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Mutual Recognition in International Finance

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Mutual Recognition in International Finance

Pierre-Hugues Verdier*

In recent years, scholars have devoted considerable attention to transnational networks of financial regulators and their efforts to develop uniform standards and best practices. These networks, however, coexist with an emerging trend toward regional and bilateral mutual recognition arrangements. This Article proposes a theoretical account of mutual recognition that identifies its potential benefits, the cooperation problems it raises, and the resulting institutional frameworks in multilateral and bilateral settings. The multilateral model adopted in Europe relies on extensive delegation to supranational institutions, cross-issue linkages, and political checks on delegation. An alternative bilateral model, illustrated by the recent arrangement between the SEC and Australia, relies on selective membership, bilateral enforcement, and limited duration and renegotiation clauses. The multilateral model is unlikely to be effective without strong, preexisting supranational institutions—in other words, outside Europe. Therefore, international efforts at mutual recognition are more likely to resemble the SEC's program. This bilateral model, however, is most likely to succeed between jurisdictions with developed financial markets as well as similar regulatory objectives and resources. It also requires sufficient private demand and enhanced cross-border supervision and enforcement agreements. Finally, it is less likely to be effective where one country seeks to improve regulatory standards in the other. These insights are relevant for other contemporary mutual recognition initiatives, such as between Europe and third countries and within ASEAN.

Introduction

The rapid globalization of finance since the 1970s has taken place against the background of a decentralized legal framework shaped primarily by national regulators. In the absence of an international organization devoted to financial regulation, they have relied on less formal means of cooperation to address cross-border issues. Among those means, transnational regulatory networks ("TRNs") have attracted the most scholarly attention. Despite significant achievements, however, TRNs suffer from substantial limitations stemming from the domestic legal and political constraints they face, the distributive implications of many cooperation efforts, and their lack of monitoring or enforcement capabilities.[1] Indeed, in the wake of the global financial crisis, many commentators agree that TRNs did not live up to expectations in pivotal areas, such as bank capital adequacy standards.[2]

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1. *See* Pierre-Hugues Verdier, *Transnational Regulatory Networks and Their Limits*, 34 Yale J. Int'l L. 113, 122–28 (2009).

2. *See* U.S. Dep't of the Treasury, Financial Regulatory Reform: A New Foundation (2009); Comm. on Capital Mkts. Reg., The Global Financial Crisis: A Plan for Regulatory Reform

Thus, while TRNs continue to occupy center stage in several initiatives to coordinate international responses to the crisis,[3] there is growing recognition that they alone cannot address all the challenges of international financial regulation. At the same time, a formal supranational regulator remains a distant—perhaps impossible—prospect. What more, then, can regulators accomplish within the current decentralized framework to further common goals, such as controlling the international externalities of regulatory failures and reducing unnecessary regulatory obstacles to cross-border finance? One alternative approach that has emerged in recent years is for regulators to negotiate bilateral or regional mutual recognition arrangements. In a mutual recognition system, two or more states agree to recognize the adequacy of each other's regulation as a substitute for their own. Accordingly, firms or activities that comply with their home state's regulation may access the host state pursuant to an exemption from some or all of the host state's regulatory requirements.

Mutual recognition finds a key precedent in Europe, where since the late 1980s it has been the dominant paradigm for eliminating regulatory barriers to the common market in financial services.[4] More recently, the U.S. Securities and Exchange Commission ("SEC") entered into a mutual recognition arrangement with Australia, as part of a broader program contemplating similar arrangements with Canada and Europe.[5] While the U.S. program has

213 (2009) ("[G]lobal financial regulation has always turned to so-called 'regulatory networks' to deal with the increasing globalization of finance. However, during the current financial crisis, these industry-specific networks have failed to perform effectively."); Daniel K. Tarullo, Banking on Basel: The Future of International Financial Regulation 131–35 (2008); Chris Brummer, *Post-American Securities Regulation*, 98 Calif. L. Rev. 327, 327, 335, 359–62 (2010); Eric J. Pan, *The Challenge of International Cooperation and Institutional Design in Financial Supervision: Beyond Transgovernmental Networks*, 11 Chi. J. Int'l L. 243, 243, 263–71 (2010); David Zaring, *International Institutional Performance in Crisis*, 10 Chi. J. Int'l L. 475, 475, 479–85 (2010); Cally Jordan, *Does 'F' Stand for Failure: The Legacy of the Financial Stability Forum* 19–26 (Univ. of Melbourne Legal Studies Research Paper, No. 429, 2009), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1478527.

3. *See* The G-20 Toronto Summit Declaration, Grp. of 20 (June 26–27, 2010), *available at* http://www.g20.org/Documents/g20_declaration_en.pdf; Leaders' Statement: The Pittsburgh Summit, Grp. of 20 (Sept. 24–25, 2009), *available at* http://www.g20.org/Documents/pittsburgh_summit_leaders_statement_250909.pdf; Fin. Stability Bd. Charter art. 1, Sept. 25, 2009; Letter from Mario Draghi, Chairman, Fin. Stability Bd., to the Grp. of 20 Leaders (June 24, 2010), *available at* http://www.financialstabilityboard.org/publications/r_100627a.pdf?noframes=1. The newly established Financial Stability Board is now coordinating a vast effort on the part of the major TRNs to develop international standards on a range of issues including capital adequacy, cross-border resolution of systemically important institutions, hedge fund and credit rating agency regulation, over-the-counter ("OTC") derivatives, executive compensation, and accounting standards.

4. Mutual recognition also plays an important role in the General Agreement on Tariffs and Trade ("GATT")/World Trade Organization ("WTO") system, which strives to reduce barriers to trade by restricting the ability of importing countries to impose product requirements above those of the exporting country. *See* Kalypso Nicolaidis & Gregory Shaffer, *Transnational Mutual Recognition Regimes: Governance without Global Government*, 68 Law & Contemp. Probs. 263, 271 (2005).

5. Under the Arrangement, certain Australian securities exchanges and broker-dealers may be authorized to conduct business in the United States under exemptions from the Securities Exchange Act of 1934. The Arrangement followed an assessment of the comparability of the parties' regulations. *See* Mutual Recognition Arrangement between the United States Securities and Exchange Commission and the Australian Securities and Investment Commission, Together with the Australian Minister for Super-

made little progress since the intensification of the subprime crisis in late 2008, the Committee of European Securities Regulators ("CESR") has continued to explore mutual recognition with non-European Union jurisdictions.[6] Australia has also entered into mutual recognition agreements with other jurisdictions.[7] Finally, as part of an ambitious program by the Association of Southeast Asian Nations ("ASEAN") to create an economic community by 2015, the ASEAN Capital Markets Forum ("ACMF") recently adopted an implementation plan providing that "[t]he core strategy for regional integration is to develop a mutual recognition process with gradually expanding scope and country coverage."[8]

Thus, mutual recognition retains considerable appeal across the world. Moreover, proponents of the SEC program have made a forceful case for mutual recognition,[9] and several commentators have argued that it should be extended to the transatlantic context as well as other countries and substantive areas of financial regulation.[10] In time, mutual recognition's appeal may grow as regulators struggle with the cross-border implications of the many reforms prompted by the financial crisis. To date, however, there is no comprehensive account of mutual recognition in financial regulation that

annuation and Corporate Law, U.S.-Austl., Aug. 25, 2008 [hereinafter SEC-Australia Arrangement], *available at* http://www.sec.gov/about/offices/oia/oia_mututalrecognition/australia/framework_arrangement.pdf. The SEC also has an older arrangement with Canada (the Multi-Jurisdictional Disclosure System) that allows certain non-financial disclosure documents that comply with the requirements of one jurisdiction to be used in the other. *See* Multijurisdictional Disclosure and Modifications to the Current Registration and Reporting System for Canadian Issuers, Securities Act Release No. 33-6902, 56 Fed. Reg. 30,036 (July 1, 1991).

6. In June 2009, CESR solicited comments to identify areas with the highest potential gains. Press Release, Comm. of European Sec. Regulators, Call for Evidence on Mutual Recognition with non-EU Jurisdictions (June 8, 2009) [hereinafter Call for Evidence], *available at* http://www.cesr-eu.org/popup2.php?id=5766. *See infra* Part III.C.1.

7. In February 2006, Australia entered into a mutual recognition agreement with New Zealand covering disclosure documents for offerings of securities (as well as interests in managed investment schemes). The agreement entered into force in June 2008. *See* Agreement between the Government of Australia and the Government of New Zealand in Relation to Mutual Recognition of Securities Offerings, Austl.-N.Z., Feb. 22, 2006 [hereinafter Australia-New Zealand Agreement], *available at* http://www.med.govt.nz/upload/31106/text-of-agreement.pdf. In 2008, Australia also entered into a mutual recognition arrangement with Hong Kong regarding managed investment schemes. *See* Declaration on Mutual Recognition of Cross-Border Offering of Collective Investment Schemes, Austl.-H.K., July 7, 2008, *available at* http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/Declaration_SFC_ASICv2.pdf/$file/Declaration_SFC_ASICv2.pdf. For a summary of these Australian initiatives, see Austl. Sec. and Invs. Comm'n, Enhancing Capital Flows Into and Out of Australia, Rep. 134 (2008) [hereinafter ASIC Report 134], *available at* http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/REP_134.pdf/$file/REP_134.pdf.

8. Press Release, ASEAN Capital Markets Forum, Implementation Plan Endorsed at the 13th ASEAN Finance Ministers Meeting (April 9, 2009) [hereinafter Implementation Plan], *available at* http://www.theacmf.org/ACMF/report/ImplementationPlan.pdf. *See infra* Part III.C.2.

9. *See generally* Edward F. Greene, *Beyond Borders: Time To Tear Down the Barriers to Global Investing*, 48 Harv. Int'l L.J. 85 (2007); Howell E. Jackson, *A System of Selective Substitute Compliance*, 48 Harv. Int'l L.J. 105 (2007); 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 (2007); Int'l Bar Ass'n Sec. Law Subcomm., Report of the Task Force on Extraterritorial Jurisdiction 265–301 (2008), *available at* http://www.ibanet.org/LPD/Financial_Services_Section/Securities_Law_Committee/Projects.aspx#extra.

10. *See infra* notes 18–23 and accompanying text.

identifies its benefits and limitations as well as the circumstances in which it is likely to succeed. This Article remedies this gap.

Part I, after defining mutual recognition and identifying its principal benefits, argues that it involves an enforcement problem, as states have incentives to exploit the market access granted by others while eluding their own reciprocal obligations to maintain high regulatory standards and open their markets. Mutual recognition also involves significant uncertainty about behavior since other states cannot easily verify compliance with these obligations. International institutional design scholarship indicates that, to address these problems, states typically: delegate rulemaking, monitoring, and enforcement to collective institutions; link their agreements to other issues to facilitate side payments and strengthen incentives for compliance; and include withdrawal clauses to prevent institutional overreach. It also suggests that, as an alternative, states may achieve cooperation by strictly limiting membership, relying on bilateral enforcement, and adjusting their obligations over time through periodic renegotiation.

Institutional design theory does not, however, predict the circumstances under which states are likely to choose to pursue multilateral or bilateral mutual recognition. This Article proposes three hypotheses. First, collective institutions capable of monitoring and enforcing compliance may be so difficult and costly to create as to make the multilateral option inefficient unless such institutions are already available, as in Europe. Second, private demand for reciprocal market access—primarily from export-oriented firms—is important for mutual recognition to succeed. Several factors, however, may limit such demand. Exporters may have alternative means of accessing the foreign markets, or non-regulatory obstacles such as tax or capital controls may nullify the benefits of mutual recognition. Finally, bilateral mutual recognition is unlikely to be effective where a dominant state aims to improve regulatory standards in a smaller state, because of the latter's incentives to defect and the lack of institutions to verify compliance.

Part II examines case studies of two major mutual recognition efforts in light of these hypotheses. In Europe, member states can rely on exceptionally strong supranational institutions with rulemaking, monitoring, and enforcement powers. While many firms initially resisted the common market in financial services, increasing private demand eventually led to an integrated regional system of financial regulation. These institutions and the extensive other benefits linked with European Union ("EU") membership also drove implementation in the new Eastern European member states. In contrast, the SEC's program attempts to achieve mutual recognition through bilateral arrangements without any delegation to collective institutions or explicit linkages. Instead, it relies on careful choice of partner jurisdictions with similar levels of financial market and regulatory development, prior assessments of the comparability of regulatory objectives and outcomes, en-

hanced cross-border supervision and enforcement, and monitoring and enforcement by the parties themselves.

Together, the theoretical framework and case studies provide several insights regarding the mechanics, implications, and future of mutual recognition, which are developed in Part III. First, they suggest that the effectiveness of multilateral mutual recognition depends on strong supranational institutions. As a result, future mutual recognition initiatives are more likely to resemble the SEC's program than Europe's, making the former an important precedent despite its own uncertain future. This bilateral recognition approach, however, is itself likely to succeed only where certain conditions are met. First, it requires states with well-developed financial markets, similar regulatory objectives, and comparable levels of supervision and enforcement capacities. Second, there must be sufficient demand for reciprocal market access to attract support from financial services exporters, which will depend on many factors outside the regulators' immediate control. Third, it requires enhanced cross-border cooperation in supervision and enforcement, beyond existing instruments like the International Organization of Securities Commissions ("IOSCO") Multilateral Memorandum of Understanding ("MMOU").[11] Finally, it is unlikely to be an effective tool for one jurisdiction to secure improvements of regulatory standards in another.

This analysis suggests that an important challenge as the EU pursues mutual recognition with the United States and third countries will be to assure them of the uniformity of implementation and enforcement throughout Europe. Within ASEAN, wide disparities in market and regulatory development mean that despite the multilateral nature of the organization, mutual recognition will likely be limited at first to a subset of the most developed countries. This orientation is already reflected in the ACMF's priorities, as it pursues mutual recognition alongside efforts to develop regulatory and market infrastructure, strengthen coordination and monitoring capabilities, and encourage liberalization of capital transfers and tax reforms. In both the EU and ASEAN, regulators have sensibly chosen a gradual process in collaboration with market participants to identify and prioritize countries and areas of regulation likely to provide the greatest benefits.

I. Mutual Recognition in Theory

A. *International financial regulation and the limits of networks*

Leaving aside the limited areas of international finance that fall within the purview of formal institutions such as the International Monetary Fund

11. Int'l Org. of Sec. Comm'ns, Multilateral Memorandum of Understanding Concerning Consultation and Cooperation and the Exchange of Information (2002) [hereinafter IOSCO MMOU], *available at* http://www.iosco.org/library/pubdocs/pdf/IOSCOPD126.pdf.

("IMF"), the principal vehicles of governance in this area are informal transnational networks of regulators. These TRNs—including IOSCO, the International Association of Insurance Supervisors ("IAIS"), and the Basel Committee on Banking Supervision—share certain broad characteristics. They are generally informal and inclusive, and their initiatives focus on enforcement coordination and gradual harmonization of substantive regulation. TRNs are informal in the sense that they generally have no international legal personality, operate by consensus without formal voting, adopt nonbinding standards—often characterized as "soft law"—rather than formal treaties, and do not have monitoring or dispute resolution mechanisms.[12] The membership of many TRNs has become increasingly inclusive over time, extending to virtually all the national regulatory bodies active in their respective fields, including states with very different levels of financial development and regulatory capacity.[13]

In a prior article, I argued that due to their institutional features, TRNs are more suited to areas of international cooperation that involve coordination problems than those that involve more complex distributive or enforcement problems.[14] They have made significant progress in creating legal frameworks to facilitate coordination of securities and antitrust enforcement across borders while maintaining national discretion to withhold cooperation.[15] They have, however, encountered significant difficulties in their attempts to harmonize national financial regulation by adopting international standards or "best practices," which often involve significant distribution and enforcement problems. Within TRNs, conflicts over the content of potential standards are often solved by carving out provisions that are objectionable to individual states, leading to a lowest common denominator outcome.[16] Given the difficulty of establishing meaningful uniform standards across such diverse countries, they also tend to be framed at a high level of generality. After a standard is adopted, enforcement problems also arise as individual states have incentives to defect to gain a competitive advantage. TRNs have had limited success in controlling defection due to their lack of monitoring, dispute resolution, or enforcement capabilities.[17]

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12. *See* Verdier, *supra* note 1, at 117–19.

13. The Basel Committee is an exception, insofar as its membership was originally limited to the "G-10" countries and has only recently expanded to twenty-seven jurisdictions. It is, however, generally seen as a global network because many nonmember countries have agreed to comply with the Basel Capital Accords and the Committee's other standards.

14. *See* Verdier, *supra* note 1.

15. *See id.*

16. *See id.* at 134–37 (describing this phenomenon in the context of the Basel Accord). Indeed, despite the substantial demand for stronger regulation generated by the financial crisis and the G-20's political coordination efforts, major differences are emerging between the United States and Europe on many of the issues covered by the G-20/Financial Stability Board effort.

17. For example, while there was widespread agreement in the 1990s that Japanese banks were severely undercapitalized and met the Basel standards only through forbearance by their regulators, the Committee was unable to formally monitor or sanction their actions. *See* Charles K. Whitehead, *What's Your Sign?—International Norms, Signals, and Compliance*, 27 MICH. J. INT'L L. 695, 720–39 (2006);

Given these limitations, individual states have generally been unwilling to open their borders to foreign financial providers based solely on compliance by their home state with such international standards. In the EU, financial market integration has not relied primarily on networks but on a mutual recognition system buttressed by centralized institutions with substantial rulemaking authority and monitoring and enforcement powers. Outside Europe, commentators are increasingly advocating mutual recognition agreements as a substitute for substantive harmonization. Kalypso Nicolaidis and Gregory Schaffer, who develop a theoretical account of mutual recognition in international trade, argue that the concept is "a core element of any global governance regime that eschews global government."[18] Ethiopis Tafara and Robert Peterson, two SEC officials who played a central role in the Commission's recent mutual recognition program for securities exchanges and broker-dealers, argued that it "would help cement an alliance of like-minded regulators committed to working together to provide for high quality investor protections and regulatory standards."[19] Eric Pan goes further, arguing that the SEC proposal "[did] not go far enough to resolve the regulatory differences" and that the United States should instead adopt as a model the "more ambitious blueprint"[20] embodied by a recent European directive on financial market regulation.[21] Along similar lines, Roberta Karmel argues that, in areas such as accounting standards and exchange regulation, the EU's growing power is putting the United States under increasing pressure to abandon its unilateralist approach and turn to mutual recognition.[22] Likewise, considering the equivalence approach adopted by the United States and Europe for credit rating agencies and financial accounting standards, Hal Scott suggests that it "can work with many areas of regulation."[23] Others are less sanguine: John Coffee believes

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Tarullo, *supra* note 2. This pattern was repeated when concessions made by national regulators to their banks, such as allowing them to include certain categories of preferred stock in regulatory capital, did not attract formal condemnation from the Committee but instead led to similar concessions by other regulators to their own banks. *See* Verdier, *supra* note 1, at 137–39.

18. Nicolaidis & Shaffer, *supra* note 4, at 263.

19. Tafara & Peterson, *supra* note 9, at 54.

20. Eric J. Pan, *A European Solution to the Regulation of Cross-Border Markets*, 2 Brook. J. Corp. Fin. & Com. L. 133, 138–39 (2007); *see also* Cheryl Nichols, *Mutual Recognition Based on Substituted Compliance: An Integral Component of the SEC's Mandate*, 34 N.C. J. Int'l L. & Com. Reg. 1, 62–68 (2008).

21. *See* Directive 2004/39/EC, of the European Parliament and of the Council of 21 April 2004 on Markets in Financial Instruments and Amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and Repealing Council Directive 93/22/EEC, 2004 O.J. (L 145) [hereinafter MiFID Directive]. Specifically, Pan argues that several features of MiFID, such as minimum standard harmonization, home country supervision, and robust mechanisms for regulatory cooperation based on the CESR model, could serve as a blueprint for mutual recognition arrangements between the United States and other jurisdictions. Pan, *supra* note 20.

22. Roberta S. Karmel, *The EU Challenge to the SEC*, 31 Fordham Int'l L.J. 1692, 1693–97 (2008).

23. Hal S. Scott, The Global Financial Crisis 173 (2009); *see also* Tzung-Bor Wei, *The Equivalence Approach to Securities Regulation*, 27 Nw. J. Int'l L. & Bus. 255, 294–98 (2007) (arguing that "equivalence has already begun to evolve into equivalence-plus-reciprocity" in areas including accounting standards and auditor regulation).

that the difficulty of assessing the comparability of foreign regulation and enforcement will be a major obstacle, while Chris Brummer argues that mutual recognition is unlikely to be effective as a convergence mechanism.[24]

This diversity of opinions regarding the future of mutual recognition and the relevance of the European model reveals the need for a more comprehensive theoretical analysis that identifies its potential benefits and limitations, the different institutional forms it can take, and the circumstances in which it is likely to succeed. The following sections undertake to provide such an analysis.

B. The concept of mutual recognition

The first step in assessing the potential and limits of mutual recognition is to define it, identify the goals it seeks to advance, and distinguish it from other approaches to international regulatory cooperation. For purposes of this Article, mutual recognition may be defined as an understanding among two or more states under which each recognizes the adequacy of the other's regulation or supervision of an activity or institution as a substitute for its own. Private actors who comply with the applicable home state rules may therefore access the host state pursuant to an exemption from some or all of the host state's rules.[25] As a conceptual matter, mutual recognition goes further than national treatment, which simply entitles foreign private actors to access the host state by complying with the same rules as its nationals.[26] Instead, private actors can operate in the host state while complying only with the regulatory requirements of their home state. Mutual recognition also differs from harmonization, which involves a systematic effort to eliminate substantive differences between countries' regulatory requirements, usually by amending them to conform to uniform international rules. Instead, mutual recognition rests on an assessment that the home state's regulation is "equivalent" or "comparable" to that of the host state, and vice versa.[27]

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24. *See* John C. Coffee, Jr., *Law and the Market: The Impact of Enforcement*, 156 U. Pa. L. Rev. 229, 309–11 (2007); Brummer, *supra* note 2, at 353–56.

25. See Nicolaidis & Shaffer, *supra* note 4, at 264 for definitions; *see also* Patrick B. Griffin, *The Delaware Effect: Keeping the Tiger in Its Cage: The European Experience of Mutual Recognition in Financial Services*, 7 Colum. J. Eur. L. 337 (2001); Joel P. Trachtman, *Embedding Mutual Recognition at the WTO*, 14 J. Eur. Pub. Pol'y 780 (2007).

26. Or, as Nicolaidis and Shaffer describe it, mutual recognition consensually transfers authority from the host state to the home state: instead of the former applying its laws extraterritorially to protect its residents, the latter applies its laws extraterritorially to protect others. Nicolaidis & Shaffer, *supra* note 4, at 268.

27. "Equivalence" (or "comparability") is not, however, a logical necessity, nor is the requirement that recognition be mutual; a host state could unilaterally grant recognition to another's regulatory system, and it could do so unconditionally (i.e., without regard to equivalence). For reasons to be clarified below, however, this is not typically the case. In fact, national regulators sometimes unilaterally rely on home state regulation to some degree in granting access to foreign firms.

Why would states enter into a mutual recognition arrangement? There are two broad categories of benefits. First, mutual recognition is a means of *market liberalization* insofar as it facilitates private cross-border transactions by eliminating the need to comply with multiple and sometimes inconsistent rules.[28] Second, mutual recognition is also a means of *raising regulatory standards* and *controlling international externalities*. Financial regulatory failures can have significant effects on other states, either directly or through contagion and other forms of systemic risk. To the extent that a mutual recognition agreement effectively conditions market access on the existence of an equivalent regulatory system in the home state, it reduces the risk that regulatory failures in the home state will affect the host state.

In theory, both of these goals could also be met through substantive harmonization. If all participating states took part in a sufficiently detailed effort to develop uniform international rules and implement them, private actors could conduct transnational transactions by complying only with those rules—thus fulfilling the market liberalization objective. Assuming that the rules were adequate to protect investors and preserve financial stability, harmonization would also address the concern that inadequate regulation in one state might harm others. Why, then, is mutual recognition increasingly regarded as a superior alternative?

First, it has considerable practical benefits over harmonization. Most significantly, it bypasses time-consuming efforts to harmonize national rules. In one regulator's assessment, "the prospect of achieving absolute harmonization between sovereign jurisdictions is so fraught with impediments as to be practically unachievable."[29] Determining that a foreign regulatory regime is equivalent is a much less ambitious undertaking than attempting to reform it to conform to detailed international standards. Indeed, the mutual recognition approach was pioneered by the European Commission ("EC") when it realized that, at the then-current pace, substantive harmonization of national regulatory standards to create a common market would take decades.[30] At the international level, the drawbacks of substantive harmonization have become clear as major efforts—such as the Basel II Accord and the convergence of the U.S. Generally Accepted Accounting Principles ("GAAP") and International Financial Reporting Standards ("IFRS")—led to complex and protracted negotiations.[31] In addition, even where national

28. In some cases, such as exchange regulation, it may be impossible for an institution to comply with several national regulatory frameworks at the same time; in such cases, mutual recognition removes what is effectively a complete barrier to access.

29. Susan Wolburgh Jenah, *Commentary on a Blueprint for Cross-Border Access to U.S. Investors: A New International Framework*, 48 Harv. Int'l L.J. 69, 76 (2007); *see also* Wei, *supra* note 23, at 284–86.

30. *See White Paper from the Commission to the European Council: Completing the Internal Market*, ¶ 64, COM (1985) 310 final (June 28–29, 1985), *available at* http://europa.eu/documents/comm/white_papers/pdf/com1985_0310_f_en.pdf; Hal S. Scott, International Finance: Transactions, Policy, and Regulation 256–57 (17th ed. 2010).

31. *See* Scott, *supra* note 30 (on accounting standards); Tarullo, *supra* note 2, at 87–137 (on the negotiation of the Basel II Accord).

rules are harmonized, their concurrent application can still create duplicative procedural burdens.[32] These are eliminated in a mutual recognition system where the home state has exclusive authority.

Second, mutual recognition is likely to preserve a greater degree of regulatory competition and genuine difference among national laws. In many areas, uniform international rules would likely prove inefficient in the myriad economic, social, and cultural environments in which they would be applied.[33] In addition, the widely-accepted principle of subsidiarity suggests that economic regulatory policies should be left to local authorities unless there is evidence that they cannot effectively address the relevant issues.[34] Mutual recognition also preserves the possibility of regulatory competition, which may be a useful check on inefficient national systems and allow individual states to serve as laboratories of regulatory innovation.[35] Finally, mutual recognition is more flexible insofar as it allows national regulatory policies to change over time in response to changes in circumstances or preferences.

A third potential benefit of mutual recognition arises from an important recent insight regarding the interaction of international agreements and domestic politics. In addition to their well-recognized role in facilitating cooperation between states by producing information, international agreements can also marshal domestic support for cooperation by allowing "the formation of domestic coalitions between those who will benefit by their own state's compliance with the international legal rule, and those who will ben-

32. For instance, even if disclosure requirements for securities offerings are harmonized in countries A and B, an issuer might still need to file with both securities commissions and pay the relevant fees, retain local counsel in both countries, answer two sets of follow-up staff questions, etc.

33. For instance, difficulties encountered in harmonizing international financial reporting standards illustrate the extent to which domestic rules are embedded in a web of other state-specific policies (for example, corporate governance, securities regulation, tax, and regulation of the accounting and legal professions). Recent literature in comparative institutional economics further emphasizes that differences in institutional capacity are also crucial in determining the most efficient substantive regulation in a given country. *See, e.g.*, Andrei Shleifer, *Understanding Regulation*, 11 Eur. Fin. Mgmt. 439 (2005). From an economic standpoint, regulatory differences form part of a state's comparative advantage in international trade. *See* Daniel W. Drezner, All Politics Is Global: Explaining International Regulatory Regimes 46–47 (2007). There is no clear dividing line between a state's economic regulation and a host of other domestic policies (for example, tax, health, and education) and factor endowments, and there is little sense in attempting to harmonize them.

34. The principle of subsidiarity is often applied in the contexts of federal systems and supranational institutions. In general terms, it holds that federal (or supranational) institutions should perform only those tasks that cannot effectively be performed at a local (or national) level. For instance, it is a fundamental principle of European law and is expressly enshrined in the constituting treaties. *See* Consolidated Versions of the Treaty on European Union and the Treaty on the Functioning of the European Union art. 5(3), Feb. 7, 1992, C83 O.J. 1 ("Under the principle of subsidiarity, in areas which do not fall within its exclusive competence, the Union shall act only if and in so far as the objectives of the proposed action cannot be sufficiently achieved by the Member States, either at central level or at regional and local level, but can rather, by reason of the scale or effects of the proposed action, be better achieved at Union level."). From a policy standpoint, subsidiarity rests on the idea that local (or national) governments are more accountable and responsive to their immediate constituents than federal (or supranational) institutions, and that they are more attuned to local needs and circumstances.

35. *See* Griffin, *supra* note 25, at 338; Wei, *supra* note 23, at 287–88.

efit from other states' compliance with the international legal rule."[36] This effect is most apparent in the context of international trade agreements. Import-competing industries, since they benefit by trade barriers and are concentrated, generate strong demand for protectionism. The main beneficiaries of lower import tariffs are consumers, but the benefits to them are generally too diffuse to make it worthwhile for them to campaign for trade liberalization.[37] International trade agreements, since they promise reciprocal liberalization by foreign countries in return for lower tariffs at home, mobilize an additional constituency in favor of liberalization: exporters who stand to benefit from access to foreign markets. Since they also constitute a concentrated interest with an effective voice in domestic politics, their support may tip the scale toward trade liberalization.[38]

Likewise, a potential obstacle to international financial cooperation is resistance by powerful domestic constituencies such as dominant local firms, while the potential benefits accrue to diffuse constituencies like depositors, investors, or taxpayers. For instance, the benefits of international harmonization of bank capital standards accrue mostly to depositors and taxpayers, while banks and their shareholders resist such standards because they decrease profitability. To date, efforts at international harmonization of financial regulation are not typically linked to market access concessions. Mutual recognition, by contrast, is founded on a promise of reciprocal market access that may harness a constituency of financial services "exporters" to provide domestic political support for new agreements.[39] In turn, as new exporters emerge to exploit the opportunities created by foreign market access, domestic support for further mutual recognition arrangements may increase. After mutual recognition is in place, these financial services exporters may also resist attempts by other constituencies to lobby for laxer financial regulation, since they would bear the costs of withdrawal of market access by host states. Thus, support from exporters may tip the scales toward cooperation both at the adhesion and compliance stages.

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36. Joel P. Trachtman, *International Law and Domestic Political Coalitions: The Grand Theory of Compliance with International Law*, 11 Chi. J. Int'l L. 127, 128 (2010); *see also* Xinyuan Dai, *Why Comply? The Domestic Constituency Mechanism*, 59 Int'l Org. 363 (2005); Andrew Moravcsik, *Taking Preferences Seriously: A Liberal Theory of International Politics*, 51 Int'l Org. 513 (1997); Robert D. Putnam, *Diplomacy and Domestic Politics: The Logic of Two-Level Games*, 42 Int'l Org. 427 (1988).

37. On the relative weakness of diffuse constituencies, see Mancur Olson, The Logic of Collective Action: Public Goods and the Theory of Groups 53–65 (1965).

38. In fact, export-oriented industries have been instrumental in supporting trade liberalization throughout the world since World War II. On the role of reciprocal trade agreements in mobilizing pro-trade domestic constituencies, see Gene M. Grossman & Elhanan Helpman, *The Politics of Free Trade Agreements*, 85 Am. Econ. Rev. 667 (1995); *see generally* Thomas Oatley, International Political Economy 80–82 (4th ed. 2010).

39. This may exist in multilateral harmonization efforts because some firms benefit from harmonized rules and lower transaction costs, but this benefit is much more diffuse than immediate market access promised by mutual recognition. For instance, while compliance of the home state with the Basel rules is used by some states as a factor in evaluating whether foreign banks should be allowed to set up branches in their territory, it is generally but one of several factors. Adoption and implementation of the Basel Accord is not systematically tied to a promise of market access in other countries.

C. Designing institutions for mutual recognition

Achieving the potential joint benefits of mutual recognition—market liberalization and improvements in domestic regulation—is, however, complicated by a series of problems that hinder effective interstate cooperation. Two problems are most salient in this context. First, while each participating state benefits from access to the others' markets and the overall reduction of systemic risk and externalities, maintaining adequate regulation of activities originating in its territory is a cost. Therefore, each state would prefer to avoid its obligations to maintain adequate regulation and provide market access to others, while reaping the benefits of the arrangement—essentially a prisoner's dilemma.[40] Second, participating states face considerable uncertainty about the behavior of others. One state cannot easily observe the existence of an equivalent (or otherwise adequate) regulatory system in another. While the adoption of formal laws and regulations may be easily observable, many other factors are less transparent, including: the relative effectiveness of the other state's regulatory philosophy;[41] the expertise, independence, integrity, and zeal of its regulators; and its commitment to policing cross-border activities that harm foreigners.

The rational institutional design literature provides several hypotheses as to how states may solve these problems when constructing international institutions or agreements, some of which are tentatively supported by empirical research. In a series of tests on a random sample of international agreements, Barbara Koremenos finds that cooperation problems analogous to the ones described above—enforcement problems, uncertainty about behavior, and uncertainty about the state of the world—are associated with the presence of formal dispute resolution mechanisms, such as arbitration or adjudication, as well as other forms of delegation by individual states to collective institutions.[42] These features also increase with the number of participating states.[43] These results are consistent with the rationalist literature on international cooperation, which holds that such mechanisms facili-

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40. *See* Susanne K. Schmidt, *Mutual Recognition as a New Mode of Governance*, 14 J. Eur. Pub. Pol'y 667, 672–73 (2007) (characterizing mutual recognition as a prisoner's dilemma). This dilemma may be most acute in cases where mutual recognition would, by significantly increasing the international mobility of firms, pave the way for races to the bottom in areas where they are attracted to suboptimal regulation. *See* Tafara & Peterson, *supra* note 9, at 50. States may also have incentives to adopt discriminatory laws that exempt their firms from some home state regulation when operating abroad, so as to give them a competitive advantage.

41. Examples of such differences include the use by regulators of more precise rules or more open-ended standards—as well as their recourse to "moral suasion" as an alternative to formal enforcement proceedings.

42. *See* Barbara Koremenos, *The Law and Politics of International Delegation: When, What and Why Do States Choose to Delegate?*, 71 Law & Contemp. Probs. 151 (2008); Barbara Koremenos, *If Only Half of International Agreements Have Dispute Resolution Provisions, Which Half Needs Explaining?*, 36 J. Leg. Stud. 189 (2007); *see also* Barbara Koremenos, *The Continent of International Law* (Mannheimer Zentrum für Europaïsche Sozialforschung, Working Paper No. 128, 2009) (examining a set of cooperation problems including enforcement problems and uncertainty issues).

43. Koremenos (2007), *supra* note 42, at 205.

tate cooperation in repeated interactions by identifying defections and organizing collective punishment.[44] Since cooperation is more difficult to achieve when these problems arise in larger groups of states, the theory also predicts that formal mechanisms should be more prevalent in those cases.[45]

Koremenos also finds that the degree of delegation of authority is inversely correlated with other design features, such as clauses providing for renegotiation of the agreement after a specific time period, and positively correlated with others, such as clauses allowing states to withdraw unilaterally from the agreement.[46] She hypothesizes that both delegation and finite duration provisions address the problem of uncertainty about the distributive impact of the agreement over time and are therefore a substitute for each other, while withdrawal clauses serve as a "safety net" by allowing states to escape highly delegated regimes. The rational design literature also proposes several other conjectures relating to the number and homogeneity of member states. Institutions that attempt to resolve serious enforcement problems are more likely to impose restrictions on membership and to expand the scope of issues covered to create enforcement linkages. Cooperation among more heterogeneous groups of states is also facilitated by expanding the scope of issues covered to create distributive linkages that satisfy their diverse interests.[47] Finally, obligations are likely to be less precise where more authority is delegated, as collective institutions come to serve a gap-filling function.[48]

So far, the results of this research suggest two alternative idealized institutional frameworks to achieve international cooperation in the presence of enforcement problems and uncertainty about behavior. The first is a multilateral regime that substantially delegates rulemaking and dispute resolution to collective institutions and preserves state autonomy through withdrawal clauses. The second is a bilateral (or small-n) regime with less delegation and finite duration clauses as a means of adjusting to external changes over time.[49] The rational design hypotheses also imply that, in a multilateral setting, cross-issue linkages are more likely to be used, both to facilitate initial agreement among more heterogeneous states (through side

44. *See generally* Andrew T. Guzman, How International Law Works (2008); Kenneth A. Oye, *Explaining Cooperation under Anarchy*, *in* Cooperation under Anarchy 1, 20–22 (Kenneth A. Oye ed., 1985).

45. *See, e.g.*, Miles Kahler, *Multilateralism with Small and Large Numbers*, 46 Int'l Org. 681, 702–07 (1992). *But see* Guzman, *supra* note 44 (pointing out that incentives to defect do not necessarily increase with the number of states if their interests are aligned).

46. *See* Koremenos (2008), *supra* note 42; Barbara Koremenos, *Contracting around International Uncertainty*, 99 Am. Pol. Sci. Rev. 549, 551–53, 561 (2005); Barbara Koremenos, An Economic Analysis of International Rulemaking (2009) (unpublished manuscript), *available at* http://www.law.northwestern.edu/colloquium/international/documents/Koremenos.pdf.

47. *See* Barbara Koremenos et al., *The Rational Design of International Institutions*, 55 Int'l Org. 761, 785–86 (2001).

48. In her subsequent empirical research, however, Koremenos does not find statistically robust evidence to support this last conjecture.

49. *See* Lisa L. Martin, *Interests, Power, and Multilateralism*, 46 Int'l Org. 765, 782–83 (1992).

payments) and to increase incentives for compliance (by making defection more costly). Koremenos's framework also suggests that the parties' obligations are likely to be less precise in the multilateral regime.

While suggesting this bifurcation in the institutional framework of mutual recognition, however, the rational design literature does not clearly point to either result as more likely in specific circumstances. Three other strands of scholarship about international cooperation, however, provide relevant hypotheses. First, while centralized monitoring and dispute resolution typically facilitate international cooperation in rationalist models, the literature points to circumstances where its benefits may be limited. Robert Scott and Paul Stephan argue that decentralized, informal enforcement by the parties to an agreement is more effective than formal collective mechanisms where defection is observable by others but cannot be cost-effectively established before an adjudicative or enforcement body.[50] This possibility may be highly relevant in the context of international finance if, as noted above, the obligation of each party is to maintain an effective regulatory system that provides protection to a foreign state's residents equivalent to that which prevails in their own country. If compliance with this obligation cannot be monitored without creating elaborate collective mechanisms capable of expertly evaluating the quality of foreign regulatory systems, the costs may well outweigh the benefits.[51] In such cases, states may rationally favor a bilateral solution, unless the mutual recognition effort can rely on strong preexisting collective institutions.[52]

Second, the political economy literature cited above[53] indicates that mutual recognition is more likely to be successful where it can attract support from potential financial services exporters who desire enhanced access to foreign markets. The strength of their support for mutual recognition, in turn, is likely to depend on the attractiveness of the new export opportunities to be created, on the one hand, and on the practical importance of the regulatory barriers that mutual recognition can alleviate, on the other. The latter is an important point because exporters may have alternative means of accessing the relevant foreign markets, such that mutual recognition would not significantly improve their position. In other cases, the existence of other obstacles to cross-border transactions—such as capital controls or tax considerations—may limit or nullify the benefits of mutual recognition for exporters.

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50. *See* Robert E. Scott & Paul B. Stephan, The Limits of Leviathan: Contract Theory and the Enforcement of International Law (2006).

51. As discussed below, however, it may be that compliance with the obligation to open a country's markets to foreign providers is easier to verify than compliance with the obligation to provide adequate home state regulation.

52. It is also possible that technological solutions, the development of reliable measures, or proxies for the quality of domestic regulation may facilitate monitoring and enforcement and make the multilateral solution viable. *See* Ronald B. Mitchell, *Regime Design Matters: Intentional Oil Pollution and Treaty Compliance*, 48 Int'l Org. 425 (1994).

53. *See generally* notes 36–38 and accompanying text.

Finally, while most of the international institutional design hypotheses appear to be premised on an approximately symmetrical distribution of power and of the benefits of cooperation, another strand of scholarship addresses the effects of asymmetrical power and externalities on the shape of international regulatory cooperation. Beth Simmons proposes a model of international financial regulation based on the interaction of a dominant center and smaller "follower" states.[54] She categorizes areas of regulation along two axes: the significance of the negative externalities caused by substandard policy in small states and the market incentives for the followers to emulate the regulatory model proposed by the dominant center. Where negative externalities are low, the dominant center pursues unilateralism and does not actively seek to incentivize other states to follow its model.[55] When negative externalities are high, however, the dominant center has reasons to actively promote convergence. If other states have no natural market incentives to converge, the dominant state must exercise coercive pressure or offer side payments or other incentives such as market access.[56]

At first glance, Simmons' theory might appear to predict that dominant centers will use the promise of market access through mutual recognition to achieve convergence by smaller states and therefore reduce negative externalities. This conjecture, however, requires an important qualification because market access, unlike other benefits that the dominant center can offer, may actually aggravate its exposure to negative externalities by facilitating access by poorly regulated firms from the smaller state. In other words, mutual recognition is likely to be a viable approach in such cases only where the dominant center can effectively monitor the quality of financial regulation in the smaller state. However, as discussed above, such monitoring is inherently difficult, especially in the bilateral model without strong institutions. This suggests that bilateral mutual recognition arrangements will likely not be an effective tool for dominant states to control negative externalities by securing convergence by smaller states with their regulatory standards.[57] Instead, they may be more likely to rely on coercive arrangements or side payments not involving market access.

In sum, the theoretical analysis proposed above suggests that three factors will play an important role in determining the institutional structure and

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54. *See* Beth A. Simmons, *The International Politics of Harmonization: The Case of Capital Market Regulation*, 55 Int'l Org. 589 (2001).

55. They may, however, do so on their own if market incentives, such as facilitating international transactions by their firms, are present.

56. Ronald Mitchell and Patricia Keilbach point out that, in some cases, the negative externalities run from stronger to weaker states, in which case cooperation would involve the smaller states offering side payments to the dominant center. Ronald B. Mitchell & Patricia M. Keilbach, *Situation Structure and Institutional Design: Reciprocity, Coercion, and Exchange*, 55 Int'l Org. 891 (2001).

57. Daniel Drezner's theory of "rival standards," however, suggests a possible motivation for dominant states to pursue mutual recognition. They might do so, not to control externalities, but to encourage smaller states to converge to their standards rather than those of their rivals. On rival standards, see Drezner, *supra* note 33, at 78–81.

success of mutual recognition efforts: the cost of delegating monitoring, dispute resolution, and enforcement to collective institutions and their availability; the strength of the demand by private actors for enhanced cross-border market access; and whether the relevant situation is one in which a dominant state seeks to use cooperation arrangements to improve regulatory standards in another. The next Part examines the role of these factors in two prominent mutual recognition efforts in international finance, namely the European common market and the SEC's bilateral mutual recognition program.

II. Mutual Recognition in Practice

The concept of mutual recognition has played a central role in the development of the European common market in financial services from the late 1980s until today. The SEC's program, for its part, culminated with the adoption in 2008 of an arrangement on mutual recognition of securities exchanges and broker-dealers.[58] Although its implementation came to a standstill as the global financial crisis unfolded, it remains the most far-reaching effort to date at developing a concrete framework for bilateral mutual recognition in securities regulation. As such, it is an important precedent that reveals many of the features and difficulties likely to be found in future mutual recognition initiatives.

A. *Multilateral mutual recognition: The EU model*

The EU's approach to financial regulation is often cited as a potential model for mutual recognition at the international level. It indeed constitutes the most highly developed instance of a multilateral mutual recognition system. There are, however, several major differences between the European experience and most international contexts. The development of the legal framework for the common market in financial services has always been intertwined with the broader political project of European integration. It rests on unique institutional underpinnings, including supranational legislative, executive, and judicial branches, and is supported both by private demand for market integration and political demand for successful integration of the new member states. In addition, although European financial regulation remains in principle rooted in mutual recognition, initiatives adopted since 1999 to deepen the common market reveal a move toward increasingly de-

58. At the outset, a distinction should be drawn between these "second-generation" mutual recognition regimes and "first-generation" agreements, such as pre-1985 efforts to harmonize securities exchange listings and prospectus requirements in Europe, or the Canada-U.S. Multi-jurisdictional Disclosure System ("MJDS"). While these earlier efforts focused on the recognition of foreign rules, the ones examined here often involve the mutual recognition of the home state supervision of firms. In that context, the quality of the home state's supervision is harder to observe and the cooperation and uncertainty problems described above arise more acutely. I am grateful to Eric Pan for this point.

tailed harmonization and more centralized rulemaking and implementation at the European level.

1. *The evolution of the European approach*

In the 1980s, European institutions, frustrated with the slow progress of substantive harmonization efforts to eliminate regulatory barriers to the European common market, turned to a mutual recognition approach. Beginning in the late 1970s, a series of decisions of the European Court of Justice ("ECJ") had begun to limit the ability of host states to impose additional standards on goods and services already regulated by their home state.[59] The EC, in a 1985 White Paper, laid out an ambitious program combining mutual recognition and harmonized minimum standards to remove technical barriers across a broad range of sectors by 1992.[60] The Single European Act of 1986 facilitated this program by allowing many of the relevant measures to be adopted by a qualified majority—rather than unanimity—in the Council.[61]

In the financial regulation sector, this "1992 Program" led to the adoption of several important measures, including the Second Banking Directive, the Investment Services Directive ("ISD"), the Public Offers Directive ("POD"), and amendments to the Listing Particulars Directive ("LPD"). With respect to financial institutions, the EC created "European passports" allowing banks, insurers, and investment firms authorized in one member state to provide services throughout the Community without additional authorization procedures or prudential supervision by host member states.[62] Likewise, the POD and LPD provided for recognition by host states of the admission of a security to trading or the approval of a public offering prospectus by the relevant home member state.[63] At the same time, the directives established a "safety net" of minimum harmonized substantive standards to ensure that beneficiaries of the passport would be subject to adequate home state regulation and supervision.[64] This safety net was supplemented by the residual authority of host states to impose certain "general

59. *See* Case 120/78, Rewe-Zentral AG v. Bundesmonopolverwaltung für Branntwein, 1979 E.C.R. 649 ("Cassis de Dijon") and subsequent case law.

60. *White Paper from the Commission to the European Council: Completing the Internal Market*, *supra* note 30. For a nuanced account of the evolution of the ECJ's case law on regulatory barriers to trade and the complementary role of the Court and the EU's lawmaking institutions, see Joseph H. H. Weiler, *Mutual Recognition, Functional Equivalence and Harmonization in the Evolution of the European Common Market and the WTO*, *in* The Principle of Mutual Recognition in the European Integration Process 25 (Fiorella Kostoris Padoa Schippoa ed., 2005).

61. *See* Griffin, *supra* note 25, at 350 n.42.

62. *See* Paulina Dejmek, *The EU Internal Market for Financial Services—A Look at the First Regulatory Responses to the Financial Crisis and a View to the Future*, 15 Colum. J. Eur. L. 455, 460 (2009).

63. *See* Howell E. Jackson & Eric J. Pan, *Regulatory Competition in International Securities Markets: Evidence from Europe in 1999—Part I*, 56 Bus. Law. 653, 662 (2001).

64. *See* Griffin, *supra* note 25, at 351. As a general rule, the minimum harmonization provisions of the directives regulated institutions rather than products so that a uniform home state regime would apply to any given firm. *See* Dejmek, *supra* note 62, at 461.

good" requirements on passported institutions and activities. This system of "imperfect" mutual recognition was praised for allowing faster integration by bypassing the extensive harmonization required for "pure" mutual recognition.[65]

At the time, the EC comprised twelve Western European states with comparable levels of economic and financial development but which followed significantly different financial market policies reflecting their respective market structures.[66] The mutual recognition-minimum harmonization model was a compromise to accelerate the European common market while minimizing transition costs, preserving regulatory diversity and competition, and reassuring host states that entrants would be subject to adequate standards.[67] It was premised on several distinctive institutional features of the EC that facilitated agreement on minimum standards and made commitment to those standards credible. These features included: the authority of the EC legislature to adopt by a qualified majority instruments legally binding on member states; the Commission's ability to monitor implementation and exercise pressure on member states, including through enforcement proceedings before the ECJ; and the ECJ's authority to invalidate host state regulatory requirements inconsistent with the EC Treaty, unless permitted by the limited "general good" exception. In other words, enforcement did not depend on bilateral retaliation or withdrawal of market access, but on supranational institutions empowered to impose sanctions or make rulings with direct effect in member states.[68] The EC institutions also provided a forum for close cooperation among national regulators in charge of implementing EC rules.

Despite this unprecedented supranational framework, the results of the 1992 program of financial market integration were widely perceived as deficient. Implementation of the relevant directives was slow and uneven, with some still unimplemented in several member states as late as 1997.[69] While the European passport was relatively successful in some areas, such as bank-

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65. *See* Gerard Hertig, *Imperfect Mutual Recognition for EC Financial Services*, 14 INT'L REV. L. & ECON. 177, 180 (1994).

66. For example, French financial markets were dominated by large banks and insurers, while Italy had many small banks. Likewise, while London, Paris and Frankfurt had well-established stock markets, other countries like Italy did not. Preferences also differed with respect to investor protection, with France insisting on higher standards. *See* Griffin, *supra* note 25, at 350.

67. *See id.* at 337 ("European regulators attempted to develop an application of mutual recognition that, on the one hand, facilitated the creation and functioning of a pan-European financial services market and, on the other hand, ensured an appropriate level of regulatory control so as to be acceptable to member states requiring high regulatory standards.").

68. *See* Markus Möstl, *Preconditions and Limits of Mutual Recognition*, 47 COMMON MKT. L. REV. 405, 415–16 (2010) ("The more the Union legislature, in order to complete the internal market, decides to withdraw regulatory autonomy from the Member States . . . the more the Union legislature must be ready to step in, resume political responsibility and provide for a sufficient level of protection at the Union level instead.").

69. *See* Caroline Bradley, *Consumers of Financial Services and Multi-Level Regulation in the European Union*, 31 FORDHAM INT'L L.J. 1212, 1217–18 (2008); Daniel Mügge, *Reordering the Marketplace: Competition Politics in European Finance*, 44 J. COMMON MARKET STUD. 991, 1004–05 (2006).

ing, it was of limited use in others, mostly because of additional requirements imposed on providers by host states.[70] The European legislative process also proved incapable of promptly delivering the many instruments needed to fully implement the mutual recognition system.[71] As a result, experts concluded, "[i]t became clear by the mid-1990s that the embryonic capital-market regime was not working."[72]

In 1999, the Commission responded with an ambitious new program—the Financial Services Action Plan ("FSAP")—that set out a long list of measures needed to achieve the common market in financial services.[73] The cumbersome European legislative process, however, remained a substantial obstacle. In 2001, a Committee of Wise Men led by Baron Alexandre Lamfalussy recommended that, in order to achieve the FSAP's objectives, the European financial regulation process should be reformed.[74] Under the Lamfalussy proposals, which focused on securities regulation, the European legislature[75] would adopt "level 1" instruments establishing broad framework principles in each area, without prescribing detailed rules. These instruments would delegate authority to adopt detailed "level 2" implementation measures to a "comitology" process involving the Commission and a pan-European committee of representatives of the member states.[76] Finally, while implementation and enforcement would remain the responsibility of national regulators, enhanced cooperation would be facili-

70. *See* Niamh Moloney, *New Frontiers in EC Capital Markets Law: From Market Construction to Market Regulation*, 40 Common Mkt. L. Rev. 809, 809–11 (2003). For instance, member states continued to impose burdensome conduct-of-business rules on investment firms pursuant to their authority under the ISD. The ISD's attempt to limit such local rules to nonprofessional investors was largely unsuccessful given that member states were left with significant discretion to define professional investors. *See* Mügge, *supra* note 69, at 1007. Likewise, the LPD and POD were "rarely used" because of "perceived . . . flaws in their design, in particular with regard to the extent to which it remained permissible for individual Member States to require prospectuses and listing particulars to include additional information for their home market and to insist on full translation of the documents." Eilís Ferran, *Cross-Border Offers of Securities in the EU: The* Standard Life *Flotation*, 4 Eur. Company & Fin. L. Rev. 461, 462 (2007); *see also* Andrea M. Corcoran & Terry L. Hart, *The Regulation of Cross-Border Financial Services in the EU Internal Market*, 8 Colum. J. Eur. L. 221, 242–43, 264–65 (2002); Jackson & Pan, *supra* note 63, at 680–82; Eric J. Pan, *Harmonization of U.S.-EU Securities Regulation: The Case for a Single European Securities Regulator*, 34 Law & Pol'y Int'l Bus. 499, 519–20, 531 (2003).

71. *See Final Report of the Committee of Wise Men on the Regulation of European Securities Markets*, at 10 (Feb. 15, 2001) [hereinafter *Lamfalussy Report*], *available at* http://ec.europa.eu/internal_market/securities/docs/lamfalussy/wisemen/final-report-wise-men_en.pdf; *see also* Matteo Ortino, *The Role and Functioning of Mutual Recognition in the European Market of Financial Services*, 56 Int'l & Comp. L.Q. 309, 326–28 (2007); Pan, *supra* note 70, at 532.

72. Moloney, *supra* note 70, at 810.

73. *Implementing the Framework for Financial Markets: Action Plan*, COM (1999) 232 final (Nov. 5, 1999).

74. *See Lamfalussy Report*, *supra* note 71.

75. The legislature is normally the European Parliament and Council acting on an initiative from the Commission.

76. *Lamfalussy Report*, *supra* note 71, at 19–36. The main benefit of the process was that time-consuming adoption of detailed instruments by EU institutions—especially the European Parliament—would largely be bypassed.

tated by a "level 3" process led by a new Committee of European Securities Regulators ("CESR").[77]

In the early 2000s, the EU officially adopted this "Lamfalussy Process," eventually applying it not only to securities regulation but also to insurance and banking. It delivered extensive reform in a series of new directives that supplanted most of the original 1992 program instruments as the backbone of EU financial regulation. The new directives differ in important ways from the prior generation. Their substantive coverage is broader, leaving fewer areas to national regulation. They are much more detailed, including very specific rules rather than general principles. They often specifically prohibit member states from adopting more onerous requirements, thus moving from a *minimum* harmonization to a *maximum* harmonization approach.[78] They also strengthen the home country principle and reduce the discretion of host states to impose additional requirements, even in areas where such requirements were common under the older instruments.

Thus, under the Market in Financial Instruments Directive ("MiFID") that succeeded the ISD, host states lost control over customer protection and other conduct of business rules for investment firms, which are now harmonized at the European level.[79] Likewise, the new Prospectus Directive provides that an offering prospectus that complies with uniform European disclosure standards is valid throughout Europe and generally prohibits *both* home and host states from imposing additional requirements.[80] More generally, the new directives establish clearer "choice of law" rules assigning regulatory responsibility to home states,[81] but also require harmonization of the powers of national regulators.[82] By 2005, the fundamental elements of the new regime were in place, and the EC stated that its objectives over the next five years would be to implement the new legislation, consolidate financial market integration, and enhance supervisory cooperation.[83]

One commentator has characterized the shift in the EU's approach as one "from a minimum harmonization-based market construction regime to a highly interventionist and increasingly sophisticated market regulation system."[84] What explains this rapid shift from a flagging mutual recognition

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77. *Id.* at 37–39.

78. *See* Bradley, *supra* note 69, at 1221–22.

79. *See* Niamh Moloney, *Financial Market Regulation in the Post-Financial Services Action Plan Era*, 55 Int'l & Comp. L.Q. 982, 987 (2006). The Directive regulates in detail conduct of business, best execution, and order allocation and handling.

80. Council Directive 2003/71, 2003 O.J. (L 345) 64, (EU); *see also* Commission Regulation 809/2004, 2004 O.J. (L 149) 1 (EU). These instruments establish detailed uniform European rules for many other aspects of the offering process, including exceptions to the prospectus requirement.

81. *See* Duncan Alford, *The Lamfalussy Process and EU Bank Regulation: Another Step on the Road to Pan-European Regulation?*, 25 Ann. Rev. Banking & Fin. L. 389, 431 (2006).

82. Moloney, *supra* note 79, at 992.

83. *Commission White Paper on Financial Services Policy 2005–2010*, at 3, COM (2005) 629 final (Dec. 2005), *available at* http://ec.europa.eu/internal_market/finances/docs/white_paper/white_paper_en.pdf.

84. Moloney, *supra* note 79, at 982. *See also* Bradley, *supra* note 69, at 1224; Mügge, *supra* note 69, at 992 ("[P]roactive pan-European harmonization has been substituted for 'mutual recognition' of nation-

system to an ambitious integration program involving detailed maximum harmonization? In a recent article, Daniel Mügge provides an account of this transition.[85] In his view, in the early years of the 1992 Program, European financial service providers generally did not support a strong mutual recognition regime because, given the dominance they enjoyed in their respective national markets, they benefited from the protection afforded by regulatory barriers. Several member states, too, still viewed financial regulation as an essential component of their interventionist approach to economic policy and therefore resisted limitations on their authority and defended the interests of their "national champions."[86] Therefore, both supported a weak form of mutual recognition that preserved a significant degree of regulatory duplication and obstacles to market access.[87] "The meagre integration record for investment services," Mügge concludes, "was not pre-determined by the mutual recognition approach, but stemmed from the lack of political will and diverging national agendas."[88] He argues that things changed around the turn of the century because of three factors: the rise of cross-border financial activity facilitated by technological innovation; financial disintermediation and competition by U.S. investment banks; and the adoption of the euro. These factors simultaneously increased demand by large European providers for integration and reduced member state demand for nationally distinct regulation.[89] The largest and most influential firms across Europe, along with their powerful industry groups, aligned with the Commission to support integration. They took the lead in advocating a maximum harmonization approach against protectionist interests consisting of smaller firms[90] and some national governments.[91]

In addition to the factors Mügge cites, the imminent enlargement of the EU to incorporate twelve new member states, many with relatively short post-Communist histories of financial regulation, likely provided further impetus for the reforms.[92] Banks from the core EU countries desired a sys-

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ally idiosyncratic rules. The Financial Services Action Plan (FSAP), tabled by the European Commission in 1999, marks this shift.").

85. Mügge, *supra* note 69.

86. *Id.* at 1005–06.

87. *Id.* at 1007.

88. *Id.* Mügge's account, however, does not explain why the 1992 Program in financial services was initiated in the first place. The answer would appear to be that the EU institutions themselves, along with certain member states, were committed to deepening the common market as part of the broader political project of European integration. However, as will be seen, the success of this initiative—at least with respect to financial services—was inhibited for some time by the lack of domestic demand and the limitations of the institutional framework as it existed prior to the *Lamfalussy Report*. I am grateful to Eric Pan, whose comments led me to clarify this point.

89. *See id.* at 1010–11.

90. *See id.* at 1011–13; Bradley, *supra* note 69, at 1227–28. There remain some differences along national lines, but they mostly reflect the greater prevalence of large firms in certain markets such as the United Kingdom and Germany. *See* Moloney, *supra* note 79, at 990–92 on such differences in connection with the MiFID systematic internalizers rules.

91. *See* Mügge, *supra* note 69, at 1013–15.

92. *See* Karmel, *supra* note 22, at 1697.

tem that would allow them to enter the new member states' markets in reliance on their home state regulation to benefit from the post-accession economic boom. Indeed, as Eastern European countries privatized their financial sectors and opened their markets as part of the pre-accession process, foreign banks rapidly dominated many of them—seizing more than two-thirds of market share in the Czech Republic, Estonia, Hungary, Lithuania, Malta, Poland, and Slovakia in 2003.[93] The EU institutions may also have been concerned that weaker financial regulation in the accession states might create negative externalities for Western Europe, thus requiring more uniform EU-wide regulation. Ironically, as Katharina Pistor notes, the opposite actually happened as the EU's home country principle hindered attempts by Eastern European governments to limit the expansion of credit and preserve financial stability.[94]

The financial crisis is also accelerating the transfer of financial authority to European institutions. In January 2009, the EU strengthened the three Lamfalussy "level 3" committees by giving them more explicit mandates to monitor and assess financial stability, empowering them to reach decisions by qualified majority rather than consensus, and requiring national authorities to explain deviations from the committees' standards.[95] In February 2009, a European high-level group issued a report recommending, among other changes, the creation of a European risk supervisor, the transformation of the regulatory committees into European regulatory authorities with substantially expanded legal powers, and stronger substantive European regulation of credit rating agencies, financial derivatives, and hedge funds.[96] As a result, the EU is now in the process of establishing the European Banking Authority, the European Insurance and Occupational Pensions Authority, and the European Securities and Markets Authority.[97] These authorities' new powers may include adopting common interpretations of EU instruments, mediating disputes between national supervisors, imposing binding decisions where mediation fails, adopting binding emergency measures, and

93. *See* European Central Bank, *Banking Structures in the New EU Member States*, Annex 32–34, 36–39 (2005), *available at* http://www.ecb.int/pub/pdf/other/bankingstructuresnewmemberstatesen.pdf.

94. *See* Katharina Pistor, *Into the Void: Governing Finance in Central & Eastern Europe* (Ctr. for Law and Econ. Studies, Columbia Univ. Sch. of Law, Working Paper No. 355, 2009).

95. *See* Commission Decision 2009/78/EC, Establishing the Committee of European Banking Supervisors, 2009 O.J. (L. 25) 23; Commission Decision 2009/79/EC, Establishing the Committee of European Insurance and Occupational Pensions Supervisors, 2009 O.J. (L 25) 28; Commission Decision 2009/77/EC, Establishing the Committee of European Securities Regulators, 2009 O.J. (L 25) 18; Dejmek, *supra* note 62, at 463–64.

96. *See High-Level Group on Financial Supervision in the EU, Report* (Feb. 25, 2009) (the "de Larosière Report"), *available at* http://ec.europa.eu/internal_market/finances/docs/de_larosiere_report_en.pdf.

97. *See* Press Release, European Commission, Commission Adopts Legislative Proposals to Strengthen Financial Supervision in Europe (Sept. 23, 2009), *available at* http://europa.eu/rapid/pressReleasesAction.do?reference=IP/09/1347.

directly supervising credit rating agencies.[98] Substantive legislative proposals with respect to hedge funds, alternative investments, hybrid capital, large exposures, securitization, colleges of supervisors, and credit rating agencies either have been adopted already or are making their way through the legislative process.[99] The trend in Europe is clearly toward even more centralized financial regulation.

2. *The European politics of mutual recognition*

Europe's mutual recognition system for financial services is generally consistent with the multilateral solution explained above. In order to solve the fundamental problem of mutual recognition—credibly reassuring the host state that home state regulation will adequately protect host-state residents—Europe had a unique tool at its disposal: supranational institutions with the authority to enact and enforce uniform standards. As a result, the system relies extensively on delegation, with very general treaty provisions entrusting the EU legislature and increasingly powerful specialized committees to produce detailed rules. It also relies on the substantial monitoring, enforcement and dispute resolution capabilities of the Commission and the Court. Because member states derive many other benefits from EU membership, these institutions can credibly threaten costly responses to noncompliance by individual member states. One important deviation from the multilateral model is the absence of a real withdrawal option. While a theoretical possibility, withdrawal from the EU in response to institutional overreach would be an extremely costly option, unrealistic in most circumstances. Instead, the EU includes mechanisms intended to reduce the likelihood that individual states will see their interests disregarded, such as qualified majority voting in the Council. So far, the system appears largely functional, with substantial, albeit slow, implementation in all member states despite their growing number and heterogeneity.

To what extent, then, can the EU financial services regime serve as a model for international mutual recognition? A closer examination of the three factors discussed above—existing collective institutions, private sector demand, and relative power—shows considerable strength along all three dimensions in Europe. First, as described above, the EU institutions played a crucial role in designing and implementing both the 1992 program and the FSAP, which suggests that multilateral mutual recognition requires detailed rules and expert monitoring and enforcement. In addition, as Europe pursued these successive rounds of deeper financial integration, EU institutions played a greater role, their power and autonomy were expanded, and their approach shifted from minimum harmonization and mutual recognition of

98. *See* Fabio Recine & Pedro Gustavo Teixeira, *The New Financial Stability Architecture in the EU* 12–14 (Goethe-Universität Frankfurt-am-Main, Inst. for Law and Fin., Working Paper No. 110, 2009), *available at* http://www.ilf-frankfurt.de/uploads/media/ILF_WP_110.pdf.

99. *See* Dejmek, *supra* note 62, at 468.

home country standards to ever more detailed maximum harmonization.[100] Outside Europe, establishing institutions capable of fulfilling the same functions solely for the purpose of supporting mutual recognition in financial services is unlikely to be cost-effective. In other words, the ability of the European financial regulation system to make use of strong supranational institutions and multiple linkages is unique, and will likely remain so in the near future.

The European experience also shows that even with strong institutions, monitoring and enforcing compliance by states remains a significant problem. Under the 1992 program, member states took advantage of the minimum harmonization scheme to impose additional regulatory requirements to protect their markets against foreign firms, a tendency that had to be carefully policed by the Commission and the ECJ.[101] More worryingly, under a mutual recognition system, some countries may have incentives to gain market share through lax regulation and externalize regulatory failures. While not all variations in home state regulation are harmful, it may be difficult to identify and effectively address areas in which they are. In Europe, the case of Iceland illustrates some of the dangers. Iceland, a country of approximately 320,000 without a significant domestic financial market, increased its share of world banking substantially after it became a member of the European Economic Area ("EEA") and gained access to the common market. The EU deposit insurance rules required home states to provide a mandatory minimum amount of coverage but did not explicitly impose specific funding requirements. When the Icelandic banks failed in 2008, the claims of British and Dutch depositors exceeded by several orders of magnitude the Icelandic insurance fund's reserves.[102] While the question of whether Iceland was legally bound to provide funding is still debated, it is clear that its deposit insurance system was inadequate to support the vast expansion of its banks' business in Europe and that the EEA institutions failed to prevent this outcome. The Greek sovereign debt crisis of 2010 also raises significant questions regarding the ability of EU institutions to monitor compliance and accurate reporting by member states.[103]

100. This last development may have been driven in part by bureaucratic requirements, as the EU institutions are better equipped to monitor compliance with specific legislative instruments than to assess regulatory equivalence among member states.

101. *See supra* note 70.

102. *See* Dejmek, *supra* note 62, at 469. In October 2009, the Icelandic parliament approved agreements with the UK and the Netherlands to reimburse €4 billion—nearly 50% of Iceland's pre-crisis annual GDP—between 2016 and 2024. *See* Andrew Ward, *Iceland Agrees Failed Bank Pay-Outs*, FIN. TIMES, Oct. 19, 2009, at 10. Iceland's president, however, later refused to ratify the agreements, and they were submitted to a referendum in which ninety-three percent of voters rejected them. *See* Andrew Ward, *Iceland's Voters Vent Anger Over Bank Deal*, FIN. TIMES, Mar. 8, 2010, at 6. As of the date of this writing, the impasse between the three countries had not been fully resolved.

103. In October 2009, Greece revised its deficit estimates for 2009 from 3.7% of GDP to 12.5%, and those for 2008 from 5% to 7.7%, leading to a European Commission report severely critical of the integrity and independence of Greece's deficit and debt statistics. *See* European Commission, *Report on Greek Government Deficit and Debt Statistics*, at 3, 20, COM (2010) 1 final (Jan. 8, 2010). The U.S. Federal

Second, the evolution of EU financial regulation reveals the importance of domestic demand for market access for the success of mutual recognition arrangements. Under the 1992 Program, the desire of the EU institutions and some member states to deepen the common market was insufficient to create a strong mutual recognition regime, despite the potential gains to investors and users of financial services. According to Mügge's account, the interests of large providers, most of whom preferred protectionism and market segmentation, prevailed and led to a weak regime. Later, exogenous factors—the rise of cross-border finance, U.S. competition, and the euro—increased private demand for financial integration, contributing to a much stronger European regime.[104] This combination of private demand and strong institutions eventually led to today's maximum harmonization regime.[105]

The lesson from this shift is that the theoretical possibility of reciprocal market access and the existence of institutions capable of implementing a mutual recognition program are insufficient in themselves to create a strong program. Support from export-oriented domestic constituencies is another important element, and it is contingent on economic, technological, and legal factors that are—at least in part—exogenous to the mutual recognition effort. This being said, although his account is otherwise compelling, Mügge's apparent assumption that the factors it relies on were purely exogenous may require qualification.[106] Certainly, the architects of Maastricht saw the efforts to create a common market in financial services under the 1992 Program as a step toward a monetary union.[107] It appears likely that the 1992 Program contributed to paving the way for the euro and the increase in cross-border finance. If this is correct, then the first round of mutual recognition contributed to the later demand for further integration. It may also have facilitated later progress by laying out the foundations of EC law in each area and creating a pool of experience at the national level, both in implementing EC directives and in cooperating through regulatory committees.

Finally, the evolution of mutual recognition in European financial regulation is consistent with the theoretical account proposed above regarding the

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Reserve later indicated it was examining the role of Goldman Sachs in arranging derivatives transactions with Greece that allegedly helped the country understate its debt figures after it joined the EU. *See* Alan Rappeport, Tom Braithwaite & David Oakley, *Goldman Role in Greek Crisis Probed*, Fin. Times, Feb. 26, 2010.

104. *See* Mügge, *supra* note 69, at 1004–16.

105. *See* Wolfgang Kerber & Roger Van den Bergh, *Mutual Recognition Revisited: Misunderstandings, Inconsistencies, and a Suggested Reinterpretation*, 61 Kyklos 447, 454 (2008) ("Experience in the EU demonstrates that the precondition of 'equivalence of objectives or effects' can lead to the opposite effect of an increased tendency to harmonisation.").

106. *See* Mügge, *supra* note 69, at 1008–09.

107. *See, e.g.*, *Comm. for the Study of Econ. and Monetary Union, Report on Economic and Monetary Union in the European Community*, at 9–10 (Apr. 12, 1989), *available at* http://ec.europa.eu/economy_finance/publications/publication6161_en.pdf (the influential "Delors Report").

impact of relative power and externalities. Among the core European financial centers, market integration and improvement of regulatory standards through mutual recognition likely brings joint benefits. More interesting from this perspective is the relationship between the core EU member states and the new members, mostly in Eastern Europe, that joined the Union in 2004 and 2007. The turn to a maximum harmonization approach and greater limits on home state discretion in the late 1990s and the 2000s is consistent with the desire of European banks to access Eastern Europe based on their home country rules. The EU institutions may also have been concerned with minimizing the potential negative externalities from new states with little tradition of financial regulation. The accession states, for their part, derived many benefits from EU membership, which makes it difficult to pinpoint the relative importance of financial market access as an incentive. This being said, banks from the core EU countries rapidly came to dominate many Eastern European markets, arguably reducing the autonomy of their macroeconomic policy.[108] This outcome suggests that mutual recognition may have imposed net costs on the accession countries, which they believed to be outweighed by the other benefits of membership. Finally, the implementation of EU financial regulation as part of the "accession package" is also consistent with a desire on the part of the EU to strengthen the international influence of its standards relative to those of the United States, which had been influential in Eastern Europe in the 1990s.

In sum, Europe combines the three factors that favor a stronger mutual recognition regime. The EU has strong collective institutions with the ability to make and enforce common rules. The private demand for financial market integration across many sectors, while initially weak, has increased over time. The original EU countries' dual wishes to gain market share for their banks in Eastern Europe and to improve regulatory standards there also help explain the stronger post-FSAP regime. These factors also suggest that the European experience is exceptional, particularly because of the EU's unique supranational rulemaking and enforcement system. In addition, the combination of strong institutions and private demand has led to a system that increasingly relies on detailed rules and maximum harmonization, thus moving in some respects beyond the model of mutual recognition described above and sacrificing some of its benefits in terms of national autonomy and regulatory competition. Therefore, while the European system of international financial market integration is without any doubt the most advanced in the world, its utility as a model for other mutual recognition efforts may be more limited than is often assumed.

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108. *See* Pistor, *supra* note 94, at 22–24.

B. Bilateral mutual recognition: The SEC-Australia arrangement

In contrast to the European system, the SEC's program, which would have allowed certain foreign exchanges and broker-dealers to access U.S. markets under broad exemptions from U.S. regulations, was an elaborate attempt to meet the challenges of mutual recognition on a bilateral basis with a minimal institutional framework. The SEC-Australia framework agreement signed in August 2008 reveals many of the features of such a system.

1. *The Tafara-Peterson article and the SEC-Australia arrangement*

Prior to the mid-2000s, the SEC relied primarily on two approaches to address international regulatory issues: substantive harmonization or convergence through networks such as IOSCO, on the one hand; and unilateral adaptation of certain SEC rules to clarify their jurisdictional reach or to facilitate access by foreign issuers to U.S. markets, on the other.[109] In some instances, such as the Multi-Jurisdictional Disclosure System ("MJDS") in force between the United States and Canada, the SEC adopted a mutual recognition approach.[110] These instances, however, were exceptional and, despite their limited scope, somewhat controversial due to SEC concerns about the quality of foreign regulation and enforcement, even in countries with systems substantially similar to that of the United States.[111] These limited mutual recognition regimes also did not extend to important areas such as oversight of stock exchanges, broker-dealers, or mutual funds, which continued in most instances to require registration under the Exchange Act to access U.S. customers.[112] The SEC's cautious approach stood in contrast to rulings by the Commodity Futures Trading Commission ("CFTC") allowing foreign derivatives exchanges to place trading screens in the United States.[113]

Then, in 2007, Ethiopis Tafara and Robert Peterson, two high-ranking officials in the SEC's Office of International Affairs, published an article outlining a proposed system of "substituted compliance" under which foreign stock exchanges and broker-dealers could apply for an exemption from

109. Regulation S and the SEC's tender offer regulations establish detailed rules for determining the applicability of U.S. law to cross-border transactions. The rules implementing the Sarbanes-Oxley Act of 2002 with respect to foreign private issuers, as well as other disclosure rules, defer to home state regulation in some respects.

110. *See* Karmel, *supra* note 22, at 1696–97.

111. On the MJDS, *see* Scott, *supra* note 30, at 191–96.

112. *See* Tafara & Peterson, *supra* note 9, at 47–48. There are some limited exceptions (a low volume exemption for exchanges, Rule 15a-6 for broker-dealers, modified disclosure and other requirements for foreign issuers).

113. *See* Roberta S. Karmel, *The Once and Future New York Stock Exchange: The Regulation of Global Exchanges*, 1 Brooklyn J. Corp. Fin. & Com. L. 355 (2007); Howell E. Jackson, Andreas M. Fleckner & Mark Gurevich, *Foreign Trading Screens in the United States*, 1 Capital Markets L.J. 54, 61–62 (2006).

U.S. registration.[114] Such exemptions would be granted "based on [the applicant's] compliance with substantively comparable foreign securities regulations and laws and supervision by a foreign securities regulator with oversight powers and a regulatory and enforcement philosophy substantively similar to the SEC's."[115] As Tafara and Peterson acknowledged, this system would represent a significant shift from the SEC's prior emphasis on "universal regulatory convergence" toward a bilateral approach.[116] Remarkably, the proposal did not propose circumscribing access to sophisticated investors. Instead, it contemplated that foreign firms might access U.S. retail markets—the core of the SEC's investor protection mandate.

The proposal, however, emphasized several crucial prerequisites, as well as one important caveat. First, exemption from U.S. regulatory requirements would be the outcome of a bilateral and reciprocal process through which regulators from both countries would satisfy each other of the comparability of their rules, examinations and other requirements and make any adjustments necessary to prevent gaps or systemic risks.[117] Crucially, Tafara and Peterson acknowledged that a foreign regulatory system may be "comparable" for mutual recognition purposes despite not offering "oversight and investor protections as extensive as those in the United States."[118] The criteria would be that it "provide sufficiently robust regulation and investor protections that U.S. investors seem comfortable assuming any additional risks these markets entail,"[119] including certain minimum requirements set by the SEC.[120] The foreign entity would also be required to disclose to U.S. investors that they are leaving usual U.S. protections behind and to state the salient differences between U.S. regulation and the applicable foreign system.[121] The comparability assessment would undergo *de novo* review at least every five years.[122]

Tafara and Peterson also made it clear that, beyond comparability of foreign law and regulations, mutual recognition would also require "an unambiguous arrangement between the SEC and its foreign counterpart to share extensive enforcement- and supervisory-related information."[123] These ar-

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114. Tafara & Peterson, *supra* note 9. According to Roberta Karmel, "[a]lthough the SEC as a matter of policy disclaims responsibility for statements by an SEC staffer, this article nevertheless was a trial balloon of a new approach to a policy of mutual recognition." Karmel, *supra* note 22, at 1707–08.

115. Tafara & Peterson, *supra* note 9, at 32. The exemption would likely be based on the general exemptive authority granted to the SEC by Section 36 of the Exchange Act, 15 USC 78mm. *See* Erik R. Sirri, Dir., Division of Market Regulation, U.S. Sec. & Exch. Comm'n, A Global View: Examining Cross-Border Financial Services (Aug. 18, 2007), *available at* http://www.sec.gov/news/speech/2007/spch081807ers.htm.

116. Tafara & Peterson, *supra* note 9, at 55.

117. *Id.* at 58–59.

118. *Id.* at 53.

119. *Id.* at 53.

120. *Id.* at 64 (exchanges), 66 (broker-dealers).

121. *Id.* at 55, 57, 65.

122. *Id.* at 63.

123. *Id.* at 32, 56.

rangements would go beyond typical information-sharing and enforcement cooperation agreements such as IOSCO's MMOU: the parties would agree to "share inspections reports, conduct joint inspections, and cooperate with each other at the prudential oversight level."[124] Finally, even with such a system in place, the SEC would retain jurisdiction to enforce U.S. anti-fraud provisions, including Rule 10b-5, where exempted foreign entities would be required to agree to SEC jurisdiction and service of process for such purposes.[125] Tafara and Peterson, however, left open the possibility that the SEC's framework might restrict private rights of action to those available in the exempted entity's home jurisdiction, provided that the latter are comparable.[126]

Contemporaneously with the publication of Tafara and Peterson's article, the SEC launched several initiatives that demonstrated its commitment to rapid progress on mutual recognition. In June 2007, it convened a roundtable of regulators, academics and markets participants to discuss mutual recognition with respect to foreign exchanges and broker-dealers, and solicited public comments on the proposal.[127] Senior SEC officials delivered a number of speeches outlining the proposal and its progress.[128] In early 2008, progress appeared to accelerate, as SEC Chairman Christopher Cox and European Commissioner for the Internal Market and Services Charlie McCreevy released a joint statement that "mandated their respective staffs to intensify work on a possible framework for EU-US mutual recognition for securities in 2008."[129] The SEC released an ambitious plan to implement mutual recognition for "high-quality regulatory regimes" in other countries, which contemplated pilot programs with individual countries, followed by the adoption of a "formal process for engaging other national regulators on the

124. *Id.* at 58, 63. *See* IOSCO MMOU, *supra* note 11.

125. *Id.* at 32, 57–58.

126. *Id.* at 61–62.

127. *See* U.S. Sec. & Exch. Comm'n, Unofficial Transcript of Roundtable Discussion on Mutual Recognition (June 12, 2007) [hereinafter SEC ROUNDTABLE] *available at* http://www.sec.gov/news/openmeetings/2007/openmtg_trans061207.pdf.

128. Paul S. Atkins, Comm'r, U.S. Sec. & Exch. Comm'n, Remarks Before the Investment Company Institute's 2008 Mutual Funds and Investment Management Conference (Mar. 17, 2008), *available at* http://www.sec.gov/news/speech/2008/spch031708psa.htm; Kathleen Casey, Comm'r U.S. Sec. & Exch. Comm'n, Remarks Before the Conference on SEC Regulation Outside the United States (Mar. 6, 2008), *available at* http://www.sec.gov/news/spe ech/2008/spch030608klc.htm; Annette L. Nazareth, Comm'r U.S. Sec. & Exch. Comm'n, Remarks Before the Securities Industry and Financial Markets Association Annual Meeting (Nov. 9, 2007), *available at* http://www.sec.gov/news/speech/2007/spch110907aln.htm; Sirri, *supra* note 115.

129. Press Release, U.S. Sec. & Exch. Comm'n, Statement of the European Commission and the U.S. Securities and Exchange Commission on Mutual Recognition in Securities Markets (Feb. 1, 2008), *available at* http://www.sec.gov/news/press/2008/2008-9.htm.

subject of mutual recognition."[130] The SEC subsequently announced that it was engaged in formal discussions with Australia and Canada.[131]

The talks with Canada eventually came to a standstill, apparently due to the difficulties posed by its decentralized system of provincial securities regulators.[132] In August 2008, however, the SEC announced that it had entered into a Mutual Recognition Arrangement ("The Arrangement") with the government of Australia and the Australian Securities and Investments Commission ("ASIC").[133] The Arrangement is broadly consistent with the Tafara and Peterson proposal: it contemplates that the SEC and Australian authorities will consider applications for exemption made by stock exchanges and broker-dealers regulated by the other.[134] The Arrangement purports to be based on existing staff assessments of the comparability of the two regimes' "core securities regulatory principles and the manner these principles are given effect via regulation within each system."[135] In the case of Australian entities active in the United States, exemptive relief requires notice to U.S. investors that the exempted entity is not generally subject to U.S. laws and regulations, and preserves the application of U.S. anti-fraud protections and administrative proceeding authority.[136] In an apparent departure from the Tafara and Peterson proposal, however, the Arrangement limits access by Australian broker-dealers to U.S. "Qualified Investors."[137]

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130. Press Release, U.S. Sec. & Exch. Comm'n, SEC Announces Next Steps for Implementation of Mutual Recognition Concept (Mar. 24, 2008), *available at* http://www.sec.gov/news/press/2008/2008-49.htm.

131. Press Release, U.S. Sec. & Exch. Comm'n, SEC Chairman Cox, Prime Minister Rudd Meet Amid U.S.-Australia Mutual Recognition Talks (Mar. 29, 2008), *available at* http://www.sec.gov/news/press/2008/2008-52.htm; Press Release, U.S. Sec. & Exch. Comm'n, Schedule Announced for Completion of U.S.-Canadian Mutual Recognition Process Agreement (May 29, 2008), *available at* http://www.sec.gov/news/press/2008/2008-98.htm.

132. Press Release, U.S. Sec. & Exch. Comm'n, Schedule Announced for Completion of U.S.-Canadian Mutual Recognition Process Agreement, *supra* note 131, indicated that a "process agreement" would be concluded in mid-June 2008, but no such agreement has been concluded to date.

133. Press Release, U.S. Sec. & Exch. Comm'n, SEC, Australian Authorities Sign Mutual Recognition Agreement (Aug. 25, 2008), *available at* http://www.sec.gov/news/press/2008/2008-182.htm; SEC-Australia Arrangement, *supra* note 5.

134. In the case of the United States, an eligible "Market" is defined as a national securities exchange registered under § 6 of the Securities Exchange Act ("SEA"); in the case of Australia, it formally means "a financial market licensed under the Corporations Act of 2001," *SEC-Australia Arrangement*, *supra* note 5, ¶ 7, but is limited, for the time being, to markets operated by the Australian Stock Exchange ("ASX"). *Id.* ¶ 17(a)(i). Likewise, while the definition of an eligible "Broker-Dealer" in the U.S. includes all brokers or dealers registered under § 15(b) of the SEA (other than security futures dealers registered under paragraph 11), *id.* ¶ 8(a), eligible Australian broker-dealers are limited to ASX participants. *Id.* ¶ 17(b)(i).

135. *Id.* ¶ 19.

136. *Id.* ¶ 20.

137. *Id.* ¶ 17(f). The definition, a specialized one previously used in connection with the exemption of U.S. banks for broker-dealer registration, is as set forth in § 3(a)(54)(A) of the SEA, *id.* ¶ 5. It includes, in addition to several categories of financial institutions, corporations, partnerships and natural persons "own[ing] and invest[ing] on a discretionary basis, not less than $25,000,000 in investments," a high standard that is nevertheless less demanding than that generally applicable to foreign broker-dealers under Rule 15a-6. Securities Exchange Act of 1934 § 3(a)(54)(A)(xii), 15 U.S.C. § 78c (2006). Access by U.S. broker-dealers is reciprocally restricted to "Australian Wholesale Clients," SEC-Australia Arrange-

No such limits apply to exempted Australian exchanges, which should therefore be able to gain full access to U.S. investors, albeit through U.S. or exempted Australian broker-dealers.[138]

In addition to the initial comparability determination, the Arrangement contemplates close and continuous communication between regulators, including periodic meetings of the chairmen of the SEC and ASIC, an undertaking to inform each other of material changes in their regulatory systems, and periodic review of comparability assessments no less than every five years.[139] Each authority retains the right to terminate the Arrangement unilaterally by sixty-day written notice.[140] Most significantly, the Arrangement is premised on parallel cooperative arrangements on supervisory and enforcement cooperation which, as advocated by Tafara and Peterson, go beyond existing Memoranda of Understanding ("MOUs").[141] While the scope of the Arrangement's MOUs is not limited to firms operating under a mutual recognition exemption, the Supervision MOU singles them out for enhanced cooperation by requiring advance notice by each authority of pending regulatory changes, other material changes, and enforcement or regulatory actions relating to such exempted entities.[142] It also requires, upon request, "the fullest possible cooperation" by the home supervisor in facilitating the oversight of exempted entities, including provision of confidential information such as financial and operational data, internal control procedures, regulatory reports, filings and examination reports, trading audit trails, and "[a]ny other information that an Exempted Entity may be required to maintain or provide to the Requesting Authority pursuant to the terms and conditions of its exemption."[143]

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ment, *supra* note 5, ¶ 6, ¶ 17(g)—a complex definition set out in § 761G of the Corporations Act of 2001 which, in the case of non-professional investors acquiring most financial products for non-business purposes, requires $2.5 million in assets or $250,000 in gross income over the past 2 years. This approach is more modest than that advocated in a contemporary Australian consultation paper on mutual recognition, which contemplated access to retail investors. Australia Government Treasury and ASIC, Joint Consultation Paper, Cross Border Recognition: Facilitating Access to Overseas Markets and Financial Services 49 (2008) [hereinafter Joint Consultation Paper], *available at* http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/Consultation_paper_98_Cross_Border_Recognition_v1.pdf/$file/Consultation_paper_98_Cross_Border_Recognition_v1.pdf. The most likely inference is that the SEC was unwilling to provide foreign broker-dealers access to U.S. retail markets even within the framework of a mutual recognition scheme.

138. SEC-Australia Arrangement, *supra* note 5, ¶ 17(a).

139. *Id.* ¶ 21–23.

140. *Id.* ¶ 26.

141. Memorandum of Understanding Concerning Consultation, Cooperation and the Exchange of Information Related to Market Oversight and the Supervision of Financial Services Firms, U.S. Sec. & Exch. Comm'n-ASIC, Aug. 25, 2008 [hereinafter Supervision MOU], *available at* http://www.sec.gov/about/offices/oia/oia_mutual_recognition/australia/supervisory_mou.pdf [hereinafter Supervision MOU]; Memorandum of Understanding Concerning Consultation, Cooperation and the Exchange of Information Related to the Enforcement of Securities Laws, U.S. Sec. & Exch. Comm'n-ASIC, Aug. 25, 2008 [hereinafter Enforcement MOU], *available at* http://www.sec.gov/about/offices/oi_mutual_recognition/australia/enhanced_enforcement_ mou.pdf.

142. Supervision MOU, *supra* note 141, art. 3, ¶ 22.

143. *Id.* art. 3, ¶ 23.

The exchange of such information by a regulator supposes a high degree of trust in the integrity of its counterpart's confidentiality procedures as leaks could have significant competitive implications for regulated firms or compromise ongoing enforcement actions. Indeed, the MOU contains extensive confidentiality provisions requiring the requesting authority to protect any shared information, limit its sharing with other government entities or countries, as well as its use in enforcement actions.[144] The MOU also provides for cooperation in the supervision of non-exempted entities regulated in both jurisdictions, for instance, by establishing procedures for on-site visits in each other's territory.[145]

The Enforcement MOU, for its part, expressly declares the parties' intent to go "beyond the international benchmark established by the IOSCO MMOU,"[146] and establishes additional categories of assistance, including sharing of accounting and audit information, telephone, internet, credit card and travel records, employment information, and corporate records requested for the purpose of enforcement actions.[147] The authorities also agree to seek authority to assist each other by freezing proceeds of possible regulatory violations,[148] obtaining testimony and statements on each other's behalf,[149] and providing unsolicited information on a best efforts basis if it is likely to be of assistance to the other in ensuring compliance.[150] Like the Supervision MOU, the Enforcement MOU requires the requesting authority to preserve the confidentiality of the relevant information and to use it only for authorized purposes.[151] Both MOUs may be terminated by either signatory upon a thirty-day notice.[152]

While the SEC-Australia Arrangement appeared to set the stage for further expansion of the program, subsequent changes at the SEC have put mutual recognition on hold. The last two years of the Bush Administration saw the departure of several of the program's strongest supporters.[153] The financial crisis, the transition to the Obama administration, and widespread

144. *Id.* art. 7.

145. *Id.* art. 4, ¶ 27–28.

146. Enforcement MOU, *supra* note 141, intro. *See* IOSCO MMOU, *supra* note 11.

147. Enforcement MOU, *supra* note 141, art. 3, ¶ 1, Annex A.

148. *Id.* art. 3, ¶ 2.

149. *Id.* art. 3, ¶ 5.

150. *Id.* art. 9.

151. *Id.* art. 6–7.

152. *Id.* art.11; Supervision MOU, *supra* note 141, art. 8, ¶ 37.

153. The departures included mutual recognition supporters Chairman Christopher Cox and Commissioner Annette L. Nazareth, as well as a skeptic, Commissioner Roel Campos. *See Cox Quits SEC*, The Straits Times, Jan. 21, 2009, *available at* http://www.straitstimes.com/Breaking%2BNews/Money/Story/STIStory_328932.html; Press Release, U.S. Sec. & Exch. Comm'n, Commissioner Campos to Leave SEC (Aug. 9, 2007), *available at* http://www.sec.gov/news/press/2007/2007-163.htm; Press Release, U.S. Sec. & Exch. Comm'n, Commissioner Nazareth Announces Intention to Leave SEC (Oct. 2, 2007), *available at* http://www.sec.gov/news/press/2007/2007-210.htm. One of the new Commissioners has publicly expressed doubts about the approach. *See SEC Commissioner Walter Has Doubts About Mutual Recognition*, Thomson Routers Accounting Blog (Mar. 6, 2009), https://community.dynamics.com/blogs/thomsontax/comments/19980.aspx (last visited Oct. 8, 2010).

calls for strengthened regulation shifted attention away from mutual recognition. Although it has not been officially abandoned, no new action has been announced since August 2008, and no exemptions have been granted under the SEC-Australia Arrangement to date. Australia, for its part, announced contemporaneously with the adoption of the Arrangement that one of its "key areas of focus" in the coming years would be to "[c]ontinue to pursue recognition opportunities with key jurisdictions across a range of areas."[154] It has since entered into agreements with New Zealand on securities disclosure and with Hong Kong on managed investment schemes, and is pursuing talks with Singapore with respect to the latter.[155]

2. *The bilateral politics of mutual recognition*

The SEC program, as implemented in the SEC-Australia Arrangement, is generally consistent with the bilateral model of mutual recognition. It consists of a bilateral agreement without any delegation of rulemaking, monitoring, or dispute resolution to collective institutions. It contemplates monitoring and enforcement by the parties themselves, through notices of material regulatory changes, periodic reassessments of comparability, and unilateral termination by either party. Australia and the other potential candidates for the program—Canada and the European Union—are industrialized jurisdictions with highly developed financial markets and regulators. The program's scope is narrow and does not involve explicit linkages to other matters or areas of financial regulation.

The experience accumulated to date under the SEC program and its suspension hold significant lessons. First, the program attempts to establish a viable mutual recognition system without the benefit of preexisting collec-

154. ASIC Report 134, *supra* note 7, art. C, ¶ 75. In many respects, Australia's mutual recognition program may be seen as an outgrowth of the unilateral recognition regime incorporated in the 2001 reform of its securities regulation regime. Thus, the Corporations Act allows ASIC to relieve foreign securities disclosure documents, exchanges, financial service providers and collective investments schemes from several aspects of Australian regulation on the basis of sufficient equivalence with respect to investor protection, market integrity and reduction of systemic risk. *See* Austl. Sec. and Inv. Comm'n, Regulatory Guide 54: Principles for Cross Border Financial Services Regulation, art. 2–3 (2002). In 2008, there were over 200 foreign financial service providers and six foreign markets providing financial services in Australia pursuant to its unilateral recognition provisions. *See* Joint Consultation Paper, *supra* note 137, art. A ¶ 3, art. B ¶ 23. ASIC and the Australian Treasury, in a joint consultation paper, outlined a proposal to complement this regime that would provide substantial further relief for foreign financial service providers and markets—including access to retail investors—based on mutual recognition arrangements with their home jurisdictions. *Id.* art. E. The framework proposed in the paper was very close to that eventually incorporated in the SEC-Australia Arrangement, although as noted above, the latter did not give foreign service providers access to retail investors.

155. *See supra* note 7 and accompanying text; E-mail from Grantly Brown, Senior Manager, Int'l Strategy, Austl. Sec. and Inv. Comm'n, to Pierre-Hugues Verdier (Aug. 26, 2010) (on file with author). An October 2009 report on the Australia-New Zealand Agreement indicated that it had been used six times by New Zealand issuers and 211 times by Australian issuers; it was generally viewed favorably by firms due to the legal and documentation cost savings and faster regulatory approval process; and firms supported expansion of mutual recognition with major Asian countries and other sophisticated markets. *See* Austl. Sec. and Inv. Comm'n, Report 174: Effects of the Australia-New Zealand Mutual Recognition Regime for Securities Offerings, art. B ¶ 16, art. D ¶ 27, art. E ¶ 35 (2009).

tive institutions. As noted above, because mutual recognition raises enforcement and information problems, cooperation requires mechanisms to support the credibility of each state's commitment to comply with its obligations to provide adequate regulation and market access. How can this be accomplished without supranational oversight? The SEC-Australia Arrangement is particularly instructive. Contrary to the rational design conjecture that less delegated agreements are likely to be more detailed, it does not rely on detailed standards but on a relatively high-level "comparability" assessment. While the presence of enforcement problems and limited information suggest that the Agreement should provide for some degree of formal monitoring and dispute resolution, no such mechanisms are present. Instead, the parties apparently rely on the implicit threat to terminate the Agreement if one party's noncompliance causes significant harm to the other.

The SEC-Australia Arrangement, along with its attached MOUs, also reveals the importance of effectively coordinating cross-border supervision and enforcement. Even though the home state has ultimate responsibility for regulation, as a practical matter, effective regulation will often require such coordination. The home regulator may need to inspect or investigate a firm's activities in the host country; there must be mechanisms to transmit complaints from host country customers to the home regulator, and supervisory information must flow between the home and host regulators so that appropriate measures can be implemented. In these respects, existing international enforcement coordination standards developed by TRNs may be a starting point,[156] but they were clearly seen as insufficient. Under those standards, home countries retain substantial discretion to withhold cooperation—a situation unlikely to satisfy host states that they can safely exempt the relevant firms from local regulation. As a result, effective mutual recognition will likely require enhanced cooperation arrangements between the regulators involved, as illustrated by the SEC-Australia MOUs.

Second, like the evolution of Europe's regime, the SEC program also shows the pivotal role of domestic demand in supporting mutual recognition. As noted by Jackson, the SEC insisted that the main beneficiaries would be investors, who would gain from greater diversification as mutual recognition lowered the transaction costs of investing in foreign markets.[157] While this argument addresses the charge that mutual recognition forsakes the SEC's consumer protection mandate, U.S. investors are unlikely to provide a strong source of domestic support for such a program. Like consumers of imported products, investors are dispersed and unlikely to mobilize effectively given the small individual benefits of mutual recognition. Moreover, since large institutional investors already have substantial access to foreign

156. *See* Nicolaidis & Shaffer, *supra* note 4, at 278.
157. *See* Jackson, *supra* note 9, at 110–111.

securities markets,[158] the benefits of mutual recognition are concentrated among retail investors—the most dispersed and least influential category of investors. Even for them, the reduction in transaction costs may well be dwarfed by the high costs and delays involved in small securities transactions abroad.[159] Greater efficiencies are often available simply by diversifying abroad through exchange-traded funds or mutual funds.[160]

On the other side of scale, like in the case of trade liberalization, there are significant domestic constituencies with an interest in opposing mutual recognition. U.S. broker-dealers and exchanges, particularly smaller ones whose activities are primarily domestic, stand to lose market share to foreign broker-dealers and exchanges. Unsurprisingly, they have opposed mutual recognition, arguing that foreign firms subject to different regulatory regimes would have an unfair competitive advantage in the U.S. market. They expressed concern that foreign issuers would be able to access U.S. investors by listing on a foreign exchange subject to mutual recognition, thus bypassing U.S. registration. U.S. exchanges also argued that burdensome U.S. regulations—such as regulatory approval for the introduction of new products and the limited ability of exchanges to sell data—should be reformed before granting access to foreign exchanges not subject to such burdens.[161]

The question then becomes whether other firms have incentives to support mutual recognition, and whether that support can outweigh protectionist interests. Foreign broker-dealers and exchanges would benefit from U.S. market access, and support the initiative.[162] Their interests, however, likely carry little weight domestically. What mutual recognition requires is sup-

158. *See* Howell E. Jackson & Eric J. Pan, *Regulatory Competition in International Securities Markets: Evidence From Europe—Part II*, 3 Va. L. & Bus. Rev. 207 (2008); Jackson & Pan, *supra* note 63. *See also* comments by Bepler, Kelly & Howell in Sec Roundtable, *supra* note 127, at 9–16. Proposed revisions to Rule 15a-6 that would liberalize access to U.S. institutional investors by foreign broker-dealers (regardless of whether their country is party to a mutual recognition arrangement with the SEC) would further decrease the benefits of mutual recognition to both. *See* Exemption of Certain Foreign Brokers or Dealers, 73 Fed. Reg. 39182, 39185 (Proposed Jul. 8, 2008). U.S. institutional investors may even actively resist the effort, arguing that it would dilute investor protection (and perhaps the competitive advantage they derive from easier access to foreign markets). *See* George W. Madison & Stewart P. Greene, *TIAA-CREF Response to "A Blueprint for Cross-Border Access to U.S. Investors: A New International Framework*," 48 Harv. Int'l L.J. 99 (2007).

159. *See* comments by Greene in Sec Roundtable, *supra* note 127, at 85–86.

160. *See id.* Also, in light of the financial crisis, there may be a shift away from the rationality assumptions that support the benefits of diversification opportunities toward a more paternalistic approach to financial regulation, one that attempts to protect investors from their own cognitive limitations. In this case, the rationale for mutual recognition as a pro-investor initiative is likely to be called into question.

161. *See* Letter from Joan Conley, Senior Vice President and Corporate Secretary, NASDAQ OMX, Group, Inc., to Nancy M. Morris, Secretary, SEC (Mar. 14, 2008), *available at* http://www.sec.gov/comments/4-539/4539-9.pdf.

162. The Federation of European Securities Exchanges, NYSE Euronext, and Deutsche Börse commented favorably on the proposal and urged the SEC to expand it further and avoid restrictions on the types of investors who could access foreign markets. *See* Letter from Juka Ruuska, President, Federation of European Securities Exchanges, to Christopher Cox, Chairman, SEC (Aug. 17, 2007), *available at* http://www.sec.gov/comments/4-539/4539-7.pdf; Letter from John A. Thain, Chief Executive Officer, NYSE Euronext, to Nancy M. Morris, Secretary, SEC (Sept. 14, 2007), *available at* http://www.sec.gov/comments/4-539/4539-6.pdf; Letter from Reto Francioni and Andreas Preuss, Executive Board, Deutsche

port from U.S. firms attracted by the prospect of enhanced access to foreign markets. In connection with the SEC program, these potential exporters consist primarily of large, internationally-oriented broker-dealers, as well as the largest exchanges. Both of these categories, however, already have substantial access to many foreign markets—in fact, from an international standpoint, the United States is an outlier in subjecting foreign broker-dealers and exchanges to full local registration and regulation. Thus, as things stand, the potential benefits of mutual recognition may be insufficient to generate strong support from potential exporters, especially broker-dealers.[163]

Recent trends, however, suggest that with respect to stock exchanges, support for mutual recognition may have grown stronger. The largest U.S. exchanges—through de-mutualization, separation of regulation and market activities, and mergers with foreign exchanges—have made substantial investments with a view to creating fully integrated global exchanges.[164] These investments will fully pay off only if they are allowed to operate under an integrated regulatory system. This is likely why NYSE Euronext strongly supported the SEC program and its eventual extension to Europe.[165] Beyond exchange and broker-dealer registration, Edward Greene points out that there are many areas, including mutual funds, investment advisers, and primary offerings, where the industry would welcome a mutual recognition approach.[166] The lesson of the SEC's experience may be that the determinants of domestic demand for mutual recognition are largely exogenous to the effort itself and cannot be taken for granted, especially where potential exporters can already access foreign markets through alternative means.

Finally, the U.S. mutual recognition program appears consistent with the hypotheses derived from the literature on asymmetrical power relationships. Australia and Canada, the two principal candidates mentioned by the SEC, have well-developed and competitive financial sectors, with modern regulatory systems along U.S. lines. In this context—subject to successful implementation of coordinated enforcement—both sides are likely to derive benefits from market integration, negative externalities are likely to be bidirectional and low, and the United States derives the additional benefit of

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Börse, to Christopher Cox, Chairman, SEC (Nov. 6, 2007), *available at* http://www.sec.gov/comments/4-539/4539-8.pdf.

163. The probable retention of 10b-5 private rights of action will also reduce the potential benefits of the proposal for foreign firms. *See* Jackson, *supra* note 9, at 116.

164. *See* Stavros Gadinis & Howell E. Jackson, *Markets as Regulators: A Survey*, 80 S. Cal. L. Rev. 1239 (2007); Karmel, *supra* note 113.

165. *See* Pan, *supra* note 20, at 136–138; Pierre Schammo, *Regulating Transatlantic Stock Exchanges*, 57 Int'l & Comp. L.Q. 827 (2008). NYSE Euronext is now, by a significant margin, the largest stock exchange in the world, but differences in regulation require that its U.S. and European markets are operated in parallel and therefore, it cannot realize the full efficiencies from the merger. NASDAQ also pursued several merger possibilities in Europe, including the London Stock Exchange, but its bid failed and it instead merged with OMX, a smaller operator of exchanges in Northern Europe.

166. *See* Greene, *supra* note 9, at 95–96; *see also* Jackson, *supra* note 9, at 117–18. At the time his article was written, Greene was General Counsel of Citigroup's Institutional Clients Group.

pulling more countries closer to its regulatory model. This is consistent with the narrow scope of the proposed agreements, which suggests that these countries sufficiently value the benefits of reciprocal market access not to require side payments or enforcement linkages.[167] In contrast, mutual recognition may not effectively drive improvements in regulatory standards where significant concerns about regulatory externalities arise, especially with respect to countries like offshore financial centers whose competitiveness may depend on lenient regulation.

In sum, the 2008 Arrangement, in addition to conforming in broad outline to the bilateral model of mutual recognition, also provides several concrete insights regarding the negotiation process for such agreements, their substantive provisions and the cross-border cooperation arrangements they require. It also reveals how the success of bilateral mutual recognition may be affected by the balance between demand for cross-border access by financial services exporters and resistance by firms that benefit from market segmentation. This balance, in turn, depends on factors ranging from the size of the other country's market to the practical importance of regulation relative to other obstacles to access. It also supports the hypothesis that bilateral mutual recognition is more likely between countries with close levels of financial market development and legal and regulatory systems, and unlikely to be used successfully to elicit fundamental regulatory reforms.

III. Reexamining Mutual Recognition

This Part draws on the lessons of both the European and U.S. models to derive insights as to how mutual recognition may be applied in other contexts and its implications for international regulatory convergence. It then examines two emerging mutual recognition initiatives—between the European Union and third countries, and within ASEAN—in light of these considerations.

A. *Mechanics*

The EU mutual recognition regime and the SEC program are generally consistent with the theoretical account proposed above. The former involves multilateralism, substantial delegation to collective institutions, and multiple linkages with other issues. The latter is bilateral, with no collective institutions but instead bilateral monitoring by the parties themselves, extensive cross-border supervision and enforcement coordination, and periodic renegotiation clauses. What, then, accounts for the adoption of one model or the other in each case? The multilateral solution is costly because

167. The relevant countries might still be tempted to avoid their obligation to provide adequate market access to foreign firms. This kind of noncompliance, however, is likely easier to detect than failure to provide adequate regulatory standards. *See supra* note 51.

it rests on detailed rules and a strong institutional framework to harmonize standards and monitor and enforce compliance. In Europe, this solution was viable because supranational institutions were already in place and a much broader program of economic integration—including the removal of capital controls and the adoption of a common currency—concurrently paved the way for a common market in financial services. At this point, however, no other regional organization has institutions in place with powers comparable to those delegated to the EU. As a result, before we see the development of multilateral mutual recognition regimes similar to Europe's in other regions, they will first have to make substantial progress toward political and economic integration

In the meantime, the question becomes whether and in what circumstances the bilateral solution pioneered by the SEC presents a viable alternative. While it does not require the degree of integration found in Europe, its implementation nevertheless presents significant challenges. First, it requires a process to assure each state that the other's regulation will protect the interests of its residents. That process must be such that equivalence or comparability can be established at the outset, monitored on an ongoing basis, and failures sanctioned.[168] How can these objectives be achieved in the thin institutional framework of a bilateral agreement?

Instead of relying on centralized rulemaking and monitoring, the SEC's program relies on a prior comparability assessment. But what does "comparability" mean? At the most elementary level, laws that are discriminatory on their face—for example, laws that provide less regulatory protections to foreigners—will usually be unacceptable to host states. They are also easy to identify and eliminate in the negotiations leading up to mutual recognition. There are, however, many other ways in which the home state's regulatory system can fail, especially in situations involving cross-border activities: the home state may have laws that, while not discriminatory on their face, are less strictly enforced when foreigners are harmed; its regulatory regime may be excessively lenient across the board; it may tolerate political interference to benefit domestic interests; or its regulators may be understaffed, incompetent or corrupt. All of these deficiencies are difficult for other states to detect and discipline.

This difficulty may, to some extent, be alleviated by developing more systematic approaches to compare regulatory systems. One possibility is to assess the host state's compliance with international standards, such as those adopted by the Basel Committee and IOSCO.[169] However, as discussed

168. In the international trade context, Nicolaidis and Shaffer provide several examples of mechanisms that support "managed" mutual recognition: prior conditions; selective recognition of individual actors or associations instead of entire national regulatory systems; adjustment to the scope of recognition; and ex post guarantees such as monitoring, dispute resolution, and ultimate reversibility. *See* Nicolaidis & Shaffer, *supra* note 4, at 290–291.

169. *See* Greg Tanzer, *Substituted Compliance: An Australian Regulator's Perspective*, 48 Harv. Int'l L.J. Online 21, 29 (2007); *see also* Régis Bismuth, *Financial Sector Regulation and Financial Services Liberaliza-*

above, such standards—for instance IOSCO's *Objectives and Principles of Securities Regulation*[170]—are often very general in nature, and were not designed to cover all concerns a host state may have about matters like investor protection and disclosure standards. Another approach would be to systematically compare the content of the home state's laws and regulations to that of the host state. Obviously, however, insisting on identical regulation as a prerequisite to mutual recognition would make it tantamount to harmonization and defeat its purported benefits. For these reasons, Tafara and Peterson suggest that the assessment is to be made at a more general level, emphasizing similarity of objectives between the systems and comparisons of certain "core" regulatory requirements.[171]

This focus on the objectives and principles formally enshrined in regulation, while necessary, could be substantially improved by developing and using quantitative comparative indicators, such as measures of regulatory resources, enforcement actions, and market outcomes.[172] Thus, Howell Jackson, reviewing the Tafara and Peterson proposal, points out that different countries devote very different amounts of resources to supervisory oversight and that comparability assessments should include consideration of such resources.[173] Indices of enforcement activity, both public and private, may be another important indicator of the intensity of financial regulation. More broadly, Allan Ferrell suggests that regulators consider financial outcomes (such as bid-ask spreads, market liquidity, and World Bank financial sector development indicators) as proxies for the effectiveness of home state regulation.[174] In this respect, the choice of Australia may reflect the SEC's preoccupation with enforcement intensity, as quantitative measures indicate that Australia's "approach to enforcement appears to be at least as aggressive as that of the United States."[175]

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tion at the Crossroads: The Relevance of International Financial Standards in WTO Law, 44 J. World Trade 489, 497 (2010) (arguing that international financial standards are "useful assessment tools for a state claiming the benefit of mutual recognition measures" pursuant to the GATS Annex on Financial Services).

170. Int'l Org. of Sec. Comm'ns, Objectives and Principles of Securities Regulation (2003), *available at* http://www.iosco.org/library/pubdocs/pdf/IOSCOPD154.pdf.

171. *See* Tafara & Peterson, *supra* note 9, at 59–61; *see also* Greene, *supra* note 9, at 90 (arguing that it "must be a 'forest level,' principles-based assessment in order to be successful" rather than an "in the weeds" rule-by-rule examination). The SEC's press release announcing the Australia assessment indicated that the results would be made public, but they do not appear to be available at this point. *See* SEC Press Release 2008-52, *supra* note 131.

172. There is a substantial and growing literature on such quantitative measures. *See, e.g.*, Howell E. Jackson & Mark J. Roe, *Public and Private Enforcement of Securities Laws: Resource-Based Evidence*, 93 J. Fin. Econ. 207 (2009); Howell E. Jackson, *The Impact of Enforcement: A Reflection*, 156 U. Pa. L. Rev. Pennumbra 400 (2008); Howell E. Jackson, *Variation in the Intensity of Financial Regulation: Preliminary Evidence and Potential Implications*, 24 Yale J. on Reg. 253 (2007); Coffee, *supra* note 24.

173. *See* Jackson, *supra* note 9, at 115–16.

174. *See* Sec Roundtable, *supra* note 127; *see also* Wei, *supra* note 23, at 262 (citing a study comparing the impact of IAS versus U.S. GAAP on various market proxies for information asymmetry, such as bid-ask spread, share turnover, analysts forecast dispersion, and IPO underpricing).

175. Coffee, *supra* note 24, at 281. Such quantitative evaluations should, however, take into account the resources devoted specifically to enforcement in cross-border cases. For instance, some research indi-

Thus, as researchers and policymakers develop more sophisticated ways to measure and compare the effectiveness of national regulatory systems, "comparability" assessments may become more reliable and facilitate bilateral mutual recognition. For the time being, however, such comparisons remain rudimentary. To further complicate matters, the data currently available focus on domestic outcomes rather than on the effectiveness of a country's regulatory system in addressing cross-border activities. The latter, though, will matter as much or more to a potential mutual recognition partner. While an effective domestic financial regulatory system is *ceteris paribus* more likely to regulate cross-border activities effectively, many additional variables can affect cross-border outcomes. Differences in market structure and legal environments may mean that regulation that produces successful outcomes in one market will perform inadequately in another. In addition, the SEC's experience indicates that effective cross-border supervision and enforcement under bilateral mutual recognition requires a degree of cooperation between regulators that goes substantially beyond typical bilateral agreements or the IOSCO MMOU. Instead of a largely passive regime where regulators agree to provide enforcement assistance at the other's request, the SEC-Australia Arrangement contemplates a proactive one where regulators share detailed information and consult each other to provide effective joint supervision in "real time."

What do these considerations suggest regarding the choice of potential partners for bilateral mutual recognition agreements? It seems clear that, for this purpose, the United States and Australia relied less on formal comparability assessments than on a more general sense that the other jurisdiction had ample incentives to maintain an adequate regulatory system, both because of their substantial domestic financial markets and the value their firms place on long-term, uninterrupted access to the other jurisdiction. Thus, in designing the Arrangement, the parties focused more on designing enhanced cross-border enforcement and supervision mechanisms than on evaluating the comparability of the other's regulatory system in the abstract or requesting changes to substantive rules.[176] This experience suggests that, while bilateral mutual recognition may circumvent the need for strong institutions, it will likely be workable only between states with very close levels

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cates that U.S. private and public securities enforcement "seldom focuses on foreign issuers." *Id.* at 288, 308.

176. Thus, while the Australian Joint Consultation Paper insists on the importance of enhanced cooperation arrangements for mutual recognition, it refers to the same general definitions of *substantive* regulatory equivalence used for Australia's unilateral recognition provisions (which provide less relief to foreign entities). *See* Joint Consultation Paper, *supra* note 137, at 40, 45, 50. Likewise, while the Australia-New Zealand Agreement obligates each party to ensure that "its securities regulator shall accord complaints from persons in the host country in relation to offers made under the Scheme no lesser priority than similar complaints from persons in the home country in respect of offers made in the home country," it is unclear how breaches of this provision could be effectively sanctioned (other than, in grave circumstances, by termination of the agreement). Australia-New Zealand Agreement, *supra* note 7, art. 7, ¶ 2.

of financial market development, as well as similar regulatory objectives and capacities.

This conclusion is supported by several additional considerations. First, a significant challenge to effective bilateral enforcement is that many regulatory shortcomings—for instance, careless procedures for investigating serious allegations of fraud, such as in the Madoff case,[177] or a dysfunctional supervisor, as in Iceland[178]—will not be easily observable by the other state before catastrophic losses are incurred. Thus, bilateral mutual recognition must by necessity rely on ex post sanctioning rather than on ex ante assessment and monitoring. Such a system, however, will only be an effective deterrent if each participant has a low discount rate so that it does not prefer to exploit access to the other's market to reap short-term gains through lax regulation. Second, the enhanced supervision and enforcement coordination required by mutual recognition presupposes extensive sharing of sensitive information, strong confidentiality provisions, and a high level of trust in the integrity of the other regulator. For that reason, it will be difficult or impossible where the foreign regulator is insufficiently independent, which may be the case in some important emerging markets.[179] Finally, as a practical matter, mutual recognition arrangements require familiarity on the part of participants with the other country's regulators, markets and firms. Therefore, it is more likely to succeed between countries with preexisting financial links and similar legal systems.

B. *Effects*

These considerations suggest that bilateral mutual recognition is only likely to be a viable option between states with comparable levels of economic development and financial regulation.[180] Beyond this, conjectures about its future are bound to be tentative since it remains in its infancy. Nevertheless, the theoretical framework and the case studies suggest answers to several important questions: Is bilateral mutual recognition likely to lead

177. *See* Press Release, SEC Office of Investigations, Investigation of Failure of the SEC to Uncover Bernard Madoff's Ponzi Scheme (Aug. 31, 2009), *available at* http://www.sec.gov/news/studies/2009/oig-509.pdf.

178. In a report released in April 2010, a Special Investigation Commission established by the Althingi, the Icelandic Parliament, found that the Icelandic Financial Supervisory Authority (FME) "was not well enough equipped to sufficiently monitor the financial institutions when they collapsed in the autumn of 2008" and noted severe shortcomings in its supervision of the banks that ultimately failed. *See* Special Investigation Comm'n, Report of the Special Investigation Commission, ch. 21, 98–104 (2010), *available at* http://sic.althingi.is/pdf/RNAvefurKafli21Enska.pdf.

179. Even when the regulator is formally independent, assessing the likelihood that this independence will be scrupulously respected in trying circumstances may require an inquiry into the quality and independence of the foreign country's entire judicial and administrative system. *See, e.g.*, Joint Consultation Paper, *supra* note 137, at 40 (one of the general criteria for equivalence assessments is that "the overall regulatory regime is clear, transparent and certain (including being subject to a reputable rule of law)").

180. *See* Greene, *supra* note 9, at 92 (recommending pilot programs with jurisdictions that "are already known to have philosophically similar regimes and sufficiently comparable regulations").

to substantive regulatory convergence? If it does, will the outcome effectively amount to harmonization, or will the distinctive benefits of mutual recognition be achieved? Finally, are bilateral mutual recognition arrangements likely to expand over time to a larger group of states?

Mutual recognition regimes appear to have motivated regulatory reforms in some cases. Thus, the Vice-Chair of the Ontario Securities Commission stated that the MJDS between the United States and Canada (a precursor of the SEC's mutual recognition program) produced "considerable pressure on Canadian regulators to keep Canadian regulatory standards broadly in line with U.S. regulation to address perceived gaps and generally to minimize relevant differences so as not to jeopardize the continued availability of the MJDS to eligible Canadian issuers."[181] She described reforms undertaken after the adoption of the Sarbanes-Oxley Act in the United States to implement comparable standards in Canada, and specifically to ensure "that our securities regulatory environment remains closely aligned in principle with that in the United States."[182] Likewise, the SEC's decision to delay mutual recognition negotiations with Canada because of the complexity of negotiating with its decentralized network of provincial securities regulators may have contributed to the recently renewed impetus to create a nationwide regulator.[183] In the transatlantic context, there are some examples where, although not part of a formal mutual recognition process, the adoption by Europe of rules requiring equivalent home state regulation led to regulatory reforms in the United States.[184]

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181. Jenah, *supra* note 29, at 78.

182. *Id.*

183. *See* Expert Panel on Sec. Regulation, Final Report and Recommendations (2009), *available at* http://www.expertpanel.ca/eng/documents/Expert_Panel_Final_Report_And_Recommendations.pdf. In a study commissioned by the Panel and annexed to the report, Eric Pan argued that "[t]o the extent that the structure of Canada's financial regulatory system hinders Canada's full participation in . . . international discussions [including mutual recognition negotiations], structural reform should be undertaken to give Canada a stronger and more consistent voice." Eric J. Pan, *Structural Reform of Financial Regulation in Canada*, *in* Expert Panel on Securities Regulation, Final Report and Recommendations, app. 3, at 2 (2009), *available at* http://www.expertpanel.ca/eng/reports/research-studies/index.html; *see also* Press Release, Dep't of Fin. Can., Minister of Finance Announces Launch of Canadian Securities Regulator Transition Office, News Release 2009-064 (June 22, 2009), *available at* http://www.fin.gc.ca/n08/09-064-eng.asp.

184. For instance, Roberta Karmel argues that the threat that the EU might require U.S. companies to reconcile their financial statements to IFRS "proved an important prod to SEC acceptance of IFRS for reporting purposes by foreign issuers." Karmel, *supra* note 22, at 1700. Likewise, in response to the EU's requirement that foreign financial conglomerates be subject to home country supervision "equivalent to that provided for by the provisions of this Directive," the SEC adopted a system of consolidated supervision for U.S. investment banks that were not at that time subject to Federal Reserve oversight. *See* Parliament and Council Directive 2002/87/EC, art.18, 2003 O.J. (L 35) 12. The SEC's "Consolidated Supervised Entity" program, however, failed to prevent the collapse of two major firms, Bear Stearns and Lehman Brothers, and the remaining firms were either consolidated or converted into bank holding companies, leading to the termination of the program. *See* Press Release, U.S. Sec. & Exch. Comm'n, Chairman Cox Announces End of Consolidated Supervised Entities Program (Sept. 26, 2008), *available at* http://www.sec.gov/news/press/2008/2008-230.htm. This experience may well illustrate the limits of the ability of powerful states to induce significant reforms in one another through threats to limit market access.

On the other hand, the comparability assessment between the United States and Australia does not appear to have led to substantive reforms on either side as a prerequisite to the 2008 Mutual Recognition Arrangement.[185] In addition, the examples above relate to mutual recognition arrangements between countries whose regulatory systems were already substantially similar. For the most part, they address concerns relating not to the fundamental adequacy of each country's substantive regulation, but to features—such as technical differences in rules or regional decentralization—that might hinder the enhanced cross-border cooperation required by the bilateral model. These observations appear to confirm the conjecture that bilateral mutual recognition is unlikely to be used as a lever for reform in countries with substantially different rules or regulatory capacies.

These observations are also directly relevant to the second question, namely whether mutual recognition is, at the margin, effectively the same as substantive harmonization. As seen above, one of the theoretical benefits of mutual recognition is that, by opening markets without detailed harmonization, it preserves legitimate differences in regulation and some degree of competition. These benefits may be compromised if the only real strategy for states to assure each other of "comparability" is to harmonize their rules in detail. In Europe, the legislative institutions' massive output of detailed financial regulation suggests that this is a real concern in a multilateral setting.[186] The SEC-Australia Arrangement, however, alleviates this concern in the bilateral context. In that case, two countries with generally comparable levels of financial regulation—but different substantive rules—did not require an extensive, costly, and time-consuming overhaul of their respective regulatory systems to satisfy each other of comparability. As noted above, the concerns related mostly to effective coordination of cross-border enforcement and were addressed through MOUs between regulators without the need for significant domestic legislative changes. More generally, the distinction between mutual recognition and substantive harmonization may be that host states, when considering the risks of allowing foreign market access, will not be concerned with all features of home country regulation but only with those that may have reasonably foreseeable cross-border effects. Also, some regulatory differences—such as details of securities disclosure requirements—can likely be "priced in" by market participants, making closer convergence unnecessary.

Nevertheless, mutual recognition may set in motion competitive forces that promote substantive convergence. Since it allows foreign firms regulated under different systems to access the host state, it will put local firms at a competitive disadvantage if their regulation is more burdensome. As a result, they may demand that domestic standards be relaxed to "level the

185. In response to an e-mail query regarding such changes, ASIC declined to comment. *See* e-mail from Grantly Brown to author, *supra* note 155.

186. *See* Kerber and Van den Bergh, *supra* note 105, at 454–55.

playing field." Thus, some U.S. exchanges expressed concern about the SEC initiative, insisting that the most burdensome aspects of U.S. regulation should be reformed before granting access to foreign exchanges.[187] If regulators comply with such demands, "races to the bottom" might result if market participants have incentives to prefer suboptimal regulation.[188] To prevent this, negotiators should identify differences in national rules that are likely to have significant competitive implications and require sufficient convergence as a prerequisite to mutual recognition.[189]

Finally, a third question is whether bilateral mutual recognition may expand from modest beginnings to encompass more regulatory issues or more countries, thus providing a "bottom-up" alternative to "top-down" international financial regulation through uniform standards. First, mutual recognition may create a "virtuous circle" in which regulatory reforms undertaken to achieve equivalence with a foreign regime facilitate further arrangements with other countries. As seen above, before granting recognition, the host state will want to ensure that the home state's regulation is non-discriminatory and provides adequate protection to its residents. Initially, this may require significant modifications to the home state's regulatory system as discriminatory laws are eliminated, the system is brought up to par with host country demands, and regulators are given the appropriate legal authority, resources and incentives to engage in enhanced cross-border cooperation. After this is done once, reaching agreements with additional host countries should be greatly facilitated. Second, at the domestic level, early mutual recognition arrangements may strengthen exporters and weaken protectionist firms, thus increasing support for further arrangements.[190] Thus, both these arguments suggest that mutual recognition may be self-reinforcing and lead to a "virtuous circle" of liberalization.[191]

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187. Domestic exchanges might request (i) mutual recognition of registration statements (so that foreign securities can be traded in the United States too), and (ii) faster approval process for new products that are easier to set up elsewhere at the moment (e.g. futures, etc.). *See* SEC ROUNDTABLE, *supra* note 127, at 43–45; Letter from Joan Conley, *supra* note 161; *see also* Hal S. Scott, *International Finance: Rule Choices for Global Financial Markets*, *in* RESEARCH HANDBOOK IN INTERNATIONAL ECONOMIC LAW 361 (Andrew T. Guzman & Alan O. Sykes eds., 2007) (describing an analogous phenomenon within the mutual recognition system for European banks).

188. *See* Kerber & Van den Bergh, *supra* note 105, at 455–56.

189. This is, of course, easier said than done, as it supposes that regulators can identify ex ante the areas where regulatory competition is likely to be beneficial or harmful, and in the former case will refrain from imposing excessive conditions on recognition to advance their own interests. This question is beyond the scope of this paper, but the fact that bilateral mutual recognition without extensive prior harmonization or delegated collective rulemaking is being seriously considered in important jurisdictions is cause for some optimism.

190. For analogous argument in the trade context, see HELEN V. MILNER, RESISTING PROTECTIONISM: GLOBAL INDUSTRIES AND THE POLITICS OF INTERNATIONAL TRADE 18 (1988) (arguing that "greater integration of American industries into the international economy [in the post-World War II period] altered domestic actors' preferences and thus forestalled recourse to protectionism").

191. If this is true, mutual recognition may lead over time to de facto multilateral convergence of regulatory standards, thus bolstering the thesis that the objectives pursued by multilateralism are sometimes better achieved through bilateralism. *See* Gabriella Blum, *Bilateralism, Multilateralism, and the Architecture of International Law*, 49 HARV. INT'L L.J. 323, 326 (2008) (arguing that "ideologies and values

The cases studies developed above, however, require significant qualifications to this optimistic scenario. First, they provide scant support for the notion that costs decrease as a country enters into mutual recognition agreements with more partners. While the cases do not provide direct evidence of how institutional costs increase as a function of the number and heterogeneity of members, the absence of significant multilateral mutual recognition arrangements outside Europe suggests that they may increase too rapidly for such arrangements to be efficient.[192] If this conjecture is correct, bilateral arrangements are unlikely to be a precursor of multilateralism. The cost argument, however, may be correct with respect to the substantive areas of regulation covered by a given bilateral arrangement. Assuming sufficient demand, those may expand over time as regulators gain increasing confidence in the quality of each other's supervision and experience in cross-border cooperation.

The European case does provide some support for the second argument, as the implementation of the 1992 mutual recognition regime may have strengthened the hand of larger, export-oriented financial firms throughout Europe and therefore increased support for deeper integration. This effect, however, is hard to separate from the other factors described by Mügge that increased demand for cross-border market access.[193] In the United States, the expectation that the SEC would liberalize cross-border market access for exchanges appears to have been part of the motivation for transatlantic mergers such as NYSE Euronext, which became a strong supporter of mutual recognition. Both the cases, however, also suggest that much of the domestic demand for mutual recognition may be exogenous and that weak demand may hinder arrangements even in "easy" cases, such as the United States and Australia.

C. *Future*

As more countries face the challenge of removing regulatory obstacles to cross-border finance while minimizing the impact on their domestic policy objectives, mutual recognition has begun to attract more attention around the world. While Europe continues to consider mutual recognition with the United States and other third countries, ASEAN has espoused mutual recognition as a cornerstone of regional financial integration. In both cases, mutual recognition would have to function without supranational institutions.

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that are commonly associated with one type of regulation may, in some cases, actually be better served by using the other"); Kene Boun My, Alban Verchere & Stéphane Bertrand, *Does Bilateralism Foster Co-operation in Europe?*, 47 J. COMMON MARKET STUD. 891 (2009) (offering experimental evidence of greater cooperation under a protocol involving parallel bilateral interactions relative to one involving a single decision to cooperate or defect on a multilateral basis).

192. In Europe itself, while the 1992 Program may have laid the groundwork for the more ambitious post-1999 reforms, the entire process relied on Europe's preexisting institutions to supply supranational rulemaking and enforcement capacity.

193. *See* Mügge, *supra* note 69, at 1008–09.

1. *Transatlantic regulatory cooperation*

In addition to Australia and Canada, the other jurisdiction often mentioned as a candidate for mutual recognition with the United States in securities regulation is the EU. As the world's two leading economic powers and most developed financial markets, the United States and the EU could derive substantial gains from deeper financial integration.[194] Transatlantic cooperation, however, has often been difficult and time-consuming. The U.S.-EU Financial Markets Regulatory Dialogue (FMRD), established in 2002, has steered progress in areas such as convergence and recognition of financial reporting standards, auditing regulation and supervision, financial conglomerates, and voluntary delisting of foreign firms from U.S. markets.[195] In April 2007, U.S. and EU leaders adopted the Framework for Advancing Transatlantic Economic Integration that included among its goals mutual recognition in securities regulation.[196] Progress continued in early 2008 with the release of a joint statement by the SEC Chairman and the EU Internal Market Commissioner, declaring that the implementation of mutual recognition would be intensified that year.[197]

As the financial crisis deepened, however, regulators on both sides of the Atlantic turned to more urgent concerns. While, as late as December 2008, the Transatlantic Economic Council "encouraged the parties to conclude this first phase as soon as possible in order to start with the comparability assessment of the U.S. and EU securities regime in 2009,"[198] mutual recognition was not mentioned in the Council's later releases. While this development probably reflects the SEC's recent disinterest, European regulators

194. A 2008 Deutsche Bank Research Report estimated that integration of the U.S. and EU financial markets would reduce trading costs by more than $48 billion per year and raise the volume of securities trading from $21 trillion to $31 trillion per year. Deutsche Bank Research, *EU-US Financial Integration —A Work in Progress*, 8 EU Monitor, June 2008, at 1, 8, *available at* http://www.dbresearch.de/PROD/DBR_INTERNET_DE-PROD/PROD0000000000225963.pdf. These numbers are based on earlier estimates in Benn Steil, Council on Foreign Relations, Building a Transatlantic Securities Market (2002), *available at* http://www.cfr.org/publications/8282/building_a_transatlantic_securities_market.html.

195. *See, e.g.*, European Commission Directorate-General for Trade, *Communication from the Commission to the Council, the European Parliament and the Economic and Social Committee: A Stronger EU-US Partnership and a More Open Market for the 21st Century*, at 9, COM (2005) 196 final (May 18, 2005); Kern Alexander et al., *Transatlantic Financial Services Regulatory Dialogue*, 7 Eur. Bus. Org. L. Rev. 647 (2006).

196. More specifically, Annex 6 on financial markets stated the relevant goal as: "Work on greater regulatory convergence toward highest quality and most effective regulation and, where appropriate, mutual recognition in the fields of securities regulation." Framework for Advancing Transatlantic Economic Integration, U.S.-EU, Annex 6, Apr. 30, 2007, *available at* http://www.eeas.europa.eu/us/docs/framework_trans_economic_integration07_en.pdf. The Framework also provided for the establishment of a Transatlantic Economic Council to oversee regulatory cooperation efforts, but recognized that "the Financial Markets Regulatory Dialogue will continue its own, separate, work program described in Annex 6, and updating the Council on its progress as appropriate." *Id.* at Annex 1.

197. *See* SEC Press Release 2008–9, *supra* note 129.

198. Transatlantic Economic Council, Review of the Progress Under the Framework for Advancing Transatlantic Economic Integration Between the United States and the European Union, Annex 1 (2008), *available at* http://ec.europa.eu/enterprise/policies/international/files/progress_report_tec_iii.pdf.

continue to explore potential mutual recognition initiatives. In June 2009, CESR released a "call for evidence" on potential mutual recognition with non-EU jurisdictions. While recognizing that progress with the United States had been "delayed," CESR expressed hope that it would soon be continued and, in any event, its intention to investigate mutual recognition with other countries.[199] The Call for Evidence focused on three potential substantive areas (trading venues, intermediaries and products) and solicited comments from market participants to assist in prioritization. More recently, CESR has concentrated on its transition to the new European Financial Markets Authority, but mutual recognition remains on its agenda.[200]

What are the implications of the analysis above on the potential for mutual recognition between the EU and third countries? First, unlike mutual recognition within the Union itself, such arrangements cannot rely on monitoring and enforcement by supranational institutions and are therefore more likely to resemble the SEC's bilateral program. In that context, a significant challenge will be to satisfy other jurisdictions that regulation and supervision are sufficiently uniform throughout Europe,[201] as recent crises such as in Iceland and Greece cast doubt on the reliability of implementation of EU rules. In addition, primary responsibility for supervision and enforcement remains with member states, whose regulatory resources and capacities vary substantially.[202] In this decentralized system, implementing the kind of enhanced cross-border supervision and enforcement that was pivotal to the SEC-Australia Arrangement may be difficult, especially in light of the Commission's stance against bilateral arrangements between individual member states and third countries.[203] This being said, the EU institutions in recent years have prioritized improving national implementation and supervision, and extreme breakdowns such as Iceland and Greece may not be representative. In addition, these issues may be less acute in some areas than others—for instance, compliance by an issuer with EU prospectus rules may be easier for host states to verify than the quality of supervision of financial intermediaries. Finally, certain jurisdictions—especially financial centers with small domestic markets—may value access to European markets sufficiently to overlook the inevitable shortcomings.

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199. *See* Call for Evidence, *supra* note 6, at 3.

200. In a May 2010 article, Eddy Wymeersch, chairman of CESR, stated that "[o]ne can expect these discussions to be resumed once the crisis has subsided: mutual recognition is indispensable in today's intertwined financial world, but presupposes a sufficient degree of confidence in the effectiveness of each other's supervisory systems . . . The issue of *mutual recognition* with third states continues to be on the table of the CESR, coordinating the action of its members in their dealings with these jurisdictions." Eddy Wymeersch, *Global and Regional Financial Regulation: The Viewpoint of a European Securities Regulator*, 1 Global Policy 201, 203 (2010).

201. This question is raised in Alexander et al., *supra* note 195, at 665–66; *see also* Deutsche Bank Research, *supra* note 194, at 17.

202. *See* Howell E. Jackson, *The Impact of Enforcement: A Reflection*, 156 U. Pa. L. Rev. 400, 406–407 (2008); Howell E. Jackson, *Variation in the Intensity of Financial Regulation: Preliminary Evidence and Potential Implications*, 24 Yale J. Reg. 253, 255 (2007).

203. *See* Schammo, *supra* note 165, at 858.

Second, an important factor for the success of mutual recognition is the existence of demand from market participants. In this regard, CESR's view that prioritization "should be reached on the basis of a microeconomic analysis of benefits arising from integration" and that "input from market participants is essential in the various steps of the work" is judicious.[204] For example, tax and distribution networks may be much more significant obstacles to cross-border sales of collective investment schemes than regulatory requirements.[205] Also, CESR's apparent willingness to provide exemptive relief to individual foreign firms may undermine support by such firms for mutual recognition with Europe. On the other hand, transatlantic exchange mergers may create greater opportunities and demand for regulatory cooperation. The comments received by CESR indicate significant interest in mutual recognition by market participants in several areas.[206] CESR has also clarified that consideration will be limited to "other important third countries with comparable high regulatory standards."[207]

Finally, in the aftermath of the global financial crisis, transatlantic mutual recognition should no longer be seen solely as a market liberalization initiative, but as a means to maintain the openness of international financial markets as the United States and the EU concurrently ramp up their regulation of the financial industry. Despite international efforts to coordinate regulatory reforms, new U.S. and European rules will in many areas not be identical, and the discrepancies may create substantial new obstacles to cross-border financial activity. This would be an unwelcome development, as it would contradict the Group of 20's objective to avoid protectionism and new restraints on international financial flows.[208] In several areas, the Dodd-Frank Act requires U.S. regulators to assess and take into account the existence of adequate home state regulation.[209] Europe has also turned to equivalence determinations with respect to credit rating agencies and finan-

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204. Call for Evidence, *supra* note 6, at 3.

205. *See, e.g.*, Comment letter from Pierre Bollon, Chief Executive, AFG, to Carlo Comporti, Secretary General, CESR (Dec. 23, 2009); Comment letter from Peter DeProft, Director General, EFAMA, to CESR (Aug. 16, 2010). As Scott points out, the U.S. tax regime for mutual funds would likely prevent cost-effective access by foreign funds to U.S. investors even if they were exempted from U.S. regulation. *See* Scott, *supra* note 30, at 807–10.

206. The comments received from industry groups, banks, intermediaries and exchanges were generally positive. Responses to *Call for Evidence on Mutual Recognition with Non-EU Jurisdictions*, CESR, http://www.cesr-eu.org/index.php?page=responses&id=139 (last visited Nov. 7, 2010).

207. Call for Evidence, *supra* note 6, at 3. Comments from various market participants revealed interest in mutual recognition with Asian jurisdictions, Switzerland and Australia, among others.

208. *See, e.g.*, Grp. of 20, *supra* note 3, at 19 ("We will not retreat into financial protectionism, particularly measures that constrain worldwide capital flows, especially to developing countries.").

209. *See, e.g.*, Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111–203, §§ 113(b)(2)(H), 115(b)(2)(B), 121(d), 165(b)(2) (2010). Other provisions of the Act that direct U.S. regulators to take into account home country regulation or to engage in international cooperation include those dealing with: access by foreign banks and broker-dealers to U.S. markets; foreign derivatives clearing organizations, swap execution facilities, boards of trade and clearing agencies; international harmonization of swap regulation; and international cooperation relating to bankruptcy of nonbank financial institutions.

cial reporting standards.[210] European proposals for a new directive on alternative investment funds, however, have raised concerns that the rules imposed on foreign funds may substantially restrict market access.[211] To what extent, if any, U.S. regulators will turn to a form of mutual recognition when implementing the Dodd-Frank Act, and which trend will prevail in Europe, remain to be seen.

2. *Toward mutual recognition in Southeast Asia?*

Mutual recognition also has considerable appeal beyond the United States and Europe, as illustrated by ASEAN's recent efforts to accelerate financial market integration among its member states. In 2007, ASEAN leaders adopted a new Charter aimed at enhancing regional cooperation and integration, notably through the establishment of an ASEAN Economic Community ("AEC").[212] To this end, they also adopted a "Blueprint" detailing an ambitious program to create a common market in goods, services and capital within the AEC by 2015.[213] Among the many objectives outlined by the Blueprint are to strengthen regional capital market development and integration, by harmonizing standards and establishing mutual recognition arrangements.[214]

Within this framework, the ACMF, composed of securities regulators from the ten member states, adopted in 2009 an implementation plan whose "core strategy for regional integration is to develop a mutual recognition process with gradually expanding scope and country coverage."[215] The Plan contemplates mutual recognition in several areas, including primary offerings, financial intermediaries, market professionals, collective investment schemes, and securities exchanges.[216] While the Plan is in the earliest stages of implementation, it is worth considering the implications of the European and U.S. experiences for mutual recognition within ASEAN.

The most striking difference between ASEAN and the EU is that even after the adoption of the Charter, the former has a much weaker institutional framework to support its economic integration program. ASEAN does not

210. *See* Commission Regulation (EC) No 1569/2007 of 21 December 2007 Establishing a Mechanism for the Determination of Equivalence of Accounting Standards Applied by Third Country Issuers of Securities Pursuant to Directives 2003/71/EC and 2004/109/EC of the European Parliament and of the Council, 2007 O.J. (L 340/66); Regulation (EC) No 1060/2009 of the European Parliament and of the Council of 16 September 2009 on Credit Rating Agencies, art. 5, 2009 O.J. (L 302/1).

211. *See, e.g.*, Martin Arnold, Sam Jones and Nikki Tait, *Geithner Warns of Rift over Regulation*, Fin. Times, Mar. 10, 2010.

212. *See* Charter of the Association of Southeast Asian Nations, Nov. 20, 2007, *available at* http://www.aseansec.org/21069.pdf. The member states of ASEAN are Brunei Darussalam, Cambodia, Indonesia, Laos, Malaysia, Myanmar, the Philippines, Singapore, Thailand, and Vietnam.

213. *See* ASEAN Economic Community Blueprint (2007), *available at* http://www.aseansec.org/21083.pdf.

214. *Id.* at 16–17.

215. Implementation Plan, *supra* note 8, at 7.

216. *See id.* at 17, 21–24.

possess centralized rulemaking, judicial or administrative bodies comparable to the European institutions, and indeed prides itself on its consensus-based process and respect for the sovereignty of its member states.[217] As a result, the ACMF must essentially rely on the goodwill and voluntary participation of each of its members to implement mutual recognition and harmonization initiatives. Despite ASEAN's ambitious statements regarding the AEC, its mutual recognition initiatives will likely be closer to the SEC's bilateral model than to the European common market.

Another important lesson from the U.S. and European experiences is that the success of mutual recognition is contingent on market demand factors that are often outside the control of policymakers. The Plan indicates that the ACMF is well aware of this constraint and of the need to carefully identify and prioritize the areas where regulatory relief would be most valuable to the private sector.[218] One of the first steps outlined is for regulators to "canvass leading market intermediaries in their home countries to obtain views on the demand for cross border products and services and identify a list of sequenced initiatives for cross-border recognition."[219] The ACMF also notes that several other obstacles hinder cross-border financial transactions within ASEAN, including the lack of tax harmonization and the imposition of capital controls by some member states.[220] While these obstacles are outside the ACMF's purview, it correctly notes that mutual recognition will bring limited benefits as long as they persist.

These considerations—particularly the persistence of capital controls in some member states—point to a more fundamental obstacle to effective ASEAN financial integration. There is wide disparity among the member states in financial market and regulatory development—not to mention political and economic systems.[221] Taking into consideration this diversity and the lack of strong institutions, the ACMF has articulated its strategy for financial integration around several prongs. First, as mentioned above, despite ASEAN's multilateral character, mutual recognition "should be imple-

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217. This is sometimes referred to as the "ASEAN Way." *See* Daniel Seah, *The ASEAN Charter*, 58 INT'L. & COMP. L.Q. 197, 198–99 (2009). As Seah points out, "the Charter has been carefully drafted to preserve the sovereignty of each member State as the ultimate source of authority that enacts and enforces laws within their territorially defined units." *Id.* at 202.

218. *See* Implementation Plan, *supra* note 8, at 8 ("The initiatives should begin with products, services and activities that are consistent with market preferences, likely to add most value to capital market development within ASEAN and/or are easy to implement. Taking regulatory action to facilitate cross-border transactions is not sufficient to promote regional integration unless the action generates increased private sector cross-border activities.").

219. *Id.* at 20.

220. *Id.* at ii.

221. GDPs per capita in 2008 at current prices in U.S. dollars range from $479 (Myanmar) to $40,326 (Singapore). IMF WORLD ECONOMIC OUTLOOK DATABASE (April 2010), http://www.imf.org/external/pubs/ft/weo/2010/01/weodata/weoselgr.aspx. While the most advanced economies within ASEAN (e.g., Singapore, Malaysia, Thailand) have large and active financial markets and well-established regulators, those in the least developed countries (e.g., Cambodia, Laos, Myanmar) are in their infancy. Likewise, political systems in member states include democracies, single-party states, and military rule.

mented *bilaterally first and then multilaterally* as other countries become ready to join in."[222] This approach is illustrated by the most notable achievement to date under the Implementation Plan, namely the adoption in June 2009 of the "ASEAN and Plus" scheme by Malaysia, Singapore and Thailand.[223] Under this scheme, offers of equity and debt in the three countries will be possible by complying with a single set of ASEAN common disclosure standards. The "Plus" refers to additional requirements imposed by host states, which the ACMF will encourage them to reduce or eliminate over time. Thus, although this particular initiative uses harmonization rather than mutual recognition, it illustrates the progress that can be achieved by restricting participation, at least at the outset, to the most developed markets within ASEAN.

The ACMF's strategy toward the other ASEAN members includes other prongs aimed at fostering market and regulatory development as a prerequisite for integration. As mentioned above, the Forum will encourage finance ministers and other government actors to liberalize capital account restrictions and reform the taxation of cross-border transactions. It will also promote several initiatives to develop financial infrastructure and establish alliances and linkages among trading and settlement systems in the region. Finally, it will strengthen cooperation and monitoring capabilities by establishing a Financial Integration Division within the ASEAN Secretariat, with a dedicated team to monitor and report on the progress of capital market integration.[224]

The ACMF's multi-pronged approach combines mutual integration and harmonization among the more mature markets with capacity-building and infrastructure development in the others. The ACMF explicitly contrasts its approach with Europe's, stating that instead of focusing on "*full harmonization of domestic laws, regulations and operations* . . . supported by mutual recognition in any sectors that are not subject to harmonization," it intends "*to create enabling conditions for access with broad harmonization, and supported by mutual recognition* and a greater freedom for capital movements."[225] The ACMF's program recognizes that ASEAN, as a multilateral association with EU-like ambitions but much weaker institutions and more disparate levels of development, cannot immediately follow Europe's lead. Instead, it contemplates a series of bilateral or small-scale agreements among a subset of members, along lines similar to the SEC program. Understood in that way, the ACMF's approach is sensible. This being said, how much can be accomplished by 2015 remains to be seen. More time will likely be required, especially to develop effective cross-border supervision and enforcement.

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222. Implementation Plan, *supra* note 8, at 9.

223. *See* Press Release, ASEAN Capital Markets Forum, Malaysia, Singapore and Thailand Implement the ASEAN and Plus Standards Scheme (June 12, 2009), *available at* http://www.asean-society.org/asean/press-release-malaysia-singapore-and-thailand-implement-the/.

224. *See* Implementation Plan, *supra* note 8, at 16.

225. *Id.* at 2 (emphasis added).

IV. Conclusion

This Article argued that, while mutual recognition can function in both multilateral and bilateral settings, the relevant institutional solutions differ significantly. The multilateral model illustrated by Europe relies on substantial delegation to collective institutions, multiple cross-issue linkages, and political mechanisms as checks on delegation. The bilateral model illustrated by the SEC-Australia Arrangement, for its part, relies on limited membership, bilateral monitoring and enforcement, and limited duration and renegotiation clauses. The costs of establishing and maintaining the collective institutions required by multilateral mutual recognition, however, make it unlikely to provide a practicable model outside Europe. For this reason, future mutual recognition efforts—even those that are embedded in a multilateral framework like ASEAN—are more likely to resemble the SEC's bilateral program than the European common market.

Thus, even though its own future is uncertain, the SEC-Australia Arrangement is an important precedent. Such bilateral arrangements, however, will likely be feasible only between countries with well-developed financial markets, similar regulatory objectives, and close levels of supervision and enforcement capacity. Regulators will also need to carefully assess the demand by firms for reciprocal market access, as it may be affected by many factors beyond their control. Bilateral mutual recognition will also require enhanced cross-border supervision and enforcement cooperation, beyond what it provided in existing instruments like the IOSCO MMOU. Finally, it is unlikely to be effective where the primary objective of one country is to improve regulatory standards in another.

Although they remain in their very early stages, mutual recognition initiatives within ASEAN and between Europe and third countries reflect many of these lessons. Beyond these considerations, the framework presented here also suggests that mutual recognition arrangements outside Europe are likely to lead only to limited substantive convergence and are unlikely to expand gradually toward multilateralism. To the extent that they are successful, therefore, their main policy benefit will be market liberalization between participating jurisdictions through the removal of obstacles to cross-border finance, rather than substantive improvement of regulation around the world.

While these conclusions suggest that the United States would benefit from reviving the SEC's mutual recognition program, they also have broader implications for international financial regulation. For instance, they suggest that smaller states, such as developing countries and offshore financial centers, are unlikely to join mutual recognition arrangements that would require costly reforms. Therefore, powerful states are likely to continue to exercise pressure on them through other means, such as encouraging the IMF and the World Bank to monitor the implementation of international

standards and demanding reforms in offshore financial centers through clubs like the Organization for Economic Cooperation and Development and the Financial Action Task Force. The largest markets will also likely continue to exercise bilateral pressure, as illustrated by recent U.S. efforts to compel Swiss banks to release information to the Internal Revenue Service. At the multilateral level, universal standards and best practices prepared by TRNs and steered by the G-20 and the Financial Stability Board will remain an important element of international financial regulation, especially in addressing coordination problems where their lack of monitoring and enforcement capabilities is not a significant obstacle to compliance.[226]

Whether these coexisting and sometimes competing approaches add up to an effective system of international regulation remains to be seen, especially in light of the many international regulatory spillovers revealed by the global financial crisis. Rationalist international law theory suggests that states have, at each level, designed agreements so as to optimize the benefits of controlling such externalities against the cost of institutions to improve compliance.[227] Given, however, the costs and delays involved in creating international rules and institutions, the rapid technological and policy changes that have fueled financial innovation and international integration in recent years, and profound uncertainties and disagreements on financial regulation, more research is needed to determine whether the current governance framework can adequately address the international externalities associated with financial regulatory failures.

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226. *See* Verdier, *supra* note 1.

227. *See, e.g.*, Guzman, *supra* note 44, at 132–33.