 (1992); see also generally Arnoud W. A. Boot & Anjan V. Thakor, *Can Relationship*

distinct communities, coincides with the treatment of crucial questions of financial law by courts. In fact, the U.S. Supreme Court portrayed the banking market as highly disaggregated into small geographic units in its seminal 1963 ruling in *United States v. Philadelphia National Bank*, 374 U.S. 321 (1963), which considered the application of antitrust rules to the banking industry for the first time. Following the Supreme Court's approach, the U.S. administrative agencies responsible for authorizing mergers between banks have tended to define geographic markets for banks narrowly into small units such as counties.¹¹⁹ Thus, U.S. law recognizes the implications of the dispersed character of these markets for public policy.

To establish dominance in dispersed markets, financial firms from the dominant center must expand their chain of local outputs abroad, as Figure 2 demonstrates. As discussed above, dominant-center financial firms are able to disregard costs they face due to regulatory discrepancies between the home and host jurisdictions, either because they can pass them on to investors, or because they have already incorporated them into their business models and have succeeded over their competitors. Thus, there is lower demand

Banking Survive Competition?, 55 J. FIN. 679 (2000). According to Boot and Thakor, relationships allow financial firms, and banks in particular, to complement the extension of credit with services based on specific information on investors available only to them: screening (*see generally* Franklin Allen, *The Market for Information and the Origin of Financial Intermediation*, 1 J. FIN. INTERMEDIATION 3 (1990) (arguing that informed intermediaries invest in assets that are not attractive to others because of risk)), monitoring (*see generally* Douglas W. Diamond, *Financial Intermediation and Delegated Monitoring*, 51 REV. ECON. STUD. 393 (1984) (arguing that financial intermediaries monitor loan performance and thus reduce monitoring costs for individual lenders)), and liquidity transformation (*see generally* Douglas W. Diamond & Philip H. Dybvig, *Bank Runs, Deposit Insurance, and Liquidity*, 91 J. POL. ECON. 401 (1983) (arguing that banks will be able to transform illiquid assets into liquid assets as long as investors maintain their confidence to the banking system)). Moreover, foreign financial firms have been traditionally treated with suspicion and fear by local communities. *See* Collender & Shaffer, *supra* note 117, at 28–29. Local presence may assist foreign firms in overcoming these inhibitions and signaling their commitment to local communities.

¹¹⁹ *See* U.S. DEP'T OF JUSTICE, BANK MERGER COMPETITIVE REVIEW – INTRODUCTION AND OVERVIEW 1-5 (1995).

for reducing regulatory discrepancies within the dominant center, and the dominant center's government is likely to be indifferent toward policy coordination.

Similarly, political factors in foreign jurisdictions will tend to render foreign governments indifferent to policy coordination. Foreign investors pick financial firms locally and do not face the costs of cross-border activities directly. Although these investors may suffer the costs of regulatory discrepancies passed on to them by dominant center firms, they have difficulties identifying the source of additional charges. Foreign financial firms would face significant challenges in expanding internationally and catering to clients with cross-border needs, as they will have to compete against the already well-established dominant-center firms. Indeed, the market share that dominant firms have accumulated in dispersed markets suggests that internationally active firms in foreign jurisdictions are limited in number. As a result, any foreign financial firms will turn to a primarily local clientele, and will thus be indifferent to policy coordination. As a result, support for policy coordination is low in this quadrant, although moves to accommodate firms' concerns in individual jurisdictions are possible.

*IV.b.4. Case Study: Audit Firms Regulation - Strong U.S. Dominance in the
Market for Audit Services against a Dispersed Issuer Base*

The market for auditing services is dispersed—in each jurisdiction, a number of locally operating firms offer auditing services to corporations based or present in that country. Many jurisdictions require that financial statements of publicly traded corporations be audited by qualified professionals with knowledge of the accounting

principles by which financial statements must abide.¹²⁰ As such, auditing firms located within a certain jurisdiction and catering to local clientele are better placed to develop the necessary expertise. Proximity to the company's headquarters and local language skills are also important for auditor selection, as the audit process revolves around review of company documentation. Thus, audit firms seeking to expand internationally have sought to obtain a local presence in targeted jurisdictions, either by merging with local firms or building start-up practices.

Four large multinational accounting firms (the "Big Four") dominate the global accounting market. They include Deloitte & Touche, PricewaterhouseCoopers ("PwC"), Ernst & Young ("E&Y") and KPMG. According to a 2003 General Accountability Office ("GAO") study, the Big Four audit 97 percent of all publicly traded companies in the United States whose annual sales exceed \$250 million.¹²¹ In 2005, the Big Four audited 99 of the 100 biggest publicly traded companies in the United Kingdom and 242 of the next 250 biggest; this pattern is persistent over time, as only 4 percent of publicly traded companies per year switch auditors.¹²² Similar trends prevail in other large European markets, where the Big Four's market share for 2005 is very high among top-tier firm audits (97 percent in Germany, 73 percent in France, 100 percent in Italy, 97 percent in Spain) and slightly less strong, although still significant, among all publicly traded firms

¹²⁰ See e.g., Securities and Exchange Act of 1934 § 10A, 15 U.S.C. § 78j-1 (2000). European Union-wide requirements for audited financial statements were first introduced in the Fourth Company Directive (1978), which also introduced format and valuation reforms and required the preparation of annual accounts providing a true and fair view of the company's assets and liabilities. See Fourth Council Directive 78/660/EEC of 25 July 1978 based on Article 54(3)(g) of the Treaty on the Annual Accounts of Certain Types of Companies, 1978 O.J. (L 222) 0011.

¹²¹ U.S. GENERAL ACCOUNTING OFFICE, PUBLIC ACCOUNTING FIRMS: MANDATED STUDY ON CONSOLIDATION AND COMPETITION 22 (July 2003), available at <http://www.gao.gov/new.items/d03864.pdf>.

¹²² OXERA, COMPETITION AND CHOICE IN THE UK AUDIT MARKET, REPORT PREPARED FOR DEPARTMENT OF TRADE AND INDUSTRY AND FINANCIAL REPORTING COUNCIL 3 (Apr. 2006), available at www.oxera.com/cmsDocuments/Reports/DTI%20Auditors%20executive%20summary.pdf.

in these countries (55 percent in Germany, 42 percent in France, 88 percent in Italy, 91 percent in Spain).¹²³ The same four firms audit more than 80 percent of publicly traded companies in Japan and more than 65 percent of publicly traded companies in Canada in 2003.¹²⁴ Each Big Four firm maintains offices in a wide network of locations around the world.¹²⁵ Although these firms grew through a series of mergers and acquisitions of smaller national and international firms, they originated either in the United Kingdom or in the United States and have matured in the Anglo-American accounting tradition, which often clashed with local cultures in earlier stages of their expansion.¹²⁶ Today, their U.S. revenues amount to one-third of their global revenues on average, as Table 6 below illustrates, far outweighing revenues from any other single jurisdiction. In general, Big Four revenues from their U.S. operations are twice as large as their U.K. revenues, and three to four times larger than their revenues in the world's other principal economies.

*Table 6. Revenues of Big Four Accounting Firms (2004), in millions USD**

	Global	U.S.	U.K.	France	Germany	Asia Pacific
PwC	18,998	5,180	3,470	702	1,469	1,753
Deloitte	18,200	6,876	3,021	552	630	1,800

¹²³ LONDON ECONOMICS IN ASSOCIATION WITH RALF EWERT, STUDY ON THE ECONOMIC IMPACT OF AUDITORS' LIABILITY REGIMES (MARKT/2005/24/F), FINAL REPORT TO EC-DG INTERNAL MARKET AND SERVICES 20 (Sept. 2006), available at http://ec.europa.eu/internal_market/auditing/docs/liability/auditors-final-report_en.pdf.

¹²⁴ *Called to Account*, ECONOMIST, Nov. 20, 2004, at 71–73.

¹²⁵ Clients of audit firms explicitly stated that geographic spread does not affect their choice of auditor. See LONDON ECONOMICS, *supra* note 123, at 35.

¹²⁶ See Ignace De Beelde et al., *The Introduction of the Anglo-American Audit Firms in France* (Univ. of Ghent Dept. of Econ. & Bus., Working Paper No. 392, 2006), available at http://www.FEB.UGent.be/fac/research/WP/Papers/wp_06_392.pdf.

E&Y	17,467	5,511	1,842	941	1,224	1,790
KPMG	13,444	3,808	2,497	894	1,344	1,650

*Source: Firm Websites

In adopting the Sarbanes-Oxley Act in 2002, the U.S. Congress sought to restore investor confidence in U.S. markets following the high-profile corporate scandals of the early 2000s. Enron's collapse was partly attributed to deficient auditing and resulted in the rapid meltdown of Arthur Andersen—one of the (then) five biggest accounting firms—under the burden of SEC investigations and impending criminal liability.¹²⁷ Until then, U.S. auditors operated under a self-regulatory regime: while the SEC was responsible for government oversight, it allowed the American Institute of Certified Public Accountants (“AICPA”), the professional organization of American auditors, to set audit standards and rules on professional ethics.¹²⁸ To tighten up the regulatory framework for public company auditing, the Sarbanes-Oxley Act ended the self-regulation of the accounting profession and established a new regulatory body, the Public Company Accounting Oversight Board (“PCAOB”).¹²⁹ The PCAOB is not part of the U.S. Government—it is a private non-profit entity funded by levies and fees it collects from regulated audit firms and public companies under the Sarbanes-Oxley Act.¹³⁰ Its primary responsibilities consist in maintaining a register of accounting firms that offer audit services to companies publicly traded in the United States, setting auditing and

¹²⁷ See generally John C. Coffee Jr., *Understanding Enron: “It’s About the Gatekeepers, Stupid,”* 57 BUS. LAW. 1403 (2002).

¹²⁸ Andrea Bather & Priscilla Barnaby, *The Public Company Accounting Oversight Board: National and International Implications*, 21 MANAGERIAL AUDITING. J. 657, 659 (2006).

¹²⁹ Sarbanes-Oxley Act § 101, 15 U.S.C. § 7211 (Supp. II 2002).

¹³⁰ See Bather & Barnaby, *supra* note 128, at 662.

ethics standards for auditors, conducting periodic inspections of audit firms, and initiating investigations and disciplinary proceedings against audit firms. The PCAOB operates under SEC oversight; the SEC appoints the Board's five members, only two of whom can be certified public accountants.¹³¹ In addition, the SEC must approve PCAOB rulemaking, review registration refusals and disciplinary action taken by the PCAOB, and undertake an appeal function when audit firms seek review of PCAOB actions.¹³² Thus, the Sarbanes-Oxley Act has subjected a previously self-regulated industry to supervision by a new independent body ultimately controlled by a strong government agency.

Establishment of the PCAOB regime has significant extraterritorial implications. The Sarbanes-Oxley Act extends the requirement for registration with the PCAOB, and thus its jurisdiction, to any firm that offers audit services to a company whose stock is publicly traded in U.S. markets. Almost 1400 foreign issuers are currently participating in the U.S. public markets, many of them audited by audit firms in their home countries.¹³³ Moreover, international branches or subsidiaries of U.S. public companies also utilize local audit firms, on whose opinion U.S. auditors must rely in their audits of the parent company. Finally, the big accounting firms have established an impressive network of multinational operations. As a result, of the 1732 firms registered with the PCAOB to date, 861 (almost half) are based outside of the United States.¹³⁴ Similar to U.S. registrants, foreign firms are required to comply with PCAOB rules and are subject to periodic inspections, and occasionally they may be the object of PCAOB investigations

¹³¹ *Id.*

¹³² Sarbanes-Oxley Act § 107, 15 U.S.C. § 7211 (Supp. II 2002).

¹³³ Daniel L. Goelzer, Board Member, PCAOB, The PCAOB and the Oversight of Non-US Auditors, Address at the Inaugural Baker & McKenzie International Law Lecture Series (Apr. 19, 2004), *available at* http://www.pcaobus.org/News_and_Events/Events/2004/Speech/04-19_Goelzer.aspx.

¹³⁴ PCAOB, *Registered Public Accounting Firms with the Public Company Accounting Oversight Board*, http://www.pcaobus.org/Registration/Registered_Firms.pdf (last visited Jan. 9, 2007).

or sanctions. Clearly, the imposition of the U.S. supervisory regime over local regimes dramatically raises the regulatory costs for foreign firms, who must familiarize themselves with a second regulatory framework, hire U.S. experts, and devote substantial efforts in resolving any conflicts that may arise. Supervising a firm located in another jurisdiction also raises costs for U.S. regulators and presents them with formidable challenges, especially with regard to enforcement. The diversity of regulatory regimes for statutory auditors around the world, many of which rely on self-regulation by professional associations, prevented a mutual recognition solution with the United States, which had boldly moved away from self-regulation. Moreover, higher regulatory costs constitute a competitive disadvantage for U.S. firms in foreign markets where local competitors are not subject to comparable oversight. An international regulatory harmonization agreement could address these concerns by leveling the playing field between foreign and U.S. firms and allowing U.S. regulators to rely fully on their foreign counterparts.

Harmonization, however, has few supporters in this case due to the conditions prevailing in a dispersed market characterized by strong U.S. dominance. As their share of the global accounting market implies, U.S. firms hardly face any competitive threat and can easily absorb the additional costs a stricter U.S. regime entails. As U.S. firms have already found their way into foreign markets, which they dominate, they have already incurred the bulk of the costs associated with operating across multiple jurisdictions. Additional regulatory divergence may result in further costs for U.S. firms; however, as these costs do not affect their competitive position abroad, their motivation for harmonization remains modest.

Foreign firms with a U.S. presence still face increased regulatory costs due to the divergence between the U.S. regime and their local one. Yet the United States is but one of the many foreign jurisdictions where they operate, given the dispersed structure of the market. Harmonization between a foreign firm's local regime and the U.S. regime would have only a limited impact on its regulatory costs, as its operations would still span a number of non-harmonized regimes. Thus, contrary to centralized markets, harmonization between the dominant center and another jurisdiction in dispersed markets has limited benefits.

A global agreement to harmonize the regulatory regime for auditors would greatly benefit multinational audit firms. To this end, prominent figures in the accounting industry often express hope for greater convergence. However, there are numerous practical difficulties associated with reaching such an agreement. With no single national regime emerging as a model for harmonization, negotiation costs are high. With U.S. firms offering only modest support for harmonization, the United States has little motivation to either alter its domestic regime for the benefit of harmonization or use political capital to promote an immediate solution at the negotiation table. Similarly, other governments are unwilling to incur the domestic political costs associated with shifting to a different regulatory regime for the sake of global harmonization. As harmonization is not a priority for the industry, its likelihood of success is limited.

While mutual recognition between the government-controlled U.S. regime and the self-regulatory foreign regimes is unjustified and no government initiatives for international regulatory harmonization have so far emerged, U.S. regulators are required by law to face the challenges of supervising numerous non-U.S. firms. As foreign audit

firms initiated the registration process with the PCAOB, conflicts between U.S. law and off-shore rules became clear: Local privacy and confidentiality laws prevented foreign auditors from furnishing some of the information required by U.S. law. The PCAOB decided to accommodate foreign firms by allowing them to withhold information so long as they produced sufficient evidence that local laws prohibited the disclosure of the information in question.¹³⁵ With regard to conducting inspections abroad and relying on home country regulators, the PCAOB opted for a “sliding scale approach”: its rules permit varying degrees of reliance on the home country regulatory system such that the more independent from the profession a home country system is, the greater the reliance the PCAOB will place on its output.¹³⁶ To determine independence from the auditing profession, the PCAOB will consider the home country system’s funding arrangements, transparency measures, and track record.¹³⁷ In advance of the inspection, the PCAOB offers to negotiate a work program with the foreign firm’s regulatory body. Further, the PCAOB relies, to the maximum extent possible, on the home jurisdiction’s investigatory and disciplinary systems. To the extent that additional conflicts of law arise, the PCAOB tries to address them through this cooperative process and to resolve them through special permissions or voluntary waivers. Overall, while the PCAOB approach offers a practical solution to mitigate differences between various national regimes, it does not try to reconcile these differences in substance.

¹³⁵ See PCAOB Rule § 2105, rendered effective on June 5, 2003, following approval by the SEC; see SEC Release No. 34-47990, 80 S.E.C. Docket 1179, 2003 WL 21301067.

¹³⁶ Briefing Paper, PCAOB, Oversight of Non-U.S. Public Accounting Firms (Oct. 28, 2003) (on file with author).

¹³⁷ See PCAOB Rule § 4011-12, rendered effective on July 20, 2004, following approval by the SEC; see SEC Release No. 34-50047, 83 S.E.C. Docket 1066, 2004 WL 1960113.

The corporate scandals of the early 2000s reverberated across borders. As a policy response to these events, the abolishment of self-regulation for the auditing profession and the establishment of a stricter auditing-standards regime influenced the approach of other jurisdictions to auditor regulation. For example, the European Union, faced with the Parmalat and Ahold corporate scandals, adopted a directive that ought to disentangle auditors' supervision from professional groups, ensure robust public oversight of auditing firms and introduce common auditing quality standards.¹³⁸ While the directive does not require registration of foreign firms and allows significant leeway for member-states to formulate their own regimes, it effectively requires them to establish non-industry regulators and establishes a mechanism for cooperation among them. Moreover, it provides for the future adoption of international auditing standards by the European Union.

Perhaps PCAOB may be able to cooperate more closely with these newly established regulators in the future. Yet, policy coordination with the U.S. was not a major concern in foreign countries' regulatory reforms with regard to auditors' oversight. Thus, auditor regulation remains largely heterogeneous across borders, and any regulatory discrepancies are addressed through ad hoc cooperation.

V. The Politics of Competition

While a state's dominance in financial markets allows it to pursue its regulatory agenda unilaterally, market developments may pose a challenge to the dominant state's

¹³⁸ Council Directive 2006/43 of 17 May 2006 on Statutory Audits of Annual Accounts and Consolidated Accounts, 2006 O.J. (L 157) 87, 107.

power. Technological progress may open new channels of communication between markets, thus turning distant firms into close competitors; consolidation among smaller firms or market venues outside the dominant center may produce large players that enjoy the same economic efficiencies as dominant center firms; small firms may develop an innovative business model that revolutionizes interaction with investors. In short, competitors to dominant-center firms may arise for many reasons.

When competition between financial firms of different national origin intensifies, regulation can affect market outcomes in various ways. First, regulatory requirements determine the costs of entry to and exit from a market for foreign firms and investors; the greater the regulatory discrepancies between markets, the larger the entry and exit costs. Thus, regulation can erect barriers around national markets, either to prevent foreign firms from expanding there, and consequently assisting national firms in preserving their market share, or to prevent investors from migrating to foreign markets. Second, regulation may confer advantages to a market's firms. For example, some national regimes may impose lower standards for supervised firms than others, may allow for greater flexibility in the firm-investor relationship, or may employ a more relaxed and less costly approach for administrative oversight. Clearly, regulatory discrepancies have the same effect on international financial markets even in times of dominance. Yet as competition between national markets grows and firms invest more efforts into preserving or expanding their global market shares, the impact of international regulatory discrepancies comes to the forefront of international policymaking.

As financial firms in the dominant center face increasing competition, they can no longer disregard the impact of regulatory discrepancies between the dominant center and

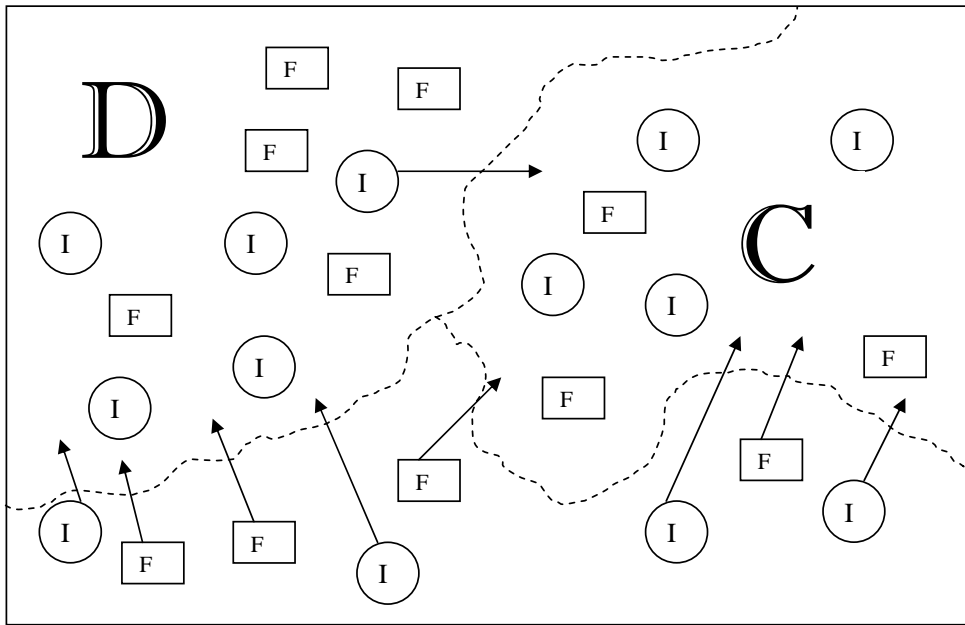
other markets. Fighting to preserve their market share, dominant firms would greatly benefit from regulation that could prevent market activity from migrating abroad, reduce the importance of any advantages their competitors have, and gradually lure investors back. Thus, dominant firms are likely to lobby their government to promote these regulatory goals. Increased competition affects not only the dominant center's firms, but also firms and investors in other jurisdictions. In the dominant setting illustrated above, foreigners sought to take advantage of the dominant center's unique market conditions. However, when competing markets offer comparable advantages to foreign firms and investors in alternative locations, foreigners' motives to enter the dominant center weaken. Thus, increased competition transforms the politics of financial regulation both within and outside of the dominant center. Regulatory outcomes as to policy coordination vary accordingly.

To better track the effect of increased competition on politics in both the dominant center and in foreign jurisdictions, the sections below again distinguish between centralized markets and dispersed markets. As noted above, centralized markets draw investors and firms from foreign jurisdictions within the centralized market's territory, whereas dispersed markets require firms from each jurisdiction, however dominant, to expand their operations into numerous outlets around the world. Thus, territorial politics in these two types of markets differ greatly, and policy coordination outcomes reflect these differences.

V.a The Politics of Competition in Centralized Markets

In centralized markets, competition between the dominant center and a new venue leads to increased polarization. International financial firms and investors are split between the dominant center and its competitor. In Figure 3, the area marked with C represents the competitor's jurisdiction, which now attracts a significant share of firms and investors from third countries.

Figure 3: Cross-border Activity in Centralized Markets under Increased Competition



When the dominant center faced no competition, it accumulated the largest portion of investment activity. The emergence of a competitor, however, drives liquidity away from the dominant market. Firms and investors are split, with some heading toward the newly emerging competitor and others remaining loyal to the dominant center. While

the dominant center still has better access to the large investment pools accumulated among dominant-center investors, the dominant market's competitors are gaining ground.

Although the emergence of a competitive foreign alternative changes market realities for the dominant center's financial firms, it does not affect them uniformly. Entities directly involved in the operation of the market, such as stock exchanges, trading systems, and clearing houses, whose activities occur largely within their domestic market, are especially hit by the development of an overseas competitor. These entities are likely to request protection from the government until they are ready to compete. Moreover, domestically oriented financial firms that handle activity primarily of the dominant center's market operator will be hurt by the erosion of its market share and demand protection from the government. However, other financial firms are internationally active and have access to the foreign competitor's markets, either directly or through their subsidiaries. As these firms participate in the success of foreign markets and benefit from the advantages competing market operators offer in comparison to the dominant market operator, they are indifferent to deteriorating conditions within the dominant market.¹³⁹ Indeed, internationally active financial firms may be well-placed to capture the largest portion of the investment outflows from the dominant market operator to its competitors. Foreign centralized markets also appeal to dominant center investors who wish to partake in the new opportunities foreign centralized markets offer. Investors would like to ensure that the costs of participating in a foreign market are as low as possible. To sum up, the

¹³⁹ Internationally active firms participate in all competing markets and are indifferent to the costs of regulatory divergence, which they have already paid. In contrast, they may benefit from variations in regulation between competing market operators because they differentiate between the services each market operator offers and provide investors with more choices. For a more detailed presentation of this view, see Thomas J. Chemmanur & Paolo Fulghieri, *Competition and Cooperation Among Exchanges: A Theory of Cross-Listing and Endogenous Listing Standards*, 82 J. FIN. ECON. 455, 457 (2006).

dominant center's domestically oriented financial firms are looking to their government for support; internationally active financial firms are largely unaffected by market developments and are indifferent to this state of affairs; and investors would prefer cost-effective access to foreign markets.

Foreign market actors also adjust their preferences with increasing competition. As they rely on investors outside their jurisdiction to increase the investment pools they handle, they seek greater openness and cheaper market access. As the largest portion of global investment resources still exists in the dominant center, foreign market operators will lobby their governments to smooth access to the dominant center's investors. Foreign financial firms have similar motives to their dominant center counterparts. Internationally active firms are largely unaffected by changes in market operators' trade shares. Domestically oriented firms, which expect their business to grow if local market turnover rises, join local market operators in their requests for greater market openness toward local governments.¹⁴⁰ Likewise, foreign and dominant-center investors alike would benefit from cost-effective access to market operators regardless of location. Thus, market actors' preferences in foreign jurisdictions are aligned toward greater openness to international investment activity.

Although foreign governments may request that the dominant center's government lift regulatory barriers through greater policy coordination, they are unlikely to find much support from interest groups within the dominant center. Market operators

¹⁴⁰ The preferences of domestically oriented firms in foreign markets and in the dominant center have the same starting point: their fortunes are closely tied with the fortunes of the market operators they principally serve. Yet the dominant centralized market and its foreign competitor have opposing positions toward policy coordination: the dominant market operator wants protection, and therefore supports maintaining regulatory barriers, while the foreign market operator wants market openness, and thus supports policy coordination. Consequently, domestically oriented firms in the dominant center are against policy coordination, while domestically oriented firms in foreign markets favor coordination.

and domestically oriented financial firms are hostile to the increased competition associated with openness and policy coordination, while internationally active firms are largely indifferent to this debate. Investors, who could benefit greatly from increased competition between local and foreign market operators, are a large and disaggregated group whose collective action problems impede lobbying efforts. Thus, the groups opposing coordination and seeking protection from the dominant center's government are likely to have greater domestic influence; these entities are typically cohesive and well-resourced interest groups perceived as central to the local economy. As foreign market operators and firms do not have direct channels of political influence to the dominant center's government, the likelihood that greater policy coordination will be achieved is limited.¹⁴¹ Eventually, the dominant center's government will maintain regulatory barriers that increase the costs investors from the dominant center face when seeking to access the competitor's market.

The dominant center may further engage in a race to the top or to the bottom against its competitor to attract more investors from third countries.¹⁴² While race theories predict that all jurisdictions will converge to a similar set of rules, a full race between the dominant center and its competitor here is unlikely. If the dominant center lowers its regulatory standards, it will face increased risk of fraud or systemic imbalance in its market and may harm its reputation. Moreover, the dominant center has an incentive to increase, not decrease, domestic investors' exit costs from the dominant

¹⁴¹ Pressures from domestic interest groups would inhibit the dominant center government from entering into negotiations for a mutual recognition arrangement recognizing the equivalence of the two regimes. Thus, even if the competitor jurisdiction was willing to amend its standards to approximate the dominant center's standards, it would have to do so unilaterally, taking the risk that the dominant center would not eventually agree to the equivalence. Given the costs of a regulatory change, such a scenario is highly unlikely.

¹⁴² See *supra* text accompanying notes 36–41.

market to secure the largest investor base for its market globally and gain greater policymaking flexibility than its competitors. Consequently, the dominant center will not amend its standards fully so as to surpass its competitor, as race theories may suggest, but will adopt minor changes that render its market more attractive at the margin to third-country investors without increasing the risk of fraud.

The case study that follows illustrates how coordination efforts in centralized markets fail when competition among market centers is pronounced.

V.b. Case Study: Harmonizing Regulation for Exchanges' Trading Screens - U.S.

Dominance Contested in the Centralized Stock Exchange Market

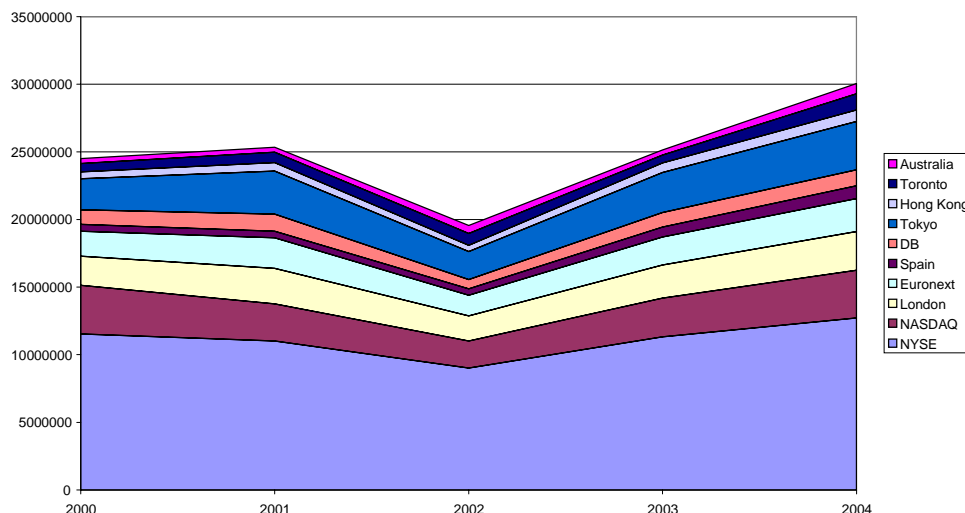
Stock exchanges are centralized markets; their function is to aggregate trading orders. The relevant actors are investors (purchasers of financial services) and brokers (suppliers of financial services), where brokers provide investors access to the exchange in return for a commission. The network externalities associated with stock-exchange liquidity have centralized trading activity in a handful of market centers around the world. The aggregate market capitalization of world stock exchanges in 2004 amounted to \$37,168.4 billion, of which \$30,104.9 billion was centralized in the ten biggest stock markets.¹⁴³ As of the end of 2007, the total capitalization of the New York Stock Exchange ("NYSE"), the largest stock exchange in the world, was almost four times that of its closest competitor, the Tokyo Stock Exchange.¹⁴⁴ The third largest exchange, NASDAQ, is also a U.S.-based marketplace that arose from a communications network

¹⁴³ See WORLD FED'N OF EXCHS., 2004 ANNUAL REPORT, *supra* note 100, at 49–50.

¹⁴⁴ *Id.*

connecting professional dealers.¹⁴⁵ Table 4 below lists the remaining exchanges by market capitalization.¹⁴⁶

Table 4: Market Capitalization - 10 Largest Stock Exchanges



Although capitalization data confirm the preeminence of U.S. markets in terms of size, developments in foreign stock exchanges during the 1990s have allowed them to contest the dominance of U.S. market operators. European stock exchanges, in particular, have employed advanced technology to improve trading efficiency. They operate electronic trading systems, largely based on the interaction of orders inserted by brokers in a computerized matching system, which offer lower trading costs and achieve order

¹⁴⁵ On the evolution of NASDAQ, see NASDAQ, 2005 ANNUAL REPORT, available at http://files.shareholder.com/downloads/NDAQ/52812485x0x36919/4926252F-A3F3-446A-85D0-AEA84A42CB82/NASDAQ_2005AnnualReport.pdf. The National Association of Securities Dealers (“NASD”) founded NASDAQ in 1971 as a wholly owned subsidiary that ran an electronic communications network connecting dealers around the United States through screens. See LOUIS LOSS & JOEL SELIGMAN, FUNDAMENTALS OF SECURITIES REGULATION 754 (2004). NASDAQ became operational as a national securities exchange on August 1, 2006, after receiving SEC authorization on January 13, 2006. See Press Release, NASDAQ, NASDAQ Becomes Operational as a National Securities Exchange (Aug. 1, 2006), available at <http://ir.NASDAQ.com/releasedetail.cfm?ReleaseID=205921>.

¹⁴⁶ See WORLD FED’N OF EXCHS., *supra* note 100.

execution in a matter of seconds.¹⁴⁷ In contrast, the NYSE has remained faithful to an open out-cry system, in which brokers interact directly with each other on the floor of the exchange, and where a particular category of traders—the specialists—intervene by trading against the current market trend so as to reduce imbalances in supply and demand for a certain stock.¹⁴⁸ An order on the NYSE requires an average of twenty seconds for execution,¹⁴⁹ and not surprisingly, trading costs are higher. Time-consuming execution also limits the number of orders a manual system can complete in a day. As trading volume has increased dramatically since the mid-1990s, electronic systems have been better-equipped to accommodate rising demand. Finally, electronic trading systems allow investors with large shareholdings to buy and sell in very small increments of time, turning large profits even from small price movements. As a result, electronic trading systems offer significant advantages to market operators.

The organizational structure of foreign stock exchanges is also more flexible than that of U.S. exchanges, allowing them to follow a more dynamic business strategy. In particular, foreign stock exchanges transformed themselves from not-for-profit membership organizations to private for-profit corporations, and often sought to raise capital by conducting a public offering in the primary equity markets and then listing in their own stock market. Table 5 below provides some information about the major

¹⁴⁷ See Stavros Gadinis, *Regulation and Innovation: Comparing the U.S. and European Equity Trading Markets* 22–26 (Feb. 16, 2006), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=887645. See also Poser, *supra* note 86, at 501; RUBEN LEE, WHAT IS AN EXCHANGE? THE AUTOMATION, MANAGEMENT, AND REGULATION OF FINANCIAL MARKETS 62 (1998).

¹⁴⁸ See Dale A. Oesterle, Donald A. Winslow & Seth C. Anderson, *The New York Stock Exchange and Its Out Moded Specialist System: Can the Exchange Innovate to Survive?*, 17 J. CORP. L. 223, 224 (1992); Morris Mendelson & Junius W. Peake, *Intermediaries' or Investors': Whose Market Is It Anyway?*, 19 J. CORP. L. 443, 444 (1994).

¹⁴⁹ See Robert Battalio, Brian Hutch, and Robert Jennings, *All Else Equal?: A Multidimensional Analysis of Retail, Market Order Execution Quality*, 6 J. FIN. MRKTS. 143, 155 (2003). See also Jeffrey Bacidore, Katharine Ross & George Sofianos, *Quantifying Market Order Execution Quality at the New York Stock Exchange*, 6 J. FIN. MRKTS 281, 284 (2003).

exchanges' move to a for-profit structure.¹⁵⁰ While stock exchanges were traditionally controlled by their brokers and adjusted their business strategy to accommodate their brokers' interests, they now operate on the basis of shareholder primacy and their strategy seeks to maximize shareholder value. The new structure urges management to follow a business-oriented strategy and opens the way for mergers and alliances with exchanges in other jurisdictions.

The market value of U.S. and foreign exchanges illustrates how competition from foreign exchanges has begun to contest U.S. dominance. NYSE's later decision to adopt a for-profit structure itself allows us to compare its market value against that of its competitors.¹⁵¹ As Table 5 illustrates, its market value at the time of its transformation was roughly equal to that of Deutsche Börse, whose capitalization is less than ten percent that of the NYSE.

¹⁵⁰ Data in Table 5 come from publicly available sources. The market value of listed exchanges is as of September 7, 2005. The data was included in Andreas M. Fleckner, *Stock Exchanges at the Crossroads: Competitive Challenges – Reorganization – Regulatory Concerns*, Harvard Law School Olin Center Discussion Paper Series (10/2005) (on file with author). This paper was later published with data on a different date. See Andreas M. Fleckner, *Stock Exchanges at the Crossroads*, 74 *FORDHAM L. REV.* 1 (2006).***If the data was published in this later journal, can we remove the citation to the working paper? No, because data in the published paper are different (see reference to different date above)*** Data on the New York Stock Exchange came from the Wall Street Journal and refer to March 8, 2006, the first date the NYSE stock became available to investors. See Steve Gelsi, *Moving the Market: NYSE Begins its Life Today as a Listed Stock*, WALL ST. J., Mar. 8, 2006, at C5. The Tokyo Stock Exchange and the Swiss Exchange Group adopted a for-profit, corporate structure in 2001 and 2002 respectively, but have not conducted an IPO and have not listed their shares on an exchange so far. Data on BME Spanish Exchanges in the 2005 Market Value Column refer to its market value on July 14, 2006, the first date the BME stock became available to investors.

¹⁵¹ Pushed in part by SEC regulatory reforms that favor electronic trading systems, the NYSE announced in 2004 a plan to establish such a system itself, the NYSE Hybrid Market; see SEC Release No. 34-50277; File No. SR-NYSE-2004-05, also at <http://www.sec.gov/rules/sro/nyse/34-50277.pdf>. In the context of this plan, the NYSE merged with Archipelago Exchange, a small U.S. electronic trading system operator. Following the merger in March of 2006, the NYSE, which had until recently remained a non-profit partnership held by its 1366 members, became a for-profit corporation with shares listed on its own exchange. Throughout the recent reform period, NYSE executives emphasized that the new trading system and operational structure will allow them to compete more effectively with their international counterparts. NYSE has now fully implemented its proposal; for details, see <http://www.nyse.com/productservices/nyseequities/1203073705005.html>.

Table 5: World Stock Exchanges Transformation and Market Value

Stock Exchange	For-profit structure	Listed	2005 Market Value (USD)	2007 Market Value (USD)
Euronext	1997	2001	4.6 billion	Merged w/NYSE
London Stock Exchange	1999	2001	2.7 billion	10 billion
Deutsche Börse	2000	2001	9.9 billion	34 billion
Hong Kong Exchanges	2000	2000	3.3 billion	3.2 billion
Tokyo Stock Exchange	2001	-	-	-
TSX Group	2002	2002	0.9 billion	3.3 billion
BME Spanish Exchanges	2003	2006	3 billion	5.8 billion
Swiss Exchange	2002	-	-	-
NYSE	2006	2006	10 billion	23.8 billion

Source: Thomson Datastream; Dow Jones; Firm Websites

While exchanges with open out-cry trading floors are limited to on-floor trading, electronic exchanges can expand internationally through telecommunication networks. In electronic exchanges, any broker with a terminal and an internet connection can access the exchange's trading system, even if the exchange is located in another jurisdiction. European exchanges sought to establish trading facilities (known as "trading screens") in the United States, but the SEC has so far resisted these efforts. In particular, the SEC has stated that it doubts whether exchanges it does not license or supervise offer adequate protection to U.S. investors.

In its 1997 Concept Release on Alternative Trading Systems (“ATS”),¹⁵² the SEC contemplated various approaches to authorizing foreign-exchange presence in the United States, ranging from reliance on home-country regulation, provided there is substantial convergence with U.S. regulation (i.e., an approach similar to that later utilized in the accounting standards case), to subjecting foreign exchanges to full U.S. oversight. At this stage, an effort to establish a mutual recognition regime for stock exchanges between U.S. and foreign jurisdictions was clearly on the negotiating table. However, in its 1998 Regulation ATS,¹⁵³ the SEC did not address foreign exchange presence in the United States, deciding to consider any application by a foreign exchange on an ad-hoc basis.

Soon after, treatment of foreign exchanges’ applications to the SEC suggested that the real objective of the 1998 Regulation was to insulate U.S. exchanges from competition. In 1999, two European exchanges filed an application for establishing trading screens in the United States.¹⁵⁴ The first one was Deutsche Börse (through one of its subsidiaries), a top-ten exchange with significant liquidity often preferred by German and international issuers. The second foreign exchange that sought to establish trading screens in the United States was Tradepoint, Inc.—now Virt-x, a subsidiary of the Swiss Exchange, but an independent firm at the time—a small electronic market that

¹⁵² See Regulation of Exchanges, Exchange Act Release No. 38,672, 62 Fed. Reg. 30,485, at 30,522 (June 4, 1997). The SEC first dealt with the trading screens question in the context of formulating a regulatory framework for electronic trading platforms (“Alternative Trading Systems” or “ATS”), i.e., U.S.-based marketplaces such as Archipelago Exchange that emerged as significant competitors to exchanges in the mid-1990s.

¹⁵³ See *Regulation of Exchanges and Alternative Trading Systems*, Securities and Exchange Commission, Release No. 34-40760 (File No. S7-12-98) (December 8, 1998), 63 Fed. Reg. 70,844 (1998), implementing Rules 300-303 under the Securities Exchange Act of 1934, codified in 17 C.F.R. § 242.300-303 (2007).

¹⁵⁴ See Howell E. Jackson, Andreas Fleckner & Mark Gurevich, *Foreign Trading Screens in the United States*, 1 CAP. MKTS. L.J. 54 (2006).***Author to provide pin cites and a copy of the journal from Howell E. Jackson***

established itself in the United Kingdom to compete with the London Stock Exchange.¹⁵⁵ The SEC rejected Deutsche Börse's application,¹⁵⁶ but granted authorization to Tradepoint¹⁵⁷ subject to two conditions: first, that its overall trading volume remain below \$40 million; and second, that the public could only trade on securities already registered with the SEC.¹⁵⁸ Qualified institutional buyers¹⁵⁹ (i.e., investors for whom the regular safeguards of securities regulation do not apply) could trade on securities not registered with the SEC provided that their order flow did not exceed the trading volume cap. Although the SEC sought to justify its decision on the basis of its investor protection mandate, it is hard to reconcile this mandate with the "low volume" condition. A \$40 million fraud could represent a significant threat for U.S. retail investors, while qualified institutional buyers are generally exposed to much more substantial risks. However, the SEC insisted on its "low volume" condition, stating that

the Commission believes that it is appropriate to grant a low volume exemption only to an exchange that is a low volume exchange in its home country. The Commission believes that a U.S. limited volume exchange

¹⁵⁵ For more information on Tradepoint, see Alberto Cybo-Ottone, Carmine di Noia, & Maurizio Murgia, *Recent Developments in the Structure of Securities Markets*, 2000 Brookings-Wharton Papers on Financial Services 223, 258.

¹⁵⁶ See Jackson, Fleckner & Gurevich, *supra* note 154, at [].***Author to provide pincites***

¹⁵⁷ Tradepoint Financial Networks plc, Order Granting Limited Volume Exemption From Registration as an Exchange, Exchange Act Release No. 34-41199, 64 Fed. Reg. 14,953 (Mar. 22, 1999) [hereinafter *Tradepoint Order*].

¹⁵⁸ See *id.* at 14,957. ***Not sure if the second exemption stated in the article's text is obvious from the source – we can't find it. Condition B allows only qualified institutional buyers to trade in unregistered securities; thus, the public could only trade on securities already registered with the SEC***

¹⁵⁹ The qualified institutional buyer exemption was established by Rule 144A, which allows purchases of unregistered foreign stock for highly sophisticated institutions, such as institutions that own and invest at least \$100 million in securities, or that are owned exclusively by other qualified institutional buyers. For broker-dealers, the minimum investment is set at \$10 million, and for banks it is set at \$100 million. 17 C.F.R. § 230.144A (2007).

should not be owned, directly or indirectly, by a foreign exchange that has a significant market share in its home country.¹⁶⁰

Of the eight comments that the SEC received with regard to its Tradepoint decision, the only commentator fully objecting to any establishment of a foreign exchange in the United States was the NYSE.¹⁶¹

The Tradepoint rationale clearly has the effect of keeping from U.S. markets any foreign exchange that is a significant market player in its home jurisdiction. Given their market presence, these exchanges could provide U.S. investors with such liquidity that, in combination with the other advantages conferred by more advanced technology (such as lower trading costs and higher execution speed), could attract large numbers of U.S. investors, erode the network advantages of U.S. exchanges, and eventually reduce their market share. As long as foreign stock exchanges contested U.S. dominance in this market, the United States continued to oppose harmonization efforts.¹⁶²

V.c. The Politics of Competition in Dispersed Markets

In dispersed markets, financial firms must enter several jurisdictions simultaneously to meet the financing needs of investors in these local markets. A competitor to the dominant jurisdiction emerges when firms from another country manage to penetrate many third-country markets through a global network of branches and subsidiaries and capture a significant share of those markets. Thus, dominant-center

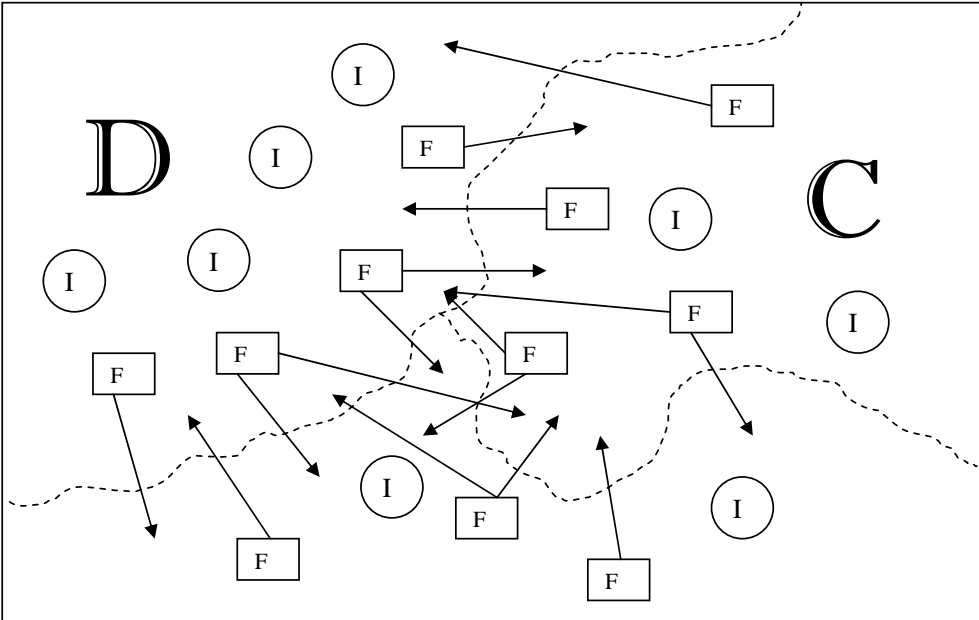
¹⁶⁰ See *Tradepoint Order*, *supra* note 157, at 14,957.

¹⁶¹ *Id.* at 14,955.

¹⁶² For recent developments in this area, see *infra* text accompanying notes 192-194.

firms, their sizeable foreign competitors, and third-country financial firms compete against each other in most third countries, as Figure 4 shows.

Figure 4: Cross-border Activity in Dispersed Markets under Increased Competition



The attitudes of market actors toward international policy coordination reflect this increasingly competitive situation. Dominant-center firms and their competitors wish to secure as many regulatory advantages in third countries as possible. In particular, while both dominant-center and competitor firms have already paid market-access costs upon entering foreign countries, they continue to incur ongoing compliance and divergence costs. However, these costs may not be identical for both players, and to the extent that the dominant center's market share is deteriorating, it may suggest that competitors enjoy regulatory advantages in these third countries. Overall, this reflects the fact that in dispersed markets under increased competition, the dominant center's regulatory regime

competes not just against its primary competitor's regulatory regime, but also that of each third-country jurisdiction.

Under these conditions, dominant-center firms could push their government to enter into a regulatory race to the bottom with the competitor jurisdiction. However, regulatory races are not generally an enticing option for policymakers because they have uncertain outcomes and increase the risk of fraud and instability in the financial system. Races in dispersed markets present further disadvantages. As discussed above, competing jurisdictions race not only against each other, but also against the third-country regimes where their firms operate. Some third-country governments may decide to participate in the race, thus pushing the dominant jurisdiction to either lower its standards further or forgo the race with respect to that jurisdiction. Other third-country governments may prevent further relaxation of regulatory standards by introducing minimum requirements, which reduce the effectiveness of the race. This mosaic of different regimes is not satisfactory for internationally active financial firms because it increases the ongoing compliance and divergence costs they incur. Thus, a regulatory race is not a satisfactory solution for the dominant center, because it offers no guarantee of uniform results across jurisdictions, and may instead increase divergence costs.

As such, market actors perceive both advantages and disadvantages to policy coordination. Dominant center firms view greater policy coordination as an opportunity to mitigate any regulatory advantages their competitors enjoy. Moreover, policy coordination removes uncertainties and reduces ongoing compliance and divergence costs. Thus, the dominant center's government is likely to initiate a global policy-coordination effort, in part to convince third-country governments to eliminate these

regulatory advantages. Dominant center proposals also serve the interests of third-country financial firms, which suffer similar market share losses from the regulatory advantages that the dominant center's competitors enjoy. Thus, these firms are likely to exert pressure on third-country governments to support coordination efforts. Overall, coordination will gain support from firms originating both in the dominant center and in third-country markets.

With financial firms supporting greater policy coordination and investors neutral to it, governments in the dominant center and other third-country jurisdictions are likely to further the cause of coordination.¹⁶³ While competitor firms and their government may oppose coordination, political channels of influence to the dominant center and third-country governments are limited. From a business perspective, if these contesting firms wish to maintain their market shares, they must continue operations in those third-country jurisdictions that accede to the coordination proposals. Once the dominant center throws its weight behind coordination efforts, and requires foreign firms operating in its jurisdiction to comply with coordinated standards, market pressure toward foreign jurisdiction is mounting. As increasing numbers of jurisdictions join the coordination cause, it becomes imperative for the contesting jurisdiction to conform, especially since the dominant center's market itself is large in size. Ultimately, the contesting jurisdiction will acquiesce to these coordination proposals, as the case study below demonstrates.

¹⁶³ As discussed above, investors in dispersed markets are indifferent to cross-border concerns, as they satisfy their investment needs from their local market. *See supra* Part IV.b.3.

V.d. Case Study: The 1988 Basel Accord – Contested U.S. Dominance in the
Dispersed Banking Market

In banking markets, activity is largely conducted at a local level. Even in the smallest communities, bank branches offer deposit-taking and lending services to consumers. Likewise, enforcement of banking regulation takes place at the local level, under the oversight of national banking regulators.¹⁶⁴ Overall, then, the banking market is dispersed.

Until 1980, U.S. banks controlled approximately 30 percent of the international banking business, while Japanese banks' market share sat at 20 percent.¹⁶⁵ By 1985, however, the situation was almost the reverse: U.S. banks' market share had decreased to 23 percent, while Japanese banks had increased their share to 26 percent.¹⁶⁶ Five years later, the Japanese banks' market share in international lending jumped to 38 percent, capturing 12 percent of the U.S. market and 23 percent of the U.K. market.¹⁶⁷ The success of Japanese banks was overwhelming—in 1981, only one of the ten largest banks worldwide was Japanese; in 1988, that figure jumped to seven.¹⁶⁸ What was the driving force behind the Japanese banks' rise in the international market? At the time, many commentators attributed their success partly to a favorable regulatory regime for capital adequacy. According to increasingly stringent guidelines by the U.S. regulators in 1981

¹⁶⁴ For an overview of the regulatory structure of banking supervision in various jurisdictions, see SCOTT, INTERNATIONAL FINANCE, *supra* note 71, at 153–195 (United States), 225–247 (European Union) & 283–309 (Japan).

¹⁶⁵ See Thomas Oatley & Robert Nabors, *Redistributive Cooperation: Market Failure, Wealth Transfers, and the Basel Accord*, 52 INT'L ORG. 35, 44 (1998).

¹⁶⁶ *Id.*

¹⁶⁷ See John D. Wagster, *The Impact of the 1988 Basel Accord on International Banks*, 51 J. FIN. 1321, 1322 (1996).

¹⁶⁸ See *id.*

and 1983,¹⁶⁹ U.S. banks' capital holdings—including equity and some types of equity-like instruments, such as preferred stock or subordinated debt—amounted to 6 to 7 percent of the risk-weighted assets of the bank. This requirement limited the lending activity of banks and increased aggregate transaction costs, as the extension of additional credit required the withholding of additional capital. In contrast, Japanese regulations permitted domestic banks' capital-to-risk-weighted ratios to reach as low as 2 percent.¹⁷⁰ Not surprisingly, U.S. banks argued that U.S. regulations eroded their international competitiveness.

These circumstances pushed U.S. policymakers into action, as the increasing threats to U.S. dominance in international lending markets were at least partly due to regulatory divergence. They were thus faced with a dilemma. They could either relieve their banks of the burden of holding additional capital by introducing changes to U.S. regulations, or they could try to eliminate their competitive disadvantage by promoting an international agreement on capital standards that would ultimately drive up Japan's regulatory thresholds. Amending domestic legislation was hardly an appealing option. Following an international sovereign debt crisis that revealed U.S. banks' huge exposures to Latin American governments, Congress, outraged with "the incapability of the regulators to effectively monitor and prevent the unsound operation and lending practices of U.S. banks," passed the International Lending Supervision Act. The Act required banking regulators to introduce risk-weighting mechanisms while setting capital-

¹⁶⁹ See Sun Bae Kim & Ramon Moreno, *Stock Prices and Bank Lending Behavior in Japan*, 1994 ECON. REV. OF FED. RES. BANK SAN. FRAN. 31, 32 (1994).

¹⁷⁰ Oatley and Nabors provide an overview of the capital/asset ratios of banks in the most important economies worldwide throughout the 1980s. See Oatley & Nabors, *supra* note 165, at 48. Other estimates of Japanese banks' capital ratios in this period range from a high of 2.73%, see Hal S. Scott, *The Competitive Implications of the Basle Capital Accord*, 39 ST. LOUIS U. L.J. 885, 889 tbl.3 (1995), to less than 1%, if certain types of reserves are excluded, see Kim & Moreno, *supra* note 169, at 35.

adequacy standards, so as to capture more accurately banks' exposure to credit risk.¹⁷¹ To further demonstrate its seriousness in the matter, Congress expressly authorized bank regulators to enforce these standards, in direct contravention of an earlier court judgment that cast doubt on their enforcement authority.¹⁷² The potential international implications of these requirements were a source of concern for Congress, which included a provision in the Act requiring the Federal Reserve Board and the Treasury Department to "encourage governments, central banks, and regulatory authorities of other major banking countries to work toward maintaining, and where appropriate, strengthening the capital bases of banking institutions involved in international lending."¹⁷³ U.S. lawmakers had expressly decided to elevate the issue to the international sphere.

Since 1974, central bank governors of the Group of Ten ("G10") countries,¹⁷⁴ as well as Luxembourg, had formed an informal committee under the auspices of the Bank for International Settlements in Basel ("Basel Committee") to promote convergence of banking supervisory practices.¹⁷⁵ The Basel Committee focused on capital adequacy standards in the beginning of the 1980s, noting the degree of divergence among national supervisory systems.¹⁷⁶ U.S. proposals for uniform international capital adequacy standards were met with resistance, not only from Japan but also from France and

¹⁷¹ See Gary A. Goodman & Robert W. Becker, *The New Basel II Capital Accord: Business and Legal Challenges for Real Estate Lenders*, 120 BANKING L.J. 309, 310 (2003).

¹⁷² See *First Nat'l Bank of Bellaire v. Comptroller of the Currency*, 697 F.2d 674 (5th Cir. 1983); see also HOWELL E. JACKSON & EDWARD SYMONS, REGULATION OF FINANCIAL INSTITUTIONS 185 (1999).

¹⁷³ See 12 U.S.C. § 3907(b)(3)(C) (2000).

¹⁷⁴ These G10 countries are Belgium, Canada, France, Germany, Italy, Japan, the Netherlands, Sweden, Switzerland, the United Kingdom, and the United States. Bank of International Settlements, Group of Ten, <http://www.bis.org/publ/g10.htm> (last visited Mar. 18, 2008).

¹⁷⁵ See Joseph Jude Norton, *Capital Adequacy Standards: A Legitimate Regulatory Concern for Prudential Supervision of Banking Activities?*, 49 OHIO ST. L.J. 1299, 1336-38 (1989).

¹⁷⁶ See *id.*

Germany.¹⁷⁷ Especially for French and Japanese banks, convergence to the U.S. requirements required significant infusions of additional capital, as their definitions of capital were substantially different from the U.S. proposals. Moreover, these countries did not share the United States' view that higher capital adequacy requirements were the most appropriate response to financial stability risks, as they believed that their national safety nets against financial stress were stronger than those of the United States.¹⁷⁸ The Basel Committee was thus moving toward an informal agreement that would accommodate the views of its various members, but fall short of the U.S. objective of leveling the playing field between U.S. and foreign banks.

Unsatisfied by these developments, the United States sought to promote its agenda by exercising pressure on foreign jurisdictions.¹⁷⁹ In January 1987, it side-stepped the Basel Committee and entered into a bilateral agreement on capital-adequacy standards with the United Kingdom, another major financial market whose banks were facing similar competitive challenges and had seen their market share diminish.¹⁸⁰ Moreover, the United States and the United Kingdom announced their intention to apply these standards to foreign banks already present or wishing to enter their markets, threatening to expel any non-compliant firms.¹⁸¹ Large international banks could not afford to be absent from these markets and direct negotiations between the United States and Japan began immediately after the announcement of the U.S.-U.K. agreement. Some bankers castigated this "bullish" approach that endangered future attempts for a

¹⁷⁷ See Oatley & Nabors, *supra* note 165, at 69.

¹⁷⁸ See Hal S. Scott, *The Competitive Implications of the Basle Capital Accord*, *supra* note 170, at 887–88 (1994).

¹⁷⁹ See Ethan B. Kapstein, *Resolving the Regulator's Dilemma: International Coordination of Banking Regulations*, 43 INT'L ORG. 323, 344 (1989).

¹⁸⁰ See Ethan B. Kapstein, *Between Power and Purpose: Central Bankers and the Politics of Regulatory Convergence*, 46 INT'L ORG. 265, 266 and 282 (1992); see also Oatley and Nabors, *supra* note 162, at 48.

¹⁸¹ See Oatley & Nabors, *supra* note 170, at 69.

negotiated international compromise. However, they recognized that the industry had little choice but to conform to regulations in the large U.S. and U.K. financial markets.¹⁸² In December 1987, the Basel Committee published its own proposal for capital adequacy standards that were very similar to, although less stringent than, the U.S. position. After a six-month consultation period, the Basel Committee adopted its final set of capital adequacy standards, known as the 1988 Basel Accord.

To sum up, coordination of capital adequacy rules resulted from pressure the dominant market exercised over its competitors. As the theoretical framework proposed in this Article indicates, coordination emerged as the most appropriate solution for dominant-center firms that operated simultaneously in various jurisdictions due to the dispersed structure of the banking markets.

VI. Conclusion

This Article develops a theoretical framework to explain why international policy coordination succeeds in some financial markets but fails in others. After summarizing the Article's main argument, the paragraphs below demonstrate how the proposed framework can explain coordination outcomes in other key debates in international finance, such as supervision of financial conglomerates and reinsurance collateralization. Moreover, the Article's framework can explain developments in countries' positions over time by examining changes in their competitive position, i.e., moves from a strong to a contested dominance situation and vice versa. Specifically, the paper focuses on the Basel

¹⁸² See Norton, *supra* note 175, at 1344–45.

II capital adequacy framework, and on proposals by SEC officials for mutual recognition of stock exchange oversight.

This Article argues that the success or failure of international policy coordination depends on the strength of a competitive challenge facing the dominant center and the importance to foreign market participants of entering the dominant center's jurisdiction. Specifically, when U.S. dominance in a market is strong, the United States is indifferent to policy coordination and thus coordination outcomes vary according to whether other states are willing to make the necessary compromises to minimize differences with the U.S. regulatory regime in place. Foreign governments will seek coordination with the United States in a centralized market, as their constituents must be present in the U.S. market and bear significant costs from any regulatory discrepancies. Foreign firms and investors do not have similar incentives in dispersed markets, however, as there is sufficient liquidity outside of the U.S. market to operate. In these circumstances, policy coordination will not succeed despite strong U.S. dominance.

When a competitor challenges U.S. dominance, however, U.S. firms and investors can no longer be indifferent to the impact of regulation on international financial activity. In centralized markets, the U.S. market competes with one or a few main markets around the world; thus U.S. regulators will maintain regulatory barriers to keep serious contenders out of the U.S. market. In dispersed markets, however, dominant and competitor firms compete in many national markets around the world; here, U.S. policymakers are incentivized to eliminate the advantages that divergent regulatory regimes confer on competitors through coordination.

Four case studies support the theoretical arguments of this Article. International accounting standards convergence occurred in the centralized market of primary securities offerings, where foreign jurisdictions felt market pressure to minimize differences with the standards of a strongly dominant jurisdiction, the United States. Yet, when U.S. dominance in a centralized market gave way to competition, coordination was impossible, as the trading screens case illustrates. In dispersed markets, strong U.S. dominance leads to non-coordination, as in the case of auditor regulation post-Sarbanes-Oxley. But increasing competition against the U.S. dominant center leads to coordination, as Basel I demonstrates. These four case studies rank among the most important regulatory coordination puzzles in international finance in the last twenty years.

This framework offers strong predictive guidance in other recent cases of international regulatory coordination. For example, there is no coordinated global framework for the regulation of financial conglomerates, i.e., holding companies whose subsidiaries include both banking and securities firms.¹⁸³ While the operations of these firms are dispersed around the world, the three largest banking and securities conglomerates are U.S.-based.¹⁸⁴ The consequences of a crisis in an international financial conglomerate would spread across the various jurisdictions in which it operates, providing a strong efficiency rationale for policy coordination.¹⁸⁵ Although no such crisis

¹⁸³ For an overview of the theoretical justifications for regulatory oversight at the level of the conglomerate, see Howell E. Jackson, *Consolidated Capital Regulation for Financial Conglomerates*, in CAPITAL ADEQUACY BEYOND BASEL: BANKING, SECURITIES, AND INSURANCE 123 (Hal S. Scott ed., 2005).

¹⁸⁴ Size as measured by shareholder equity. See Euromoney, The world's largest banks in 2006 (Aug. 1, 2006), <http://www.euromoney.com/Article/1079885/Title.html>.

¹⁸⁵ A G10 report recognized the increased systemic risk resulting from interdependencies within complex international financial institutions that combine bank and non-bank financial activities that emerged following a wave of consolidation in the financial industry in the 1990s. The report calls for greater cooperation among banking supervisors across borders. See Group of Ten [G10], *Consolidation in the Financial Sector – Summary Report* (Jan. 2001), at 15–16, 19, 31, available at <http://www.bis.org/publ/gten05summ.pdf>.

has emerged so far, the collapse of certain international financial institutions in the 1990s offers a glimpse of the chaotic cross-border challenges regulators could face.¹⁸⁶ In response to these concerns, the European Union adopted the Financial Conglomerates Directive,¹⁸⁷ which required special standards for the consolidated supervision of these firms. As the United States lacked a comparable framework, the European Union threatened to impose additional regulatory oversight on U.S. firms operating in Europe. However, instead of moving to policy coordination, the SEC adopted special rules to facilitate U.S. firms operating in the European Union in complying with the consolidated supervision requirements.¹⁸⁸ As predicted by the framework predicted here, strong U.S. dominance in a dispersed market did not lead to policy coordination, and cooperation was limited to the accommodation of regulatory differences by special rules.

An example of a highly centralized market where U.S. dominance is contested is the reinsurance market, where activity takes place in networks of reinsurers situated either in the United States or in Europe. European firms are serious competitors to U.S. firms.¹⁸⁹ Efforts to recognize the equivalence of U.S. and European regimes have failed. As European firms have sought entry into U.S. markets, U.S. lawmakers have tried to protect the domestic industry by imposing strict regulatory requirements on these new

¹⁸⁶ See Richard Herring, International Financial Conglomerates: Implications for Bank Insolvency Regimes 4–5 (July 2002) (paper prepared for the Second Annual International Seminar on Policy Challenges for the Financial Sector in the Context of Globalization), available at http://www1.worldbank.org/finance/assets/images/Herring--intl_finan_conglom-doc.pdf.

¹⁸⁷ See Council Directive 2002/87 of 16 December 2002 on the Supplementary Supervision of Credit Institutions, Insurance Undertakings and Investment Firms in a Financial Conglomerate, 2002 O.J. (L 35).

¹⁸⁸ See Alternative Net-Capital Requirements for Broker-Dealers that Are Part of Consolidated Supervised Entities, 69 Fed. Reg. 34,428 (June 21, 2004).***Pincite needed, if possible. I am referring to this Rule as a whole. ***

¹⁸⁹ See generally Eur. Comm'n, The EU-US Financial Markets Regulatory Dialogue: Experiences and Expectations (Sept. 14, 2005), available at http://ec.europa.eu/internal_market/finances/docs/general/20050914_fsc_eu_us_paper_en.pdf; see also Julianne Von Reppert-Bismarck, Moving the Market: EU Official Vows to Press U.S. to Cut Reinsurance Collateral, Wall St. J., Apr. 8, 2005 at C3.

entrants. In particular, they require all foreign reinsurers to fully collateralize claims (i.e., to keep an amount equal to potential claims in cash or cash-equivalent investments), while U.S. reinsurers have no such obligation.¹⁹⁰ This additional burden has effectively kept foreign firms away from the U.S. reinsurance market. Just as the third quadrant would predict, U.S. regulators have insisted on regulatory heterogeneity to shield U.S. firms from foreign competition.

The framework suggested in this article can also explain variations in states' positions regarding policy coordination over time. A characteristic example of how the U.S. position evolves as its dominance becomes more or less contested is the controversy surrounding the U.S. implementation of the revised set of capital adequacy standards, known as Basel II. The U.S. masterminded the 1988 Basel Accord (now known as "Basel I") when its dominance in the international banking industry was severely contested. Now that its dominance has become more solid, it has proved unwilling to fully implement the revised Basel II capital adequacy framework. Although the Basel II framework promotes uniformity in capital adequacy rules so as to level the playing field among international banks, following the rationale of Basel I,¹⁹¹ its implementation requires significant investment in risk assessment techniques and information technology infrastructure, which is particularly burdensome for small regional banks. After a long negotiation process, the United States surprisingly withdrew its support for harmonization and sought to accommodate the needs of its smaller banks by rendering

¹⁹⁰ See Cassandra Cole, Kathleen McCullough, & Lawrence Powell, *Regulation of Reinsurance Recoverables: Protection or Protectionism?* 3-4 (May 18, 2007), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=922057.

¹⁹¹ See Jamie Caruana, *A Vision of Stability Within the Basel Accord*, FIN. TIMES, Oct. 30, 2003, at 21 (summarizing the objectives of Basel II).

Basel II mandatory only for the largest, most internationally active banks.¹⁹² Thus, the United States sought to impose a special regime for its smaller banks as the international banking market moved from a position of contested dominance to strong dominance.

Another recent development that resonates with this article's predictions concerns the SEC's stance toward allowing foreign stock exchanges to operate trading screens in the United States. In a recent article, the director of the SEC's Office of International Affairs put forward a proposal to substitute SEC oversight of incoming foreign exchanges with proof of compliance with home rules, provided that home rules are deemed comparable with SEC supervision and are well-enforced.¹⁹³ This proposal comes after U.S. exchanges have considerably strengthened their position vis-à-vis their European rivals—NYSE has merged with Euronext, which controls the stock exchanges in Paris, Amsterdam, Brussels, and Lisbon, and NASDAQ has acquired a significant stake in the London Stock Exchange.¹⁹⁴ Moreover, NYSE has introduced a successful electronic trading system.¹⁹⁵ Thus, as U.S. firms are regaining international prominence in the centralized market for stock exchange trading, U.S. regulators are more willing to discuss

¹⁹² See Press Release, Federal Reserve Board (July 11, 2003), available at <http://www.federalreserve.gov/BOARDDOCS/PRESS/BCREG/2003/20030711/default.htm>. Although small banks were exempted from mandatory implementation of Basel II, they became concerned that the sophisticated risk measurement techniques of Basel II would unduly favor large U.S. banks because these banks would be required to put aside less capital than their smaller domestic competitors. See Rebecca Christie, *Rules on Bank Capital Draw Fire; FDIC Move May Delay Final Accord Covering World Financial System*, WALL ST. J., Dec. 8, 2003, at B8. These domestic concerns created an impasse for U.S. regulators and delayed the implementation of Basel II in the United States. See Daniel Tarullo, *A Simple Escape Route from the Gridlock of Basel II*, FIN. TIMES, Aug. 4, 2006, at 13. Finally, bank regulators in the United States agreed to introduce amendments to the Basel I framework so as to reduce the competitive disadvantages for smaller banks, while implementing Basel II for large internationally active banks. See Joint Press Release, Federal Reserve Board et al., *Banking Agencies Announce Revised Plan for Implementation of Basel II Framework*, (Sept. 30, 2005), available at <http://www.federalreserve.gov/boarddocs/press/bcreg/2005/20>.

¹⁹³ See Ethiopis Tafara & Robert J. Peterson, *A Blueprint for Cross-Border Access to U.S. Investors: A New International Framework*, 48 HARV. INT'L L.J. 31, 32 (2007).

¹⁹⁴ See Gadinis & Jackson, *supra* note 73, at 1241–42.

¹⁹⁵ See Matt Chambers et al., *Electronic Trading Clears Floors of Commodity, Stock Exchanges*, WALL ST. J., Nov. 3, 2006, at C2.

policy coordination frameworks—an outcome the framework would predict as a centralized market moves from contested dominance to strong dominance.

The framework suggested in this Article highlights the political factors that determine policy coordination. By linking domestic political economy considerations to international policy outcomes, it focuses on dimensions that remained unexplored in either regulatory competition or institutional efficiency theories, although it incorporates insights from both. The two explanatory variables of this paper may also serve to explain regulatory harmonization in fields other than global finance. First, variations in U.S. dominance have political and regulatory ramifications; understanding these ramifications is important, because global competition is rising and emerging markets are gaining prominence. The second variable, which distinguishes between centralized and dispersed market structures, conveys a key insight: when access to U.S. markets is crucial for foreign market participants, the United States may exercise significant pressure toward policy coordination if it deems coordination to be in its interest. Overall, the interaction between levels of competition and desirability of market access determines how domestic and foreign market players respond to regulation, and whether international policy outcomes will tend toward harmonization.