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Beyond ‘Best Practices’: The International Regulation of Capital Markets¹

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Abstract: It is widely acknowledged that there is considerable international pressure for international ‘best practices’ to be adopted via national legislation. This would occur either by means of model laws or through the passing of country specific legislation that closely replicates foreign legal formats, administrative rules, and or regulation. These attempts to spread the implementation of ‘best practices’ have gained importance in the international debate due to the liberalization of international capital flows. The oversight, country reports, and technical assistance carried out by international organizations along with the growing internationalization of investors have also contributed to this growing pressure. In this respect, due to the constant evolution of transactions and the end objective of making sure that capital markets are developed with just rules, structures, and methods, this article looks to analyze the adoption of standardized models of capital market regulation. Furthermore it looks to examine the motivation and interest of states and other ‘stakeholders’ at the international level.

Keywords: international recommendations; financial regulation; best practices.

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1 Introduction

It is widely acknowledged that there is considerable international pressure for international ‘best practices’² to be adopted by national legislation. This would occur either by means of model laws or through the passing of country specific legislation that closely replicates foreign legal formats, administrative rules, and or regulation.

Still, we must ask, what are the factors that cause the adoption of standardized models? Does there exist a tendency towards the globalization of regulation? This article begins by describing the current situation regarding the establishment of standardized regulation with respect to capital markets. It moves on to present some elements that may answer why countries either adopted or reject a model. We then take a look at whether these models are adequate and whether they conform to the distinct realities of different countries. To conclude we attempt to make some suggestion.

2 Scenarios for the establishment of standardized models

In the beginning, when markets were largely domestic, questions regarding predictability and the establishment of rules, along with their substantive content, were circumscribed to the regulatory environment of each country. In an increasingly globalized world, such topics become the worry of other jurisdictions in which transactions by foreign investors may be carried out. This phenomenon has led to the tendency towards the globalization of regulatory models and or their substantive content.

The need to standardize international rules regulating capital markets comes from the fact that, in many situations, national actors conduct business that extends across national borders. The political consequences of living in an increasingly globalized world are well known and heavily discussed by global governance specialists.³ As Slaughter (2004) affirms, seen from the perspective of global

² In this paper the expressions ‘best practices’, recommendations, standards or standardized models, are used interchangeably.

³ See the contribution of Rosenau (1997) for the concept of governance: “With ever greater interdependence corroding long-established boundaries and enabling the consequences of actions by individuals and groups as well as those launched by governments to spread well beyond the

governance, the aim is not to regulate nation states by telling them in which way they should regulate their own citizens in their own respective jurisdictions. Instead, the exerted force is focused on providing solutions to problems that arise from the fact that these very citizens are often times globalized.

The formation and adoption of regulatory models is no longer necessarily within the sovereign operational realm of states. Rather, it is a direct result of the juridical situation inherent to the globalized world. The most obvious causes of this phenomenon are: the internationalization of international capital flows, and the need for making regulation predictable in order to reign in the so-called legal or regulatory risk⁴.

With respect to the first cause, over the course of many years investors have been intensifying capital flows between countries, making their financial market operations both more sophisticated and international. Indeed, cross-border operations, ones that have participants and structures registered in more than one jurisdiction, have been increasing in frequency since the 1990s⁵.

The possibilities for the sharing of opinions and information via technologically advanced methods are enormous. Technological evolution has allowed investors to become participants in global markets, it has opened new operational opportunities for financial intermediaries, and has permitted companies to list their shares on the markets of multiple countries⁶. Also, due to their facilitating nature and growing use of technology, global capital markets have been one of the principal poles of attraction for financial resources emanating from distinct origins.

This is a topic on which a respectable amount of academic studies have been carried out, beginning quite some time ago. When Keohane and Milner (1996)

communities in which they originate, governance along the Frontier has come to be marked by density and complexity”.

⁴ There is still a more specific cause, embedded in the last two, which consists of the pressures applied by international communities that participate in the discussion and formulation of best practices. With respect to this situation, see item 6 – Differences and motivations

⁵ Eatwell and Taylor (2000) affirm that the present wave of capital market liberalization in fact began in the 1950s with the opening of Eurocurrency markets. They further report that it was only after the end of Bretton Woods, that the explosion of currency markets took place, followed by the creation of global bond markets in the 1980s, and global equity markets in the early 1990s.

⁶ Despite relationship taking place between similar economic agent (such as securities issuers, investors, and intermediary entities), these same actors are also located at the same time in more than one regulatory environment of more than one country. Depending on their particular situation they may involve international relations between numerous different countries (in this case they would be called either cross-border or transnational operations or relations). An extreme example would be an Asian investor that could place his resources via a London manager, who would then make an investment in securities in Brazil through a New York broker.

analyzed the international economy and its effect on domestic politics, they highlighted the significant influence of changing cost for international financial market transactions. The authors confirmed the fast growth of international capital markets and pointed to three factors that led to this rapid increase: (1) deregulation of capital markets and finance by governments, (2) rapid growth of world trade and investment, both of which generated huge financial flows, and (3) technological innovation, making capital flows move faster and at lower costs.

This increase in international capital flows has independently led to an evident connectivity between markets and their participants. This phenomenon has created situations that have called the attention of regulators, responsible for regulation, enforcement, and supervision of capital markets⁷.

The second cause leading to the globalization of regulatory content is also associated with global capital flows. This would be the increased clamor for greater predictability of regulation across international financial markets. This new demand can greatly be measured to the ease by which the exact cost generated by the lack of what is called ‘legal certainty’. At times, the lack of legal certainty may even lead investors to abandon an investment or to simply stop investing in a specific regulatory environment. As such, making sure that markets are developed with just, orderly, and clear rules is not a question of convenience. Rather, it can often times be a requisite for an actor’s participation.

Conscious of this dilemma, many academics and other entities⁸, the world around, have spent enormous efforts in the debate regarding the regulation of cross-border investments. Some resulting suggestion have been,

(i) to implement uniform practices in order to improve communication between the diverse trading systems,

(ii) to standardize the rules regarding the holding, custody, and transfer securities, especially with regard to cross-border trading systems,

⁷ Despite operations being transnational, it is known that in the majority of cases regulation in the markets where transactions take place continue to be constructed domestically. In their normative and regulatory functions, the authorities are especially interested in the effects that price movements of securities can have for market participants/operators and their eventual risk of failure.

⁸ A few examples of entities that dedicate themselves to the elaboration of recommendations are the IOSCO – *International Organization of Securities Commissions*, <<http://www.iosco.org>> and the FSB – *Financial Stability Board*, <<http://www.financialstabilityboard.org>>. And, specifically in the case of post-trade negotiations we should highlight the CPSS – *Committee on Payment and Settlement Systems*, <<http://www.bis.org/cpss/>>, and the *Group of 30*, <<http://www.group30.org/>>.

(iii) to minimize operational and legal risks, suggesting the utilization of elevated standards of risk analysis, along with the adoption of more solid legal frameworks for clearing and settlement systems (post-trading), and

(iv) to raise regulatory and supervisory standards of institutions and market participants, along with those of self-regulatory organizations and oversight authorities.

Why is this important? On the one hand, a greater legal predictability, along with actual interconnection between market participants, may serve to attract more investors to international markets and as a result increase capital flows to those countries that wish to take advantage of new financing opportunities⁹. On the other hand, it is good to remember that there are market agents (intermediaries) that may compromise the solvency of the whole system due their leveraged positions. The way the system is designed means that in the case an intermediary were to fail, the number of final investors that would be affected would be very large.

Aside from these two aspects, it is worth highlighting that the trading models of market participants (whether they be investors or intermediaries) take into account systemic risks, technological changes, along with regulatory standards that provide a minimum of predictability, security, and liquidity. The predictability of regulation is therefore directly related to the transaction cost of the market.

These would appear to be the principle justifications of the forces that seem bent, and increasingly so, on realizing global financial regulation based on so-called ‘best practices’. Before presenting how these ‘best practices’ are elaborated and approved, it would seem appropriate to first give an overview of the different regulatory models.

3 International regulation of capital markets

In order to determine if, in the case of capital markets, there exists an ideal international regulatory model, it becomes interesting to turn to the contribution of Hurrell (2007) who analyses the relation between markets (from the point of view of economic order) and the political construction of norms and rules. To this end, the author compares the reciprocity and mutual advantages (the inherent logic of the markets) with both political hierarchies as well as shared values (the logic of politics).

⁹ This discussion will be taken up again in item 5 – Scenarios for the internalization of standardized models

In the case of the first, Hurrell (2007) points to the importance that the general reliance on markets (with globalization driving itself a significant shift of power from states to markets) played in the move from the concept of government to that of governance. This idea refers to the standing form of global economic governance as well as its foundations. With this in mind the author provides four regulatory models, that he describes as: (1) statist, but based on only limited formal agreements amongst states ('minimal agreed rules'), (2) imperial, citing examples such as the process of colonization, in which a sovereignty-based legal order sought to regulate transnational spaces, with a return of this idea in the contemporary period, such as the increased hegemony of the dollar as a global currency, (3) statist, but with the possibility for a more extensive and intrusive regulation, (4) private ordering of economic transactions in which some private authority structures, or private conflict resolution systems, either produce rules or private solutions via the standardization of techniques or the development of internal regulations between transnational countries and actors (such as in the case of the well known system ISO 9000).

The formulation of 'best practices' in capital markets is very close to the fourth model, since it uses many of the same premises in its elaboration. Effectively, the proposal that inspired the formalization of recommendations (or standards) corresponds to the attempt to eliminate differences in legal treatment when states had shared interests. Over time, the interest of other non-state actors (such as investors, intermediaries, and market administrators, or simply stakeholders) was also taken into account. The principle difference is that, unlike the fourth model mentioned by Hurrell, the majority of standardized models of capital market regulation are still highly influenced by (and counts with the participation of) regulators or state based agents. The next section will describe, in a more detailed manner, how international recommendations for 'best practices' are elaborated in an activity that we usually refer to as 'international regulation of markets'.

4 How are ‘best practice’ recommendations formed?

In order to describe the formulation of the principle standards relevant to capital markets, we will reference the recommendations approved by the IOSCO – *International Organization of Securities Commissions* – and by the FSB – *Financial Stability Board*¹⁰.

With reference to their institutional structure, such entities are usually categorized as international discussion forums or governmental networks¹¹, classified by means of the participation of state or government officials. Furthermore, the activity of establishing standards ends up causing these entities to be referred to as ‘capital market standard setters’ or simply ‘standard setters’.

Within this body of work, the IOSCO can point to very significant results that have had regulatory impact, such as the well-known *Objectives and Principles of Securities Regulation*. This document has proven a gold standard for what is considered high quality regulation¹². It has also produced other documents about relevant themes, such as standards for listed issuers and credit rating agencies¹³. With regards to cooperation between regulators, it is also important to mention the structure developed by the IOSCO, that is derived from a document entitled *Multilateral Memorandum of Understanding (MMoU)*¹⁴.

¹⁰ The IOSCO is an organization that brings together the regulatory agencies of more than 100 countries representing almost the totality of the capitalization of all the world’s real estate securities markets. Indeed, the IOSCO has become the principal international forum for discussions between security market regulatory authorities (see <www.iosco.org>). The FSB was created to coordinate, at the international level, between national financial authorities and international regulatory bodies. It was also create with an eye towards developing and promoting the implementation of efficient regulatory policies, oversight, as well as other policies related to the financial sector. The body brings together national authorities responsible for the financial stability of important international financial hubs, international financiers, regulatory and oversight authorities, and central bank specialist committees (<www.financialstabilityboard.org>).

¹¹ The theory of governmental networks was made popular by Slaughter, 2004.

¹² IOSCO. *Objectives and Principles of Securities Regulation*, May/2003. Available at: <<http://www.iosco.org/library/pubdocs/pdf/IOSCOPD154.pdf>>.

¹³ On disclosure standards for issuers, see *International Disclosure Standards for Cross-border Offerings and Initial Listings by Foreign Issuers*, September 1998, available at: <<http://www.iosco.org/library/pubdocs/pdf/IOSCOPD81.pdf>>, and *Principles for Periodic Disclosure by Listed Entities*, February 2010, available at: <<http://www.iosco.org/library/pubdocs/pdf/IOSCOPD317.pdf>>. On credit rating agencies, see *Statement of Principles Regarding the Activities of Credit Rating Agencies*, September 2007, available at: <<http://www.iosco.org/library/pubdocs/pdf/IOSCOPD151.pdf>> and *Code of Conduct Fundamentals for Credit Rating Agencies*, Revised May 2008, available at <<http://www.iosco.org/library/pubdocs/pdf/IOSCOPD271.pdf>>.

¹⁴ The MMoU established a standardized format for cooperation and the exchange of sensitive information between the capital market regulatory authorities of various countries, especially for investigative and enforcement purposes. The IOSCO has a process to analyze and approve the

The FSB, for its part, was responsible for the publishing of various documents and principles with the objective of strengthening the global financial system. Many of these were directly applicable to capital market participants and operations. In this respect there are a few documents that should be mentioned, namely, the *Report on Enhancing Market and Institutional Resilience*, the *Principles for Sound Compensation Practices*, and finally the *Principles for Reducing Reliance on CRA Ratings*.¹⁵

The process for the formulation of international recommendations begins with the formation of a working group that leads the collection of information. Next is the carrying out of a process of consulting the organization's members as well as other main players. This consulting is aimed at looking for responses to specific concerns raised by the working group. The result of this process is generally a report with suggestions for new regulation. These suggestions are then submitted to a process of hearings that are attended by all the involved parties (members and non-members of the body). From the documents and returned questionnaires, recommendations are formulated and approved by the responsible committee/body, and from this point the recommendations are widely distributed¹⁶. With reference to the transmission and approval of the recommendations, there are three interesting reflections.

The first regards the institutional structure of the standard setters. It is worth repeating that these entities are necessarily informal, which means that they are not formal international intergovernmental organizations. They do not hold a status recognized by international law; instead, they only possess reputational power. This characteristic is a direct consequence of the question of the sovereignty of states, which for them is a very important concept to be maintained¹⁷.

Still, with regard to this topic, this conceptual tool of 'governmental networks' has received considerable criticism in the sense that the term in itself does not explain

authorities that are interested in signing the MMoU, and today it counts with the participation of almost 80 percent of the regulatory authorities that are members of the IOSCO. See <www.iosco.org>.

¹⁵ Report on Enhancing Market and Institutional Resilience, April 2008, available at: <http://www.financialstabilityboard.org/publications/r_0804.pdf>, Principles for Sound Compensation Practices, April 2009, available at http://www.financialstabilityboard.org/publications/r_0904b.pdf and Principles for Reducing Reliance on CRA Ratings, October 2010, available at: <http://www.financialstabilityboard.org/publications/r_101027.pdf> .

¹⁶ See BRUMMER (2012, p. 68, 69, 74, 77, 78, 99, 113).

¹⁷ According to Brummer (2011), the recommendations or 'best practices' are usually guidelines to be followed both by domestic regulators as well as supervisory firms. Due to this, they often reflect both public as well as private interests.

how domestic regulators (nor market participants) are connected¹⁸. It is worth mentioning that regulators are not integrated into an analytical mold within the global economic order, for example, via an international intergovernmental organization. Thus, each regulator reflects the emanated recommendations to their domestic environments as it thinks fit.

Additionally, there are those who criticize the fact that the recommendations originating from standard setters have a soft law approach, which would suggest a certain fragility or even a lack of international commitment. This could only be overcome if the recommendations were to have the support of a super-national entity, an idea that is also rather polemic¹⁹. In contradiction to this argument, it is understood by many that it is exactly this soft power formulation that allows greater renewal. It allows national authorities to perceive the standard setters as flexible and efficient in terms of cost; they also perceive institutions with certain structural similarities to domestic administrative and regulatory agencies²⁰.

A second reflection is in respect to the widely debated topic of the legitimacy of the formulated recommendations²¹. It is well known that the committees/bodies that are responsible for the final approval of the recommendations are usually made up only of state authorities, with private (non-state) actors having access only to very little information during the process of the formulation of the recommendations. The minutes of the committee meetings, the discussions of the working groups, and the comments received by the public are considered to be below the necessary level of transparency to permit the inference of the base of the formulated decisions. Moreover, the unequal participation of states in the formulation of recommendations and in the consultation processes has also been questioned, along with the entities' susceptibility to be influenced by the financial sector, the sector that it should supposedly be regulating²².

This perception is confirmed by Keohane and Nye (2002). In an influential paper, the two academics present a specific evaluation of the democratic legitimacy of governmental networks, like the Basel Committee and the IOSCO. On one hand,

¹⁸ As Brummer (2012) states, in this sense, 'network theory is an intrinsically limited conceptual tool'.

¹⁹ On the topic see, for example, the position of Eichengreen (2008).

²⁰ In this regard see Helleiner e Porter (2009).

²¹ Brummer (2012) explores in detail the main elements, tools, commitments and participation in the formulation of standards and how they relate to a broader involvement in the global standard-setting processes.

²² HELLEINER; PORTER, 2009.

Keohane and Nye consider that, because these networks act informally and with the strong support of personal contact among participants, they are often times able to operate more quickly and efficiently than if they were formalized. But, on the other hand, the authors point out that these same entities are not open to a broad range of participants; many times their meetings are closed ('secretive'); and they are only accountable to a small set of relatively powerful elites. From this derives the criticism of a lack of accountability. Nevertheless, these authors highlight positive aspects of this format, such as the fact that these governmental networks typically operate through persuasion instead of through authoritarian decision-making. This comes to promote cooperation between politicians and their governments, 'when the alternative could be to leave all of decisions to markets'.

This scenario leads us to a third observation in respect to the alignment of interest groups in the formulation of 'best practices'. Due to the previously mentioned opaqueness regarding the decision making process in these bodies, such alignments are also difficult to appreciate objectively. Nevertheless, using the expression coined by Raustiala (2002), it is known that usually, if not always, the decisions end up reflecting the evident intention of 'exporting' regulatory formats.

In practical terms the 'exportation' of regulation means the top-down diffusion of rules, practices, and even complete institutional structures, which, at the same time, forces the promotion of a political convergence between states. This political convergence allows for two other interesting discussions: the first, refers to the eventual dominance/influence of some states in the final formulated recommendations; and the second refers to whether the observed model of international regulation will become more homogenous or more fragmented.

With regards to the first question that treats the influence of a few countries in the formulation of 'best practices', Raustiala (2002) mentions that due to their 'club' like nature, governmental networks end up reinforcing the dominance of the more economically powerful countries, and thus promoting their regulatory 'exportation'. It should be taken into account that not only is it the format of these 'clubs' that ends up supporting the dominance of the economically powerful countries, but equally important are the characteristics of these countries, such as their size/magnitude of

capital markets, their degree of development, their financial depth, and their importance in the global financial system²³.

Regarding the international regulatory environment, Helleiner and Pagliari (2011) understand that there is a general trend towards a looser form of cooperation between countries – which they call a ‘cooperative decentralization’ – derived from the difficulty to create strong international standards. In practice, this scenario is mitigated through the development and promotion of broad principles-based international regulatory standards²⁴ as well as activities such as information-sharing, research collaboration, international early warning systems, and capacity building.

The following would appear to be, at this moment, of great importance: in the end, what causes countries to adopt ‘best practices’ with regard to capital markets? Different countries would appear to have different motivating factors for adopting these ‘best practices’, and knowing what they are should allow for a more refined understanding of the effectiveness of these recommendations.

5 Ways of internalizing standardized models

There are diverse factors that may be identified as motivators for countries to adopt standardized ‘best practice’ models: (i) reputational, with the consequent pressure applied by state and non-state actors inserted directly into the standard setting bodies; (ii) the idea that the adoption of good regulation helps to avoid systemic risk. It is worth recognizing these elements with respect to the domestic environment, and to observe how the latter behaves when confronted with the process of the internationalization of capital flows.

²³ This occurred, in an evident manner, in the case of the United States, via its evident exposure to the global economic crisis of 2008. This event demanded a specific regulatory response at the domestic level by the United States. There was also a clear intention for the United States’ model to be adopted by other jurisdictions, attempting when possible to anticipate international recommendations. As the most developed market, the country had greater expertise in so-called ‘innovative’ products and markets, a fact that was used to justify its effort to influence an innumerable amount of initiatives regarding the vehicles and practices that had been fingered for being responsible for the global financial crisis. See comparison of issued initiatives by different countries in the post-crisis scenario, in Rachman, 2013.

²⁴ With regard to this topic, see an interesting categorization made by Julia Black, in *The Rise, Fall and Fate of Principles-based regulation*, available at www.lse.ac.uk/collections/law/wps/wps.htm and at <http://ssrn.com/abstract=1712862>, last visited: 14 Feb. 2014.

As an initial finding, this paper asserts that the adhesion of a certain country to the standards approved by the international forums would denote the investment environment of this country as being safer and more predictable. As such, it effectively represents a signal that is associated with a heightening of country level reputation²⁵.

In this respect, Keohane and Milner (1996) have pointed to a change in the preferences of the involved actors. This is the equivalent of saying that, upon making their options, investors stimulate changes in the domestic policies and institutions of select countries. It is this type of pressure that causes states, which have jurisdiction over the regulation of domestic capital markets, to alter their domestic regulatory regimes.

The debate brought to the forefront by Keohane and Milner looks at the relative importance of the constraints and incentives imposed by the world economy, and those inherent in preexisting domestic institutions, as well as how these international and domestic constraints interact. The authors' conclusion is that internationalization of the world economy has had profound effects on domestic policies, but these effects change depending on the institutional and political economy conditions of each country.

But how many domestic policies and institutions of the countries actually change due to these international pressures/restrictions that derive from international capital flows, or perhaps also from the mere existence of 'best practices' approved by international networks?

An important premise that should be considered is that the internalization of recommendations or 'best practices' is usually accompanied by the adoption of well formulated regulation. In the end, a basic evaluation of a regulatory system (or of a country) is enough to know whether this system is good, adequate, simply acceptable, or if it needs reforming. And, what are the criteria to assess whether a regulatory system is good or not? The answer to this question begins with an explanation of the necessity for regulation.

From the point of view of politics, there are several criteria that are usually cited by government or governmental entities to account for good regulation.

²⁵ See Brummer (2011), who believes that countries that do not follow international standards may experience a greater cost of capital and their governmental authorities may suffer reputational costs with reference to the international community.

According to Baldwin, Cave, and Lodge (2012), some of those are proportionality, accountability, consistency, transparency, and targeting. These same authors point out five questions that serve in determining whether regulatory action is worthy of support, or, in other words, if it is legitimate: 1) if the initiative is supported by legislative authority, 2) if it has an accountability scheme, 3) if its procedures are fair, accessible, and open, 4) if the regulator is acting with sufficient expertise, and 5) if the initiative is efficient.

A few international economic organizations have also suggested, indeed quite some time ago, that this was a very important topic. They even presented their vision of which criteria and aspects would be adequate; they followed this up by adopting minimum principles for the maintenance of good regulatory policy (World Bank, 2004, and OECD, 2005).

These arguments seem to prioritize procedural aspects of regulation. With regards to capital markets it would be appropriate to consider more substantive content such as if good regulation would require the maintenance of a transparent, just and orderly market. Or, further, if the key objective of regulation would be to protect investors and minimize risks while guaranteeing systemic stability (EATWELL; TAYLOR, 2000).

Taking an economic outlook, good regulation should maximize wealth. But the notion of efficiency can also include aspects of morality and risk. In capital markets, the periodic necessity for regulation is aimed at the correction of inherent market failures. These failures occur when the markets no longer produce efficient results due to externalities such as competitive monopolies, poor price formation, and the manipulation and or failure of information (STIGLITZ, 2010).

Via the Coase Theorem it is known that regulated markets reduce transaction costs. According to this theorem, in order for market participants to attain efficient results, they must have their property rights well defined and be well informed, two items that could involve significant costs. In this sense, an organized market with good regulation does not just reduce so called transaction costs but also serves to quell systemic risks²⁶.

²⁶ On this specific issue, Eatwell and Taylor (2000) consider systemic risk as an externality, not priced by the markets, which make investors taking excessive risks. These authors point out that “totally free financial markets induce risks that pose a threat to the economy”, which was the main reason justifying the creation of authorities with strong regulatory power as a response to domestic financial liberalization.

Finally, the main preoccupation of regulatory authorities searching for good regulation is to find ways of making investors consider the inherent risks in finance, while also correcting distortions created by asymmetric information, reducing ‘moral hazard’²⁷, and preventing criminal activities (such as the manipulation of the market and the use of privileged information). Generally speaking, the role of regulators in the attempt at good regulation are well summed-up by Eatwell and Taylor (2000): “1st) to ensure that markets work effectively by managing systemic risks and by preventing market abuse and economic crime, and 2nd) protect the consumer” (investors).

It would then appear clear that there exist various forms for evaluating if a country does or does not possess good regulation. It is worth mentioning here that, in this paper, the concept of ‘good regulation’ takes into consideration all that touched on by the aforementioned literature, whether it be procedures related to economics or to the very politics of regulation.

These elements lead to the label of ‘best practices’ to be embedded in the idea of good regulation, so characterized by the rules that dictate the appropriate and expected behavior of capital markets and their participants.

These possible elements are perhaps a little more abstract. But they allow for the identification of the existence of incentives whose categories could best be categorized as following:

- (i) on one hand, private incentives, such as those that lead investors to apply their resources in the market,
- (ii) on the other hand, state incentives, or those generated by public policy, such as macroeconomic policies that are aimed at achieving greater economic growth and providing greater benefits to economic agents. Or even, those that are aimed at eliminating contamination risks in the case of systemic risk, and the consequent fleeing of capital.

These would appear to be the premises that enclose the scenario that has led states to decide in favor of the adoption of so-called ‘best practices’. In the next section we will take a look at some of the difficulties that have been overcome at the domestic level in this process of internalization.

²⁷ ‘Moral hazard’ is the expression used to designate the asymmetry or market failure in which market participants adopt a certain posture of confidence in a pre-determined behavior on the part of the public sector. For example, the saving of failed American banking institutions during the financial crisis.

6 Differences and motivations in the adoption of standardized models: what do these differences represent?

There are situations in which, in order to achieve the implementation of recommendations or international standards, the regulatory authorities must first seek out domestic input. In some countries, it will be necessary to first modify or ratify specific legislation before its eventual implementation. In other words, regulatory authorities often depend on cooperation with other domestic government bodies, such as those found in the legislative and judicial branches, along with that of social groups that may have an interest in the adoption of specific international recommendations²⁸. In this regard, the various motivations driving states can be (and general are) quite different.

What more, it should be emphasized that the objectives of regulation of capital markets, at least the objectives of the regulator, may also distinctly benefit some interests more than others. Could it be that this factor is quite as important as say, the way regulation (either domestic or international) controls the use of information, the equity of trades, the market's price mechanism, or even the use of leverage by market participants?²⁹ Apart from the distinct objects of regulation, each state has interests, preferences, specifications, and even legal systems with distinct traditions in which these various elements are given different weight.

The principle motivation for the adoption of 'best practices' has already been provided in this paper. First, there is an interest in the prevalence of a known model. Second, and perhaps as a complement to the latter, there is credibility to be won by such adoption along with increased foreign investment flows. In addition, having also already been mentioned, there is a certain political will to diminish transaction costs and to prevent systemic risks.

Despite these forces having the capacity to create a large impact and to even coexist and complement one another, the construction of domestic initiatives

²⁸ See Drezner (2013), who identifies the relevance of the transposition of international norms into domestic structures, pointing out that: the originator of the process of the internalization of rules, the state level structure of the country, the effects of interaction between domestic and international institutions, and the role of international institutions.

²⁹ See COFFEE et al., 2007. On specific objectives of regulation related to the investor protection, see Hertig et al. (2009).

following the divulgence of international standards or ‘best practices’, occurs in an environment in which nearly everything is predictable. This is due to the nature of the assimilation to an international recommendation, which usual occurs parallel to a movement that is looking for a true wave a harmonization. Indeed, this phenomenon relates to the allocation of a collection of restrictions and incentives that are reflected in the combined force of the community that participates in the general discussion. The same community that provides recommendations and that also has an invested interest in the diffusion of these standards³⁰.

It is these factors – distinction and standardization – that cause us to believe that the expected effects, as well as those that have already been realized, generated by standardized regulations should not be simply left to the side. This reflection obviously applies also to the domestic level where the regulations will be applied.

7 To adopt or not to adopt the standards: an inclination or a trap?

Still, the question lingers as to whether international standards are adequate considering the legal and institutional differences that are found among countries.

On one hand, as I have already noted, the standardization of rules and behaviors appears to confer some sort of legal certainty to those who adopt them. In the adoption of these standards come gains of economic efficiency (through the reduction of transaction costs) for all those involved in a market that is increasingly globalized.

Looking at things in a different way, simply through the import of new rules, there will be a certain abandonment of the particular institutional environment in which these new rules are to be established, the domestic environment. This result would appear to be a bit chimerical, to say the least. Indeed, the forecast for the results produced by this adoption cannot guarantee the economic success of the newly

³⁰The waves of harmonization may be verified via diverse objectives of international institutions. Also, their implementation in regulatory models and structures are widely recognized, principally regarding topics inherent to post-trading activities that occur immediately after the securities trading cycle. These topics include, a Centralized Payment System, the existence of a Central Counterparty (CCP) for the payment of asset sales, the Delivery versus Payment (DVP) system, and the selling of securities three days following their activation (D+3). The global history of the implementation of these recommendation, which are also put through rounds of public input and discussions, can be found on the CPSS’ website – *Committee on Payment and Settlement Systems*, <<http://www.bis.org/cpss/>>.

implanted regulatory regime: quite the opposite, this import of international standards could signify a trap, and one that deserves a more careful examination.

In this respect, it is worth highlighting the work of Milhaupt and Pistor (2008)³¹. In their work the authors evaluate how law – in this specific case, regarding the regulatory framework treating corporate governance – necessarily interacts with the market in a rather dynamic form. They show that this occurs via the mediation of individuals and the utilization of pre-existing institutional mechanisms. The authors suggest the need for an ‘institutional autopsy’ in order to better understand this relation.

In other words, the mere transplant of accepted international rules would not be enough to guarantee specific result, or succeed in fulfilling expectations and forecasts. It is always necessary to remember that whatever collection of newly approved rules will always need to pass through pre-existing institutions and dialogue with the pre-existing rules and practices of each and every legal system.

In order to illustrate the interaction between domestic institutions and models emanating from international recommendations (along with a search for the factors that explain the resistance to recommended ‘best practices’) the following section will present four cases; the first being generic, and related to the adoption of the Objectives and Principles of the IOSCO by 74 countries. The other three relate to the adoption of international standards on the part of Brazil in specific topics: fund transparency, the prohibition of short selling, and the registration of over-the-counter (OTC) derivative trades.

7.1 Implementation of the IOSCO Principles

Here I will reference the work of Carvajal and Elliot (2007), in which the authors discuss the implementation status of the IOSCO Objectives and Principles Securities Regulation in 74 countries. These Principles are considered the basic regulatory framework or ‘best practices’ for capital markets. In their paper, Carvajal and Elliot, point to several factors as the greatest weaknesses or points in which there was a very low level of implementation of the Principles and Objectives:

³¹ In this work the authors demonstrate via ‘institutional autopsies’ (using companies located in the United States, Japan, Germany, South Korea, China, Singapore, and Russia) that international standards, in respect to corporate governance, take on their own profiles when they are questioned in local institutions.

- the inability of local regulators to supervise and enforce the rules in each jurisdiction.
- the poor (or complete absent) valuation rules regarding collective investment vehicles (investment funds), and
- insufficient risk management and internal controls at market participants.

The study also confirmed a positive correlation between the countries' income level and the implementation of the Principles and Objectives. This last point has a clear and pretty intuitive explication, as institutional economics already has shown that countries with a greater income level have higher quality institutions as well as a greater portion of this income directed toward regulatory activities.

Nevertheless, the actual conclusion is not as linear as the correlation between a material deficiency and the enforcement of rules that was demonstrated in the study. Such inability can be a direct result of the regulators inability to sufficiently fund itself, but it can also be the result of other factors. These include the credibility of the legal model, the vulnerability of specific social aspects, the interests and expectations of other interested parties (or stakeholders), the lack of political will, an effective independence of regulators, or a deficiency in the legitimacy of the adopted standards.

As such, the elements of resistance or rejection to or of the specific part of the standards that were unsuccessfully implemented were associated with an inconsistency between those same standards and the legal system or that system's institutions. The cost involved in the new standards implementation was and is also often a considerable roadblock.

7.2 Transparency requirements for investment funds

Investment funds transparency regulation is a relevant discussion considering the size of these collective investment vehicles worldwide, as well as the amount of savings captured by these funds.

In 2009, the IOSCO divulged the Consultation Report on Unregulated Financial Markets and Products, with the main purpose of reestablishing confidence in securitization by means of suggesting a process for promoting the transparency, integrity, and quality of the securitization market. In 2010, the Technical Committee of the IOSCO formulated some specific recommendations regarding the categories of

information that should be periodically collected in order to adequately follow the movements of hedge funds in global markets (Template for the Global Collection of Hedge Fund Information)³²

These recommendations were attested to by the Brazilian regulatory authority (*Comissão de Valores Mobiliários*, or CVM), which in 2001 divulged two official documents containing new rules regarding investment funds' constitution, administration, functioning, and information disclosure. In these documents there is an explicit acknowledgment that the CVM intended to adopt the recommended standards that were being discussed by the IOSCO.

Regarding the public hearing documents published by the CVM on the theme, the context in which the Brazilian regulator made mention to the IOSCO serves rather diverse functions³³. Actually, the various references made by the CVM were related to general goals of IOSCO's work already in progress, as well as to previously publicized consultation reports and press releases, with no specific details as to an eventual convergence of standards. In this case, referencing IOSCO seems simply to indicate the Brazilian regulatory body's source of inspiration for its having adopted the new rules. In fact it could serve to justify the necessity of aligning the country's regulatory framework with IOSCO's recommendations, or even for the Brazilian system to adapt to international standards.

Whatever the function seems to be, the main aspect to be emphasized on this case is that the formal recognition of the international standard was always in the sights of the Brazilian regulator (the CVM).

7.3 Short selling banning

The prohibition of short selling on the global level derived from the 2008 global financial crisis and the enormous volatility that this event caused in the markets. A common concern of a great number of global markets was to slow speculative behavior related to the manipulation of security prices. Operations known as 'naked short selling' had been detected in the market. These operations involve

³² See more information regarding these two documents, respectively at <<http://www.iosco.org/library/pubdocs/pdf/IOSCOPD290.pdf>> and at <<http://www.iosco.org/news/pdf/IOSCONEWS179.pdf>>.

³³ For a specific evaluation of IOSCO standards used by Brazil, see Rachman, Prado, and Coelho (2013).

investors that short-sell securities without actually holding them, creating an intentional fall in the respective securities' price and generating a profit for the investor. This type of operation occurred in the securities lending market, where there was actually no lender or actual exchange of securities, but instead just interest rate swaps. This operation format was considered one of the casual factors of the crisis, and as a result the majority of markets adopted restrictive measures with respect to short selling and the securities lending market.

The IOSCO issued a response in 2008, in which it listed the initiatives that were being implemented worldwide in order to address the problem. In 2009, the IOSCO divulged the 'Final Report on the Regulation of Short Selling', in which it formulated specific recommendations³⁴.

In Brazil where the stock market demonstrated the same volatile behavior, it was widely pondered whether some type of restriction should be put in place and perhaps even prohibit of this type of operation. In this specific case, Brazil already had some regulatory content that led to an interpretation different from the one put forward by the IOSCO. In the end, and shortly after the IOSCO release in early 2008, the Brazilian regulatory authority (CVM) decided to publish a statement explaining the differences between the two positions and how the eventual nonalignment did not put the country in a territory of regulatory risk³⁵.

Despite new regulation being rather far off (in the end Brazil did not prohibit short selling as international 'best practices' had suggested), it was evident in a certain way that the Brazilian regulator had scrutinized the international rules and standards and had released its own conclusion on the matter³⁶. Via this action, the Brazilian regulator attempted to demonstrate the compatibility of the Brazilian regulatory environment, an action that could also be interpreted as the association of the domestic scene to that of global finance.

³⁴ See the final report of the IOSCO available at <<http://www.iosco.org/library/pubdocs/pdf/IOSCOPD292.pdf>>.

³⁵ The conclusion was that there was no need to put into place such restriction due to the difference between the Brazilian model of securities lending and the international model. Nor was it necessary due to the specifics of the processes that would be initiated in the case of a failure in the settlement of the transactions. The Brazilian model possessed structural characteristics that, although not entirely preventing price manipulation through a combination of short sales and securities lending, at least made it more difficult. Punitive and preventive measures adopted in Brazil, mainly associated with settlement enforcement, ended up removing whatever incentive to use short selling to manipulate market prices. As such, there was no reason to justify the ban of short selling via regulatory maneuvers.

³⁶ See the Brazilian Securities Commissions' press release, dated June 30, 2008, <[http://www.cvm.gov.br/port/infos/comunicado%20sobre%20venda%20a%20descoberto%20\(IOSCO\)%200210082.asp](http://www.cvm.gov.br/port/infos/comunicado%20sobre%20venda%20a%20descoberto%20(IOSCO)%200210082.asp)>.

7.4 Regulation of over-the-counter derivatives trading and the demand for the centralized registration of OTC transactions

The demand for the registration of over-the-counter derivative transactions and the sharing of information on the registered contracts are proposals that gained momentum in the international debate after the global financial crisis of 2008.

In 2010, the FSB published specific recommendations on this subject in a document entitled ‘Implementing OTC Derivatives Market Reforms’. Later, the CPSS/IOSCO published a report in 2011³⁷, pointing to the minimum requirement that should be observed so that information on the derivatives OTC transactions would be handed over to the ‘Trade Repository’ and afterwards made available to regulators. The report also discussed issues such as authorities’ access to information as well as that of the entities that distribute information. It also hit on the dissemination of select data to the public covering OTC derivatives while taking into account the need for information secrecy.

On this topic, Brazilian regulation requires that OTC derivatives (contracts) not only be registered in an organized market entity, but that they also be approved by that entity so as to prevent the formation of artificial prices or general fraud. This regulation also demands that information on registered contracts be shared among market entities³⁸ and that it remain permanently available to the Brazilian regulators, the CVM and the Central Bank.

Transparency is thus a fundamental characteristic in the treatment of OTC derivatives in the Brazilian market. In 2008, at the peak of the turbulence in international markets, Brazilian regulators followed the exposure of a wide spectrum of institutions, including banks, brokers, intermediaries, managers, and private companies. This action is relatively coherent with the international debate.

To synthesize, the methods that international recommendations have sought to provide in order to protect against a lack of transparency are now a consolidated reality in the Brazilian market. The international standardization for the registration of OTC derivatives transactions was developed after having come into effect in Brazil.

³⁷ See the document available at <<https://www.bis.org/publ/cpss100.htm>>.

³⁸ CVM Directive 486 determines the sharing of information on over-the-counter derivative contracts between organized market actors.

This demonstrates a situation in which Brazil's domestic rules go further than international recommendations as well as the standing rules in foreign markets³⁹. However, this does not mean that the content and details of the international recommendations will not be scrutinized and considered by the Brazilian regulatory authorities with regard to future rules.

7.5 Conclusions

The illustrative examples that have been presented demonstrate situations in which the international model or standard of 'best practices' had different results when countries had to reflect on their internalization into different domestic regulatory and institutional environments. In the case of the adoption of the selected standards by Brazil, one situation demonstrated complete internalization, though this cannot be said of the other two occurrences. Generally speaking, it may be affirmed that there is a fine line when trying to decide whether or not to continue with or abide by international standards. Such a decision implies in analyses and balancing of domestic market interests, adaptation costs, or even the defense of existing solutions as being adequate for the domestic environment. Even when the options of domestic regulators clearly do not correspond to the international standards, there would appear to exist a necessity to justify an eventual nonalignment. This result comes from the same forces that many times lead to the internalization of 'best practices': reputation in the market and predictability of rules.

8 Conclusion

This work looks to provide an overview of the discussion regarding the international standardization of capital market regulation. From the arguments given to this point a few inferences may be formulated.

States take into consideration various factors when they are trying to provide reasons for the reformulation of initiatives that augment their reputation at the international level. In this latest analysis, the important task is to confirm the

³⁹ See LOYO; AZEVEDO, 2010.

existence of solid domestic regulation based on ‘best practices’, so long as these are able to function within the pre-existing institutional structure and culture of the country in question.

In calm times the empirical evidence appears to confirm that well regulated capital markets contribute to economic growth, as they serve for an alternative form of finance for countries’ productive sectors.

However, during moments of crisis these results tend to fall apart. During the global financial crisis of 2008 capital markets had a destabilizing effect. Clear failures in regulation were widely cited as a principle cause of the crisis⁴⁰.

In this context, the argument that a single model or standardized regulation does not work for all, became evident. On one hand, market participants have their own institutional base that determines their actions as well as investment opportunities. On the other hand, those countries that create and determine regulatory (historically determinant factors) models don’t always follow them, this along with conjectural factors can lead to periods of global instability.

There are diverse weaknesses and challenges that will continue to allow for a constant revisiting of these problems, with the necessity of applying new perspectives and ideas.

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⁴⁰ See Stiglitz (2010) and Eichengreen (2011).

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