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Soft Law: The Optimal Legal Framework for Global Financial Regulation

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SOFT LAW: THE OPTIMAL LEGAL FRAMEWORK FOR GLOBAL FINANCIAL REGULATION

Yussuf A Aleem[*]

ABSTRACT

The regulation of global finance comprises an unorthodox legal framework. Unlike other areas of economic regulation or international law, more generally, this framework is not directed through intergovernmental organizations with formal legal status. Moreover, commitments (or best practice standards) made by various regulatory officials are non-binding and subject to significant variation. This departure is especially unique when comparing financial regulation to areas such as international trade law or environmental law.[1]

The purpose of this Paper is to provide a positive analysis explaining the prevalence of this form of "soft" law, and normatively suggest why such a framework is the optimal form of regulation in this arena. In doing so, I first explain the need for financial regulation, the transboundary nature of financial systems, and other unique features endemic to global finance, including the need to account for dynamism, complexity and sovereignty considerations. I compare the financial regulatory framework to the formal treaty-making process used in international environmental law as well as the experiences of the World Trade Organization (WTO). I then address certain criticisms of the current regulatory framework and identify areas where there may be room for improvement, including enhanced administrative law mechanisms and increased participation from the Global South.

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[1] This Paper contrasts the global financial regulatory experience to that of international environmental law for several reasons. First, both areas of regulation are transboundary in nature. Climate change, like financial contagion, does not stop at a national border. International environmental law is also a developed area of law—there are thousands of bilateral and multilateral treaties. This Paper also compares global financial regulation to the experiences of international trade law. This comparison is useful considering that both domains concern economic policy as well as the WTO's oft-mentioned dispute mechanism system.

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I. THE NEED FOR FINANCIAL REGULATION AND AN INTERNATIONAL FRAMEWORK

A. The Critical Functions of Financial Systems

As a threshold matter, one may ask why any regulation over financial systems, whether in the form of a hard or soft law framework, is necessary in the first place. Virtually all economists today view the financial sector as having a critical function in facilitating economic growth.[2] Financial systems promote the most efficient allocation of resources by: providing for the mobilization of savings, the facilitation of payments and trade of goods and services, project

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[2] *See* JOHN ARMOUR ET AL., PRINCIPLES OF FINANCIAL REGULATION, 26 (1st ed. 2016) (". . . the better view is that development in the financial system is causally important for economic growth").

selection and monitoring of investments, and the sharing of investment information, as well as several other key initiatives beyond the scope of this paper.[3] Armour et al. idyllically note that the pareto-optimal property of competitive markets is an "almost magical feature."[4] Economists likewise refer to the "magic" of the transformative function of fractional reserve banking.[5] Moreover, some scholars have posited that financial systems, both indirectly and through enhanced access to markets, contribute to poverty reduction.[6]

Excessive financial regulation risks defeating the very functions that financial systems are designed to serve. Excessive regulation is generally understood to increase costs and often forces regulators to make difficult decisions involving trade-offs. For example, measures that limit credit booms may have negative consequences for economic output and employment.[7] Onerous prudential measures can induce a reduction in credit supply, which in turn may encourage banks to take on higher risk, potentially undermining financial stability.[8] Investor and consumer protection may also conflict with financial stability by reducing diversity in the financial system, which in turn may reduce its resilience to systemic shocks.[9]

B. Systemic Risk and System Shock

Notwithstanding the foregoing challenges, financial crises and their aftermaths provide us with a better understanding of these critical economic functions. When left unchecked, these functions have a notable Achilles' heel: they expose the inherent fragility of financial systems, and therefore present risks of systemic failure and potentially severe economic costs.[10] In economic terms, financial regulation exists precisely because of market imperfections and the negative externalities financial institutions impose on society.[11] According to research by Lavean and Valencia, banking crises since 1970 have resulted in

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3 *Id.* at 24.

4 *Id.* at 54.

5 *See* PRINCIPLES OF ECONOMICS, (Univ. of Minn. Libraries Publ'g, 2011) (ebook) https://open.lib.umn.edu/principleseconomics/chapter/24-2-the-banking-system-and-money-creation/.

6 *See* Juzhong Zhuang et al., *Financial Sector Development, Economic Growth and Poverty Reduction: A Literature Review* 1–9 (ADB Economic Working Paper, No. 173, 2009).

7 *See* XAVIER FREIXAS ET AL., SYSTEMIC RISK, CRISES, AND MACROPRUDENTIAL REGULATION, 266 (2015).

8 *Id.*

9 *See* ARMOUR ET AL., *supra* note 3, at 71.

10 *Id.* at 51 ("Particular features of free markets make them especially prone to malfunction . . . in the case of finance, the consequence of actions may not be revealed for extended periods of time, perhaps even years or decades, then the potential for failure and the complexities of correcting it are much greater.").

11 *See* FREIXAS ET AL., *supra* note 8, at 203.

average output losses of 30.1 percent of GDP, with average increases in public debt in the amount of 26 percent of GDP.[12] For example, during the 2007-08 global financial crisis, the aftermaths quantified and realized in 2016 by the crisis had cost the United States 15 percent of GDP, or $4.6 trillion. A 2018 study by the Federal Reserve Board found that the crisis cost every single American a staggering $70,000, on average.[13] In addition to market imperfections and efficiency considerations, it should be emphasized that the failure of financial systems generates significant and adverse distributional effects. During the aforementioned global financial crisis, for instance, low-income earners suffered significantly more than high-income earners in terms of job prospects.[14] Moreover, some research has suggested that the financial crisis created a significant sector of "newly poor" households in certain middle-income nations from an exacerbated middle class.[15] Such increases in poverty and inequality should raise additional questions of fairness when one considers regulatory actions that socialize losses, namely bank bailouts.[16] Finally, recovery from economic crises, which are marked by severe economic downturn, is far more difficult than recovery from ordinary business cycle recessions.[17]

For these reasons, and others discussed in more detail below, financial regulation aims not just to regulate certain conduct (e.g., investor, consumer protection) but also, (and more importantly) to prevent systemic risk.[18] Prior to the 2008 global financial crisis, it was thought that banks' overall risk-taking and propensity for contagion could be managed effectively by microprudential regulation, including capital adequacy rules as well as certain *ex post*

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[12] *Id.* at 144 (citing Luc Lavean and Fabian Valencia, *System Crisis Banking Revisited* 206 (IMF Working Paper No. 18, 2018)).

[13] *See* Gautam Makunda, *The Social and Political Costs of the Financial Crisis, 10 Years Later*, HARV. BUS. REV. (Sept. 2018), https://hbr.org/2018/09/the-social-and-political-costs-of-the-financial-crisis-10-years-later.

[14] *See* Ippei Shibata, *The Distributional Impacts of Recessions: The Global Financial Crisis and the Pandemic Recession* 96 (IMF Working Paper No. 20, 2020).

[15] *See* Bilal Habib et al., *The Impact of the Financial Crisis on Poverty and Income Distribution: Insights from Simulations in Selected Countries*, 7 THE ECONOMIC PREMISE (WORLD BANK) (Mar. 2010), https://openknowledge.worldbank.org/bitstream/handle/10986/10206/537450BRI0EP70Box345626B01PUBLIC1.pdf?sequence=1&isAllowed=y.

[16] *See* Paul Krugman, *Bailouts for Bunglers*, N.Y. TIMES, Feb. 1, 2009, https://www.nytimes.com/2009/02/02/opinion/02krugman.html. The Federal Reserve's decision to "bail out" Bear Stearns but allow Lehman Brothers to collapse has been a hotly debated subject.

[17] *See* ARMOUR ET AL., *supra* note 3, at 409.

[18] *See* ARMOUR ET AL., *supra* note 3, at 73 (describing the various goals and strategies of financial regulation, such as governance, insurance and resolution; *see also* Llewellyn, *infra* note 24, at 14–15 (discussing regulatory matrix of prudential regulation, systemic regulation, conduct and competition).

mechanisms, such as deposit insurance and resort to lender of last resort ("**LOLR**") facilities. The global financial crisis belied these assumptions. Accordingly, following the financial crisis, the regulatory and supervisory framework has shifted its focus from microprudential tools, ensuring the safety and soundness of individual institutions, to macroprudential regulation.[19]

C. Macroprudential Approach to Regulation

Following the global financial crisis, macroprudential tools, including cross-sectional and time-varying measures (e.g., countercyclical capital buffers and other liquidity requirements) have been implemented to prevent and manage various forms of risk to *the system as a whole,* taking into account the various interlinkages that can create feedback and spillover effects.[20] It is important to emphasize that as a result of the global financial crisis we have learned that a particular financial intermediary does not have to fail for a systemic shock to be triggered. In other words, macroprudential mechanisms recognize that a shock can be transmitted through interlinking investment strategies.[21] To this end, in 2009, the Basel Committee for Banking Supervision ("**Basel Comittee**") and the Financial Stability Forum (which later became the Financial Stability Board, or "**FSB**") produced proposals for new measures as part of Basel III.[22] Basel III, among other measures, introduced certain liquidity requirements, increased minimum capital requirements, and a non-risk-based leverage ratio. These standards are discussed in greater detail below.

To summarize, financial regulation, despite its potential drawbacks and inefficiencies, is essential to prevent and contain systemic risks. Specifically, since the global financial crisis, measures of macroprudential policy have been implemented to prevent (*ex ante*) and contain systemic risks given the severe costs that financial shocks impose. These costs often have a disproportionate and negative impact on the most vulnerable members of society.[23]

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[19] *See* ARMOUR ET AL., *supra* note 3, at 409.

[20] *See* FREIXAS ET AL., *supra* note 8, at 251–90 (noting that distributional consequences of macroprudential policy and its impact on inequality, both ex ante and ex post, is an important issue for systemic risk); [*see also*] Joel P. Trachtman, *The International Law of Financial Crisis: Spillovers, Subsidiarity, Fragmentation and Cooperation*, 13 *J. OF INT'L ECON. L.,* 719, [X] (2010).

[21] *See* ARMOUR ET AL., *supra* note 3, at 65.

[22] *See id*. at 409.

[23] *See* Pierre-Hugues Verdier, *The Political Economy of International Financial Regulation*, 88 IND. L. J. 1405, 1461 (2013) ("As a result of GFC, controlling systemic risk (and moral hazard) has become the central focus of financial regulation.").

D. The Transboundary Nature of Global Finance and Systemic Risk

Why then is an *international* regulatory framework necessary? After all, most nations nine (particularly in the developed world) have elaborate (and diverse) domestic regulatory and supervisory architectures to address the foregoing concerns and related matters of macroeconomic policy described in this paper.[24] The answer lies, in part, on the impact of globalization on financial systems and the consequential growth of interlinkages among these systems.[25] The scale of international flows of capital across borders has significantly increased over the last several decades, especially as a result of pro-liberalization efforts to embrace global trade in the 1970s and 1980s, as well as the preeminence of the US dollar as the primary currency of the International Reserve. Recent cross-listings of securities, particularly bond financing on US exchanges, have further increased transboundary capital flows.[26] Technological developments in information and communication (namely the internet) have also further facilitated financial transactions across borders. Moreover, *institutions* have become increasingly global in their operations.[27] According to Tooze, "what drives global trade are not the relationships between national economies but multinational corporations coordinating far-flung 'value chains.'"[28] Consequentialy, in 2011 the FSB developed a policy framework to address the systemic and moral hazard risks associated with systemically important financial institutions.[29] Moreover, one of the main focuses of the Basel III guidance was to introduce capital surcharges for global systemically important financial institutions (or "G-SIFI"s).[30]

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[24] *See generally* David Llewellyn, Institutional Structure of Financial Regulation and Supervision: The Basic Issues, World Bank Seminar: Aligning Supervisory Structures with Country Needs in Washington DC (June 6–7, 2006) (addressing regulatory architecture and the criteria to assess the optimality of institutional structure); *See also* ARMOUR ET AL., *supra* note 3, at 597.

[25] *See* ARMOUR ET AL., *supra* note 3, at 44; *see also* Galbraith and Zaring, *Soft Law as Foreign Relations Law,* 99 CORNELL L. REV. 735, 737 ("In the wake of the financial crisis, the Chairman of the Federal Reserve Board (the Fed) acknowledged that 'the world is too interconnected for nations to go it alone in their economic, financial, and regulatory policies.'); *see also* Joseph J. Norton, *International Financial Law, an Increasingly Important Component of International Economic Law*, (internal quotations omitted) 20 MICH. J. INT'L. 133 (1999).

[26] *See* ARMOUR ET AL., *supra* note 3, at 45.

[27] *Id.* at 46.

[28] Adam Tooze, RETHINKING THE 2008 FINANCIAL CRISIS (excerpt), NATIONAL POST (2019), https://nationalpost.com/opinion/adam-tooze-book-excerpt-rethinking-the-2008-financial-crisis.

[29] *See* FIN. STABILITY BD., *Policy Measures to Address Systemically Important Financial Institutions* at 1, 4 (Nov. 4, 2011), https://www.fsb.org/2011/11/r_111104bb/.

[30] *See* Verdier, *supra* note 24 at 1439. (" . . . as financial firms become global and their structure becomes more complex, supervising them internationally becomes more challenging. Without some coordination and allocation of responsibility among national authorities, some firms may avoid effective regulation altogether.").

It should be no surprise then that financial shocks in one country can quickly spread to markets and institutions across the globe.[31] The global financial crisis and fall of Lehman Brothers, a U.S.-based investment bank, is often cited as a contributing factor to the European Sovereign Debt Crisis.[32] Fearing the imminent failure of financial institutions and a credit freeze on short-term funding, European governments borrowed funds to bail out financial institutions, which in turn threatened the solvency of some of those governments. As Armour et al. succinctly put it, "contagion does not stop at national boundaries."[33] As such, international coordination and cooperation is necessary to ensure that information is shared among regulators, that there is consistency among regulation, and that action in one nation does not have unanticipated cross-border effects in another.[34] Given the transboundary nature of financial systems and growing significance of G-SIFIs, consistency across regulators is vital to mitigate regulatory arbitrage, whereby firms attempt to capitalize on weaknesses or gaps in a particular financial system to evade unfavorable regulations at home. In summary, the international coordination of financial regulation is required to address problems posed by a productive but risky industry that spreads both its benefits and risks across borders.[35]

II. SOFT LAW IN THE GLOBAL FINANCE CONTEXT

A. *What Is Soft Law?*

Soft law is an informal label that generally refers to non-binding regulatory principles or commitments. Soft law stands in opposition to "hard" obligations found in formal legal instruments between or among nations, such as a treaty, protocol or convention.[36] Soft law has been described as an "experiment in global governance" to see whether a successful architecture of international regulations could be created without the formal use of treaties, diplomats, or

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[31] Galbraith and Zaring, *supra* note 26, at 793 ("Now that the world is truly flat, financial crises are evidently contagious, and global warming cares not for national borders, it is naive to hope that regulators can meet their regulatory missions without cooperating with their foreign counterparts.").

[32] *Id.* at 47.

[33] *Id.* at 407.

[34] *Id.*

[35] *See* David Zaring, *Legal Obligation in International Law and International Finance*, 48 Cornell Int'l L. J. 1, 178 (2015).

[36] *See* Vivienne Bath and Luke Nottage, *International Investment Agreements and Investor-State Arbitration in Asia,* HANDBOOK OF INTERNATIONAL INVESTMENT LAW AND POLICY 571 (J. Chaisse et al. eds.,2020) (soft law "describes a set of rules which are made by international standard-setting bodies and not adopted in legally binding forms. Those non-binding rules appear in the form of 'principles', 'guidelines', 'memorandum of understanding' (MOU), best practices, etc.").

state custom.[37] In this sense, some have even reasoned that soft law is (at least as a technical matter) not even law at all.[38]

Most sources of global financial regulation are developed by informal, non-governmental institutions that set standards (and agendas) for the international regulatory community.[39] These institutions, aside from the IMF and World Bank,[40] generally do not have a treaty mandate.[41] Coordination is led by central banks, regulatory agencies and supervisors, and finance ministers.[42] The best known among these groups are the Basel Committee on Banking Supervision and the FSB, the International Organization on Securities Commissions ("IOSCO"), and the International Association of Insurance Supervisors ("IAIS").[43] Global financial regulation also comes in multiple species of soft law. Soft law often takes the form of best practices, standards, or principles that promote sound regulatory supervision. The "Core Principles" of regulation set by the Basel Committee, IOSCO, and IAIS are generally considered the most important of these standards.[44] The "Key Attributes" set by the FSB form another critical element of policy standards. Adopted by the G20 in the wake of the global financial crisis, these measures outline resolution regimes to address G-SIFIs that were once thought to be "too big to fail."[45] Regulatory reports and observations (the data collected, shared, and utilized by national regulators), as well as memorandums of understanding among regulators form another important aspect of the global financial regulatory framework.

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[37] Zaring, *supra* note 36, at 176.

[38] *See Id.*; *see also* Chris Brummer, *Why Soft Law Dominates International Finance – Not Trade*, 13 J Int'l Econ. L. 631 (2010).

[39] *Id.* at 627.

[40] The IMF and World Bank generally do not create regulatory standards, even though they can serve as monitors of regulatory activity.
See Adam Feibelman, *Law in the Global Order: The IMF and Financial Regulation*, 49 N.Y.U. J. OF INT'L L. & POL. (2017) (Discussion on the treaty mandate and hard law nature of the IMF); *see* Hassane Cisse, *Alternatives to 'Hard' Law in International Financial Regulation: The Experience of the World Bank,* Proceedings of the Annual Meeting, 106 AM. SOC'Y OF INT'L L., 317–20 (2012) (Discussion on the positive experiences the World Bank has had with soft law,).

[41] While the WTO, discussed *infra*, has a treaty mandate, only one of its commitments touches on financial services, the General Agreement on Trade and Services (GATS), which relates to the treatment of foreign investment by national authorities, and is not prudential in nature. Brummer, *infra* note 68, at 627.

[42] *Id.*

[43] *Id.*

[44] *Id.* at 628–29

[45] *See* BANK FOR INT'L SETTLEMENTS, *FSB Key Attributes–Executive Summary* (May 29, 2019), https://www.bis.org/fsi/fsisummaries/fsb_key_attributes.htm.

B. Soft Law in Action: The Basel Standards

There is perhaps no greater example of soft law in action then the Basel Standards, the signature achievement of global financial regulation.[46] The Basel Standards were not promulgated through a process coordinated by an established international organization such as the United Nations or IMF, but rather through a series of informal meetings among various banking regulators from Europe, the United States, and a small number of other countries.[47] As mentioned earlier, Basel III was developed in response to the deficiencies in financial regulation revealed by the global financial crisis and intends to provide a foundation for a resilient banking system that avoids the accumulation of systemic vulnerabilities.[48] Specifically, Basel III aims to strengthen bank capital requirements (generally, to 4.5 percent of common equity from 2 percent under Basel II, calling for an additional 2.5 percent buffer requirement), increase bank liquidity (it provides two liquidity ratios—the Liquidity Coverage Ratio and the Net Stable Funding Ratio), and decrease bank leverage (it provides a non-risk-based leverage ratio to serve as a backstop).[49] Despite such an important (and perhaps ambitious) scope of regulatory coverage, the Basel Committee has repeatedly reinforced that "its conclusions do not have, and were never intended to have, legal force."[50]

C. The Blurred Line Between Soft and Hard Law

The formal distinction between soft and hard law is perhaps in many respects much ado about nothing. Soft law in the global finance context, according to Zaring, has "more similarities to hard law then one might expect, given that the concepts were conceived as opposites."[51] Indeed, global financial regulation shares many similarities to public international law, the latter of which "creates a great deal of its necessarily fuzzy content through contestation . . . ."[52] Such "fuzziness" is particularly manifest in the case of customary international law, which obliges states to binding legal obligations *in absence of* an explicit treaty or contractual commitment.[53] Moreover, public international law, as with global

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[46] Zaring, *supra* note 36*,* at 206.

[47] Galbraith and Zaring, *supra* note 26, at 735.

[48] BASEL COMMITTEE ON BANKING SUPERVISION, *High Level Summary on Basel III Reforms* (Dec. 2017), https://www.bis.org/bcbs/publ/d424_hlsummary.pdf.

[49] BASEL COMMITTEE ON BANKING SUPERVISION, *Basel III: The Liquidity Coverage Ratio and liquidity risk monitoring tool*s (Jan. 2013), https://www.bis.org/publ/bcbs238.pdf.

[50] Zaring, *supra* note 36, at 181.

[51] Zaring, *supra* note 36, at 251.

[52] *Id.* at 181.

[53] *Id.* at 183.

financial regulation, ultimately depends on domestic enforcement for its legitimization. Some have even proposed that global financial regulation should, in the case of the United States, be elevated to the level of foreign relations law and therefore subject to exceptionally deferential treatment by courts.[54] The framework of global financial regulation and its relationship to administrative law is discussed in more detail below.

D. Further Muddling in the International Environmental Law Context

It is often difficult to determine, especially as a matter of function, what truly constitutes "hard" international law. Even where nations have entered into formal legal instruments, such as treaties, the line between hard and soft law can blur in many instances. Uncertainty of legal status is a recurring feature in international environmental law, particularly with respect to the more prominent treaties addressing climate change: the United Nations Framework Convention on Climate Change ("UNFCCC"), the Kyoto Protocol, and the Paris Agreement.[55] This section explores these treaties and the nature of their commitments in more detail. In doing so, it underscores the reality that *formal* legal instruments nonetheless typically contain soft, non-binding elements. The myriad of challenges involved in the treaty-making process are addressed afterward.

The UNFCCC is considered a hard law instrument even though it effectively provides no substantive binding commitments. Indeed, the UNFCCC is so broad that it does not even identify specific greenhouse gasses or recommend specific mitigation (or adaptation) procedures for countries to adopt to reduce climate change emissions. Nonetheless, it is a binding, hard law instrument that was ratified by the United States Senate, domestically.[56] As a "framework" convention, this treaty leaves the setting and adoption of specific obligations to subsequent agreements (which are typically characterized as "protocols").

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[54] *See* Galbraith, *supra* note 26, at 764; *See also* David Zaring, *International Law by Other Means: The Twilight Existence of International Financial Regulatory Organizations*, 33 TEX. INT'L L.J. 281 (1998).

[55] United Nations Framework Convention on Climate Change, May 9, 1992, S. Treaty Doc No. 102-38, 1771 U.N.T.S.; Kyoto Protocol to the United Nations Framework Convention on Climate Change, Dec. 10, 1997, 2303 U.N.T.S. 162; Paris Agreement to the United Nations Framework Convention on Climate Change, Dec. 12, 2015, T.I.A.S. No. 16-1104.

[56] *See generally*, Harrold Koh, *Presidential Power to Terminate International Agreements* 128 YALE L.J. 432, 467 (2019). Unlike the Paris Agreement, which was entered into by Executive Agreement, the Trump administration likely did not have the legal authority to unilaterally withdraw from the UNFCCC given that the Senate approved it for ratification.

Framework conventions are said to elevate political will for action and provide flexibility by leaving room for consensus on details at a later stage.[57]

The Kyoto Protocol—which the U.S. Senate ultimately failed to recommend for ratification—is also broad, notwithstanding certain binding elements therein. While the Kyoto Protocol, a follow-up to the UNFCCC, sets binding reduction targets and timetables for certain developed countries, it fails to prescribe specific mitigation actions. Moreover, despite the formality of an enforcement mechanism in the treaty, sanctions under the Kyoto Protocol have proven ineffective.[58] For example, Canada essentially went unsanctioned when it announced it had no intention of complying with its commitments under the agreement.[59] The lack of enforcieability of the Kyoto Protocol can be viewed as particularly frustrating considering that the instrument took five years to negotiate, and an additional seven years to enter into force.

The Paris Agreement, a follow-up to the Kyoto Protocol and its progeny, formally entered into force in 2016, 4 days prior to the election of former President Trump. This treaty has an even more mystifying legal status. The Paris Agreement technically contains a mix of hard obligations, but only to the extent that such commitments are limited to: procedural issues, issues of cooperation and information exchange, and issues of interpretating its framework convention, the UNFCCC.[60] In other words, the binding portions create no additional substantive obligations on the parties beyond what was previously agreed to in the previously discussed anemic UNFCCC. The treaty's nationally-determined contributions ("NDC"s), designed to reduce greenhouse gas emissions, are completely voluntary and therefore do not allow for any state-to-state enforcement under international law.[61] The treaty also fails to recommend

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[57] ECONOMIC COMMISSION FOR EUROPE–THE COMMITTEE ON HOUSING AND LAND MANAGEMENT, *Framework Convention Concept* (Oct. 4, 2011), https://unece.org/fileadmin/DAM/hlm/sessions/docs2011/informal.notice.5.pdf.

[58] *See* David B. Hunter, *The Hard Choice for Soft Commitments in the Climate Change Regime*, in ADVOCATING SOCIAL CHANGE THROUGH INTERNATIONAL LAW: EXPLORING THE CHOICE BETWEEN HARD AND SOFT INTERNATIONAL LAW (D. Bradlow & D. Hunter, ed., 2020) at 20–21 ("But experience with the Kyoto Protocol implementation, as well as environmental agreements more generally, highlighted the shortcomings of formal enforcement and sanctions in gaining compliance with binding targets").

[59] HUNTER, D., SALZMAN, J., ZAELKE, D. INTERNATIONAL ENVIRONMENTAL LAW AND POLICY, 74 (6th ed. 2021).

[60] *See* Harrold Koh, *supra* note 57, at 467, for a discussion on the legal standing of the Paris Agreement in the United States, ("The 2015 Paris Climate Change Agreement was not a sole executive agreement but what some have called an executive agreement plus, a bundle of commitments made by executive initiative, but with general congressional awareness and approval in a zone of significant congressional power") (internal quotations omitted).

[61] *See* Salzman, *supra* note 60, at 74. The Obama negotiators could avoid the need for Senate ratification only if any new mitigation commitments were non-binding.

any specific mitigation or adaptation strategies. In its latest NDC report, Saudi Arabia, the world's second largest producer of fossil fuels, provided that it would combat climate change solely by "support[ing] the planting of mangrove seedlings along its coasts."[62] Given such modest ambition from some nations, it is perhaps no surprise that current NDCs, in the aggregate, fall far short of the Paris Agreement's aim to limit temperature increase to 1.5 or 2 degrees Celsius above pre-industrial levels.[63] Additionally, the Paris Agreement does not have an enforcement mechanism in place. While Article 15 of the Agreement directs the Conference of the Parties to implement a means of enforcment, they have still yet to do so.

The Montreal Protocol on Substances that Deplete the Ozone is known as the crown jewel of international environmental law. This treaty, as amended, has led to the phase out of most ozone depleting success substances ("ODS"), such as CFCs. Although it was not initially intended to address climate change, this treaty has indirectly had the greatest positive impact on climate change. This is primarily due to the fact that many ODS are also greenhouse gasses.[64] Nonetheless, while the Montreal Protocol provides for a binding enforcement mechanism that includes trade measures, such measures have rarely, if ever, been implemented.[65] The Implementation Committee has seldom recommended revoking a nation's access to technology and financial assistance under the Multilateral Fund. In each case of noncompliance, the nation-party was able to adopt corrective measures and avoid enforcement (i.e., sanctions).[66] Thus, even among the more triumphant treaties in international environmental law, enforcement procedures often boil down to informal mechanisms of soft law, which will be explored in more detail below.[67]

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[62] UNFCCC*, The Intended Nationally Determined Contribution of the Kingdom of Saudi Arabia under the UNFCCC* (Nov. 2015), https://www4.unfccc.int/sites/ndcstaging/PublishedDocuments/Saudi%20Arabia%20First/KSA-INDCs%20English.pdf.

[63] *See* UNEP, *UNEP Emissions Gap Report 2020*, https://www.unep.org/emissions-gap-report-2020. As things stand world is still heading for a temperature rise in excess of 3°C this century.

[64] The more recent 2016 Kigali Amendment to the Protocol has further led to reduced greenhouse gas emissions with the phase-down of certain CFC substitutes, namely HFCs.

[65] *See generally, NRDC v. EPA*, 464 F. 3d 1 (D.C. Cir. 2006). The legal status of certain aspects of the Montreal is especially unclear with respect to whether decisions of the Committee of the Party, which supplement and enforce certain obligations to the treaty, are binding. This question has been addressed in this case. The Court ruled that EPA had no legal obligation to ensure that its rules for the production and consumption of methyl bromide, an ozone depleting substance, complied with decisions for its use made by the Parties to the Montreal Protocol.

[66] Donald Goldberg et al., *Effectiveness of Trade & Positive Measures in Multilateral Environmental Agreements: Lessons from the Montreal Protocol*, CENTER OF INTERNATIONAL ENVIRONMENTAL LAW, UNITED NATIONS ENVIRONMENTAL PROGRAM, https://www.ciel.org/Publications/EffectivenessofTradeandPosMeasures.pdf.

[67] *See Center for Biodiversity v. United States*, Memorandum Opinion, Civ. Action No. 18-563 (D.D.C.

E. *Soft Law's de facto Enforcement Mechanisms*

Contrary to conventional wisdom, soft law in the global financial regulation context does have robust, albeit indirect, enforcement mechanisms.[68] Instances of non-compliance with international standards, particularly in the case of egregious deviations, can result in meaningful reputational and market costs. First, entry into significant markets (e.g., U.S., UK, EU, Japan) require home countries to meet the Basel Standards. Second, the IMF and World Bank reference implementation of these standards as an indication of appropriate domestic policy. Compliance with such standards is often the basis upon which loans are granted by the IMF and the World Bank. In this sense, members can use the lever of IMF and World Bank conditionality to induce compliance.[69]

Financial institutions, such as the Basel Committee or the FSB, can also publicly signal a member's failure to comply with certain principles or standards. This "name-and-shame" approach subjects a regulator or supervisor to potential social opprobrium within a relatively small community should they fail to deliver on certain commitments. Moreover, such ridicule signals that the non-cooperative nation suffers from weak domestic oversight and supervision. Targeted nations will in turn find it harder to raise capital or attract firms to transact business in their countries; it is in their best financial interest to comply with standards.[70] By way of specific example, the FSB has adopted measures to promote compliance with international financial standards concerning cooperation and information exchange. In doing so, the FSB provided that it can consider a "toolbox of possible measures," which include undesirable name-and-shame measures.[71]

2019). Enforcement in other areas of international environmental law have been equally disappointing. As of today, for example, the Conference of the Parties under the Rotterdam Convention (which entered into force in 2004) has still not agreed on a compliance mechanism. Moreover, in the case of the United States, even "hard" (binding) commitments under the Paris Agreement cannot be enforced domestically. A lawsuit brought by the Center for Biological Diversity to try to force the Trump Administration to comply with the treaty was dismissed for a lack of standing.

[68] *See generally* CHRIS BRUMMER, SOFT LAW AND THE GLOBAL FINANCIAL SYSTEM: RULEMAKING IN THE 21ST CENTURY (1st ed., 2011) (providing that global financial regulation is supported by a range of reputational, market, and institutional mechanisms that make it more effective than traditional theories predict).

[69] *See* Pierre-Hugues Verdier, *supra* note 24, at 1405 ("In sum, the current system based on . . . soft law is relatively successful at enforcement cooperation"); *see also* Barr and Miller, *Global Administrative Law: The View from Basel,* 17 EUR. J. INT'L L. 15, 20 (2006).

[70] *See* Brummer, *supra* note 69, at 640–41.

[71] FSB FRAMEWORK FOR STRENGTHENING ADHERENCE TO INTERNATIONAL STANDARDS (Jan. 9, 2010), https://www.fsb.org/wp-content/uploads/r_100109a.pdf?page_moved=1.

To summarize, in light of these broad and often non-binding elements of hard law, coupled with non-existent or otherwise ineffective enforcement mechanisms, one has to stretch their imagination to determine the functional differences between hard and soft law at times. This line blurring may have critical implications when one considers the unique features and concerns of global finance as well as the challenges imposed by the treaty-making process, both of which are discussed in more detail below.

III. THE PREVALENCE OF SOFT LAW AND UNIQUE FEATURES OF GLOBAL FINANCE

Several explanations have been offered to explain the dominance of soft law in international finance. This section first explores these theories and then suggests why particular aspects of global finance warrant a soft law regime. In doing so, I highlight the many pitfalls of using a treaty-based approach in the global finance arena. The following section then contrasts the global financial framework experience to that of international trade law.[72]

A. The Inefficiency of Hard Law

The ubiquity of informal agreements can be explained as the product of power dynamics between countries. This "real-politik" perspective in international relations posits that, in the absence of hard and binding commitments, it is power rather than legal or efficiency considerations that promotes the standard setting practice.[73] Informal, non-binding commitments allow for easy exit and permit opportunism (in the form of free-riding) where it benefits a particular nation.[74] However, given the increasingly transboundary and interconnected nature of global finance and corollary systemic risk, addressed earlier, powerful nations have a significant (perhaps the greatest) incentive to build consensus and coordinate financial regulatory affairs with other nations. The prevalence of soft law in global finance should therefore be explained by more than power dynamics alone.

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[72] Not all financial regulators and supervisors have endorsed the soft law approach. *See* Comments Received on ESB CONSULTATIVE DOCUMENT: EFFECTIVE RESOLUTIONS OF S1FIS (July 19, 2011), *https://www.fsb.org/wp-content/uploads/r_110719.pdf* (Of the eight G-SIFIs that submitted comments to the FSB, BNP Paribas, Deutsche Bank, Santander, UBS, and Unicredit expressly called for some form of legally binding arrangement for resolution authority.

[73] *See* Brummer, *supra* note 69, at 630–31.

[74] *Id.*

Soft law's popularity can also be explained from the standpoint of efficiency and reduced negotiation costs.[75] Under this theory, soft law not only seeks to generate meaningful commitments from nations, but it also seeks to do so efficiently. Hard law (and the treaty-making process in particular) is remarkably unattractive in this regard.[76] With this in mind, the particular inefficiencies and challenges involved in the treaty-making process deserve special mention.

As a preliminary matter, treaties typically originate in an informal manner. For example, in the case of international environmental law, there is no prescribed process for creating a multilateral treaty. Most often, a nation will recommend that an international organization, such as the United Nations General Assembly ("UNGA") or the UN Economic and Social Council ("ECOSOC"), establish a committee or convene an international conference to consider a particular issue. Therefore in some respects, the nascent stages of the treaty-making process resemble that of global financial regulation.

However, the treaty-making process then quickly begins to sing along to a very different tune. First, treaty-making often entails years of negotiation between heads of state and their representatives.[77] The Kyoto Protocol, for instance, took five years alone to negotiate. Once negotiations have concluded or the nation-parties have otherwise agreed to principal terms, treaties are then subject to a cumbersome domestic ratification process. In the United States, for example, legally binding instruments, irrespective of their hard or soft functions, require significant support from the legislature—namely the advice and consent of two-thirds of the Senate pursuant to the Treaty Clause of the Constitution.[78] After many years of negotiation, the U.S. ultimately rejected the Kyoto Protocol, via the Bryd-Hagel resolution, by a unanimous 95-0 vote from the Senate.[79]

Treaties are also subject to several qualifications and limitations. A sovereign state may limit their consent to be bound by only a portion of a treaty. In addition, states may be able to make formal reservations, which can make the

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[75] *See* Verdier, *supra* note 24, at 1459, providing that political economy considerations explain the prevalence of soft law ("there are strong historical and political factors that favor soft law . . . and hinder the emergence of other arrangements").

[76] Brummer, *supra* note 69, at n.73.

[77] *Id.*

[78] A congressional-executive agreement requires approval from a majority of both Houses of Congress. However, as discussed *supra* note 56, the President has acted unilaterally where a treaty binds the nation only to soft law commitments. This was the approach the Obama and Biden administrations took with respect to entering (and re-entering) the Paris Agreement. This then begs the question of whether such a formal process is worth the costs; *See also* Galbraith and Zaring, supra note 26, at 749.

[79] Interestingly, the US failed to ratify the Kyoto Protocol because of the instrument's lack of commitments from developing countries, which is addressed below, in the context of global finance.

implementation and application of treaties more complex and challenging.[80] The number of reservations in treaties has risen dramatically over the last several decades. This rise is attributed to the growing number of nations and increasing public political pressure. Even where a party cannot or has not made a formal reservation or otherwise limited its consent to be bound, it may nonetheless provide a broad "declaration" to the treaty. While in theory declarations merely clarify the nation's position and do not modify the legal effect of the treaty, they nonetheless open the door to further ambiguity. Consider, by way of example, the following excerpt from the Philippines' declaration to the Paris Agreement:

> It is the understanding of the Government of the Republic of the Philippines that its accession to and the implementation of the Paris Agreement shall in no way constitute a renunciation of rights under any local and international laws or treaties, including those concerning State responsibility for loss and damage associated with the adverse effects of climate change.

Declarations such as these shed light on the nuances of a cumbersome process. They also, perhaps more significantly, raise difficult questions about the applicability of treaty obligations vis-à-vis public international law more generally.[81] In this example, the Philippines is *ex ante* identifying its potential defenses under international (and national) law for non-compliance with its obligations under the treaty.[82] Such disclaimers are especially curious in the case of the Paris Agreement, which, as we observed earlier, fails to provide for any substantive binding commitments to begin with.

The hurdles to effectuate and implement a treaty do not merely stop at the ratification process.[83] To echo the mantra of infomercials, "but wait, there's more!" The parties to a treaty are not legally bound by its terms until the treaty "enters into force." Most often the treaty will enter into force only after a certain minimum number of nations have ratified the agreement domestically and additional conditions or "triggers" have been satisfied. As noted earlier, the

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[80] *See* Salzman, *supra* note 60, at 302.

[81] Even in the absence of a formal treaty obligation, customary international law (a form of hard law), provides a myriad of defenses and exceptions to meeting international obligations. This is another example of how hard law is riddled with ambiguity with respect to both its obligations and compliance mechanisms; *see* Zaring, *supra* note 35, at 208 ("In any particular time and, indeed, in particularly important times, powerful states may break their legal obligations in the interests of their national security or other national priorities."); *see also* Roman Boed, *State of Necessity as a Justification for Internationally Wrongful Conduct*, 3 YALE HUM. RTS. & DEV. L.J. (2000).

[82] This should, perhaps more accurately, be referred to as a "preclusion from wrongfulness" in custonary international law parlance.

[83] Additional, minor requirements such as "depositing" the instrument with the appropriate depository are fairly easy to satisfy. Treaties are often ratified and deposited on the same day.

Kyoto Protocol took approximately seven years to enter into force. Below is an excerpt from the Kyoto Protocol's demanding Entry into Force clause (Article 25).

> This Protocol shall enter into force on the ninetieth day after the date on which not less than 55 Parties to the Convention, incorporating Parties included in Annex I which accounted in total for at least 55 per cent of the total carbon dioxide emissions for 1990 of the Parties included in Annex I, have deposited their instruments of ratification, acceptance, approval or accession.

To summarize, treaties and other sources of hard law are subject to many of the same ambiguities and putative limitations of soft law. Indeed, as previously observed, the boundary between hard and soft law is often unclear. While they are technically hard law instruments, most of the climate change agreements provide no specific (e.g., quantitative) commitments, action-plans, or recommendations as to how to reduce green-house gas ("GHG") admissions. The difficulty in obtaining consensus (or "buy in") among nations—resulting, in part, from their fears over the consequences of noncompliance—has arguably led to a process wherein the parties agree on the lowest common-denominator.[84] Moreover, such hard law instruments appear to confer no meaningful advantage in terms of enforcement mechanisms. As will be continued in discussion, the informal "name-and-shame" compliance tools of global financial regulation can be especially effective.[85] Furthermore, the formal requirements of hard law, namely the ratification and entry into force requirements of treaties, make this form of law exceptionally time-consuming and inefficient.[86] While the Montreal

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[84] *See* Susan Biniaz, *Comma but Differentiated Responsibilities: Punctuation and 30 Other Ways Negotiators Have Resolved Issues in the International Climate Change Regime*, 6 MICH. J. ENVTL. & ADMIN. L. 37 (2016). (Revealing that treaty negotiators often deliberately create "constructive ambiguity" for interpretive purposes as vagueness and imprecision facilitates consensus); *See also* Salzman, *supra* note 60, at 106 ("Some commentators argue that the United Nations is the wrong forum for negotiating a response to climate change, asserting that the rule of decision by consensus makes it difficult to reach agreement on broad and complex issues.").

[85] *See* Piotr Bańbula and Malgorzata Iwanicz-Drozdowska,*The Systemic Importance of Banks–Name and Shame Seems to Work*, 18 FINANCE RESEARCH LETTERS, ELSEVIER, 297 (Aug., 2016) (analyzing the impact of announcements of the list of GSIFIs by the FSB and finding that the announcement itself decreased the systemic importance of these institutions by approximately 25 percent); *cf* Edward F. Greene and Joshua L. Boehm, *The Limits of Name-and-Shame in International Financial Regulation*, 97 CORNELL L. REV. 1083 (2012); The European Banking Authority is currently in the process of creating a database to name-and-shame financial institutions with weak anti-money laundering controls. *See generally* EBA REGULATION AND POLICY, https://www.eba.europa.eu/regulation-and-policy/anti-money-laundering-and-countering-financing-terrorism.

[86] *Cf.* ALEXANDER KERN ET AL., INTERNATIONAL SOFT LAW AND THE FORMATION OF BINDING INTERNATIONAL FINANCIAL REGULATION (2005), ("A multilateral treaty framework may be necessary to ensure that most states that regulate the major financial systems adhere to accepted principles of capital adequacy, payment system regulation, and antimoney-laundering requirements").

Protocol has proven to be an undeniable success story of hard law, the climate agreements have, to date, been a disappointment at best, and a failure at worst.

B. The Dynamism and Complexity of Global Finance

The inefficiency of the treaty-making process is eminently noteworthy when one considers the peculiar nature of global finance and systemic risk. First and foremost, global finance is an extremely technical area of regulation, requiring expert, technocratic decision-making at all levels. Interlinkages among financial systems, coupled with the transboundary nature of global finance, necessitate an interdisciplinary approach covering, among other areas, expertise in finance, macroeconomics, banking regulation, securities regulation, corporate governance, and bankruptcy.[87] This expectation is especially salient following the lessons learned from the global financial crisis. A macroprudential approach to preventing and containing systemic risk focuses on risks across the entire financial system rather than to specific institutions. The importance of line-drawing between traditional banks, and other financial intermediaries (namely, shadow banks) and financial markets has waned over time. Given these considerations and many others, it is hard to imagine a well-functioning regulatory system in which less experienced heads of state (or representatives thereof), rather than specialized regulators and supervisors, devise best practices.[88] Indeed, in the case of the United States, a similar dynamic should raise the question of whether the highly-qualified Environmental Protection Agency (EPA) rather than the State Department is better suited to coordinate standards in the context of international environmental law, or at least should be consulted more.

Moreover, when it comes to global finance, perhaps moreso than any other area of law or regulation, *time is of the essence*.[89] As Armour et al. eloquently put it:

> The financial system does more than simply keep capital flowing round the economy today. It is also a time machine, linking the economy of today to the economy of tomorrow. That is a Herculean

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[87] For example, the FSB key attributes concerning resolution authority would require a sophisticated understanding of insolvency and bankruptcy law. The "no creditor worse-off than in liquidation" rule underscores this point.

[88] An exception perhaps being the G-20, an intergovernmental forum comprising 19 countries and the European Union, which includes heads of state in addition to central bankers and finance ministers. *See generally* G-20, https://www.g20.org.

[89] The notion of fractional reserve banking, the lifeblood of banking finance, depends on proper timing assumptions. Too many deposit withdrawals at once—baring certain safeguards such as insurance—cannot be satisfied due to liquidity mismatch.

> task and it demands a measure of sophistication that is the source of both its successes and failures.[90]

Financial regulators are often one step (or several steps) behind the financial industry. The financial regulation literature frequently emphasizes this temporal shortcoming as one of the primary causes of financial crises.[91] Therefore, for obvious reasons, treaties cannot keep up with systems in which automated stock market transactions are executed at lightning speed and payments are cleared and settled in real time or within 24-hours.[92] Financial intermediaries are constantly innovating novel products, vehicles for investment, and investment strategies that quickly take hold in the mainstream financial system.[93] Some of these have the potential to transmit risk and destabilize the entire global financial system. Financial innovation in derivatives, such as the creation credit default swaps, contributed to the short-term credit-supply run on the shadow banking system, which ultimately precipitated the global financial crisis.[94]

The 1974 Herstatt Bank failure, which itself led to the creation of the Basel Committee, provides a prime example of time-sensitivity considerations in international finance. The German bank incurred sizeable losses in fast-paced foreign exchange trading. The operations of the bank were then suspended in the middle of a foreign currency exchange transaction. Those entities that transferred currency to Herstatt Bank (deutschmarks) never received the agreed upon exchange currency (US dollars). This in turn led regulators to soon develop and implement the use of the Continuous Linked Settlement (CLS).[95] In short, even minor delay and regulatory foot-dragging in global finance is a potential recipe for disaster.

The temporal dimension of global finance has both significant *ex ante* and *ex post* implications in regulatory design. More recent resolution mechanisms,

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[90] Armour, *supra* note 3, at 22.

[91] Ralph Chami et al., *Financial Regulation and the Speed of Financial Risks*, 7-2 OECONOMIA 161, (2017).

[92] Brummer, *supra* note 69, at 637 ("financial markets are constantly evolving due either to innovations in the trading strategies or technological capabilities of market participants, and because of the changing macroeconomic and regulatory environment in which markets operate.").

[93] Additional technological expertise will be necessary as crypto currency and alternative, electronic clearing and settlement systems continue to develop and popularize.

[94] *See* Financial Crisis Inquiry Commission, Financial Crisis Inquiry Report (January 2011) (Conclusion, pp. xv–xxviii); *see also* Lastra, Rosa & Wood, Geoffrey, *The Crisis of 2007—09: Nature, Causes, and Reactions*, 13 J. OF INT'L ECON. L. 531 (2010).

[95] This occurred after the German bank incurred sizeable losses in fast-paced foreign exchange trading. The operations of the bank were suspended in the middle of a foreign currency exchange transaction. Those entities that transferred currency to Herstatt Bank (deutschmarks) never received the agreed upon exchange currency (US dollars).

referenced earlier, are intended to operate more quickly than ordinary insolvency laws to mitigate severe loss of value in the event of bank failure.[96] Resolution mechanisms call for the use of new tools such as asset transfer and "bail-in" creditor financed recapitalization. These tools are intended to be implemented swiftly to prevent insolvency or bankruptcy.[97] Under the FSB Key Attributes, the resolution authority can stay an institution's obligations (e.g., implement a 24-hour stay of OTC derivatives and the triggering of any liquidation preferences) to transfer its book of assets to another financial institution. Swift action is also necessary *ex post*, following the onset of a crisis. Freixas et al. note that "a speedy resolution of the crisis is of the essence, even if accompanies by high fiscal outlays to support the financial section."[98] The small and fairly homogenous makeup of global financial regulators and supervisors, such as the Basel Committee (as opposed to a diverse group of politicians, state officials or ambassadors) allows the group to respond quickly and act flexibly.[99]

The global financial regulatory framework's swift reaction to the Covid-19 pandemic is perhaps the greatest testament to the benefits of soft law in this area. As of the time of this paper, the ultimate consequences of the pandemic remain uncertain. Notwithstanding, regulators have been able to respond to this new shock to the global financial system in an impressive timely fashion. On April 10, 2020—while many jurisdictions around the world were still in quarantine—the FSB outlined its plan for coordinated action to maintain financial stability and support the real economy. Such measures included: identifying vulnerable nodes in the global financial system, promoting daily information exchanges on financial policy responses taken by FSB members, and guiding domestic authorities on ways to use the existing flexibility[100] in international standards to address the crisis.[101] The Covid-19 pandemic has also (arguably) revealed that Basel III has, to date, achieved its ongoing objective of strengthening the resilience of the banking system.[102]

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[96] Armour, *supra* note 3, at 78.

[97] G-SIFIs are subject to the FSB key attributes covering resolution scope, authority, and powers.

[98] *See* FREXIAS ET. AL, *supra* note 8, at 146.

[99] Barr and Miller, *supra* note 70, at 18.

[100] In the United States, the Federal Reserve did not extend a pandemic-crisis rule that allowed banks to relax capital levels. *See generally* FEDERAL RESERVE, *COVID-19 Supervisory and Regulatory FAQs*, https://www.federalreserve.gov/covid-19-supervisory-regulatory-faqs.htm.

[101] FINANCIAL STABILITY BOARD. *Letter to G20 Finance Ministers and Central Bank Governors: April 2020*, https://www.fsb.org/2020/04/fsb-chairs-letter-to-g20-finance-ministers-and-central-bank-governors-april-2020/; *see also* FINANCIAL STABILITY BOARD, *COVID-19 pandemic: Financial stability implications and policy measures taken – Report to the G20 on July 5, 2020*, https://www.fsb.org/2020/07/covid-19-pandemic-financial-stability-implications-and-policy-measures-taken-report-to-the-g20/.

[102] *See* Pablo Hernandez de Cos, Chairman of the Basel Committee, Speech at the BCBS-Bundesbank-CEPR workshop on evaluating financial regulation: Evaluating the Effectiveness of Basel III during Covid-19

In addition to time-sensitivity considerations, soft law in the global finance context promotes the independence of central banks. Central banks are designed with the intent to be largely insulated from domestic politics. In the United States, for example, presidential control over the Federal Reserve Board is asserted at the time of nomination of the Chairman and Board Members. After full board and chairman approval, this control effectively detaches in the interest of preserving the Board's independence and credibility in the market.[103] While Congress does exert some control over the Federal Reserve Board during the confirmation process and at periodic hearings on banking and monetary policy, the Reserve Board is independently funded through interest earned on its security holdings, meaning the Board is financially politically independent. The Office of the Comptroller of the Currency ("OCC") is also independently funded through fees paid by banks.[104] According to Barr and Miller, "independence [of central bankers] tends to promote stability in monetary policy."[105] Here again, the wisdom behind the Basel Committee's "club" of central bankers (and other regulators) may offer more benefit than ordinarily meets the eye.

Lastly, no two countries are the same. Even among developed nations, states have vastly different economies, financial system architectures, path dependencies, and political and social agendas.[106] Soft law's flexibility accounts for this variation and allows countries to narrowly tailor regulation to their particular needs.[107] For examply, the United States, as a liberal market-based economy, has a significantly lower percentage of assets as a percentage of GDP, in comparison to Switzerland, a nation that is heavily dependent on bank financing. In addition to financing sources, nations have diverse financial system architectures, ranging from systems that integrate all prudential regulation to those that have implemented twin (or triple) peak structures.[108] In the United

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and Beyond, (Apr. 20, 2021).

[103] Barr and Miller*, supra* note 70, at 18.

[104] *Id.*

[105] *Id*. at 19.

[106] *See* Chris Brummer, *How International Law Works (and How it Doesn't),* 99 GEO. L.J. 257, 327 (2011). In case of global finance, a centralized regulatory system is impractical due to incongruent domestic forms of prudential and supervisory oversight.

[107] The United States, for example, chose to develop a "bifurcated regulatory capital framework" under which most banks could continue to apply a modified version of Basel I, while the largest internationally active banks would apply the advanced internal ratings based approach developed under Basel II; *See* Bradley K. Sabel, *Basel III Framework: US/EU Comparison,* HARVARD LAW SCHOOL FORUM ON CORPORATE GOVERNANCE (Sept. 27, 2013), https://corpgov.law.harvard.edu/2013/09/27/basel-iii-framework-useu-comparison (Highlighting US and EU differences in Basel III implementation); *See also* Christian Tietje &Matthias Lehmann, *The Role and Prospects of International Law in Financial Regulation and Supervision*, 13 *J. INT'L ECON. L.* 663 (Sept. 2010) (there is no "one size fits all approach" to financial regulation and supervision).

[108] Llewellyn, *supra* note 25 at 42 ("International experience indicates a wide variety of institutional

States, for instance, banking supervision is stratified at the federal level among the Federal Reserve Board, the OCC, the Office of Thrift Supervision, and the Federal Deposit Insurance Corporation.[109] According to Barr and Miller, variation can lead to wider reach among nations and enhance the legitimacy of the standards, a concept that will be explored in more detail below.[110] As we've seen, the (perhaps illusory) promise of harmonization in the hard law context has led nations to agree on deflated commitments. Conversely, the flexibility of soft law has had an arguably far more positive impact with respect to the implementation of global financial standards.

C. Sovereignty Costs and Global Financial Regulation

Global financial standards are set by non-elected, supranational networks of regulators. Some have characterized this regime as a club of regulatory technocrats lacking in accountability and legitimacy. Others have even described the framework as "anti-US."[111] Perhaps ironically, however, it is the non-binding, elastic character of global financial regulation that allows nations to *reduce* sovereignty costs.[112] One of the greatest challenges in international law is the increasing tension between the ideal of state sovereignty and the notion of international harmonization based on law. The principle of state sovereignty demands that nations maintain the ultimate authority to govern their citizens according to national values. States, however, routinely make binding, legal commitments that either conflict with or surrender this power.[113] As observed earlier, this tension has arguably led to watered-down obligations in the framework of international environmental law treaties addressing climate change. This sovereignty tension (or "democracy deficit") is also manifest—and indeed intensifying—in other domains of public international law. In the area of international investment arbitration, for example, troves of nations, including have either terminated or replaced their bilateral and multilateral treaties as a

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regulatory formats which suggests there is no universal ideal model").

[109] Interestingly, some agencies have been more receptive to the Basel Committee than others. Barr and Miller, *supra* note 70, point out that the Federal Reserve has been more supportive of the Committee's substantive decisions than has the OCC.

[110] *See* Barr and Miller, *supra* note 70, at 31.

[111] Tom Braithwaite & Patrick Jenkins, *JPMorgan Chief Says Bank Rules 'Anti-US,'* FIN. TIMES (LONDON), (Sept. 12, 2011); *see* Barr and Miller, *supra* note 70, footnote 103.

[112] *See generally* Chris Brummer, Networks In (-)Action? *The Transgovernmental Origins of, and Responses to, the Financial Crisis*,3 THE WORLD BANK LEGAL REV., 323 (2012) (finding perceived sovereignty costs associated with strict standards limit international coordination).

[113] *See* Hathaway, Oona A*., International Delegation and State Sovereignty*, 71 L.& CONTEMP. Probs 71, 115 (2008).

reclamation of national sovereignty.[114] The non-binding and flexible nature of global financial regulation mitigates this tension for the same reasons previously discussed—states are not (at least as a formal matter) legally bound by any of these commitments and are free to tailor international standards according to their specific domestic needs. Soft law also depends on domestic approval (typically regulatory) for its domestic enforcement. Finally, as will be seen below, the adoption of certain global administrative law mechanisms can (and has) led to increased accountability and legitimacy of global financial regulation.[115]

IV. WTO LAW'S EXPERIENCE AND ROOM FOR IMPROVEMENT

While a full assessment of the criticisms of the current state of global financial regulation is beyond the scope of this paper, this section responds to some of these concerns to the extent not previously addressed.[116] Specifically, this section briefly addresses the experience of the World Trade Organization ("WTO") and its dispute settlement function, the advent of administrative law mechanisms in global financial regulation, and the potential need for increased participation from developing nations in the framework of global financial regulation.

A. WTO Law Experience

Some have argued that global financial regulation should follow the WTO model.[117] This proposes, in essence, the creation of a "WFO" to complement the

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[114] *See* G. Dimitropoulos, *National Sovereignty and International Investment Law: Sovereignty Reassertion and Prospects of Reform*, *21 J. OF WORLD INV. & TRADE,* 71, (2020).

[115] *See* Howse, Robert, *How to Begin to Think About the Democratic Deficit at the WTO*, in INTERNATIONAL ECONOMIC GOVERNANCE AND NON-ECONOMIC CONCERNS: NEW CHALLENGES FOR THE INTERNATIONAL LEGAL ORDER (S. Griller (ed., 2003).

[116] Many academics have cited subpar regulation as a contributing factor to the global financial crisis of 2007–08. *See, e.g.*, Rosa Lastra & Geoffrey Wood, *The Crisis of 2007—09: Nature, Causes, and Reactions*, 13 J. OF INT'L ECON. L. 531 (2010). This paper does not disagree with this conclusion for reasons previously addressed, *e.g.*, the lack of macroprudential focus on systemic risk (particularly with respect to liquidity risk), the failure to adequately regulate shadow banking, and so on. It is important to emphasize, however, that a shortcoming in regulatory scope or ambition is different than a deficiency in the form of the regulatory framework (*i.e.* hard versus soft law). The Covid-19 experience thus far is a testament to dynamism, responsiveness, and resiliency of soft law.

[117] *See, e.g.*, R. Michael Gadbaw, *Systemic Regulation of Global Trade and Finance: A Tale of Two Systems*, 13 *J. OF INT'L ECON. L.*, 551 (2010) (suggesting the global financial regulatory framework should more closely resemble the WTO); *See* Marrakesh Agreement Establishing the World Trade Organization, 1867 U.N.T.S. 154, 33 I.L.M. 1144 (Apr. 15, 1994); *see* Barbara C. Matthews, *Emerging Public International Banking Law? Lessons from the Law of the Sea Experience*, 10 CHI. J. OF INT'L L. (2010), an analysis comparing global financial regulation to the hard law experience of the Law of the Sea.

WTO. This argument is misguided for several reasons. First, in addition to the singular features and attributes of global finance, discussed previously, financial regulation and trade law have starkly different goals. The primary goal of the WTO is to foster trade liberalization, while global financial regulation aims to, among other things, prevent and contain systemic risk. These goals are not only distinct from one another but can also be in tension in many respects. Recall, pro-liberalization efforts to embrace global trade in the 1970s and 1980s and the preeminence of the US dollar as the primary international reserve currency encouraged competition and innovative financial products that, in turn, created systemic risks.[118]

Moreover, the WTO is by no means a success story, particularly given the current state of its Appellate Body. The WTO's Appellate Body is a critical element of the institution's dispute settlement function to adjudicate trade disputes. It hears appeals from reports issued by panels in disputes raised by WTO members. As of today, the WTO's dispute settlement function is at risk of collapsing. The United States, through both the Trump and Biden Administrations, has continuously blocked the appointment of new judges to the Appellate Body due to complaints over judicial activism and related concerns over sovereignty.[119] The dispute settlement system has effectively grinded to a halt. This dysfunction has cast doubt on the WTO's authority to enforce multilateral trade rules. The WTO's dispute settlement is another illustration of the increased sovereignty costs imposed by hard law. The WTO framework, particularly its binding nature, competes with a number of domestic national values in various countries. As such, it may be no surprise if additional countries begin to challenge the WTO's legitimacy by advocating the fundamental sovereign right to choose their own level protection on national security, environmental, domestic self-sufficiency, health emergency, or moral grounds, led by example by the United States.[120]

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[118] In addition, the WTO's aim to promote trade liberalization, by granting concessions and removing other barriers to trade, while justified under an economic theory of trade, can lead to adverse distributional effects. In this sense, global financial regulation may further diverge from trade law to the extent the latter (better) addresses issues of inequality and fairness.

[119] Bryce Baschuk, *Biden Picks up where Trump Left off in Hard-Line Stances at WTO*, BLOOMBERG (Feb. 22, 2021), https://www.bloomberg.com/news/articles/2021-02-22/biden-picks-up-where-trump-left-off-in-hard-line-stances-at-wto.

[120] As a general matter, a dispute mechanism system appears far less useful in a regulatory regime that is defined to promote financial stability. Conversely, feuds between trading partners are common and arguably need a resolution mechanism; *see* William J. Gardner Jr., *Divergent Strategies: A Legal History of the WTO's National Security Exception in the Context of a Globalized Economy, 1983–2019*, 28 U. MIAMI INT'L & COMP. L. REV. 181 (2021).

Furthermore, the WTO's aim to promote trade liberalization by granting concessions and removing other barriers to trade, while perhaps justified under an economic theory of trade, can lead to adverse distributional effects. In this sense, global financial regulation may further diverge from trade law to the extent the former strives to address issues of inequality and fairness. While trade liberalization can lead to greater total welfare, it will invariably create winners and losers. Indeed, many economists have underappreciated the distributional effects caused by free trade, which can lead to the destruction of entire industries.[121] This distributional oversight is heightened by the fact that the WTO system—even with a properly functioning dispute resolution system—only enforces prospective remedies (e.g., balance of payments or countervailing duties) that do not benefit the harmed industry.[122]

In short, the fact that both the WTO and framework of global financial regulation address economic issues in no way means they should be treated the same. These areas of law serve different functions, and can even be at odds with one another in some respects. The WTO experience also underscores hard law's increased sovereignty dilemma and related enforcement challenges.

B. Global Administrative Law and Increased Participation from the Global South

This paper has emphasized the many benefits of soft law in the global finance arena, including its efficiency, flexibility, and lower sovereignty costs. Despite these advantages, there may be room for improvement within the framework of global financial regulation. In fact, the current state of limbo of the WTO's Appellate Body should caution rather than embolden the international network of financial regulators and supervisors. Accordingly, additional reforms may have to be instituted to preserve the long-term stability of this area of soft law. If the primary goal of financial regulation is to maintain financial stability, then the stability and legitimacy of the institutions themselves, charged with this monumental task, is paramount.

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[121] *See* Timothy Meyer, *Saving the Political Consensus in Favor of Free Trade*, 70 VAND. L. REV. 985 (2017).

[122] WTO enforcement mechanisms, even with a properly functioning Appellate Body, suffer from additional flaws. The remedy of authorized retaliation leads to lower liberalization as more barriers to trade are imposed. In addition, member nations are not necessarily obligated to perform in accordance with WTO rulings. The European Union has, for decades now, endured monetary retaliation from the United States in response to its continued ban on meat treated with hormones. *See* ERNST-ULRICH PETERSMANN & MARK A. POLLACK, TRANSATLANTIC ECONOMIC DISPUTES: THE EU, THE US, AND THE WTO, at 223 (2003).

As a preliminary matter, it should be noted that the network of global financial regulators (the Basel Committee in particular) has become more transparent and accountable over time. International financial institutions have adopted significant structural changes and reforms to increase their legitimacy and accountability, including notice-and-comment processes to provide those not involved in the decision-making process with an opportunity to contribute and voice suggestions and concerns. These measures have comprised the nascent elements of what some have termed "global administrative law."[123] The Basel II standards, for example, involved extensive processes to increase public participation, transparency of its processes, and input from developing countries.[124] Basel III resulted in further advances in its processes, including increased openness and monitoring of its implementation.[125] The Committee posted the proposed Basel III standards on its website and encouraged feedback and comments from the public and interested parties. Following opportunities for comment, the Committee then provided reasons for any revised drafts of the standards.[126]

The foregoing improvements notwithstanding, several policy reforms have been proposed. These reforms include implementing more robust monitoring functions, including making compliance with global inspection and surveillance processes mandatory, as well as making the information obtained from such monitoring more available to investors[127] Others have advocated for greater participation from developing countries beyond mere input on consultative groups, especially given IMF and World Bank financing conditionality. Kern et al., for example, have argued that while soft law has served as a flexible mechanism to develop international norms and standards of banking regulation,

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123 *Id.*; Interestingly, global administrative law measures, such as transparency and notice and comment mechanisms not only enhance legitimacy but also facilitate information sharing between domestic regulators and global networks, which can lead to better market discipline and rulemaking; Moreover, global administrative law mechanisms at the national and global level are mutually reinforcing. The domestic process can improve transparency in the global standard-setting process, and vice versa. *See generally* Benedict Kingsbury et al., *The Emergence of Global Administrative Law*, 68 L. & CONTEMP. PROBS. 15 (2005).

124 *See* Barr and Miller, *supra* note 70, at 45.

125 *See* James Gallagher, Global Administrative Law: The Basel Committee Revisited, (2015) (LLM Research Paper, Victoria University of Wellington) at 9 (Discussing Basel III's Regulatory Consistency Assessment Programme (RCAP)).

126 *Id.*

127 *See* Brummer, *supra* note 69, at 642; *See* Christine Kaufmann & Rolf Weber, *The Role of Transparency in Financial Regulation*, 13 J. OF INT'L ECON, L. 13. 779 (2010) ("Transparency is a prerequisite for good governance and sound financial regulation . . . By providing legal certainty, transparency serves as an anchor for financial regulation. It is the basis for establishing trust, which is the key element of any financial system."); *See also* Steve Charnovitz, *Addressing Government Failure Through International Financial Law*, 13 J. OF INT'L & ECON. L. 743 (2011) (discussing the significance of transparency in global financial regulation).

a greater number of countries will need to participate in international standard setting to ensure accountability and legitimization.[128] Basel Committee meetings are generally only attended by central bank governors of G20 nations, to the exclusion of developing nations who may nonetheless be impacted by the Committee's decisions. In fact, according to Grynberg and Silva, such meetings are "are increasingly focused on emerging-market developments [but] the perspective is that of the impact on G-10 economies."[129] The Global South is therefore expected to comply with these decisions without a seat at the table. For these reasons, expanded membership to developing nations in key standard-setting bodies, allowing for more meaningful participation, should be introduced in the near future.

CONCLUSION

Robust financial regulation is critical given the inherent fragility of financial systems and the consequential systemic risks and costs they impose, particularly to the most vulnerable (and least culpable) sectors of society. Such regulation must be coordinated on an international level given the increasingly transboundary nature of financial systems, the cross-border spillover effects of financial risk and contagion, and the potential for powerful financial intermediaries to engage in regulatory arbitrage. Soft law is the optimal form of regulation for global finance given its unique features and attributes—namely its complexity and dynamism. Soft law's flexibility and non-binding character make it particularly well-suited for the regulation of global finance given time-sensitivity and sovereignty considerations, the variety of domestic regulatory and supervisory architectures, and the need for central bank independence. The treaty framework can be extremely inefficient and ineffective, as evidenced by the international environmental law experience and other areas of public international law. While there is surely room for improvement in this promising area of soft law, the current state of the WTO and its dispute resolution mechanism should serve more as a warning than a guidepost.

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[128] *See* KERN ALEXANDER ET AL., INTERNATIONAL SOFT LAW AND THE FORMATION OF BINDING INTERNATIONAL FINANCIAL REGULATION, at 135–54 (2005) (Suggesting that the process through which these standards have been promulgated and implemented under IMF and World Bank supervision raises issues of political legitimacy and accountability).

[129] *See also* Roman Grynberg & Sacha Silva, *Harmonization without Representation: Small States, the Basel Committee, and the WTO*, 34 WORLD DEVELOPMENT 7 at 1225 (2006).