Three Challenges for Regulatory Networks

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In this short essay, I address three current challenges to regulatory networks—the networks that, as Anne-Marie Slaughter has put it, exhibit "pattern[s] of regular and purposive relations among like government units working across the borders that divide countries from one another and that demarcate the 'domestic' from the 'international' sphere."1

The challenges are as follows. First, how should, can, and do these networks evolve? Second, how can these networks be effective? And third, how have financial regulatory networks such as the Basel Committee on Banking Supervision and the International Organization of Securities Commissions (IOSCO)—two of the oldest and best established networks directed at financial regulation—met the challenge of the 2008 global crisis in finance?

I. Evolution

The evolution of regulatory networks may be charted by tracking the way the scholarship on those networks has changed. In the early years of network analysis, scholars—including myself—were impressed at how widespread and vibrant this tool of international governance appeared to be.2 Networks were popping up everywhere, not only in financial regulation, but also in transportation, antitrust, consumer protection, and other areas where there were global spillovers and externalities, but no organized global response.3 The impulse was to count the number of institutions, marvel at their number,

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and note how different they were from traditional international law. And they were indeed different; the regulatory networks were created and operated by agencies and not by heads of state, foreign ministers, and diplomats. And they had none of the formality of traditional international legal instruments like treaties.

But as they evolved, networks have often adopted the trappings of traditional domestic administrative law. Like domestic regulators, international networks that started out sometimes in bars in Switzerland among financial and other sorts of regulators of like mind but with little attentiveness to procedure have evolved into something that increasingly requires notice, comment, and opportunity to respond. A remarkable example of this change lies in the contrast between the first Basel Accord on capital adequacy, which was concluded in secret by the Basel Committee in 1988 and released in a twelve page document, and the second one ("Basel II"), which was put through most of a decade's worth of comment by hundreds of interested individuals and institutions and resulted in a correspondingly long and detailed regulatory product. IOSCO has similarly opened its deliberations to this sort of ventilation by interested and affected parties; so have other networks. The resulting process in these cases is one that would be familiar to American lawyers accustomed to domestic rule-making.

Domestic regulation and international networks have also converged in their procedural affection for best practices in lieu of rules. In a classic best practices scheme, regulated entities themselves devise practices to comply with relatively unspecific regulatory requirements. These practices are selected and publicized as "best," but not mandated, by a loosely coordinated central regulatory body. The idea is that these best practices will subsequently be adopted by other regulated entities. Best practices are tailor-made for the rather small secretariats and nonbinding nature of international regulation, although they are increasingly popular in domestic law as well.

The result is that regulatory networks have become fully formed alternatives to the new international tribunals that increasingly meant to give form and content to international legal regimes. The World Trade Organization (WTO) Appellate Body and the International Criminal Court are examples of the turn to tribunals as a way to bolster and strengthen international governance. As networks have evolved to look like domestic rule-makers, they offer a different way to bolster and strengthen international governance. The idea, familiar to scholars of domestic administrative law, is that networks are increasingly playing the role of international rule-makers, while tribunals play the role of interna-


5. See International Law, supra note 2, for a discussion of the early procedural informality of these networks.


tional adjudicators, with the result being an increasingly elaborate form of global administrative law.9

II. Effectiveness

One of the testaments to the effectiveness of the Basel Committee lies in the blame that is being laid at the feet of its second capital accord for the current financial crisis. The first financial institutions to fail in the crisis were, at least in the view of the Securities and Exchange Commission, adequately capitalized under Basel II up to the moment they failed. This was the case for both Bear Stearns,10 which collapsed in the spring of 2008, and Lehman Brothers,11 which fell that summer. There is no question that the Basel II will be reevaluated sooner rather than later, but perhaps one lesson of the crisis is not that a regulatory network failed, but rather that a regulatory network made a difference; it was the Basel Committee that set the standards that Bear Stearns, Lehman Brothers, and the big European banks met in practice, and it was Basel II that did not, in the end, sufficiently keep the banks solvent.

By comparison, IOSCO has a very different record of success, at least success, as defined here, as actually affecting its regulated industry. Securities cooperation through IOSCO has happened on enforcement—the organization touts its multilateral Memorandum of Understanding as a chief achievement, and that memorandum is concerned with law enforcement cooperation. But the organization has failed to promulgate or even facilitate global accounting standards, although it did make efforts along those lines in the 1990s.12 Ultimately, the job for developing international accounting rules was left to the International Accounting Standards Board, which developed International Financial Reporting Standards (IFRS), with IOSCO playing only an observer role in the process.13 Nor has IOSCO promulgated capitalization requirements for broker dealers that might have kept Bear Stearns and Lehman Brothers afloat. Especially in light of the passage of Sarbanes-Oxley in 2002, it is fair to say that the United States and Europe have failed to harmonize their securities regimes. In fact, large differences between the listing requirements in American and European, particularly British, markets remain to this day. These differences have led to an increasing amount of forum shopping by market participants, as shown by Chris Brummer.14

The difference between the successes of the international banking regulatory enterprise and the more limited victories for international securities governance are particularly interesting because they look like a good, albeit not particularly rigorous, natural experiment that could test the regulatory network form. Banking regulators and securities

12. See Rulemaking, supra note 9, at 584.
13. Id.
regulators have similar incentives. In both fields, there has been the same kind of globalization of finance that makes the case for global solutions. Both banking and securities regulators have been confronted by the externalities that can result when a heavily internationalized bank or an investment firm with exposure abroad look adequately capitalized in some jurisdictions, but not on a global basis. Moreover, the domestic regulators confronted with these problems are experienced and well-institutionalized, especially in the United States and Europe, and would seem to be capable of responding to the new challenges of globalization.

In other words, there is no obvious reason why there should have been effective network harmonization and global creation of rules in the banking industry and not one, at least not one so far, in securities regulation. What explains the difference between what has happened in banking and what has happened in securities?

One way to predict whether a network will become effective, as opposed to an international talking shop, is to consider what stage of regulatory harmonization it has reached. Regulatory networks—as was the case with both IOSCO and the Basel Committee—begin with agreements to exchange information, often with an eye to assisting the members of the network in their domestic enforcement responsibilities. That initial stage of information exchange and memoranda of understandings for enforcement cooperation is only a first step in harmonization because it is a step that allows these regulators to solve problems of internationalization yet also retain their unique domestic approaches to regulation.

Very commonly, regulatory networks next move from information-sharing agreements to promulgating the principles of regulation that provide baselines that every domestic member of the network is supposed to meet. These principles are shorter than the sort of rules that form the basis of domestic financial regulation and tend to contain gauzy principles that most sophisticated regulators assume they have long met. Indeed, in financial regulation, few networks have failed to move from cooperation and the sharing of information to these sorts of statements of general regulatory principles.

The challenging step for networks is the next step—the move from principles to rules. It is a step that the Basel Committee has taken and that IOSCO has not.

Why is there a difference in what happened between the two? One difference between Basel and IOSCO lies in the way these networks are organized. One is exclusive, and one is much less so; the Basel Committee was until 2009 composed of the same twelve central bankers who founded it. The Basel Committee has not expanded its membership to include different parts of the world, the “BRIC” countries, or other developing markets. Moreover, although the Basel Committee has taken some real steps towards transparency, it still meets in secret.

IOSCO has taken a very different approach, opening up membership to all securities regulators; the organization can claim 191 members. To be sure, it has divided up that membership into a Technical Committee that focuses on the supervision of established

16. That is, Brazil, Russia, India, and China.
markets and other committees focused on emerging markets. But it could be that the exclusivity that Basel enjoys and that IOSCO does not, even at the cost of transparency and other facets of administrative good governance, is making a difference.

The result—as Chris Brummer has explained in the regional context and is positing more generally in forthcoming work—is that outfits like the Basel Committee have been able to create a regime that offers more than club goods and like advantages to membership, but that also offers real costs of exit. It is, at this point, difficult for a central bank to conceive of leaving the Basel Capital Accord Regime, and none ever has, although sometimes members have exhibited less than perfect compliance with the capital accords.

The creation of costs of exit is something that the banking supervisors have been able to achieve and that IOSCO has not done with its core principles and information exchange requirements, which require international interaction, but which do not impose harmonization mandates. Brummer suggests that the difference here looks like the difference between a social network and an economic network—the difference between, say, friendship and a telephone monopoly. That insight nicely brings the study of networks back to the social scientists who first theorized about them and that prompted lawyers to develop their persuasive theories about how international regulation really works.

III. Can Networks Pass the Test of a Financial Crisis?

Neither IOSCO nor the Basel Committee yet dominates its sphere of international financial regulation, as their roles in the 2008 financial crisis suggests. During that crisis, the Securities and Exchange Commission implemented a short-lived ban on the shorting of financial stocks. It coordinated that ban with the securities regimes of other countries, including Great Britain, Australia, Taiwan, and Pakistan. But IOSCO was not the vehicle for the short ban, and, indeed, the organization has had little to say about the financial crisis in any respect, other than a May, 2008 suggestion that its members peruse some recommendations about the subprime mortgage crisis, the precursor to the market crashes.

As for the Basel Committee, the efforts to solve the increasing internationalization of the banking crisis is something that has not sent every central banker to Switzerland, at least not as far as we know—the committee operates in secret. It, like IOSCO, has so far responded to the crisis with small beer, such as a speech on The Importance of Banking Supervision in Financial Stability.

Instead, the initial vehicles of a coordinated international response to the banking crisis have come from the G20, and its predecessor the G7, which are informal but regular meetings of the premiers of selected wealthy countries, generally on the subject of the global economy. Although financial regulators appear to do much of the underlying work in preparation for these meetings, the G20 is not their organization, but rather one headed by heads of state. And the coordinated injections of funds into the monetary supply by the central banks—their coordinated approach on monetary policy—is not obviously linked to the network that has helped them coordinate supervisory policy. Like IOSCO, the Basel Committee's publicly available regulatory production during the crisis has veered towards the anodyne statement, rather than to the substantive response.

It is too soon for a final judgment, but it does appear that at the beginning of the financial crisis, regulators and governments did not conclude that the regulatory networks that have grown and evolved in response to prior crises were the right institutions for the coordination of responses in 2008. Does the reaction to the financial crisis suggest that these networks are not the answer to the problems of global governance?

That conclusion, I think, would be premature, but the defense of IOSCO and the Basel Committee turns on admittedly less quantifiable contributions. Both organizations were founded in 1974, and it is possible that over three decades cooperation among central bankers and securities regulators has contributed to the capacity for the coordinated response that we have seen, to the degree that we have seen it. It may be (indeed it is rumored to be so), for example, that the SEC coordinated its shorting ban with its international counterparts at an IOSCO meeting, even though the coordination was done in the hallways rather than during the official session. And it could be that the coordination of the coordinated injections of capital by the world's central bankers was facilitated by their already extant supervisory cooperation. Perhaps, in other words, regulatory net-
works created the relationships that have facilitated the international responses to the crisis.

Proving a connection between response and network will not be easy, even with the benefit of hindsight. Perhaps aficionados of regulatory networks should consider the early development of the crisis to be evidence that networks will not necessarily take the lead in responding to shocks (though they may play an important role in the aftermath of shocks), but there is no need to dismiss their work entirely, even if it makes a secondary, rather than primary, contribution yet.
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