WHY DO SOME NETWORKS FAIL AND OTHERS SUCCEED? A CASE STUDY IN FINANCIAL REGULATION

Draft for Georgia Law School Workshop 2/19/09

David Zaring[*]

I. INTRODUCTION

The first commissioners of the SEC gave their speeches in the United States, concentrated on American stock exchanges, and evaluated the disclosures of American companies. As Commissioner James Landis said of the securities laws in 1933, "the public interest and the protection of investors must be the guiding consideration" for an agency that was needed because "some groups of persons associated with security flotations are not induced to refrain from material nondisclosure by fear either of the very real liability for compensatory damages at common law or fear of prosecution under the criminal law."[1]

Today, the SEC's mission is the same, but both the investors and the security flotations are as likely to be found overseas as they are in the United States. American gross trading activity in foreign securities is $7.5 trillion, up from $53 billion three decades ago.[2] Approximately two-thirds of American investors own securities of non-U.S. companies – a 30% increase from just five years ago.[3] And foreign trading activity in U.S. securities now amounts to over $33 trillion.[4] Recently, globalization has been blamed for the exposure of a number of European financial institutions to securitized American subprime mortgages, and to an American bank that failed because of them.

The impact of this globalization on the regulators who oversee American markets has been enormous. Instead of exclusively spending their time in the United States, in 2007, the SEC commissioners gave speeches in Sydney (twice), Madrid (twice), Mumbai, London (thrice), Dublin, Berlin, Frankfurt, Paris (twice), Munich, Luxemburg, Cape Town, Vancouver, Brisbane, and Tokyo (thrice).[5] Former SEC Chair Christopher Cox reports that international work now "comprises over half of my time

---

[*] Assistant Professor, Wharton School of Business. Thanks to __, and in particular to Chris Brummer, who is the source of many of the insights in the draft so far.

[1] James M. Landis, The Securities Act of 1933, Address before New York State Society of Certified Public Accountants (October 30 1933)

[2] Christopher Cox, International Business — An SEC Perspective, Address to the American Institute of Certified Public Accountants' International Issues Conference (January 10 2008)

[3] *Id*.

[4] *Id.*

[5] The analysis was concluded by visiting the agency's website, which admirably keeps track of every speech by SEC Commissioners. *See* http://www.sec.gov/news/speech/speechartchive/2007speech.shtml#chair

and responsibilities."[6] In his view, "it is no longer possible for the SEC to do its work in the United States without a truly global strategy… what goes on in other markets and jurisdictions is now intimately bound up with what happens here."[7]

That the global strategy of the agency is new is exemplified by the SEC's international affairs office, which was founded in 1989, some 56 years after the creation of the agency. The office has quickly become a central outfit for the formulation of regulatory policy.[8] Its employees spend thirty percent of their time on what Ethiopis Tafarris, its director, calls "international regulatory policy," or "representing this agency in international organizations that are developing principles, standards, papers, best practices intended to have some application in the securities market" and "looking at the impact of SEC rulemaking beyond the borders of the United States and informing and advising the Commission and staff of that impact, identifying areas where we might be creating some conflict of law, and identifying ways to mitigate conflict if at all possible."[9]

All of this international activity has come in the wake of a recognition by the SEC that the global markets have created unprecedented international challenges. Capital can leave a regulatory jurisdiction, but the regulators trying to attract it or insure that it complies with local laws are less mobile. Also, the SEC is facing a future with many more competitors, both in formal and informal financial sectors. Moreover, these competitors do not only offer an alternative to the American regulatory frameworks, they interfere with it, with regulations of increasingly extraterritorial import.[10] Finally, even the basics of the job of supervision are more difficult. There is a new speed to financial transactions that makes the monitoring of those transactions extremely difficult. And regulated industry has increasingly adopted complex and sophisticated ways of managing their balance sheets to that both exploits regulatory arbitrage and taxes the abilities of the regulators to keep up with the financial innovations. Anne-Marie Slaughter calls this an "ineffectiveness challenge," whereby control over a discrete territory alone cannot result in effective economic

---

[6] Christopher Cox, International Business — An SEC Perspective, Address to the American Institute of Certified Public Accountants' International Issues Conference (January 10 2008).

[7] Christopher Cox, *The SEC Speaks 2008*, available at http://www.knowledgemosaic.com/Gateway/Rules/SP.spch020808cc.020808.htm.

[8] Peter E. Millspaugh, *Global Securities Trading: The Question of a Watchdog,* 26 GEO. WASH. J. INTL L. L & ECON 355, 364 (1992); s*ee also* Michael D. Mann & William P. Barry, *Developments in the Internalization of Securities Enforcement*, 39 INT'L LAW. 667, 670 (2005).

[9] Interview by Wayne Carroll with Ethiopis Tafara, Assistant Director, SEC Office of International Affairs (April 9, 2006)

[10] For example, the European Union has imposed substantial fines on Microsoft, an American company, for conduct that American antitrust regulators found consistent with its own antitrust laws and regulations. Various of the opinions and other resources in the lengthy EU litigation may be found at http://ec.europa.eu/comm/competition/antitrust/cases/index/by_nr_75.html#i37_792.

governance when domestic markets become intertwined with foreign ones.[11]

But amidst all these problems, there may be an international solution. American federal regulators have addressed these daunting global developments by interacting with their counterparts abroad, and try to develop a multilateral regulatory regime of global scope. And they have done so in substantial numbers, through mechanisms that international lawyers have come to think of as networks. As Anne-Marie Slaughter has put it, these networks exhibit "pattern[s] of regular and purposive relations among like government units working across the borders that divide countries from one another and that demarcate the 'domestic' from the 'international' sphere."[12]

As the network form has developed and spread, the regulatory network has become an important tool in the arsenal of international regulation – perhaps even the primary such tool, and at any rate, a worthy alternative to either unilateralism or more institutionalized, and, perhaps, judicialized, forms of international administration.[13]

The SEC "has pursued [its] goals through a variety of international multilateral and bilateral fora, including the International Organization of Securities Commissions (IOSCO), a bilateral dialogue with the Committee of European Securities Regulators, and with fellow securities regulators" on a number of issues, including the "holy grail" issue of standardization of accounting practices.[14] All of these institutions are networks. They are not formal international organizations, created by treaty and governed by traditional principles of international law. Instead, they are informal organizations that are not hierarchical, open, or entrusted with carefully limited responsibilities and that work through collaboration and, in theory, mutual agreement.

Nor is the SEC alone in turning to an international network of similarly situated regulators to address global regulatory problems. After the agency failed to develop accounting standards through its international regulatory network, a different network, the International Accounting Standards Board, developed those standards – which the SEC has since appeared to grudgingly adopt.[15] Many other agencies have turned to regulatory networks to help them deal with their newly global problems.[16]

---

[11] Anne-Marie Slaughter, *Sovereignty and Power in a Networked World Order*, 40 STAN. INT'L L.J. 283, 284 (2004).

[12] ANNE-MARIE SLAUGHTER, A NEW WORLD ORDER 14 (2004)

[13] David Zaring, *Choice of Policymaking Form in International Law,* 45 COLUM. J. TRANS. L. ___ (forthcoming 2009).

[14] James Hewitt & Michael White Testimony before Congress, October 24 2007, available at http://www.sec.gov/news/testimony/2007/ts102407cwh-jww.htm.

[15] See infra notes __ and accompanying text.

[16] See infra notes __ and accompanying text.

Indeed, because of these facts on the ground, academics have long claimed the importance and centrality of "networks" in the regulation of international economic law. The problem is that some of these networks work well, while others do not.

Theorists have not been able to explain why some networks fail and others succeed. I try to do so in this paper by looking at the SEC's international efforts, particularly its efforts with regard to two networks.

The reason for the difference is because not all networks – and especially not the networks set up by regulators to solve the problems of the globalizing world – are the same. They differ in their origins, by the environment in which they operate, on their goals, and in their size and shape.

This does not mean that they cannot be usefully theorized. Some networks develop legal standards via soft institutional strictures by which compliance is facilitated through familiarity and positive incentives. They offer club goods as benefits, are informal, and offer easy ways in and out. Social scientists call these sorts of networks "social networks." The SEC has created one such network in IOSCO.[17]

Other networks are more likely to create hard rules through connections that incentivize compliance through lock-ins and penalize non-compliance with a range of negative externalities. They offer similar goods as benefits – the club goods of access to the network, but also real costs for exit. These networks look like telephone or utilities monopolies, and like these monopolies, they are difficult to build, but, once built, hard to leave. I think that networks that offer both the benefits of network membership, and the costs of exit from – or noncompliance with – the network approach to regulation are the most likely to be successful ones. These sorts of networks have been described as economic networks. It appears that a network the SEC has eschewed – on accounting standards – has managed this process.

All of this is directed more at the effectiveness, rather than the normative desirability of networks. Other scholars have weighed in on that normative question, and I see no need to revisit those arguments here. Networks, regardless of their normative goodness or badness, are a fact on the ground. And as such, they are worth assessing for how they actually work, as well as in what they may portend. Moreover, if we know a bit more about the impact of networks, we might be able to draw less speculative conclusions about whether to embrace or fear them.

Consider, again, the case of securities regulation. A regulatory network like IOSCO might be expected to address common approaches to supervision, harmonized reporting requirements, and a systemic approach to

[17] I attribute this insight to Chris Brummer.

information-sharing among regulations. But, so far, it is only the last of these that it has been able to pursue successfully. Its efforts to harmonize the supervisory efforts of securities regulators have foundered on gauzy unspecificities that it calls "core principles" of securities regulation. It has not yet harmonized reporting requirements, or accounting standards that would be issuers could use whether they want to list in New York, Stockholm, or Hong Kong. It is only with information-sharing commitments – and promises of future cooperation can be problematic in their own right – that the institution can claim success. And the recent financial crisis has created an incentive to act that, so far, the securities network has not availed itself of.

It has had to leave accounting harmonization to the International Accounting Standards Board, a smaller, tight outfit that devised its standards more exclusively than has IOSCO. IASB's accounting standards have roiled the world of listings, including, the SEC has finally decided, those listings in the United States.[18] IASB has some of the hallmarks of more economic networks, where exit is unthinkable, and, accordingly, more comprehensive international harmonization is possible.

The opportunities for regulatory networks, so apparent here, have been difficult for the SEC to realize. In what follows, I investigate why.

II. Globalization And Network Theory

Networks began as a practice without a theory. Although informal international relationships increasingly occupied the time of domestic regulators, who were reaching out to their counterparts abroad in an effort to design solutions to international problems that did not require the pomp, rigmarole, and high transaction costs of the treaty process, legal scholars tended not to notice.[19] For international lawyers, the formal practice of states – the treaties and legal interpretations that they announced as binding as a matter of customary international law – were the only relevant sources of law at all.[20]

Political scientists had similar blinders on. Although some international relations theorists devised an optic of "transgovernmentalism," which focused on the increasing degree of international interaction of state

[18] *See infra* notes __ and accompanying text.

[19] Since then, scholars have increasingly tried to organize the various ways that informal international institutions might develop. Stavros Gadinis thinks that the form of cooperation (or not) will depend upon the comparative sizes of the regulateds; whether there is a hegemon or no, and so on. *See* Starvos Gadinis, *The Politics of Competition in International Financial Regulation,* 49 HARV. J. INT'L L. 243 (2008).

[20] And so, for example, the Restatement (Third) of the Foreign Relations Law of the United States. suggests that an international organization "is created by an international agreement and has a membership consisting entirely or principally of states" sec. 221, and that "statehood . . . is generally a minimum qualification for membership in international organizations." § 222 cmt. a

actors outside the traditional diplomatic process, most eschewed the option.[21] To the majority, the state remained the unit level of the international system, with interests that could be discerned and predicted without looking within its borders.[22] Accordingly, as a panoply of other domestic bureaucrats began to turn abroad to do the sorts of things that they could not do domestically, a new explanation of the new range of international interaction was required.

This explanation came with network theory. Networks, the theorists have posited, allow domestic officials to interact with their foreign counterparts directly, without much supervision by foreign offices or senior executive branch officials, and feature "loosely-structured, peer-to-peer ties developed through frequent interaction rather than formal negotiation."[23]

The evolution of regulatory networks may be charted by tracking the way the scholarship on those networks has changed. In the early years of network analysis, scholars – myself included – were impressed at how widespread and vibrant this tool of international governance appeared to be.[24] Networks were popping up everywhere, in financial regulation especially, but also in transportation, antitrust, consumer protection, and other areas where there were global spillovers and externalities, but no organized global response.[25] The impulse was to count the number of institutions, marvel at their number, and note how different they were from traditional international law. And they were indeed different; the regulatory networks were created and operated by agencies and not by heads of state, foreign ministers, and diplomats, and they had none of the formality of traditional international legal instruments like treaties.

---

[21] *See, e.g.* TRANSNATIONAL RELATIONS AND WORLD POLITICS. (ROBERT KEOHANE AND JOSEPH NYE, EDS. 1974). For a history of transgovernmentalism, see Anne-Marie Slaughter, *The Accountability Of Government Networks*, 8 INDIANA J. GLOBAL LEGAL STUD. 347, 350—55 (2001).

[22] *See, e.g.,* ROBERT O. KEOHANE, INTERNATIONAL INSTITUTIONS AND STATE POWER: ESSAYS IN INTERNATIONAL RELATIONS THEORY 17 n.5 (1989) (defining regimes as "institutions with explicit rules, negotiated by states" and Robert O. Keohane, *Theory of World Politics: Structural Realism and Beyond*, in NEOREALISM AND ITS CRITICS 158, 193 (ROBERT O. KEOHANE ED., 1986). (retaining states as "the principal actors in world politics"); G. Richard Shell, *Trade Legalism and International Relations Theory: An Analysis of the World Trade Organization*, 44 DUKE L.J. 829, 835 (1995). ("[r]egime theory assumes that states are the primary actors in the international system and that states are motivated to achieve a set of . . . self-interested goals.")

[23] Kal Raustiala, *The Architecture Of International Cooperation: Transgovernmental Networks And The Future Of International Law* 43 VA. J. INT'L L. 1, (2002).; see also Risse-Kappen 1995).

[24] *See* David Zaring, *International Law by Other Means: The Twilight Existence of International Financial Regulatory Organizations,*33 TEX. INT'L L.J. 281 (1998).

[25] For examples and analysis of these networks in antitrust cooperation, see Eleanor M. Fox, *Antitrust and Regulatory Federalism: Races Up, Down, and Sideways*, 75 N.Y.U. L. REV. 1781, 1785–87, 1802–07 (2000); Anu Piilola, *Assessing Theories of Global Governance: A Case Study of International Antitrust Regulation*, 39 STAN. J. INT'L L. 207 (2003). For network and other impacts on the ownership of plant genetic resources, see Kal Raustiala and David G. Victor, *The Regime Complex for Plant Genetic Resources*, 58 INT'L ORG. 277 (2004*). See also* Joseph G. Contrera, *The Food and Drug Administration and the International Conference on Harmonization: How Harmonized Will International Pharmaceutical Regulations Become?*, 8 ADMIN. L. J. AM. U. 927 (1995) ((food and drug harmonization); George A. Bermann, *Regulatory Cooperation with Counterpart Agencies Abroad: The FAA's Aircraft Certification Experience*, 24 L. & POL'Y IN INT'L BUS. 669, 774 (1993) (aircraft certification harmonization). And of course this list is a very partial one.

But as they evolved, networks have often adopted the trappings of traditional domestic administrative law. Like domestic regulators, international networks which started out sometimes in bars in Switzerland,[26] among financial and other sorts of regulators of like mind but with little attentiveness to procedure,[27] have evolved into something that increasingly requires notice, comment, and opportunity to respond. A remarkable example of this lies in the contrast between the first Basel Accord on capital adequacy which was concluded in secret in by the Basel Committee on Banking Supervision in 1988 and released in a twelve page document, and the second one ("Basel II"), which was put through most of a decade's worth of comment by hundreds of interested individuals and institutions, and resulted in a corresponding long and detailed regulatory product.[28] IOSCO has similarly opened its deliberations to this sort of ventilation by interested and affected parties; so have other networks. The resulting process in these cases is one that would be familiar to American lawyers accustomed to domestic rule-making.

The network account has become a settled way to explain important mechanisms of international cooperation.

But when do they work, and work best? Some network based standards have enjoyed wider compliance than have others. Export credit agencies, for example, have created their own regulatory scheme that has enjoyed wide adherence at a low cost, as Janet Koven Levit has demonstrated in a series of articles.[29] And in financial regulation, the Basel Committee has been able to claim a remarkable record of international compliance with its capital adequacy requirements, as David Zaring and others have documented,[30] while IOSCO has not yet been able to develop a comparable set of international standards.[31]

Some have cautiously suggested that networks as less likely to be *as* effective as formal international cooperation,[32] or that, more generally, international efforts closely controlled by states are more likely to work

[26] Janet Koven Levitt, Int'l Law. Speech (forthcoming 2009).

[27] *See* Zaring, supra note 24 for a discussion of the early procedural informality of these networks

[28] David Zaring, *Informal Procedure, Hard and Soft, in International Administration*, 5 CHI. INT'L L.J. 547, 572-80 (2005).

[29] *See* Janet Koven Levit, *Bottom-Up Lawmaking Through a Pluralist Lens: The ICC Banking Commission and the Transnational Regulation of Letters of Credit*, 58 EMORY L.J. ___ (forthcoming 2008); *A Bottom-Up Approach to International Lawmaking: The Tale of Three Trade Finance Instruments*, 30 YALE J. INT'L L. 125 (2005); *The Dynamics of International Trade Finance Law*: *The Arrangement on Officially Supported Export Credits*, 45 HARV. INT'L L. J. 65 (2004).

[30] David Zaring, *Informal Procedure, Hard and Soft, in International Administration*, 5 CHI. INT'L L.J. 547 (2005); Walter Mattli & Tim Büthe, *Global Private Governance: Lessons from a National Model of Setting Standards in Accounting*, 68 LAW & CONTEMP. PROBS. 225, 227-28, 250-59 (Summer/Autumn 2005).

[31] David Zaring, *Informal Procedure, Hard and Soft, in International Administration*, 5 CHI. INT'L L.J. 547 (2005).

[32] Eric A. Posner, *International Law and the Disaggregated State,* 32 FLA. ST. U. L. REV. 797 (2005) (describing the difference between a traditional unitary state model and a theory that disaggregates the state, concluding that formal international cooperation is likely to do as well as networks).

better than those where powers are delegated to other international institutions.[33] But I suspect determining where a network is effective is likely to turn on the strength of the network itself.

III. Mapping Networks

In this section I consider different sorts of networks. For ease of use, I distinguish between social and economic networks. In some ways, all regulatory networks are "social" or "virtual" in that they depend upon intangible ties between the people who staff regulatory agencies and the somewhat evanescent links that a memorandum of understand, or an agreement on principles of regulation, can provide. But while social network theorists have focused on the implication of these ties, other, more economically minded scholars consider networks through the costs imposed on network membership and departure. Hence the dichotomy drawn here.

A. Social Networks

Social networks are tied together by intangible links – ties of consanguinity, say, or of affinity. Social networks theorists trace the spread of the evanescent, such as ideas, or friendships, in organizations ranging from school playgrounds to graduate school disciplines. Although, today, social networks scholars often rely on complex computer modeling and abstract algebra to model and depict complex and large-n networks, the concept has been with us for some time. No less an authority than Emile Durkheim concluded that in society, "the essential is not the number of persons subject to the same authority but the number bound by some form of relationship."[34]

Some international legal scholars have rather explicitly adopted a social networks approach to the new international governance. As Kal Raustiala has said, "networks appear to promote convergence" across jurisdictions not subject to each other's laws "through a decentralized, incremental process of interaction and emulation."[35]

One of the ways that networks do this is through knowledge exchange – a process that has been characterized as the creation of an epistemic

---

[33] Eric A. Posner & John C. Yoo, *Judicial Independence in International Tribunals,* 93 CAL. L. REV. 1 (2005).

[34] EMILE DURKHEIM,, DURKHEIM, MONTESQUIEU AND ROSSEAU: FORERUNNERS OF SOCIOLOGY, (tr. A Cuvillier 1965) (1892).

[35] Kal Raustiala, *The Architecture of International Cooperation: Transgovernmental Networks and the Future of International Law*, 43 VA. J. INT'L L. 1, 52 (2002).

community.[36] Under that theory of international relations, some of the stuff that bubbles beneath state action is explainable partly by the fact that the people involved in the action come to think the same way about issues that confront them – in ways that cross borders.[37] Thus regulators who talk to one another, and learn to think like one another may eventually come to see their regulatory projects in the same way. In this way, standards can cross borders not because of the content of the standard, but rather in a way that is developed through intellectual history – that is, by the rise of a common language and thought process of regulation. In this way international governance looks a lot like the dissemination of ideas, rather than rules. It is a squishy concept, and one that owes some allegiance to constructivist theories of international relations – but it surely plays a role in helping the network to coalesce.[38]

This is not to say that a single standard will always occur. As Raustiala has noted: "[T]he more a network is virtual …, the more likely there are to be multiple standards. But network effects do imply that convergence on one or more standards is likely and this convergence is likely to be relatively sticky."[39]

The implication of these virtual relations is that they can eventually enmesh the network nodes in a variety of ties, standards, and obligations, that eventually, as David Mitrany predicted decades ago, prove to be hard to break. "Internationally,...while a body of law grew slowly and insecurely through rules and convention, many common activities were developed effectively by means of functional organs."[40] The idea here, as with other networks is that once the actors in a network setting adopt a standard, switching to a new standard requires extensive and costly, and hence rarely achieved, collective action.[41]

Sociologists have found social networks to be very interesting, and one has bragged that "network analysis is booming and the tendency of social scientists to ignore structure is diminishing. Today, all kinds of social scientists, along with mathematicians and physicists, have embraced the structural perspective."[42] Although describing the breadth of research in

---

[36] See Peter M. Haas, *Introduction: Epistemic Communities and International Policy Coordination* , 46 INT'L ORG . 1, 3 (1992) for the principal statement on this thesis. For more legally related work in the area, see Thomas, Ashley. "International Legal Epistemic Communities" *Paper presented at the annual meeting of the International Studies Association, Town & Country Resort and Convention Center, San Diego, California, USA*, Mar 22, 2006, available at http://www.allacademic.com/meta/p99745_index.html.

[37] *See id.* (describing how similarly situated experts – or, presumably, diplomats, could eventually arrive at a common set of beliefs and policy suggestions).

[38] *See, e.g.,* ALEXANDER WENDT, SOCIAL THEORY OF INTERNATIONAL POLITICS (1999); JOHN GERARD RUGGIE, CONSTRUCTING THE WORLD POLITY (1998); Ted Hopf, *The Promise of Constructivism in International Relations Theory*, 23 INT'L SECURITY 171 (1998).

[39] Raustiala, supra note ??, at 67.

40 DAVID MITRANY, THE FUNCTIONAL THEORY OF POLITICS 113 (1975).

[41] Raustiala, supra note ??, at 67.

[42] LINTON C. FREEMAN, THE DEVELOPMENT OF SOCIAL NETWORK ANALYSIS 167 (2004).

these sorts of networks must be done cautiously – sociologists have begun to develop their own sort of statistical processes to describe the way that networks develop, political scientists such as Andrea Jung and David Lake, are doing agent-based modeling to understand how social networks work, while others are researching the phenomenon in less quantitative ways, the import of this research is promising.[43]

There is no question that the social variant of a network can be powerful. But it is worth noting that it is fragile. For one thing, some believe that social networks, at least in the international setting, atrophy as they grow. Regulatory networks of jawboners, mutual understandings, and common approaches may not expand widely across the regulatory firmament – or, at least, it is not obvious that they would do so. Some political scientists think that traditional networks like these come with expiration dates.[44]

For now, it is perhaps enough to note the ties between the ties between regulatory networks of friendship, epistemic community, and common perspective. These networks are limited in the branches between their nodes, limited to suasion and common perspectives, and, accordingly, may be limited in the compliance that they can expect in the anarchic world order.

B. Economic Networks

The significant difference between "social" and "economic" networks may lie in the intellectual history of the economic variant. Economic network theorists considered networks to be so potentially powerful (and, at times, inefficient), because the costs of membership were worth it simply because the benefits of similarity with other members of the network were so high.

Economists think that network effects can affect a market when the utility of a product to one consumer increases the more other consumers use the product. More economically tied networks exist when goods provide value to a consumer that "increases with the number of additional users of identical and/or interoperable goods." [45] To be sure, economic networks "need not be linked to a common system as are the constituents of a communications network."[46] As two law and economics scholars have put

---

[43] Andrea Jung & David Lake, *Markets, Hierarchies, and Networks: An Agent-Based Organizational Ecology* (working paper).

[44] *Id.*

[45] Mark A. Lemley & David McGowan, *Legal Implications of Network Economic Effects*, 86 CAL. L. REV. 479, 491 (1998);. Telephones are examples of "actual network goods." *Id.* at 488. The more people who purchase telephones connect to a network, the more valuable the telephones already on that network become, as the calling options available to those already on the network increase. *Id.* at 488-89.

[46] *Id.*

it, less is required: "a network effect exists where purchasers find a good more valuable as additional purchasers buy the same good."[47] For example, users of a particular word-processing program benefit when other users use the same program, making it easy to exchange files.[48] This does not, of course, mean that the word-processing system will be the best on the market, just that it is the one that more people selected, which in turn makes it attractive to new entrants, because it offers a feature – interoperability – that other, even other better designed, word processing programs do not.

Economists have approached social networks a bit grudgingly. There is an "inherent difficulty of drawing inference from the data that economists commonly bring to bear to study social interactions," as one economist has admitted.[49] Nonetheless, if social networks offer the promises of club goods, economic networks, roughly, impose costs on defectors from the network.

Economic networks, in short, are difficult to start, and difficult to exit. Although the mechanisms of cooperation for international regulators look more social than economic – that is, it looks more like friendship than it does like a water utility – the fact is that the imposition of costs of exit marks the distinction between the international regulatory efforts like those of the SEC's which have largely failed, and those of other regulators, which increasingly cannot contemplate a world where their efforts would transgress from the international norm.

IV. NETWORKS IN ACTION

A. Global Securities Market Problems

I begin with a reminder of the problems facing the SEC, and move to a consideration of the international regulatory network it has embraced, and one it has not – this reminder is slightly more technical than the initial discussion (but I have, for that reason, kept it short).

Globalization has profoundly changed the environment in which the SEC operates, in the following ways:

Cross-Listing -- First, foreign companies increasingly listed their stocks on American exchanges. The SEC generally insisted that these companies adopt American accounting and disclosure practices. Even then, oversight by the commission of these international firms was not easy.

[47] Mark A. Lemley & David McGowan, *Legal Implications of Network Economic Effects*, 86 CAL. L. REV. 479, 483 (1998); see also Robert B. Ahdieh*, Making Markets: Network Effects and the Role of Law in the Creation of Strong Securities Markets*, 76 S. CAL. L. REV. 277, 296 n.73 (2003) ("The relatively high network value and low inherent value of such goods implies that, once consumers perceive that a de facto standard has been established, tipping will occur very quickly.").

[48] Lemley & McGowan, *supra* note ??. at 491 (identifying computer software as the "paradigm example" of virtual networks).

[49] Charles Manski, *Economic Analysis of Social Interaction,* 14 J. ECON. PERSPECTIVES 115, 117 (2000).

Most of them were listed on other markets, subject to different disclosure and accounting requirements, and did their ordinary business in a language quite literally foreign to federal regulators. The inefficiencies are clear; and the value of identical standards for cross-listed companies are one of the incentives of global regulatory cooperation.

American Consumers, Foreign Markets -- Moreover, the American investors that the agency was charged with protecting, and, for that matter, the American corporations that offered the securities regulated by the SEC, have turned their attention overseas. They, and particularly its most sophisticated investors, such as hedge funds and pension funds, have begun to turn abroad for their securities, to fast-growing foreign markets, with varying degrees of oversight.

Consider the challenge of Brazil's bourse, which has tripled in value during the last decade – largely by offering investors a new class of stocks with American style disclosures, in addition to the older set already on the Bolsa.[50] Those stocks have outperformed the rest of the Bolsa, and attracted even more investors, both foreign and domestic. Nor is this a complex process. Foreign exchanges are available to American investors online and the trading pits that used to define locations like Wall Street or the City have now gone electronic, available to anyone anywhere with the right kind of internet connection.

Foreign exchanges now offer these customers well-financed markets, and have accordingly attracted, of late, over ninety percent of the world's initial public offerings and half of all investor activity.[51] The result – as some scholars have acknowledged - is that foreign markets has subjected American regulators to unprecedented competitive pressures.[52]

Regulated Industry and the Flight from Oversight – But perhaps most troubling for America regulators is the fact that they cannot oversee the investors and companies that direct their securities businesses overseas. Stock exchanges can draw on financial resources that come from all over the world now, and have started buying each other (American exchanges have taken full advantage of the prospect of alliances with foreign counterparts). The result is that the exchanges themselves have set up shop both inside the purview of federal securities regulation, and outside of it as well, both by merging with foreign exchanges subject to different regulatory

---

[50] Susan Perkins, *Signal or Symbol: Interpreting Firms' Responses to Regulatory Change s in the Brazilian Stock Market.*(working paper).

[51] Committee on Capital Markets Regulation, *Interim Report* available at <http://www.capmktsreg.org/research.html30 >

[52] *See, e.g.*, James D. Cox, *Rethinking U.S. Securities Laws in the Shadow of International Regulatory Competition*, 55 LAW & CONTEMP. PROBS. 157, 157 (1992) (arguing that increased trans-border investing will increase pressure on U.S. regulators to reform U.S. securities laws); *see also* Eric J. Pan, *Why the Word No Longer Puts its Stock in Us* 9 (Cardozo Legal Studies Research Paper No. 176, 2006, available at <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=951705 >(suggesting that greater liquidity of foreign markets is helping to attract more foreign transactions from markets governed by U.S. Regulators).

requirement and by offering "dark pools" or unregulated, unquoted markets to qualifying investors.[53] In short, not only do a vastly larger international array of exchanges compete for investment business, but also the exchanges themselves increasingly allow big investors to opt out of regulation at all.

The result is another kind of market, one that not only uses the services exchanges provide, but one for securities laws themselves. Listers and investors can choose the exchange they like, meaning that national regulators (and legislatures) eager to protect or grow their domestic financial centers are incentivized to provide attractive, cost-effective rules for issuer disclosure and corporate governance. In the same way, the exchanges themselves, which now operate markets across the globe can offer issuers greater choice as to where their securities will be sold, and thereby the kind of regulatory regime governing their offerings. The degree of competition between regulators is consequently heightened as issuers enjoy more mobility and the ability to defect to other jurisdictions.

B. SEC Responses

If these are the problems of globalization, from the SEC's perspective, what is the solution? The SEC used to deal with international problems, if at all, through unilateral and extraterritorial efforts to bring foreign investors and listers to heel. It insisted on the adoption of American accounting standards for companies that sought to make use of American markets. It has imposed American insider trading rules on financial institutions doing business in foreign jurisdictions, and generally policed overseas fraud that it concluded affected American securities markets.[54] It required foreign listers to comply with Sarbanes-Oxley.[55]

But this traditional model has resulted in what many think is a flight of capital from the United States to other jurisdictions. Accordingly, the SEC has developed outreach efforts, some bilateral, some multilateral, and perhaps most interestingly, some through a firmly established network.

Enforcement Cooperation -- In enforcing its standards in this new international milieu, the SEC has increasingly relied on foreign regulators for assistance.[56] As one SEC enforcement official has explained:

---

[53] http://sec.gov/news/speech/2008/spch020108ers.htm

[54] SEC v. Wang, 699 F.Supp. 44 (S.D.N.Y.1988); for a discussion, see Susan R. Essex, Comment, *SEC v. Standard Chartered Bank: Maintaining the Integrity of U.S. Capital Markets or Extraterritoriality Run Rampant*?, 22 LAW & POL'Y INT'L BUS. 159 (1991); for a discussion of the SEC's traditional practice with respect to overseas fraud, see Note, *Predictability and Comity: Toward Common Principles of Extraterritorial Jurisdiction*, 98 HARV. L.REV. 1310, 1315-16 (1985).

[55] For a discussion, see John C. Coffee, Leading Issues Under Sarbanes-Oxley, Part I, N.Y. L. J., Sept. 19, 2002, at 5.

[56] For a list, see http://www.sec.gov/about/offices/oia/oia_cooparrangements.htm.

> Each year, the Securities & Exchange Commission makes hundreds of requests to foreign regulators for enforcement assistance, and responds to hundreds of requests from other nations. To facilitate this type of assistance the Securities and Exchange Commission has entered into more that 30 bilateral information-sharing agreements, as well as the IOSCO Multilateral Memorandum of Understanding, the first global multilateral information-sharing agreement among securities regulators. In our last fiscal year we made 556 requests to foreign regulators, and received 454 requests from foreign regulators. These numbers reflect a 24% increase in requests to foreign regulators from our 2002 fiscal year and a 28% increase in requests from foreign regulators from our 2002 fiscal year… It seems that insider trading cases are becoming increasingly international, as we have seen a growing number of perpetrators use foreign banks, agents and accounts to try to obscure their identities and hide the illicit proceeds abroad.[57]

Technical Assistance – To develop the capacity of regulators in emerging markets, (and, to be sure, to hint at the values of harmonization with American regulatory approaches), the SEC has reached out to these regulators to provide them with education and other tools designed to improve the quality of their supervision – and thus to look out for the interests of American investors who are increasingly turning to these emerging markets. The agency has proudly pointed to its efforts to bring foreign regulators to Washington, D.C.: it "continue[s] to draw record numbers of regulators from emerging and developed markets, including 147 delegates from 70 countries at the International Institute for Securities Market Development in April, 2006."[58] But it also has evinced a willingness to go to foreign sites to provide this sort of training and resources, and indeed, has an active, but free, consulting practice for securities regulators.[59]

Policy Coordination – Finally, and most interestingly from our perspective, the SEC has attempted to coordinate international policy – in short to overcome the market for law, by joining a network of securities commissioners, IOSCO, and observing, through that network, a network of accounting standards setters, IASC. This third sort of international outreach is the most interesting and potentially far reaching form; it offers the prospect of international harmonization on securities rules and regulations. It could take what the SEC does domestically, and solve its globalization

---

[57] http://sec.gov/news/testimony/2008/ts020708lct.htm
[58] http://www.sec.gov/about/offices/oia/oia_emergtech.htm
[59] *Id.*

problems by ensuring that the identical standards are adopted and enforced around the world.

C. The Network Option

1. IOSCO

IOSCO is a regulatory organization that developed out of the Interamerican Association of Securities Commissions and Similar Agencies in 1984, when the members of that body passed bylaws transforming it from a regional group founded a decade earlier into a global collection of securities regulators.[60] IOSCO's members have agreed to "cooperate together to promote high standards of regulation in order to maintain just, efficient and sound markets; to exchange information on their respective experiences in order to promote the development of domestic markets; to unite their efforts to establish standards and an effective surveillance of international securities transactions; to provide mutual assistance to promote the integrity of the markets by a rigorous application of the standards and by effective enforcement against offenses."[61]

As a regulatory network, IOSCO is informally constituted, it has few rules, regulations, or limitations on its regulatory agenda, and is comprised of most of the securities regulators in the world. The organization has, over the quarter century of its existence, developed some core principles of securities market supervision – largely as a means of advising developing countries what the organization thinks is required of a good securities regulator – created a process for international cooperation on enforcement issues, and, perhaps most interestingly, but least successfully, tried rather unsuccessfully to agree on core regulatory approaches to market supervision.

The problems for IOSCO have lain in the fact that it has not managed to create the kind of costly ties that mark economic networks. Instead it remains a largely social network of regulators, one that the SEC has often abandoned when it has seen fit, and one which has been unable to create an international securities regime that meets the promise of a global market. Instead, the SEC's globalization dilemma remains unsolved.

---

[60] *See* Paul Guy, *Regulatory Harmonization to Achieve Effective International Competition,* in FRANKLIN R. EDWARDS AND HUGH T. PATRICK, EDS, REGULATING INTERNATIONAL FINANCIAL MARKETS: ISSUES AND POLICIES 291, 291 (1992). The bylaws of IOSCO declare that "[t]he securities commissions or similar agencies of the countries of the American Continent, as well as the Commission des valeurs mobilieres du Quebec and the Ontario Securities Commission, are charter members of the Organization." Bylaws of the International Organization of Securities Commissions pt 2, P 2.

[61] IOSCO, *2002 Annual Report* 22 (2002), available online at < http:// dev.iosco.org/annual_report/PDF/IOSCO_2002.pdf> (visited Nov 7, 2004).

A review of the organization's efforts of late is illustrative. I focus first on its success: law enforcement cooperation, and then turn to its semi-failure to play an important role in devising a government response to the 2008 financial crisis. As for policy harmonization – the holy grail of international regulatory efforts – IOSCO has little to say, and so we turn to the story of the development of international accounting standards to help us understand this process.

Enforcement Cooperation -- IOSCO's principal achievement has been law enforcement cooperation memoranda – slippery documents that require, in gauzy language, securities regulators to cooperate with their foreign counterparts on law enforcement matters. Because these memoranda permit a wide variety of regulators to maintain a wide variety of enforcement priorities, do not punish defection or reward compliance (it is quite difficult to quantify cooperation), and have been concluded with hundreds of participating entities, the initiative has failed to be the sort of onerous and exclusive commitment that I think marks a successful regulatory enterprise.

Over the past three years, IOSCO has "endorsed the requirement that all securities regulators applying for…membership…become signatories" to the *Multilateral Memorandum of Understanding concerning Consultation and Cooperation, and the Exchange of Information*,[62] "contribut[ed] actively to the work of" an accounting standards board as it "remains convinced that the adoption of IFRS…should help to achieve convergence towards high quality global accounting standards,"[63] and taken steps to establish "a more structured arrangement for…dialogue" with the financial industry and "rationalise [its] decision making process."[64]

IOSCO's main concern during the this period has been the IOSCO MOU, described as "the first global multilateral information-sharing arrangement among securities regulators," that "sets a new international benchmark for cooperation critical to combating violations of securities and derivatives laws."[65] In 2005, IOSCO "resolved…to require all members to become signatories to the IOSCO MOU, or to commit to doing so, by 1 January 2010,"[66] and has continually worked towards this goal.[67] IOSCO

---

[62] IOSCO, *2005 Annual Report* at 3, *available at* < http://www.iosco.org/annual_reports/annual_report_2005/pdf/Annual_Report_05.pdf.

[63] *Id.* at 5.

[64] IOSCO, *2006 Annual Report* at 9, *available at* <http://www.iosco.org/annual_reports/annual_report_2006/pdf/annual_report_2006.pdf.>

[65] U.S. Securities and Exchange Commission, *SEC Announces IOSCO Unveiling of Multilateral Agreement on Enforcement Cooperation*, *available at*<http://www.sec.gov/news/press/2003-145.htm.>

[66] IOSCO, *2005 Annual Report*, *supra* note 1, at 2.

[67] "The organisation considered recent developments among the membership in taking up the MOU including the progress being made as IOSCO seeks to meet the 2010 deadline by which members are required to become signatories." *IOSCO Update: Issue 6, May 2007* at 1, *available at* <http://www.iosco.org/library/newsletters/pdf/IOSCO_Update_May_2007.pdf.>

states that its mandatory participation requirements "reflect[]…[the] belief that the IOSCO MOU is critically important."[68]

This sort of cooperation is worthy, but it has remained voluntary. And even though, from the SEC's perspective, the IOSCO MOU has fit well with what it has hoped to do, it is by no means clear that it will be enough.

The SEC likes criminal and law enforcement cooperation because its international efforts have, traditionally, focused on that area – an area with a whiff of extraterritoriality about it. The goal for the agency, in law enforcement matters, at least, is to enforce its prohibitions against market participants located abroad. It is thought that regulatory networks can help agencies conduct their law enforcement responsibilities by providing for cooperation with foreign law enforcement officials; the principal idea is that the networks help agencies like the SEC by providing a path for the exchange of information; indeed, IOSCO template MOU was designed to do exactly this.[69]

The number of specific initiatives mounted by the SEC to do more international enforcement work are many – insider trading, for example, has long been a priority for the SEC, and there's nothing about the practice that limits it to the confines of the United States; the agency has been pursuing insider trading claims against foreign investors for decades now.[70] The SEC chair has often said that the agency would be essentially unable to continue its work on the area without international cooperation.[71] The claim is a plausible one, as the agency's efforts against foreign corruption suggest.

In 2008, the SEC developed more cases than ever against corporate executives who bribe foreign officials under the Foreign Corrupt Practices Act. The SEC filed 15 FCPA cases during that fiscal year; since January 2006, the SEC has brought 38 FCPA enforcement actions— which, it has said, amounts to more than were brought in all prior years combined since FCPA became law in 1977.[72]

Through the IOSCO MOU, however, it is not clear that the SEC has been able to leverage the network's international cooperation to amount to much. On the one hand, to be sure, it has cajoled the network into committing to information exchanges and law enforcement assistance. But although the SEC will soon be able to point to a vast number of signatories to the IOSCO MOU, it is unclear, in the end, whether those signatures will

---

[68] IOSCO, *2005 Annual Report*, *supra* note 1, at 3.

[69] http://www.sec.gov/news/press/2003-145.htm has the so-called multilateral MOU available on its wesite.

[70] E.g., Hong Kong case

[71] Christopher Cox, *The SEC Speaks 2008*,available at http://www.knowledgemosaic.com/Gateway/Rules/SP.spch020808cc.020808.htm

[72] http://sec.gov/news/press/2008/2008-254.htm

amount to a binding international regime that will have a real effect on global problems of cross-exchange criminality. The MOU, after all, recourses to the gauzy promises of enhanced cooperation – often "to the extent possible," and without the sort of mandates that make for an international standard.

The Network's Limitations -- Like any network, much of the work IOSCO does doesn't appear to amount to much of anything. Highlighting anecdotal initiatives isn't dispositive, of course, but consider IOSCO's recent reorganizational work. It has, for example, made changes to its decision making process, and highlighted its efforts to do so in its official publications. In 2006, IOSCO's Technical Committee "set up a task force which proposed a structured methodology combining different criteria, and a bottom up as well as a top down approach…to rationalise our decision making process."[73] The Technical Committee also "published, for the first time, its Work Program which contains an outline of the priorities which it has identified for the near future and has invited the financial industry to comment on them."[74] IOSCO stated that "despite the fact that an ongoing dialogue with the industry has already existed, either through consultation on our work or through the participation of the industry to our conference…a more structured arrangement for this dialogue should be organised."[75]

This is the international network as talking shop – an often criticized facet of international regulation that appears, nonetheless, to be the one adopted at times by IOSCO. Talking shops don't do much, but they do breed familiarity, but that familiarity has not resulted in the use of the network as the vehicle to deal with new problems.

Or so the 2008 financial crisis suggests. During that crisis, the SEC has implemented a short-lived ban on the shorting of financial stocks; it coordinated that ban with the securities regimes of other countries, including Great Britain, Australia, Taiwan, and Pakistan.[76] But IOSCO was not the vehicle for the short ban, and, indeed, the organization has had little to say about the financial crisis in any respect, other than a May, 2008, suggestion that its members peruse some recommendations about the subprime mortgage crisis, the precursor to the market crashes.[77]

2. Accounting Networks

[73] IOSCO *, 2006 Annual Report*, *supra* note 3, at 9.
[74] *Id.*
[75] *Id.*
[76] *See, e.g., Canadian Regulators Implement Short-Selling Ban*, REUTERS, Sep. 21, 2008, at http://www.reuters.com/article/governmentFilingsNews/idUSN1925996220080919.
[77] IOSCO Technical Committee Task Force on the Subprime Crisis, *Final Report on the Subprime Crisis* (May 29, 2008), available at http://www.iosco.org/library/pubdocs/pdf/IOSCOPD273.pdf

Despite taking on member participation in the IOSCO MOU as its main focus, IOSCO is also concentrating on "maintain[ing its] role as the international standard setter for securities regulation."[78] But it has largely ceded a role in developing accounting standards – a critical part of any securities enterprise (disclosure, after all, turns on the requirements of what publicly listed companies are required to disclose to potential investors) to another network.

Instead, IOSCO and the SEC abandoned the difficult effort of setting global securities standards, and another network – a smaller, more exclusive one – replaced it, exhibited the characteristics of successful network regulation that I have outlined, and ultimately appears to have created the sort of successful network effects that have ultimately pulled both the US and the international body into its orbit.

I view this as an example of the failure of the nonexclusive, nonbinding, securities network. Both the SEC and IOSCO have essentially failed to achieve the most important prospect for international securities harmonization in failing to develop a set of common accounting standards across jurisdictions. The SEC in particular missed an opportunity to build itself into a different regulatory network that appears to be working – namely, the effort to develop a comprehensive set of International Financial Reporting Standards, or IFRS. IOSCO has been left in the position of cheering IFRS on, essentially from the sidelines.

The attractiveness of common accounting standards in a world where investors and firms have multijurisdictional presences is not hard to fathom. Common standards would allow investors to evaluate companies based in the United States, Europe, or the developing world on the basis of the same kinds of financial statements. By the same token, the ability of companies to use the returns that their local accountants prepared to list stocks in New York, London, and anywhere else is clear. As one former SEC commissioner has stated, "one cannot overlook the potential expansion of investment opportunities if all issuers could use one set of accounting standards that would be accepted world-wide for securities offerings."[79] Nonetheless, harmonizing accounting standards has proven to be difficult, and has been made even less easy, because, as Beth Simmons has explained, American accounting standards are particular outliers, both because they are more strict than those in place on the European continent, and because they are extremely important, as they must be used by

---

[78] IOSCO, *2006 Annual Report*, *supra* note 3, at 4.
[79] *See* Hunt, 51 Admin. L. Rev. at 1114

companies seeking entrance to America's capital markets.[80]

Despite these incentives, the SEC recently opted out of the informal effort to create common standards that would work for any company and any exchange. It announced "concerns with respect to the IASB governance structure," among other things.[81] These sorts of strategies capsized IOSCO's 1980s efforts to develop such a standard; the SEC has also failed to seriously participate in the informal network that succeeded IOSCO in trying – the International Accounting Standards Board, though it did participate in the arm's-length IOSCO committee that monitored IASB's progress.[82] But while during the 20th century, American regulators could insist on unique American standards, in the 21st century, the preeminent place of those standards has become much more tenuous, because of the global acceptance of a European rooted principles-based system.[83]

Like IOSCO, IASB began as an informally constituted committee; it was formed in 1973 by the standard-setters--mostly private--of Australia, Canada, France, Germany, Ireland, Japan, Mexico, the Netherlands, the United Kingdom, and, indeed, it included the United States.[84] It was then reconstituted as "a not-for-profit corporation incorporated in the State of Delaware" in March of 2001 (IOSCO, by contrast, was reconstituted as a Canadian chartered corporation).[85] The corporation was later transformed into the parent entity of the IASB, which defined itself as "independent accounting standard setter based in London."[86] Like IOSCO, however, IASB looks like a network – it is informally constituted, only partially public, and not subject to the ordinary requirements and limitations of international law. Although, as the SEC has somewhat skeptically noted, "IOSCO is a committee of securities regulatory agencies, the IASC is an

---

[80] Simmons, 55 Intl Org at 595. *See also* Edward F. Greene, *Hegemony or Deference: U.S. Disclosure Requirements in the International Capital Markets*, 50 Bus. Law. 413, 418 (1995) (describing loss of market share of US exchanges to foreign exchangers, subject to less rigorous accounting requirements).

[81] John W. White address at Annual Securities Regulation Institute in San Diego, California (January 23, 2007) at <http://www.knowledgemosaic.com/Gateway/Rules/SP.spch012308jww.012308.htm>

[82] James D. Cox, *Regulatory Duopoly in U.S. Securities Markets,* 99 COLUM. L. REV. 1200, 1208 (1999) (describing this event in some detail, and noting that the stature of IASC during the mid-1990s presented the SEC with a difficult decision concerning whether to recognize its accounting standards for SEC filings and how the SEC therefore engaged with IASC, directly and through the International Organization of Securities Commissions (IOSCO), laying out basic criteria it would have to meet and providing a "stream of comment letters" on IASC proposals).

[83] Roberta S. Karmel, *The EU Challenge To The SEC*, 31 Fordham Int'l L.J. 1692 (2008).

[84] George Mundstock, *The Trouble With FASB* 28 N.C. J. Int'l L. & Com. Reg. 813 (2005).

[85] *See* IASB, General Information, available online at <http:// www.iasb.org/about/general.asp> (visited Nov 1, 2004). The IASB, however, differs from other IFROs by including private members and by its rather detailed constitution. See IASB, IASC Foundation Constitution

[86] *See* IASB, General Information, available online at <http:// www.iasb.org/about/general.asp> (visited Nov 1, 2004). The IASB, however, differs from other IFROs by including private members and by its rather detailed constitution. See IASB, IASC Foundation Constitution

independent, private sector organization,"[87] the organization has moved increasingly to publicize its deliberations, in an effort, some commentators believe, to win acceptance of IFRS by the United States.[88]

The organization tried to develop the sort of accounting standards that could stand in for the diverse standards available around the world. It did so one painful standard at a time, with regular meetings around the world, and the ready cycling in of representatives from various jurisdictions in the standard development process.[89] But once again, neither the SEC nor American accountants played a particularly important role.

During the late 1980s, the United States abandoned accounting standardization, and killed IOSCO's initial efforts along these lines. The result probably drove IOSCO's headquarters from North America to Europe and recentered the global effort on accounting in the competing network represented by IASB. As former SEC commissioner Roberta Karmel has said, "At this time, the SEC also determined not to adopt a process-oriented approach to IASB standards …. Rather, it intended to assess each IASB standard after its completion, and then recognize acceptable standards …[it only] decided instead to consider all IASB standards after the IASB completed its core standards work program."[90]

None of this stopped IFRS, however. The adoption of the standard throughout the European Union in 2005, and similar decisions by Australia, Hong Kong, and South Africa, tipped over a process that means that over 100 countries are now requiring or permitting IFRS:

> Canada, India, and Korea will each adopt IFRS by 2011. In Brazil, listed companies will have to comply with IFRS from 2010. And convergence between Japan GAAP and IFRS is expected by 2011 At the beginning of this year, China introduced a completely new set of accounting standards that are intended to produce the same results as IFRS. This represents a significant step toward convergence with the IASB standards.[91]

As John White, the current director of the agency's division of corporate finance, has noted, the European accounting system that IASB adopted is

---

[87] SEC, *Report on Promoting Global Preeminence of American Securities Markets*, available online at <http://www.sec.gov/news/studies/acctgsp.htm>

[88] The restructuring "include[s] changes in the IASC's objectives and strategy, due process, standards implementation and enforcement, and funding mechanisms." Maureen Peyton King, Note, *The SEC's (Changing?) Stance on IAS*, 27 BROOK. J INTL L 315, 332 (2001).

[89] In this it benefited from the support of IFAC, the International Federation of Accountants, another network, though one entirely private, and not one with its own designs on accounting standardization – it was happy to delegate that process to IASB.

[90] Roberta S. Karmel, *The EU Challenge To The SEC*, 31 Fordham Int'l L.J. 1692 (2008).

[91] Christopher Cox, *"International Business--An SEC Perspective" Address To The American Institute Of Certified Public Accountants' International Issues Conference, Washington, D.C., January 10, 2008,* 1669 PLI/Corp 205.

the one that seems to have caught on better with the world markets. “the rest of the world is already heading in this direction and their endpoint is IFRS — not U.S. GAAP. There was little consideration given to the idea that U.S. GAAP could become the uniform global standard. This is an "inconvenient truth" for many in the U.S,” White has said.[92]

Accordingly, even without the support of the United States, international convergence on accounting standards happened anyway. A December 2002 survey of fifty-nine countries' accounting standard-setters revealed that 90% of the standard-setters intend to converge to IFRS.[93] “Most countries are moving towards IFRSs,” as these countries found the standards to be congenial and reputable.[94]

It was not as if IOSCO was entirely missing from this process. But it did so more as a spectator and a commenter, rather than a shaper of standards.[95] The Board has charitably put it that it “and IOSCO [have] work[ed] on a programme of ‘core standards’ which could be used by publicly-listed enterprises when offering securities in foreign jurisdictions.”[96] IOSCO “contribut[es] actively to the work of the IASB, through participation in various expert committees and responses to consultation,”[97] and “continue[s] to monitor the work of the IASB.”[98] In the so-called Norwalk agreements, concluded on American soil, the IASB promised to work with both IOSCO and American accounting standard setters. But these agreements were concluded in 2002, long after IFRS had substantially completed its work.

The SEC in the end, was left with little choice on accounting standards – it decided that it had to defer to the successful global network. In 2006, it established a “database on application of IFRS,” where “[IOSCO] members can exchange information about problems and non-

---

[92] John W. White *Director, Division of Corporation Finance U.S. Securities and Exchange Commission,* 35th Annual Securities Regulation Institute, San Diego, California, January 23, 2007, available at <http://www.knowledgemosaic.com/Gateway/Rules/SP.spch012308jww.012308.htm>

[93] Donna L. Street, GAAP Convergence 2002: A Survey of National Efforts to Promote and Achieve Convergence with International Financial Reporting Standards 2, http://www.ifad.net/content/ie/ie_f_gaap_frameset.htm

[94] 40 Int'l Law. 363, 366 (.2006)

[95] In 1996, “IOSCO join[ed the IASB] as observer” and in 1999, IASB formed an “agreement with IOSCO to complete core standards by 1999” where “on successful completion IOSCO [would] consider endorsing IASs for cross-border offerings . . . . IOSCO review[ed the] . . . IASC core standards” and in 2000, “IOSCO recommend[ed] that its members allow multinational issuers to use 30 IASC standards in cross-border offerings and listings.” International Accounting Standards Board, History, http://www.iasb.org/About+Us/About+the+Foundation/History.htm (last visited April 11, 2008).

[96] See IASB, Frequently Asked Questions, available online at <http://www.iasb.org/about/faq.asp?showPageContent=no&xml=18_17_24_17122003.htm> (visited Nov 1, 2004). See also Kung, 33 L & Poly Intl Bus at 474–77

[97] INT’L ORG. OF SECS. COMM’NS (IOSCO), ANNUAL REPORT 2005 6 (2005), *available at* http://www.iosco.org/annual_reports/annual_report_2005.

[98] INT’L ORG. OF SECS. COMM’NS (IOSCO), ANNUAL REPORT 2006 6 (2006), *available at* http://www.iosco.org/annual_reports/annual_report_2006/pdf/annual_report_2006.pdf.

compliance with [the standard]." [99] IOSCO "assesses the data[,] and where it reveals varying interpretations[,] refers them to the [IASB]," the organization responsible for developing IFRS standards[100] IOSCO has a long-standing relationship with the IASB,[101] and it claims continues to "contribut[e] actively to the work of the IASB, through participation in various expert committees and responses to consultation,"[102] and "continue[s] to monitor the work of the IASB[]."[103] But the SEC has been unwilling to join IFRS, at least until recently, and is only now making its presence felt, after those standards were devised, and after the SEC has declared its intention to adopt them.[104]

In the end, the SEC had to bow to the power of this network that, again, it did not substantially participate in. The SEC has recently elected to allow foreign registrants to use IFRS, to meet their American reporting requirements.[105] As former SEC Chair Cox would admit, "our recent decision to accept IFRS financial statements in SEC filings was crafted in such a way as to support the efforts of the IASB, and many other nations, to establish IFRS as a single, global set of standards, and not so many national flavors."[106]

V. CONCLUSION

My analysis has been focused two questions: first, how the SEC might find its way forward in an increasingly uncertain world? Part of the goal here is descriptive; that is, I hope to show just what, exactly, a federal agency is doing to make its way forward in difficult international times and in a newly internationalized world.

Second, because that way forward will probably involve network-based collaboration, how to make networks work? In the earlier part of the paper, I have suggested that networks that look a bit more like economic networks, with high costs of exit, are the more likely sources of international rules of substance. In the conclusion, I will approach the question from a more

---

[99] *Id.*

[100] *Id.*

[101] In 1996, "IOSCO join[ed the IASB] as observer," and in 1999, IASB formed an "agreement with IOSCO to complete core standards by 1999," where "on successful completion IOSCO [would] consider endorsing IASs for cross-border offerings." "IOSCO review[ed the]…IASC core standards," and in 2000, "IOSCO recommend[ed] that its members allow multinational issuers to use 30 IASC standards in cross-border offerings and listings." International Accounting Standards Board,< http://www.iasb.org/About+Us/About+the+Foundation/History.htm > (last visited October 24, 2007).

[102] IOSCO, *2005 Annual Report*, *supra* note 1, at 6.

[103] IOSCO, *2006 Annual Report*, *supra* note 3, at 6.

[104] 72 Fed. Reg. 37962-01, 2007 WL 1985828

[105] For an overview, see Lawrence A. Cunningham, *A Prescription to Retire the Rhetoric of "Principles-Based Systems" in Corporate Law, Securities Regulation, and Accounting*, 60 VAND. L. REV. 1411, 1486–91 (2007).

[106] *See supra* notes [] [1669 PLI/Corp 205].

prescriptive perspective, and think about what a designer of a network might wish to try to do, aware of the theoretical insight regarding exit costs, and the actual practice of the financial regulatory networks around today.

But first, a small caveat. The SEC is not *obligated* to cooperate, through a network or any other international institution other than a treaty ratified by the Senate, of course. There are both models of non-cooperative international approaches and some evidence that the SEC is taking those approaches seriously. I do not mean to suggest here that networks are inevitable, despite their growth and breadth.

For example, a unilateralist SEC could simply hope that its foreign counterparts copy its approaches to the regulation of mobile capital. Casual interaction, such as regime copying, that does not really rely much on international dialogue at all, either through a network or through other means. This copying is often thought of as a matter for comparative lawyers, who have developed theories about "transplants" and how they work.[107] In the case of securities regulation, we have seen this sort of copying particularly in the developing world, which have, on occasion adopted European or American regulatory rules wholesale.[108]

And there has recently been developments that look like an effort to forego the sort of international cooperation that could occur in a network, and instead substitute a process of "I'm okay, you're okay," international recognition. This process also eschews the dialogue and standard setting of the network for mutual recognition that does not turn on repeated international interaction. The SEC has considered exactly this sort of approach. As two SEC officials testified to congress, the SEC has begun a process "to allow foreign and domestic registrants the alternative to submit for SEC filing purposes financial statements prepared in accordance with International Financial Reporting Standards (IFRS)."[109]

But if we were to embrace the network form, how would we go about doing it. How to deepen a network into something compelling?

Formality -- One thing that created a network that lasts is the achievement of something difficult in its regulatory arena. This could be characterized as the move from principles to rule, and somewhat surprisingly, it implies that the networks that work best when they push for accomplishment, rather than by letting evolving ties of consanguinity grow into something important. Less counterintuitively, it suggests that an effective network is difficult to create. Accordingly, the lesson here is that

---

[107] For the principal text on this, see ALAN WATSON, LEGAL TRANSPLANTS: AN APPROACH TO COMPARATIVE LAW, SECOND EDITION (2D ED. 1993).

[108] The framework for cooperation between the SEC and other foreign securities regulators "deliberately seeks to transplant features of U.S. securities regulation abroad." Anne-Marie Slaughter, S*overeignty and Power in a Networked World Order*, 40 STAN. J. INT'L L. 283, 294 (2004).

[109] James Hewitt & Michael White Testimony before Congress, October 24 2007, available at http://www.sec.gov/news/testimony/2007/ts102407cwh-jww.htm.

some formalization can help. The creation of a dispute settlement mechanism, for example, creates a policing mechanism for departure from the networks norms in a rather obvious way. Currently most networks enforce compliance with standards through self-reporting and some evaluation by outside working groups – at least, that's how it works with IOSCO. This sort of policing is no guarantee of harmonization, however, as is easy to imagine. In sum, networks may benefit from deep degrees of regulation. Technical specification can make interoperability more important, smoother – and more difficult to depart from.

Exclusivity -- Exclusivity may also be crucial – and that's not particularly consistent with the economic network model, but consistent with the insights of scholars like Lake and Jung. Small n networks have a better chance of achieving the crucial move to binding rules than do large n ones, it appears. IOSCO is a network open to all; accounting standards were devised by a more obscure and elite outfit. It may not accord with our intuitions about democracy, but it is possible that narrowly focused – and membered – networks do better at devising technical, difficult rules than do large ones.

Voice? **--** Because the goal of many of these networks is to make exit costly, offering members "voice," the other side of Albert Hirschman's dichotomy may help them stay within the process.[110] We have seen that both IOSCO and the IASC have moved towards more and longer comment periods and transparency. The IASC in particular has not surprised any of its members with its agenda or with the particulars of accounting standards,

These recommendations, or prescriptions, are meant to be more suggestive than comprehensive, and I do not develop them in detail here. They do suggest that it may be useful to think of the world of international governance as a world that works like a network. Understanding why some networks succeed and others fail may make broader conclusions about governance itself possible.

[110] ALBERT O. HIRSCHMAN, EXIT, VOICE, AND LOYALTY: RESPONSES TO DECLINE IN FIRMS, ORGANIZATIONS, AND STATES (1970).