



2011

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Recommended Citation

Jim Chen, *Soft Law and the Global Financial System*, 25 Emory Int'l L. Rev. 1561 (2011).

Available at: <https://scholarlycommons.law.emory.edu/eilr/vol25/iss3/15>

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BOOK REVIEW

SOFT LAW AND THE GLOBAL FINANCIAL SYSTEM

*Jim Chen**

From the ashes of global war, creative destruction forged the modern world.¹ From the heights of global capitalism, destructive creativity threatens the postmodern world. The free flow of capital across national borders has fueled wealth in all nations. The democratization of capital markets has enabled a far larger portion of the world's population to invest in the global economy. At the same time, this expansion in the scale and scope of the world's financial system amplifies the risk at every level, from individual investment portfolios to the very integrity of global capitalism.

A lifetime ago, the victors of the Second World War convened at Bretton Woods, New Hampshire, to write new rules for international economic engagement in the aftermath of global cataclysm. Mindful that hyperinflation and economic collapse had sparked the rise of national socialism and other tyrannical ideologies, the international community adopted three formal agreements that gave rise to the bedrock organizations of modern international economic law: the General Agreement on Tariffs and Trade (now the World Trade Organization (“WTO”)),² the International Monetary Fund (“IMF”),³ and the World Bank.⁴

These formal institutions of international economic law offered at most a modest response to the financial crisis of 2008, the deepest challenge to global markets since the Great Depression. A far more decentralized, fragmented set of institutions devised ad hoc rules for restoring order to a financial sector whose mismanagement of risk in radically democratized and destabilized

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¹ See generally JOSEPH A. SCHUMPETER, CAPITALISM, SOCIALISM AND DEMOCRACY 81–86 (Harper & Bros. Publishers 3d ed. 1950) (discussing the process of creative destruction).

² *The GATT Years: From Havana to Marrakesh*, WORLD TRADE ORG., http://www.wto.org/english/thewto_e/whatis_e/tif_e/fact4_e.htm (last visited Nov. 15, 2011).

³ *History*, INT'L MONETARY FUND, <http://www.imf.org/external/about/history.htm> (last visited Oct. 30, 2011).

⁴ *International Bank for Reconstruction and Development (IBRD): Background*, WORLD BANK, <http://web.worldbank.org/WBSITE/EXTERNAL/EXTABOUTUS/EXTIBRD/0,,contentMDK:21130269~menuPK:3168298~pagePK:64168445~piPK:64168309~theSitePK:3046012,00.html> (last visited Nov. 15, 2011).

markets had brought the entire world economy to the brink of collapse. In stark contrast with the traditional preference for international lawmaking through treaties and formal coordination among sovereign nation-states,⁵ the international legal system attempted to stabilize the global financial system through a complex web of multinational agencies, standard-setting organizations, and the rules devised by those decision-makers. During the defining economic disaster of postmodern times, soft law served as first responder.

In *Soft Law and the Global Financial System: Rule-Making in the Twenty-First Century*,⁶ Christopher J. Brummer provides a detailed and informative analysis of the international regulatory response to the global financial crisis of 2008. This accomplishment alone warrants a close look at this book. Yet, Professor Brummer goes further in this pivotal work on the law of international finance. He provides a persuasive, theoretical account of international financial law. *Soft Law and the Global Financial System* not only describes the mechanisms of lawmaking and standard-setting for global financial markets, but also delivers a workable framework for prescribing and perhaps even perfecting the regulation of the world's most vital and volatile economic institutions.

Chapter 1 of *Soft Law and the Global Financial System* examines the related phenomena of territoriality and regulatory export in international financial law.⁷ The national law of dominant markets, supplemented by the customary practices of those countries' most influential financial actors, has historically supplied many of the rules in international finance.⁸ By virtue of its preeminence in global capital markets, the United States as global hegemon has long dictated the terms by which bankers, broker-dealers, and other financial intermediaries have moved wealth around the world.⁹ The global crisis of 2008 severely undermined the American claim to economic wisdom and political legitimacy. Investors and regulators around the world freely assigned ample blame to "American-style free-market capitalism and the idea

⁵ See Joshua Kleinfeld, *Skeptical Internationalism: A Study of Whether International Law Is Law*, 78 *FORDHAM L. REV.* 2451, 2506–13 (2010).

⁶ CHRISTOPHER J. BRUMMER, *SOFT LAW AND THE GLOBAL FINANCIAL SYSTEM: RULE-MAKING IN THE TWENTY-FIRST CENTURY* (forthcoming Jan. 2012).

⁷ See generally *id.* (manuscript at 19–50).

⁸ See *id.* (manuscript at 30–35).

⁹ *Id.* (manuscript at 24, 29, 36–38, 45).

of globalization.”¹⁰ Countries that had emulated the American approach to financial regulation by “open[ing] themselves to trade and foreign investment took an especially tough hit.”¹¹ Meanwhile, countries that were “less dependent on cross-border financial flows,” whether by design or by default, “weathered the storm.”¹²

The global economy reflects the continuing decentralization of international financial law. The ongoing crisis of confidence in sovereign debt and the European banking industry exposes the European Union’s vulnerability to the sort of economic miscalculations that humbled Lehman Brothers and the entire American financial sector in 2008.¹³ Meanwhile, the “BRIC” nations—Brazil, Russia, India, and China—continue their economic and political ascendancy.¹⁴ The emerging system of international financial law exhibits distinct multipolarity without inescapable polarization.¹⁵ Hegemons old and new, from the United States and the European Union to BRIC and lesser blocs, continue to control financial rules within their borders.¹⁶ Even more important, the highly decentralized, informal, and market-driven nature of international finance enables national regulators to export their rules and norms to receptive markets around the world.¹⁷ As a result, the makers of international financial law routinely share information, engage counterparts, and exhibit a healthy inclination to forge policy through compromise rather than conflict.¹⁸

In Chapter 2, *Soft Law and the Global Financial System* describes the architecture of international financial law.¹⁹ Professor Brummer details the rise of the institutions that promulgate rules, set standards, and enforce compliance in international financial law.²⁰ In stark contrast with the WTO, IMF, and

¹⁰ IAN BREMMER, *THE END OF THE FREE MARKET: WHO WINS THE WAR BETWEEN STATES AND CORPORATIONS?* 178 (2010).

¹¹ *Id.*

¹² *Id.*

¹³ See Editorial, *Curing Europe’s Banking Ills*, FIN. TIMES (Oct. 3, 2011, 11:15 PM), <http://www.ft.com/intl/cms/s/0/f659abb6-edb9-11e0-a9a9-00144feab49a.html>; Robert Reich, Editorial, *Follow the Money: Behind Europe’s Debt Crisis Lurks Another Wall Street Bailout*, PBS (Oct. 6, 2011), <http://www.pbs.org/wnet/need-to-know/opinion/follow-the-money-behind-europes-debt-crisis-lurks-another-wall-street-bailout>.

¹⁴ BRUMMER, *supra* note 6 (manuscript at 14); Peter Apps, *A Decade on, Rise of BRICs Shaped by September 11*, REUTERS, Sept. 10, 2011, available at <http://af.reuters.com/article/topNews/idAFJOE7890CN20110910>.

¹⁵ BRUMMER, *supra* note 6 (manuscript at 46).

¹⁶ *Id.* (manuscript at 14).

¹⁷ *Id.*

¹⁸ *Id.* (manuscript at 14, 46).

¹⁹ *Id.* (manuscript at 51–95).

²⁰ *Id.*

World Bank (the troika of international economic organizations tracing their origins to Bretton Woods), the agencies of international financial law lack the attributes of formal international organizations—institutions created by formal, ratified treaties and validated by “state membership, tangible manifestations of organizational bureaucracy, and an adequate legal pedigree.”²¹ The principal creators of international financial law fall into four distinct categories: agenda-setters, sectoral standard-setters, specialists, and international monitors.²² The financial ministers and the central bankers of the Group of Twenty Finance Ministers and Central Bank Governors (“G-20”) work alongside the newer and more technocratic Financial Stability Board in setting the agenda for global financial regulation.²³ The task of setting international standards for the regulation of the banking, securities, and insurance industries falls to the Basel Committee on Banking Supervision, the International Organization for Securities Commissions (“IOSCO”), and the International Association of Insurance Supervisors (“IAIS”).²⁴ The Basel Committee, IOSCO, and IAIS in turn coordinate their efforts within the Joint Forum on Financial Conglomerates.²⁵ A wide variety of specialized standards emerges from organizations such as the International Accounting Standards Board, the International Federation of Accountants, the Committee on Payment and Settlement Systems, the Financial Action Task Force, the International Association of Deposit Insurers, and the International Swaps and Derivatives Association.²⁶ Several “hard law” organizations advance these efforts in a supporting or monitoring capacity.²⁷ The Organisation for Economic Co-operation and Development has devised standards for corporate governance.²⁸ The Bank for International Settlements not only supplies research support to international financial standard-setting organizations, but also participates as a private, for-profit provider of reserve management services to central banks and other monetary authorities.²⁹ Finally, the IMF and the World Bank monitor other regulators’ formal compliance with international financial law.³⁰ Together, these heterogeneous entities form a fragmented

²¹ David Zaring, *International Law by Other Means: The Twilight Existence of International Financial Regulatory Organizations*, 33 *TEX. INT’L L.J.* 281, 305 (1998).

²² BRUMMER, *supra* note 6 (manuscript at 58–78).

²³ *Id.* (manuscript at 60).

²⁴ *Id.* (manuscript at 61, 63–64).

²⁵ *Id.*

²⁶ *Id.* (manuscript at 58–72).

²⁷ *Id.* (manuscript at 73).

²⁸ *Id.* (manuscript at 70–71).

²⁹ *Id.* (manuscript at 73).

³⁰ *Id.*

network of structurally independent actors with distinctive sources of authority and pathways for legal decision-making.³¹

The functional paradox of international financial law lies in the relationship between elements of formal, “hard” law and the gradual development and enforcement of “soft” law. At an admittedly high level of abstraction, agencies of international financial law observe hard law rules as a matter of internal operation, but cooperate with each other and with private market actors in an informal social network disciplined principally through soft law norms.³² From a thorough examination of this phenomenon, Chapter 3 of *Soft Law and the Global Financial System* develops a compliance-based theory of international financial law.³³ By and large, best practices in contemporary global finance have not emerged through positive, prescriptive lawmaking within a single, hegemonic nation-state and the de facto export of that nation’s regulatory standards to the rest of the world.³⁴ International financial standards are even less likely to be developed through a rigid process of formal lawmaking within a treaty-based international organization.³⁵ Instead, the decentralized network of global financial actors with diverse, broadly distributed responsibilities engages in cycles of reciprocity and retaliation as a cooperative method of developing international financial law.³⁶ Over the long run, uncooperative, self-interested regulators can expect to lose the assistance of other actors within the international financial system.³⁷ Countries that fail to follow an international regulatory consensus, such as a tightening of risk-based capital requirements for banks, jeopardize their financial sector’s access to foreign markets.³⁸ Not surprisingly, the enforcement mechanisms of international financial law closely resemble the reputational tools that financiers, traders, and other private actors routinely use to patrol self-dealing and enforce socially

³¹ ANNE-MARIE SLAUGHTER, A NEW WORLD ORDER 36–64 (2004) (describing international regulation as a series of “transgovernmental networks” consisting of executive officials and international organizations).

³² BRUMMER, *supra* note 6 (manuscript at 55–56).

³³ *Id.* (manuscript at 96–141).

³⁴ *Id.* (manuscript at 36).

³⁵ *Id.* (manuscript at 15–16).

³⁶ See ANDREW T. GUZMAN, HOW INTERNATIONAL LAW WORKS: A RATIONAL CHOICE THEORY 42–48 (2008).

³⁷ See generally *id.* at 71–117 (discussing the theory of a nation’s reputation).

³⁸ See, e.g., DAVID ANDREW SINGER, REGULATING CAPITAL: SETTING STANDARDS FOR THE INTERNATIONAL FINANCIAL SYSTEM 60 (2007) (describing how American and British regulators successfully persuaded Japan to accept more stringent risk-based capital requirements for banks by making a credible threat to exclude Japanese banks from American and British markets).

beneficial norms within their own communities.³⁹ The thin shell of hard formality in international financial law adds the threat of institutional sanctions, such as the denial or withdrawal of membership in an international organization, to this arsenal.

International financial law thus combines legal pronouncements and market-based enforcement decisions among financial regulators interacting in a global and mostly informal network. The uncomfortable truth is that the nodes in this regulatory network are far from equal.⁴⁰ Chapter 4 of *Soft Law and the Global Financial System* focuses on the arguable crisis of legitimacy created by this inequality.⁴¹ International financial law demands that its enforcers accomplish the formidable political feat of demanding compliance within global financial markets while sidestepping democratic accountability within domestic and international legal institutions.⁴² At least within the academic imagination, the technocratic nature of formal lawmaking confers an advantage in accountability and authoritativeness on “hard” international law.⁴³ The crafting of formal international law through “justification and persuasion in terms of applicable rules and pertinent facts” enforces a sort of evidence-based discipline on national law and politics.⁴⁴ Governments that flout international law “without a defensible position or without reasonable efforts to justify their conduct in legal terms” will “incur reputation costs” for their treachery.⁴⁵

But those are the very terms by which soft law operates. Professor Brummer demonstrates that the conventional dichotomy between hard and soft law operates more as a sieve.⁴⁶ The self-interest of private actors, nation-states, and international regulators in reputational goodwill prevails at all points along the spectrum between hard and soft law.⁴⁷ The real source of soft international law’s democratic deficit lies in the “dynamic incorporation” of financial

³⁹ See ROBERT C. ELLICKSON, ORDER WITHOUT LAW: HOW NEIGHBORS SETTLE DISPUTES 123–36 (1991) (discussing theoretical aspects of social control); Lisa Bernstein, *Opting Out of the Legal System: Extralegal Contractual Relations in the Diamond Industry*, 21 J. LEGAL STUD. 115 (1992) (discussing the enforcement mechanisms in the diamond industry).

⁴⁰ BRUMMER, *supra* note 6 (manuscript at 142).

⁴¹ *Id.* (manuscript at 142–65).

⁴² *Id.* (manuscript at 145, 153).

⁴³ *Id.* (manuscript at 50); Kenneth W. Abbott & Duncan Snidal, *Hard and Soft Law in International Governance*, 54 INT’L ORG. 421, 429 (2000).

⁴⁴ Abbott & Snidal, *supra* note 43, at 429.

⁴⁵ *Id.*

⁴⁶ See BRUMMER, *supra* note 6 (manuscript at 136–37).

⁴⁷ See *id.* (manuscript at 101–02).

standards adopted by foreign decision-makers into domestic law, with little or no opportunity for domestic politicians or regulators to participate at the international level.⁴⁸ Dynamic incorporation without domestic deliberation is in practice the norm for the economically weakest players in global financial markets, for these are the countries and nongovernmental constituencies least likely to participate within the informal, decentralized regulatory framework for making international financial law.⁴⁹ The United States and the European Union may have lost some of their economic power over global financial markets, but Wall Street, London's "City," and the bourses of the Continent remain in practice, if not in law, the primary pacesetters for global financial traffic.⁵⁰

These fears permeate contemporary commentary on international law, and they are by no means confined to the financial context.⁵¹ In pragmatic if not philosophical terms, this purported democratic deficit pales in significance alongside the substantive performance of international law in containing global financial crises. To answer this question, *Soft Law and the Global Financial System* turns, in Chapter 5, to a close examination of the international financial crisis of 2008.⁵²

"Creativity and risk are inexorably linked."⁵³ What is true of industrial design is likewise true of finance. The global financial crisis of 2008 traces its origins to a single country, the United States, and to the unintended consequences of mindless mantras embodied in a slogan so closely aligned with national character that it was called "the American dream."⁵⁴ Homeownership, as every American schoolchild should now know, does not guarantee financial stability. Nor do home values consistently rise. But the imprudent extension of subprime mortgages and the aggressive marketing of ever more complex and exotic instruments, from mortgage-backed securities to collateralized debt obligations and credit default swaps, within a globally

⁴⁸ See Michael C. Dorf, *Dynamic Incorporation of Foreign Law*, 157 U. PA. L. REV. 103, 115 (2008).

⁴⁹ See BRUMMER, *supra* note 6 (manuscript at 158).

⁵⁰ See, e.g., Mark Scott, *The World's Top Financial Centers*, BLOOMBERG BUSINESSWEEK (Mar. 5, 2008, 12:42 PM), http://www.businessweek.com/globalbiz/content/mar2008/gb2008035_012894.htm.

⁵¹ See, e.g., Anthony Payne, *How Many Gs Are There in 'Global Governance' After the Crisis?: The Perspectives of the 'Marginal Majority' of the World's States*, 86 INT'L AFF. 729, 734–37 (2010) (discussing the global governance of trade).

⁵² BRUMMER, *supra* note 6 (manuscript at 169).

⁵³ Robert N. Jerrard et al., *Design, Risk and New Product Development in Five Small Creative Companies*, INT'L J. DESIGN, Apr. 2008, at 21, 21.

⁵⁴ See BRUMMER, *supra* note 6 (manuscript at 169).

interconnected financial industry converted the miscalculation of risk within one country into a worldwide liquidity crisis.⁵⁵ The U.S. Senate, with full hindsight, recognized that “the crisis was not a natural disaster, but the result of high risk, complex financial products; undisclosed conflicts of interest; and the failure of regulators, the credit rating agencies, and the market itself to rein in the excesses of Wall Street.”⁵⁶ The free flow of capital across national borders thus transmogrified an almost absurdly American problem of overconfidence in real estate markets into an economic calamity of global proportions.

The resulting crisis has drawn a comparably aggressive and creative cycle of regulatory responses from national governments and international agencies. Chapter 5 of *Soft Law and the Global Financial System* documents some of the most significant legal reactions on the global stage.⁵⁷ In its effort to repair the American credit crisis’ damage to financial institutions around the world, international financial law has sought to achieve goals as elusive as they are lofty: smooth coordination across national borders, full implementation of standards developed through international consensus, and consistently correct, risk-reducing regulatory policy.⁵⁸ At every turn, American and European regulators—legal actors in the jurisdictions most deeply affected by the global financial crisis—have clashed over the measures that the global financial system should adopt.⁵⁹ The Third Accord of the Basel Committee on Banking Supervision, better known as Basel III, embodies a hard-fought but arguably impotent compromise over risk-weighting and capital requirements for banks.⁶⁰ “Shadow banking” by nontraditional institutions such as hedge funds has confounded efforts to identify systemically important financial institutions and to combat the moral hazard inherent in an industry dominated by participants that are “too big to fail.”⁶¹ Overt national disagreements have blocked smooth cooperation over issues that are at once technocratic and culturally polarizing.⁶² The International Accounting Standards Board, practically speaking, must reconcile the American preference for fair value accounting with the contrasting European affinity for historical accounting

⁵⁵ See *id.* (manuscript at 169–70).

⁵⁶ STAFF OF S. PERMANENT SUBCOMM. ON INVESTIGATIONS, 112TH CONG., WALL STREET AND THE FINANCIAL CRISIS: ANATOMY OF A FINANCIAL COLLAPSE 1 (Comm. Print 2011).

⁵⁷ See BRUMMER, *supra* note 6 (manuscript at 169).

⁵⁸ See *id.* (manuscript at 187, 191).

⁵⁹ See *id.* (manuscript at 202–03).

⁶⁰ *Id.* (manuscript at 187–88, 195).

⁶¹ *Id.* (manuscript at 177–79).

⁶² *Id.* (manuscript at 180–81).

coupled with amortization. Limitless executive compensation and naked credit default swaps are anathema to Europeans, particularly the French.⁶³ Those very features define the cultural landscape of American finance.⁶⁴

Cognizant of these barriers to effective international cooperation, *Soft Law and the Global Financial System* concludes with a cautiously hopeful note on the future of international financial law. In Chapter 6, Professor Brummer rebuffs calls for the creation of a World Finance Organization.⁶⁵ The sheer complexity and scope of cross-border financial transactions, to say nothing of the primary actors' devilish creativity, thwarts the dream of a solution that parallels the Bretton Woods institutions and their management of world trade and international monetary policy. Instead, international financial law will probably proceed on some variation of the existing mechanism for developing best regulatory practices through financial diplomacy. The considerable gaps left by this international system will provide ample opportunity for intervention by national regulators.

The arc of modern international law, from the Treaty of Westphalia to the United Nations Charter and the Bretton Woods trilogy of economic accords, is seductive, symmetrical, and beautiful. International law's attraction to formality, elegant and austere, mirrors the financial world's love affair with the Gaussian mathematics that dominates contemporary business and scientific cultures.⁶⁶ In *Soft Law and the Global Financial System*, Christopher Brummer subjects this comforting mirage to the withering realism of adaptive lawmaking for global financial markets. In those unruly markets, the only thing that rises is correlation.⁶⁷ The law's efforts to coordinate markets, paradoxically and perversely, amplify financial risks and deepen the scale of losses when they accrue.⁶⁸ The lawyerly preference for ordered liberty quickly gives way to the pragmatic acceptance of international financial law as a constantly evolving body of regulatory norms that achieve neither economic nor democratic completeness. The hope that countries might cooperate formally to minimize the risk of another global financial collapse belongs to "a

⁶³ *Id.* (manuscript at 202).

⁶⁴ *Id.*

⁶⁵ *Id.* (manuscript at 218–19).

⁶⁶ See NASSIM NICHOLAS TALEB, *THE BLACK SWAN: THE IMPACT OF THE HIGHLY IMPROBABLE* 277–78 (2007).

⁶⁷ See, e.g., *The New Role of Risk Management: Rebuilding the Model*, KNOWLEDGE@WHARTON (June 24, 2009), <http://knowledge.wharton.upenn.edu/article.cfm?articleid=2268> ("The only thing that rises in falling markets is correlations.")

⁶⁸ See Charles K. Whitehead, *Destructive Coordination*, 96 CORNELL L. REV. 323, 326–27 (2011).

system of childish illusions that dominates”⁶⁹ international law. At the very point where “this fact . . . is grasped,” this elementary view of international law “like first love . . . passes into memory.”⁷⁰ In financial affairs, no less than in other dimensions of international relations, salvation often lies in nothing more tangible than soft power.⁷¹ As squalls on the economic horizon signal the next global financial collapse, this system of soft international law, at once imperfect and unpredictable, promises what may be the worthiest lifeboat in the storm.

⁶⁹ DAVID BERLINSKI, *A TOUR OF THE CALCULUS* 239 (1995) (discussing the “hope that antidifferentiation might return an elementary function to an elementary function,” a known impossibility in elementary mathematics).

⁷⁰ *Id.*

⁷¹ *See, e.g.*, JOSEPH S. NYE, JR., *SOFT POWER: THE MEANS TO SUCCESS IN WORLD POLITICS*, at xii (2004) (“[S]oft power is essential to winning the peace.”); Joseph S. Nye, Jr., Comment, *The Decline of America’s Soft Power: Why Washington Should Worry*, *FOREIGN AFF.*, May/June 2004, at 16, 16.