INTRODUCTION: RULING THE WORLD

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As recent events have taught us, globalization demands that we consider not just the national, but also the worldwide, implications of regulatory shortcomings of all sorts. There is no single country with the power to impose its legal framework throughout the world. Just as important, no country operates in legal or regulatory isolation. Legal failures and their consequences cross borders, sometimes in spectacular fashion. National economies have never been more interconnected.

Norm entrepreneurs work to connect the legal frameworks that guide and constrain behavior within these economies. International legal norms not only facilitate economic interaction among States and nonstate actors from different parts of the world, but also foster stability, predictability, and prosperity. Even isolated rule failures have the potential to reverberate throughout the world. A less visible, but no less troubling, reality is that where legal vacuums arise, opportunities go wanting.

A host of organizations, communities, and groups have stepped forward to generate norms that shape conduct across borders. The subject of this Symposium is how these entities manage the alchemical trick of turning chaos into order despite daunting legal, philosophical, practical, and cultural impediments. We focus on the development of international norms in the private law context, a process that can be contentious and even frustrating. The Symposium explores different models for the creation of international legal norms, including, but not limited to, institutional regulation, private legislators, model treaties, legislative guides, and transnational harmonization.

Of course, government actors have not abandoned the field. In fact, different lawmaking bodies compete with each other for relevance. States and domestic rule-makers vie for influence while interest groups hope to direct lawmaking activities. When norms do take root and blossom into soft or hard law, the interrelated problems of compliance and legitimacy bedevil would-be enforcers. This Symposium Issue explores these concerns and many others by considering three case studies: commercial law, taxation, and financial regulation. We are fortunate to have a diverse lineup of experts from all over the world to examine these issues.

In *Three Metaphors of Norm Migration in International Context*, Roderick A. Macdonald, F.R. Scott Professor of Constitutional and Public Law, Faculty of Law, McGill University, frames our discussion of inter-

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national norm development using three metaphors: harmonization, transplantation, and viral propagation. Each of these metaphors reveals defects in universal norm generation and highlights the fallacy that one view of the law may be good for all people at all times. Using specific commercial law examples, Professor Macdonald illustrates that the differences among States, their legal architectures, their political and legal environments, and their adaptive capabilities make perfect harmonization or transplantation of law unattainable and, perhaps, undesirable. Likewise, the ability of a legal concept or norm to infect a legal community depends on a variety of factors, including the nature of the lawmaking authority (e.g., highly centralized, hierarchically organized, or legislatively, rather than judicially, driven); the points of entry (e.g., agencies or scholarly communities); and the relationship of the State to other countries and ideology. These metaphors help us understand how States are inseparable from their social, economic, and political contexts. In doing so, we realize that international norm generation cannot be based on the unique socioeconomic and political contexts of a few States. This overarching perspective informs all of the panels and Articles that follow.

Our first panel focuses on commercial law. Henry Deeb Gabriel, DeVan Daggett Professor of Law, Loyola University School of Law, New Orleans, articulates an important resource question: is creating nonbinding general principles (soft law instruments) a worthwhile goal when there are scarce resources to generate norms? Noting the call for both harmonization and modernization, Professor Gabriel echoes the challenges identified by Professor Macdonald, positing soft law as a vehicle capable of avoiding pitfalls to harmonization. In particular, *The Advantages of Soft Law in International Commercial Law: The Role of UNIDROIT, UNCITRAL, and the Hague Conference* explores how soft law serves important functions that hard law does not. Soft law is more helpful in achieving harmonization than hard law because of its flexibility. Professor Gabriel observes that with soft law there is "less conflict between the international and the domestic law compared to a binding convention." Because soft law does not require adoption, it is "more easily and readily available for use." [1] Additionally, it serves as the basis for further work, provides guiding principles, and fosters party autonomy and neutrality. These attributes, however, also give rise to some criticism. Soft law instruments may offer less certainty because they are nonbinding. They may also suffer because a lack "of vetting, compromise,

1. Henry Deeb Gabriel, *The Advantages of Soft Law in International Commercial Law: The Role of UNIDROIT, UNCITRAL, and the Hague Conference*, 34 BROOK. J. INT'L L. 655, 656 (2009).

and ultimate acceptance usually yields instruments acceptable to the various constituencies."[2]

Amelia H. Boss, Trustee Professor of Law, Drexel University, Earle Mack School of Law, focuses on electronic commerce to highlight symbiosis at work in norm development. In *The Evolution of Commercial Law Norms: Lessons to be Learned from Electronic Commerce*, she highlights that product and form (either soft or hard law) are not as important as process, particularly the "exchange of ideas, and the education that occurs during the drafting process."[3] Moreover, she reminds us that success is difficult to judge. Success is not simply a matter of adoption or implementation. By examining the relatively recent developmental history of electronic commerce law, Professor Boss shows the process and mutual effect of national and international efforts. She also warns us of the dangers of this process, specifically fragmentation, when missteps occur in international norm development.

Boris Kozolchyk, Evo DeConcini Professor of Law, James E. Rogers College of Law, University of Arizona, recounts the long history of soft law in commercial transactions in *Modernization of Commercial Law: International Uniformity and Economic Development*. He specifically notes that "the vitality and universality of a commercial law shaped by best practices are apparent in institutions that stretch back as far as the ancient Greek version of the maritime contract and security agreement."[4] Legal culture is comprised not merely of the written positive law, but also of the attitudes towards commerce and the law, as well as the living law, i.e., how law is practiced. This last variable, how law is practiced, is crucial to the success of law.

Our second panel focuses on taxation norms. Hugh J. Ault, Professor of Law, Boston College School of Law; Senior Advisor, Centre for Tax Policy and Administration, OECD Paris, delves into the process by which the Organisation for Economic Co-operation and Development ("OECD") develops international tax norms. In particular, he tracks the changes in OECD structure and functioning. His Article, *Reflections on the Role of the OECD in Developing International Tax Norms*, considers tax competition, dispute resolution, and taxation of services. Professor Ault reveals that the OECD process has become more open and inclusive, perhaps at the cost of its ability to reach consensus. In light of these changes, he suggests means by which the OECD may further its agenda.

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2. *Id.* at 671.

3. Amelia Boss, *The Evolution of Commercial Law Norms: Lessons to be Learned from Electronic Commerce*, 34 BROOK. J. INT'L L. 673, 676 (2009).

4. Boris Kozolchyk, *Modernization of Commercial Law: International Uniformity and Economic Development*, 34 BROOK. J. INT'L L. 709, 711 (2009).

He cautions that it will be necessary for the OECD to develop techniques for securing "agreement on policy principles and technical rules" while still allowing an "escape valve" for certain sensitive issues.[5]

Reuven S. Avi-Yonah, Irwin I. Cohn Professor of Law, University of Michigan Law School, considers the subjects of tax havens and tax competition in order to explore norm development. His Article, *The OECD Harmful Tax Competition Report: A Retrospective After a Decade*, argues that the OECD has dealt successfully with preferential tax regimes, but reminds us that this is an ongoing process. He suggests additional mechanisms by which the OECD members can promote norms that combat tax competition.

Lisa Philipps, Associate Professor of Law and incoming Associate Dean (Research, Graduate Studies, and Institutional Relations), Osgoode Hall Law School, York University, Toronto, Canada and Miranda Stewart, Associate Professor of Law, Melbourne Law School, University of Melbourne, Australia conclude our tax discussion by tackling transparency norms in the budgetary context. In *Fiscal Transparency: Global Norms, Domestic Laws, and the Politics of Budgets*, they contend that the discursive roots of fiscal transparency stem from the shifts toward neoliberalism and good governance. Emphasizing fiscal discipline as well as accountability, participation, and ownership concerns, these movements were facilitated by numerous global initiatives: the International Monetary Fund Code of Good Practices on Fiscal Transparency, the OECD Best Practices for Budget Transparency, the World Bank, and the OECD and EU Stability Growth Pact. Philipps and Stewart consider how various transparency mechanisms account for "issues of distributive impact and politics."[6] Ultimately, while recognizing the emerging international architecture for transparency, they urge us to acknowledge the need to promote transparency and inclusiveness on the State level.

Our final subject is financial regulation. Kern Alexander, Director of Research in Financial Regulation, University of Cambridge, explores international banking supervision and, in particular, the Basel Committee. His Article, *Global Financial Standard Setting, the G10 Committees, and International Economic Law*, examines the soft law emanating from the Basel Committee, as well as other G10 committees, and its significant public policy influence. He also examines the decision-making process that resulted in Basel II and its weaknesses. While these standards are "voluntary," Doctor Alexander explains that the pressure on

5. Hugh J. Ault, *Reflections on the Role of the OECD in Developing International Tax Norms*, 34 BROOK. J. INT'L L. 757, 781 (2009).

6. Lisa Phillips & Miranda Stewart, *Fiscal Transparency: Global Norms, Domestic Laws, and the Politics of Budgets*, 34 BROOK. J. INT'L L. 797, 800 (2009).

States to adopt them raises serious accountability and legitimacy issues, and further suggests that the imposition of these standards on States excluded from their development could have negative consequences.

In *The Hardening of Soft Law in Securities Regulation*, Roberta S. Karmel, Centennial Professor of Law, Brooklyn Law School and Claire R. Kelly, Professor of Law, Brooklyn Law School, argue that soft law counteracts regulatory competition and makes regulatory cooperation more palatable. They trace a long history of soft law securities regulation and detail the current international efforts to shape international soft law norms. While they see this continued process as desirable, they nonetheless identify problems with international norm development via soft law, namely, those of authority, process, and legitimacy.

Finally, Elizabeth F. Brown, Assistant Professor, J. Mack Robinson College of Business, Georgia State University, explains the problem of developing international insurance norms. Professor Brown's Article, *The Development of International Norms for Insurance Regulation*, notes that there is a great deal of pressure for international insurance standards, but they have not kept pace with other international financial regulatory efforts. Existing sources of international law (e.g., GATS, NAFTA) fall short, in large part, due to U.S. reservations made to these agreements. And, in fact, some of the principles espoused by these agreements—notably, national treatment and market access—are not fully supported by state legislation. Still, the International Association of Insurance Supervisors has tried to develop guiding principles. Its efforts have been thwarted by the complexity of negotiation due to the number of U.S. states involved. Given the federalism issue posed by U.S. participation, it is difficult to imagine the development of an internationally based consensus.

These symposium Articles, and the Symposium itself, raise many issues for those interested in international norm generation. First, the process of international norm generation is just that, a process. It is ongoing, dynamic, and interconnected. And it cannot be isolated from politics or socioeconomic pressures. Further, questions regarding legitimacy, accountability, power, and transparency are unavoidable.

Second, the reach of soft law and the role it plays in international norm generation are remarkably extensive. Soft law serves a variety of values. Quite obviously, it may harden into positive hard law. More importantly, perhaps, is the role it plays in allowing for a symbiotic process of norm generation. It allows different legal cultures, perspectives, and values to coexist. More profoundly, it lays the groundwork for regulatory cooperation among States.

Third, we see that international norm generation reflects the needs and conduct of the actors affected by the norms. When these rules fail to account for the needs and values of the constituencies they serve, they fail to take hold, and lose whatever legitimacy they may have had.

Lastly, we see that national constituencies and domestic political pressures can thwart the formation of general principles and universal norms. Moreover, the diversity of interests and approaches harkens back to the note struck by Professor Macdonald at the very beginning:

> Law is both a constant process of interaction between citizens and officials, and in international affairs, a constant process of adjustment among States conceived in dyadic interaction. If we are genuinely committed to "generating international legal norms," then we can do no better than attend to Aristotelian wisdom: far from ruling the world, we will first be seeking to rule ourselves.[7]

7. Roderick A. Macdonald, *Three Metaphors of Norm Migration in International Context*, 34 BROOK. J. INT'L L. 603, 653 (2009).

THREE METAPHORS OF NORM MIGRATION IN INTERNATIONAL CONTEXT

Roderick A. Macdonald[*]

INTRODUCTION: INTERNATIONAL NORM ENTREPRENEURSHIP

Two metaphors constantly recur in the activities and scholarship of those who promote a regime of global legal norms[1]: harmonization and transplantation.[2] More recently a third hads also found scholarly favor: viral propagation.[3] Whichever metaphor is adopted, however, and regardless of whether the field is public law and judicial institutions (notably, international human rights and the rule of law),[4] environmental

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* F.R. Scott Professor of Law, McGill University. This essay is a revised version of the keynote address presented at the symposium Ruling the World: Generating International Norms, held at Brooklyn Law School, October 24, 2008. I should like to thank my United Nations Commission on International Trade Law ("UNCITRAL") colleagues Michel Deschamps, Richard Kohn, Jean-François Riffard, Uwe Schneider, Harry Sigman, Ed Smith, Catherine Walsh, and Steve Weise for many helpful conversations over the years about international commercial law reform. I am especially grateful to Neil Cohen for his friendship and generosity in sharing his insights into the themes I develop here. The Editors of the *Journal* have been most gracious in assisting me with the task of turning my symposium paper into the present Article. I trust the reader will judge that any errors of fact or interpretation (responsibility for which lies with me alone) have been made "in good faith and in a commercially reasonable manner."

1. In this Article, I focus on international norm migration as involving the conscious efforts of norm entrepreneurs, be they States acting individually or collectively (e.g., the International Institute for the Unification of Private Law ("UNIDROIT")), the agencies of which States are members (e.g., UNCITRAL), or private organizations (e.g., the National Conference of Commissioners on Uniform State Laws). For a discussion of the difference between intended norm migration and unintentional norm migration, see Finn Makela, *The Drug Testing Virus*, 43(3) REVUE JURIDIQUE THÉMIS [R.J.T.] (forthcoming 2009) (Can.) (examining the northward migration of U.S. legal norms concerning employee drug testing to Canada).

2. Both *harmonization* and *transplantation* have been staples of comparative law discourse since the mid-1970s. *See, e.g.*, Marc Ancel, *From the Unification of Law to Its Harmonization*, 51 TUL. L. REV. 108, 114–17 (1976); W.J. Kamba, *Comparative Law: A Theoretical Framework*, 23 INT'L & COMP. L. Q. 485, 501–04 (1974); Alan Watson, *Legal Transplants and Law Reform*, 92 LAW Q. REV. 79, 79–84 (1976).

3. Perhaps the most insightful discussion of the *viral propagation* metaphor in legal circles is the unpublished manuscript by Spencer Weber Waller, The Law & Economics Virus 1 (2008) (unpublished manuscript) (*available at* http://ssrn.com/abstract=1017882).

4. *See generally* BEYOND COMMON KNOWLEDGE: EMPIRICAL APPROACHES TO THE RULE OF LAW (Erik Jensen & Thomas Heller eds., 2003) (bringing together empirical studies of legal and judicial reform from across Asia, Europe, Latin America, and the United States); THE MIGRATION OF CONSTITUTIONAL IDEAS (Sujit Choudhry ed., 2006); Judith Resnick, *Law's Migration: American Exceptionalism, Silent Dialogues, and Federalism's Multiple Ports of Entry*, 115 YALE L.J. 1564 (2006) (exposing American federal-

law, labor law, or the structural components of the trading economy,[5] a single conclusion typically follows. Western law, particularly in its common law reflections, and specifically in its U.S. common law instantiations, is not just the best available earthly representation of the possibilities; it is the Platonic ideal-type.[6] Yet as far as I am aware, the assertion has not actually been put to a meaningful empirical test in many of the above fields. It remains a canon of the faith-based international law reform congregation, to which even disciples of reality-based constituencies are required to pay tribute.

My own field of interest, secured transactions law, is not immune from this type of theological proselytizing. Again and again one hears that the latest revision of Article 9 of the U.S. Uniform Commercial Code ("UCC") is the dialectical endpoint of centuries of experimentation with regimes of security on movable property.[7] As such, Article 9.3[8] is necessarily superior to all other models for modernizing the law of commercial

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ism as a both an excuse for evading transnational dialogue and a port of entry for norm migration in the context of international human rights).

5. *See generally* BOAVENTURA DE SOUSA SANTOS, TOWARDS A NEW COMMON SENSE: LAW, SCIENCE AND POLITICS IN THE PARADIGMATIC TRANSITION (1995) (critiquing modern norms as incapable of generating progressive laws for regulating the global economy).

6. The literature exploded following HERNANDO DE SOTO, THE MYSTERY OF CAPITAL: WHY CAPITALISM TRIUMPHS IN THE WEST AND FAILS EVERYWHERE ELSE (2000). *But compare* Daniel Berkowitz et al., *Economic Development, Legality and the Transplant Effect*, 47 EUR. ECON. REV. 165 (2003) (arguing that the mode in which the borrowed law was initially transplanted and received is a more important determinant of effective legal institutions than the supply of law from a particular legal family), *with* Sigrid Quack, *Agency Legal Professionals and Transnational Law-Making: A Case of Distributed Agency*, 14 ORGANIZATION 643 (2007) ("[I]n the face of weak or 'loose' government at the international level, the development of transnational legal norms follows a pattern of dispersed rule-setting that is manifested in the common law system and led by legal practitioners in large law firms and an internationalized legal profession.").

7. *See, e.g.*, Heywood Fleisig, *Secured Transactions: The Power of Collateral*, 33 FIN. & DEV. 44 (1996); Heywood Fleisig & Nuria de la Peña, *Law, Legal Institutions and Development: Lessons of the 1990s for Property Rights, Secured Transactions, Business Registration, and Contract Enforcement* (Oct. 2003), *reprinted in* WORLD BANK, GLOBAL INSOLVENCY DATABASE http://siteresources.worldbank.org/GILD/ConferenceMaterial/20260806/CEAL_Legal_Lessons%20-%20formatted.pdf. Two recent volumes provide a good conspectus of challenges and developments in the North Atlantic trading block. *See* SECURITY RIGHTS IN MOVABLE PROPERTY IN EUROPEAN PRIVATE LAW (Eva-Maria Kieninger ed., 2004), and the essays in Part I of the collection in particular; GERALD MCCORMACK, SECURED CREDIT UNDER ENGLISH AND AMERICAN LAW (2004).

8. In order to differentiate the versions of Article 9, I borrow the protocols of computer programs and characterize these official versions as Article 9.1, Article 9.2, and Article 9.3.

financing worldwide and should serve as a template for both national law and transnational legal norms.[9]

The failure to test this apostolic creed against the data provided by rigorous scholarly inquiry is, I argue, a fundamental flaw in contemporary international norm entrepreneurship, especially in those fields of business and commercial law where various versions of "economic analysis" reign supreme.[10] In the City of God, there may well be an exact coincidence between the ideal and the actual, between norm and action; in the City of Man, a somewhat more attenuated relationship is invariably present.[11]

There is another, procedural defect in the argument for universal legal norms that usually escapes the notice of law reformers. Global norm entrepreneurs do not take sufficiently seriously their privileged metaphors. Because these metaphors are familiar in popular conversation and because they seem, at least superficially, to plausibly characterize the processes for generating transnational legal norms, they lose their anchorage in the knowledge fields from which they arise. Divorced from their disciplinary contexts, these metaphors become rhetorical slogans,[12] mere ciphers.[13] If ever international law reformers were to engage carefully with any one of their harmonization, transplantation, and viral

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9. Typical of the Article 9 literature in this respect is Boris Kozolchyk & Dale Beck Furnish, *The OAS Model Law on Secured Transactions: A Comparative Analysis*, 12 SW. J. L. & TRADE AM. 235 (2005).

10. *E.g.*, Kenneth W. Dam, *Credit Markets, Creditors' Rights and Economic Development* (Univ. of Chi. Law Sch., John M. Olin Law & Econ. Working Paper No. 281, 2006), *available at* http://www.law.uchicago.edu/Lawecon/WkngPprs_251-300/281-kd-credit.pdf.

11. I have considered this theme in two recent unpublished conference papers. *See* Roderick A. Macdonald, Exporting Article 9, Presentation at the Jefferson School of Law Conference on Globalizing Secured Transactions (Mar. 14–15, 2008) (on file with author) [hereinafter Macdonald, Exporting Article 9]; Roderick A. Macdonald, Distinguishing "Interest" From "Position": Negotiating the Modernization of Secured Transactions Law in International Trade, Presentation at the Institute of Law and Finance, Johann Wolfgang Goethe Universität, Frankfurt, F.R.G. (Apr. 30, 2008) (on file with author).

12. Metaphor as rhetorical device—a memorable way to make a point that could be made otherwise—is the most usual deployment of metaphors in legal scholarship. Bernard J. Hibbitts, *Making Sense of Metaphors: Visuality, Aurality and the Reconfiguration of American Legal Discourse*, 16 CARDOZO L. REV. 229 (1994). Hibbitts is one of very few scholars who have theorized the use of metaphors *about* law by contrast with metaphors *in* law.

13. I am, of course, making a broader claim about metaphors in legal discourse. Following Finn Makela, A Viral Model of Legal Norm Migration (Nov. 14, 2008) (unpublished thesis, University of Montreal) (on file with author), I argue that "every metaphor is a submerged model." For an extended development, see Roderick A. Macdonald & Jonathan Widell, *Office Politics (Again)!*, 20 CAN. J.L. & SOC. 1, 5–8 (2005).

propagation metaphors and examine their disciplinary detail in music, botany, and genetics respectively, they would, I believe, be much less optimistic about deeming North American legal artifacts like Article 9.3 transcendent (that is, good for all times and all places).[14]

In support of this claim, I extrapolate from my experiences over a twenty-year period as a *national* law reformer in two civil law jurisdictions, Quebec and Ukraine,[15] and from lessons learned during the past six years as an *international* law reformer privileged to serve as a member of the Canadian delegation to UNCITRAL Working Group VI: Secured Transactions.[16] I draw parallels between these three experiences and the three metaphors I have identified in an effort to show how global norm entrepreneurs selectively choose (and selectively attend to the features of) their metaphors in order to validate their often unrealistic expectations about the receptivity of States to proposals for legislating international legal norms as domestic law. The reform process in Quebec was driven by the rhetorical logic of *harmonization*, in Ukraine by the rhetorical logic of *transplantation*, and at UNCITRAL by the rhetorical logic of *viral propagation*.[17] In none of these cases, however, was significant effort invested in deriving a viable model of norm migration from these metaphors. In none did norm entrepreneurs rely on a theory that would

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14. Too often when borrowed across disciplines, metaphors are stripped of their nuance, their equivocation, and their politics. *See generally* PAUL RICOEUR, THE RULE OF METAPHOR: MULTI-DISCIPLINARY STUDIES OF THE CREATION OF MEANING IN LANGUAGE 65–133 (1977). The point is further elaborated in J. DOUGLAS PORTEOUS, LANDSCAPES OF THE MIND: WORLDS OF SENSE AND METAPHOR (1990). The general point about metaphors in law is also developed by Waller, *supra* note 3, at 6–7.

15. Between 1985 and 1989, I served on a Ministerial Working Group charged with drafting articles for what became Book VI: Prior Claims and Hypothecs of the CIVIL CODE OF QUÉBEC [C.C.Q.], R.S.Q., ch. 64, arts. 2644–2802 (1991) (proclaimed in force Jan. 1, 1994). In 2003 and 2004, I served as an external Consultant to the World Bank and assisted in the drafting of what became the Ukraine Law on Securing Creditors' Claims and the Registration of Encumbrances Law No. 1255-IV, Nov. 18, 2003, Vidomosti Verkhovnoyi Rady Ukrainy [V.V.R.] [Official Bulletin of the Supreme Council of Ukraine] 2004, No.11, p.140 (Ukr.) (proclaimed in force Jan. 8, 2004), *available at* http://zakon.nau.ua/eng/doc/?uid=3020.360.0 [hereinafter Charge Law].

16. *See* Working Group VI, 2002 to Present: Security Interests, http://www.uncitral.org/uncitral/en/commission/working_groups/6Security_Interests.html (last visited Apr. 19, 2009) [hereinafter 2002 to Present: Security Interests].

17. In the oral presentation of this Article, I also used these three metaphors more generally to explore the framing of the three panels of the Symposium, thereby illustrating their analytical power. International organizations (panel I) are habitually engaged in an endeavor that can be captured by the metaphor of *legal transplants*; transnational epistemic communities (panel II) are constituted in a logic of *harmonization*; and the notion of an evolution from global soft law to global hard law (panel III) evokes an image of *viral propagation*.

have enabled them to judge the success or failure of their work against a template of testable hypotheses.[18]

To put the matter slightly differently, whether the law reform objective is to generate international legal norms located within the legal regimes of States or to generate international legal norms located within the system of international or transnational commercial law, the endeavor is similar. The fundamental questions of norm creation and norm migration do not change simply because the scope and scale of the legal order in question differ.[19]

Before discussing these experiences in detail, I should like to enter two caveats. First, my observations about the metaphors and practices of global law reform are to be understood analytically, not polemically. All three metaphors carry with them symbolic baggage. Without further specification, the idea of harmonization resonates positively—harmony is preferable to disharmony. Without further specification, the idea of transplantation is rather neutral—positive perhaps, if a life-saving organ transplant, less positive if it involves the introduction of a foreign species that destroys an indigenous habitat. Without further specification, the idea of viral propagation evokes a negative consequence—a viral disease pandemic. I ascribe no such symbolism to these metaphors. In this Article, my aim is simply to reflect on how effectively these metaphors capture the mode of norm migration at issue.

My second disclaimer pertains to the substantive field of inquiry. My reflections on the manner in which international norm entrepreneurs have promoted the reform of secured transactions law are in no way intended to denigrate Article 9.3 or its predecessors. Article 9 in all its versions is a remarkably successful legislative endeavor, and its key policies are widely acknowledged as capturing the central premises and core principles that should be pursued in any reform of secured transactions.[20] Still, success (even extraordinary success) in one domestic legal order is

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18. On the importance of modeling metaphors, see MAX BLACK, MODELS AND METAPHORS: STUDIES IN LANGUAGE AND PHILOSOPHY (1962).

19. The point has long been standard currency among legal pluralists, although its impact in the field of international commercial law reform is minimal. On norm migration in a legal pluralistic context, see the essays in LE DROIT SOLUBLE: CONTRIBUTIONS QUÉBÉCOISES À L'ÉTUDE L'INTERNORMATIVITÉ [SOLUBLE LAW: QUEBEC'S CONTRIBUTIONS TO THE STUDY OF INTERNORMATIVITY] (Jean-Guy Belley ed., 1996) [hereinafter SOLUBLE LAW].

20. This is confirmed by the principles many international organizations have identified as key to secured transactions reform. For one attempt to state these principles cogently, see WORLD BANK, PRINCIPLES AND GUIDELINES FOR EFFECTIVE INSOLVENCY AND CREDITOR RIGHTS SYSTEMS (Apr. 2001), http://www.worldbank.org/ifa/ipg_eng.pdf [hereinafter WORLD BANK, PRINCIPLES AND GUIDELINES].

no guarantee of success elsewhere. Such success does, however, provide a good benchmark for inquiring into the conditions for successful law reform and the why and how of mitigated success.

Article 9 remains an enigma for many jurists outside common law North America. Jurists from States that have not adopted the basic private law institutions of Western Europe typically find the esoteric vocabulary and conceptual structure of Article 9 to be curious.[21] Those trained in the civil law find Article 9 to be slightly schizophrenic in design. After all, none of its key structural features are conceptually new: the idea of a security right as a nonpossessory charge on property is far from foreign to the civil law tradition.[22] But the sweeping up of title transactions into the general concept of security, particularly in cases involving vendors that retain title to the property sold, suggests incoherence. How can one be both the owner of property and the titulary of a security right in the same property?[23] Of course, one must be careful not to overstate these points. On the one hand, many States have not adopted basic institutions of Western law, whether because of political theory (in socialist regimes), theology (in Islamic republics) or traditions (in some Asia-Pacific nations). Jurists from each can be expected to have their own differentiated reactions to Article 9, deriving from the particular assumptions of their different legal regimes. Moreover, the civil law tradition, like the common law tradition, is not a monolith. It would be incorrect to affirm that the secured transactions regimes in Quebec, France, Germany, Italy, and various States in Central Europe and Latin America are equally hospitable to the underlying logic of Article 9.[24] Even less are

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21. Roderick A. Macdonald, Presentation at the AALS Conference on Commercial Law at the Crossroads: Have I Got a Law for You . . . (June 14–17, 2005), outline *available at* http://www.aals.org/2005midyear/commercial/RoderickMacdonaldOutline.pdf.

22. Classical Roman law knew of the nonpossessory charge—*hypotheca*—on movable property fourteen centuries before the chattel mortgage emerged in common law countries. *See* R.W. LEE, THE ELEMENTS OF ROMAN LAW 175–78 (4th ed. 1956). The prohibition on the hypothecation of movables was a later development that did not fundamentally alter the civilian concept of hypothecation as a debtor-in-possession charge on property. *See* Pierre Crocq, *L'évolution des garanties du paiement: de la diversité à l'unité* [*The Evolution of Payment Guarantees: From Diversity to Unity*], *in* 2 MÉLANGES CHRISTIAN MOULY [A COLLECTION OF ESSAYS IN HONOR OF CHRISTIAN MOULY] 317 (1998) (Fr.).

23. For a comprehensive discussion of the problem, see JEAN-FRANÇOIS RIFFARD, LE SECURITY INTEREST OU L'APPROCHE FONCTIONNELLE ET UNITAIRE DES SÛRETÉS MOBILIÈRES: CONTRIBUTION À UNE RATIONALISATION DU DROIT FRANÇAIS [THE SECURITY INTEREST OR THE FUNCTIONAL UNITARY APPROACH TO SECURITY ON MOVEABLE PROPERTY: CONTRIBUTION TO A RATIONALIZATION OF FRENCH LAW] (1997) (Fr.).

24. For a subtle treatment of the diversity of different legal traditions, and the diversity within such traditions, see H. PATRICK GLENN, LEGAL TRADITIONS OF THE WORLD (2d

they equally hospitable to the particular mechanisms by which this logic is reduced to the specific legal norms of Article 9.3.[25]

In both substance and form, Article 9 is the necessary product of a common law regime that never fully developed the generic concept of a security right as a "legal cause of preference," embracing consensual and nonconsensual hypothecations, charges, liens, and possessory pledges. Substantively, and consistent with the evolution of the common law mortgage over land, Article 9 relativizes title according to the purposes of its deployment: a creditor's or vendor's ownership does not comprise the full prerogatives of ownership where title is used to secure the performance of an obligation. In form, Article 9 does not set out a general concept by which the "essential" characteristics of the various transactions it regulates may be identified. So, for example, it does not define the generic idea of a "security *right*." While Article 9 does incorporate the definition of a "security *interest*" provided in Section 1-201(35),[26] this definition is under-specified. Consequently, many types of transactions that could be functionally understood to create a security interest have been excluded from the scope of Article 9 by judicial interpretation.[27] At the same time, many types of transactions that are not functionally secured transactions under the opening sentence of the definition

ed. 2004). *See also* H. Patrick Glenn, *A Concept of Legal Tradition*, 34 QUEENS L.J. 427 (2008).

25. Commentators generally acknowledge that Article 9.3 is much more responsive to the particular features of secured financing in the United States and that its detailed rules and definitions diminish its suitability as a template for international secured transactions reform. *See, e.g.*, Ronald C.C. Cuming & Catherine Walsh, *Revised Article 9 of the Uniform Commercial Code: Implications for the Canadian Personal Property Security Acts*, 16 BANKING & FIN. L. REV. 339 (2000).

26. U.C.C. § 1-201(35) (2001) ("'Security interest' means an interest in personal property or fixtures which secures payment or performance of an obligation. 'Security interest' "includes any interest of a consignor and a buyer of accounts, chattel paper, a payment intangible, or a promissory note in a transaction that is subject to Article 9. 'Security interest' does not include the special property interest of a buyer of goods on identification of those goods to a contract for sale under Section 2-401, but a buyer may also acquire a 'security interest' by complying with Article 9. Except as otherwise provided in Section 2-505, the right of a seller or lessor of goods under Article 2 or 2A to retain or acquire possession of the goods is not a 'security interest,' but a seller or lessor may also acquire a 'security interest' by complying with Article 9. The retention or reservation of title by a seller of goods notwithstanding shipment or delivery to the buyer under Section 2-401 is limited in effect to a reservation of a 'security interest.' Whether a transaction in the form of a lease creates a 'security interest' is determined pursuant to Section 1-203.").

27. Douglas G. Baird & Thomas H. Jackson, *Possession and Ownership: An Examination of the Scope of Article 9*, 35 STAN. L. REV. 175 (1983). This article remains one of the best explorations of this theme.

of Section 1-102(35) have been added to the scope of Article 9; and many legal devices not caught under any conceivable definition of a security interest are included within the regulatory framework of Section 9-109(a).[28]

The discomfort of jurists outside common law North America with Article 9 can also be traced to its pragmatic, remedy-oriented structure and its highly-detailed, fact-driven drafting style—both features that particularly grate upon those who appreciate the notion of a code.[29] For many, Article 9.3 in particular is the antithesis of a code; it is anti-conceptual, written in a technical style, and not integrated within a syncretic frame of private law such as a civil code.

To shed light on the source of these misgivings about Article 9, I should like to conclude this Introduction by situating the law of secured transactions within its broader intellectual context.[30] Conceptually, the *genus* security *right* (including the *species* security *interest*) can only be fully understood within the regime governing the compulsory enforcement of obligations (or what in common law systems is conventionally called debtor-creditor law). In contemporary Western legal traditions, whether Continental civil law or Anglo-American common law, four principles underpin debtor-creditor law. The first principle, which we now take as a given, but which really only achieved its status as a principle in the nineteenth century with the abolition of debtor's prison, is that judgments are to be executed against property, not persons. The second principle is that the preferred creditor's remedy for nonperformance of an obligation is not to coerce specific performance, but rather to seek performance by equivalence, in the form of a judicial determination of money damages. The third principle (the common pledge of creditors) is that the entire patrimony of a debtor is liable for these debts. That is, the law presumes that what people own secures what they owe, and that any creditor is entitled to seek satisfaction of an unperformed obligation by seizing and selling however much of its debtor's exigible estate is required to satisfy the debt. The fourth principle is now understood in common law systems more as a feature of insolvency law, although in civil law systems it remains a feature of debtor-creditor law. Should the assets of a debtor be insufficient to pay all creditors with unpaid obligations, the money received from the sale of these assets will be

28. *See* U.C.C. § 9-109(a)(2)–(4) (2000).

29. On the key features of a code as a juristic technique, see QUEBEC CIVIL LAW: AN INTRODUCTION TO QUEBEC PRIVATE LAW 98–111 (John E.C. Brierley & Roderick A. Macdonald eds., 1993).

30. For an elaboration of this context, see PIERRE CROCQ, PROPRIÉTÉ ET GARANTIE [PROPERTY AND SECURITY] (1995) (Fr.).

distributed ratably (*pari passu*) among these creditors, unless the law gives their claim a priority status (a preference).

Once these features of debtor-creditor law are clearly articulated it is easier to grasp the basic logic of a security right and to see why an Article 9 security interest is only one species of the larger genus. This logic can be expressed as follows:

> A security right is constituted by (1) the specific and purposive affectation of property (2) to the satisfaction of a debt, (3) in a manner that improves the legal situation of an ordinary creditor (4) by attenuating the principle that an insolvent debtor's entire estate is the common pledge of creditors in which all creditors share *pari passu.*[31]

A security right may be consensual or nonconsensual. It may be a right in corporeal or incorporeal property. It may affect individual assets or a universality. It may attach to movable or immovable property. It need not be a right in assets, but may simply be a right in their proceeds. It need not generate an execution preference. It need not involve the rendering of assets into money. It may involve the direct payment of the debt by substituted performance.[32]

Of course, simply noting these features of the generic concept of a security right does not, in any meaningful sense, tell us how they may be instantiated in any particular legal regime. Nor does it tell us how legal ideas circulate or the mechanisms by which international norm entrepreneurs seek to sell their product in a globalized economy. These are the issues I address in the three following Sections of this Article.[33] I consider in turn the dominant metaphors that capture the objectives of each of the three secured transactions law reform endeavors with which I have been associated over the past three decades.[34] While the discussion is

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31. This definition is drawn from Roderick A. Macdonald & Jean-Frédérick Ménard, *Credo, credere, credidi, creditum*: *Essai de phénoménologie des sûretés réelles* [*A Phenomenological Study of Security on Property*], *in* MÉLANGES OFFERTS AU PROFESSEUR FRANÇOIS FRENETTE: ÉTUDES PORTANT SUR LE DROIT PATRIMONIAL [ESSAYS IN HONOR OF PROFESSOR FRANÇOIS FRENETTE: STUDIES IN PATRIMONIAL RIGHTS] 309 (2006) (Can.).

32. Doctrinal commentators in France have been particularly thoughtful in working through the subtleties of the generic idea of a security right. *See, e.g.*, JACQUES MESTRE ET AL., DROIT COMMUN DES SÛRETÉS RÉELLES [COMMON LAW OF SECURITY ON PROPERTY] 1–10 (1996) (Fr.); Michel Cabrillac & Christian Mouly, DROIT DES SÛRETÉS [SECURITIES LAW] 1–19 (6th ed. 2002) (Fr.).

33. I have discussed many of these points in two other recent articles. *See* Roderick A. Macdonald, *Article 9 Norm Entrepreneurship*, 43 CAN. BUS. L.J. 240 (2006) [hereinafter Macdonald, *Norm Entrepreneurship*]; Roderick A. Macdonald, *In Praise of the Hypothecary Charge*, 7/8 DECITA 287 (2007).

34. In this Article, I do not address the complementary question of whether there can (and should) be international legal norms that are proper to an international legal order

broadly cast, I pay particular attention to issues of scope: how does each law reform project address the deployment of title to secure the performance of an obligation?[35] My conclusion raises the more general issues of formalism and functionalism as strategies of international law reform and situates the endeavor within the larger context of ethical theory.

I. HARMONIZATION: THE NAIVETY OF EQUAL TEMPERAMENT

My first example, meant to illustrate the use and abuse of the metaphor of *harmonization* by international commercial law norm entrepreneurs, is drawn from the process of civil code revision in Quebec.

Exactly what does the metaphor of harmonization imply?[36] For most jurists it means reforming the law of one State to bring it into accord with the law of another State. The assumption is that there already exists a desired theme or melody, and that some discordant melody needs to be rewritten so that it is in harmony with the existing, desired theme. Other jurists see the challenge as bilateral. Harmonization implies that the existing theme or melody may have to be changed in order to better accommodate the harmonic efforts of others. Here, the assumption is that the goal is to find the best set of policies and principles (whether or not there is actually an existing legal regime that reflects these policies and principles) and to adopt these policies and principles as the guiding motifs for legislative drafting in all receiving States. In both hypotheses, however, there is a presupposition that harmony rather than discord is desirable, and that harmony will always produce substantive compatibility.[37]

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conceived as such, and that derive their first-order legitimacy from legitimating structures other than States. That is, I do not consider either so-called *legislated* international legal norms deriving from international treaties and conventions or *nonlegislated* international legal norms deriving from practice, contract, or everyday interaction. For a brief discussion of the theoretical ground for such developments in the idea of legal pluralism, see Roderick A. Macdonald, *Metaphors of Multiplicity: Civil Society, Regimes, and Legal Pluralism*, 15 ARIZ. J. INT'L & COMP. L. 69 (1998).

35. A broad overview of the alternatives in common law and civil law regimes may be found in Michael G. Bridge et al., *Formalism, Functionalism, and Understanding the Law of Secured Transactions*, 44 MCGILL L.J. 567 (1999).

36. According to the Oxford English Dictionary, "harmonization" is the "action or process of harmonizing"—meaning the reduction to harmony or agreement; reconciliation. *See* Oxford English Dictionary Online, Harmonization, http://dictionary.oed.com/cgi/entry/50102729?single=1&query_type=word&queryword=harmonization&first=1&max_to_show=10 (last visited Apr. 19, 2009).

37. For an extended discussion of harmonization through law reform, see Martin Boodman, *The Myth of Harmonization of Laws*, 39 AM. J. COMP. L. 699 (1991). I leave aside collateral issues such as whether it is necessary to achieve rhythmic coherence as

A. The Process of Civil Code Revision in Quebec

To test the utility of the harmonization metaphor I commence with several observations about the unique socio-political context of Quebec commercial law. An initial point is that Quebec is a predominantly French-speaking jurisdiction in a commercial law world dominated, until recently even in Quebec, by English. Moreover, except in matters of constitutional and public law, Quebec is a civil law jurisdiction, but finds itself surrounded by States having common law legal systems. Third, even though its political economy and governance institutions would place it among States characterized in the United States as verging on socialist, in comparison with most European States, Quebec would be seen as having a relatively unregulated North American market economy. Again, notwithstanding a significant operative overlay of common law-influenced federal commercial law in matters such as banking, bankruptcy, negotiable instruments, interest regulation, and intellectual property, basic conceptions of property and obligations have retained the central features of the French civil law tradition. Fifth, this private law of property and obligations is expressed in the style and form of the Napoleonic (*Code civil français*), not the German *(Burgerlichesgesetzbuch)* codification. Finally, Quebec's Civil Code Revision Office ("CCRO") began a process of modernizing its private law in the 1950s—that is, at the same time the UCC enactment project was getting off the ground in the United States—even though the CCRO submitted its report and Draft Civil Code ("DCC") only in 1977,[38] and the reformed Civil Code of Québec ("CCQ") did not actually come into force until 1994.[39] These six features bear greatly on how the specific reform of secured transactions took shape in Quebec.

When the provincial government published the DCC in 1978, the inspiration of Article 9 was evident in the Title on Security on Property.[40] Throughout the previous decade, the CCRO Committee on Security on Property had sought, in modernizing the 1866 Civil Code of Lower Can-

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well, and whether harmonization implies the possibility that reform might involve a "variation" on the primary theme.

38. *See* CIVIL CODE REVISION OFFICE, 2 REPORT ON THE QUÉBEC CIVIL CODE (1977) (Can.) [hereinafter REPORT ON THE CCQ].

39. On that lengthy process of codal reform, see QUEBEC CIVIL LAW: AN INTRODUCTION TO QUEBEC PRIVATE LAW, *supra* note 29, at 84–97.

40. The Chair of the Committee on Security on Property, Yves Caron, often acknowledged the influence of Article 9. *See, e.g.*, Yves Caron, *L'Article 9 du Code Uniforme de Commerce peut-il être exporté? Point de vue d'un Juriste Québecois* [*Is Article 9 of the Uniform Commercial Code Exportable? Viewpoint of a Quebecois Jurist*], *in* ASPECTS OF COMPARATIVE COMMERCIAL LAW 374 (J. Ziegel & W. Foster eds., 1969).

ada ("CCLC"), to harmonize Quebec commercial law with Article 9.2 and its Canadian derivatives, the Personal Property Security Acts.[41] Sensitive to the nationalist political undertones of Quebec's ongoing "Quiet Revolution," the Committee carefully avoided the word "unification"[42] in elaborating its proposals. It did, however, expressly adopt the general conception of a security interest found in Article 9. The DCC was submitted just following the election of a government committed to withdrawing Quebec from the Canadian Confederation. As a result, other matters (including a sovereignty referendum) took precedence, and the CCRO proposals languished for almost a decade. In early 1985, however, once again following an election, the new non-separatist government announced that enacting a reformed Civil Code would be a priority. A number of expert committees were formed to consider the text of the DCC.

Between 1985 and 1989, I served as a member of a Working Group of the Quebec Ministry of Justice charged with examining the CCRO's recommendations relating to security on property and the registration of rights. Because the DCC dealt with security on both movable and immovable property, the representatives of the legal professions on the Working Group included both commercial and real estate practitioners, and more importantly, both advocates (lawyers) and notaries. While the former in each pairing were generally favorable to the DCC proposals, the latter expressed five major concerns. First, in extending the concept of the hypothec to movables (especially to universalities of present and future movables), the DCC appeared to attenuate significantly the principle of the hypothec's "specific affectation" and the requirement of a notarial deed to constitute a hypothec. Second, in characterizing all forms of movable security as hypothecs, the DCC undermined the particularity of rules governing the creation, third-party effectiveness, priority, and enforcement of the existing panoply of movable security devices—pledges, assignments of receivables, corporate trust deeds, floating charges, special nonpossessory pledges, transfers of property in stock, etc.—a detailed knowledge of which constituted much of the expertise and intellectual capital of the profession. Third, the DCC proposed broadly opening secured credit to consumers by permitting debtor-in-possession security over movable property. Fourth, the DCC proposed an

41. *See* REPORT ON THE CCQ, *supra* note 38, at 346–72.

42. Curiously, among Quebec jurists, there seems less resistance to the specific word (independent of its conceptual content) when associated with international organizations like UNIDROIT, the International Institute for the Unification of Private Law, than with a national organization like the ULCC, the Uniform Law Conference of Canada in English, but *La conférence pour l'harmonisation des lois au Canada* in French.

extended conception of real subrogation for security rights that would mirror the Article 9 proceeds rule. Finally, the DCC adopted a functionalist logic for rationalizing transactions (including all title transactions) intended as security through a mechanism it labeled the "presumption of hypothec."[43]

More than anything else, it was the presumption of hypothec that raised the suspicion of doctrinal heresy. Despite the care of the CCRO to use the expression harmonization, many jurists saw the specter of unification in this proposal. Part of the difficulty lay in the fact that the presumption of hypothec idea departed from the procedural logic that had previously driven secured transactions reform in Quebec. That is, rather than follow a well-known regulatory technique, according to which particular formalities for creation, third-party effects, and enforcement of security were overlaid on existing transactions,[44] the idea of the presumption of hypothec was to adopt an unfamiliar deeming logic, under which even title transactions would be legislatively recharacterized as hypothecs (implying that title would vest for all purposes in a debtor, who would be deemed to have granted a security right to the creditor).[45] So,

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43. CIVIL CODE REVISION OFFICE, 1 DRAFT CIVIL CODE [D.C.C.], arts. 281–85 (1977) (Can.). The CCRO described its work as involving the horizontal and vertical integration of security rights. Vertical integration was meant to signal that different rules for creation, third-party effectiveness, priority, and enforcement of existing security rights would be brought together in a common frame; horizontal integration was meant to signal that all legal devices serving to secure the performance of an obligation would be considered security rights. *See* Yves Caron, *La Loi des pouvoirs spéciaux des corporations et les recommandations de l'office de revision du Code civil sur les sûretés réelle* [*The Special Corporate Powers Act and the Civil Code Revision Office's Recommendations on Security on Property*], *in* W.C.J. MEREDITH MEMORIAL LECTURES: LEGAL ASPECTS OF CORPORATE DEBT FINANCING 82 (1976).

44. For example, this was the approach taken in 1938 with the amendment of Articles 1535 et seq. of the Civil Code of Lower Canada, and in 1964 with the addition of Articles 1040a-1040e to the CCLC. The technique is widespread, and can be found, most evidently, in statutes like the Consumer Protection Act, R.S.Q. c. P-40.1, s. 15 (2009). Paradoxically, this is a law reform technique more familiar to the common law (consider equity's maxim "once a mortgage always a mortgage") and, even more paradoxically, was exactly that adopted by the drafters of Article 9.

45. The differences between the "substance of the transaction" approach of Article 9 and the deeming logic of the "presumption of hypothec" are reviewed in Roderick A. Macdonald, *Faut-il s'assurer d'appeler un chat un chat? Observations sur la méthodologie législative à travers l'énumération limitative des sûretés, 'la présomption d'hypothèque' et le principe de 'l'essence de l'opération'* [*Is It Always Better to Make Sure That We Call a Cat a Cat? Observations on Legislative Method in Relation to the* Numerus Clausus *of Security Rights, the "Presumption of Hypothec," and the Principle of the "Substance of the Transaction"*], *in* MÉLANGES GERMAIN BRIÈRE 527 (Ernest Caparros ed., 1993) (Can.) [hereinafter Macdonald, *Observations*]. Paradoxically, in view of

for example, installment sellers would be deemed to be secured creditors, and installment purchasers would be deemed to be owners who had granted vendor's security; buyers under a sale with a right of redemption would be deemed to be lenders, and sellers under a right of redemption would be deemed to be borrowers.

After almost four years of study and debate, the Working Group came to the conclusion that it would not take the DCC as the starting point for its recommendations to the Minister. It proposed an entirely different legislative framework—the *Avant-projet de loi* of 1989—that harkened back to the logic of the CCLC.[46] For present purposes, the most profound change was the decision to abandon a general presumption of hypothec. The CCQ did enact a presumption of hypothec in so far as traditional security devices were concerned, recasting and recharacterizing all forms of existing security as hypothecs; however, it did not extend this rationalization to title security.[47] Instead, it proposed a transaction-specific, and not altogether identical, regulation of only some title devices, those that are the most common, installment sales, sales under resolutory condition, sales with a right of redemption, finance leases, and security trusts.[48] At the end of the day, the text of Book 6 of the CCQ, Prior Claims and Hypothecs, was derived directly from the recommendations of the ministerial working group and its *Avant-projet de loi*, not from the proposals contained in the DCC.[49] Understanding why this occurred is instructive for assessing the limits of the metaphor of harmonization in international commercial law reform.

In my view, there were two key factors at play: ideology and ignorance. Ideologically, the DCC proposals were interpreted as entirely too much of a break from the civil law tradition. Ironically, this interpretation derived more from the CCRO's presentation of its recommendations, which considered security on property a new departure meant to

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the resistance to the presumption of hypothec idea, this technique is a more accurate reflection of traditional civil law methodology.

46. The *Avant-projet* was never enacted but was introduced into the National Assembly as Bill 106 of 1989. For discussion of the process, see Roderick A. Macdonald, *The Counter-Reformation of Secured Transactions Law in Quebec*, 19 CAN. BUS. L.J. 239 (1991) [hereinafter Macdonald, *Counter-Reformation*].

47. *See* C.C.Q., R.S.Q. arts. 2674, 2660, 2664–65 (1991). In other words, the CCQ adopted the concept of vertical integration of security devices as proposed by the CCRO, but did not at the same time adopt the concept of horizontal integration of security devices.

48. The regulation of these different devices in the CCQ is discussed in detail in Macdonald, *Observations*, *supra* note 45, at 572–91.

49. The process by which the *Avant-projet* was then translated into Book 6 of the CCQ is discussed in Roderick A. Macdonald, *Change of Terminology? Change of Law?*, 23 REVUE GÉNÉRALE DE DROIT 357 (1992).

modernize, rationalize, and harmonize Quebec law with laws being enacted by other North American jurisdictions, than from the actual content of the regime it proposed. So, for example, because the DCC was described as being compatible with Article 9, the Minister of Justice and others immediately (and incorrectly) declaimed the presumption of hypothec as a common law incursion into the civil law. As noted, however, the presumption of hypothec was a typically civilian way of addressing a problem that Article 9 had dealt with in a procedural, pragmatic, and characteristically Anglo-American fashion.[50] The orthodox civil law approach has been to deploy characterization as a regulatory tool.[51] So, while one might describe the Article 9 approach as "if it quacks like a duck and it walks like a duck, *treat it* like a duck,"[52] the DCC approach could be described as "if it quacks like a duck and it walks like a duck, it *is* a duck."[53] Unfortunately, the Minister and his advisers incorrectly believed that the presumption of hypothec was an example of U.S. legal imperialism aimed at unification of law; and in the name of harmonization, they proposed a regime that conceptually followed the logic of unification (even if this was unconscious) while rejecting an approach that sought a genuine harmonization respectful of the civil law tradition.

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50. While Article 9.1 clearly did not operate a recharacterization of title security—that is, it did not for all purposes deem a title-reservation sale to involve an outright sale with a vendor's mortgage back—but merely imposed a regulatory overlay for issues of creation, third-party effectiveness, enforcement, and priorities, it is an open question whether Article 9.3 and judicial interpretation have now effectively transformed the idea of a security interest into a deeming provision of the type envisioned under the presumption of hypothec. *See* Bridge et al., *supra* note 35, at 621–26.

51. A classic example of the approach can be found in the manner in which courts treated attempts to overcome the traditional prohibition on the hypothecation of movables. *See* CIVIL CODE OF LOWER CANADA [C.C.L.C.] art. 2022 (Sharp 1889). Where parties deployed a double sale mechanism—outright sale by the borrower to the lender combined with an installment sale from the lender back to the borrower—Quebec courts consistently declared these transactions to be disguised "movable hypothec" and refused enforcement to the lender. *See, e.g.*, Rousseau v. Bélanger [1952] B.R. 772 (Qué.).

52. The principle flows from § 9-109(a), "Except as otherwise provided in subsections (c) and (d), this article applies to: (1) a transaction, regardless of its form, that creates a security interest in personal property or fixtures by contract." U.C.C. § 9-109(a) (2000). *See also id.* § 1-201(35) (2001) ("'Security interest' means an interest in personal property or fixtures which secures payment or performance of an obligation.").

53. D.C.C. art. 281 (Can.). (1) No person may assert a right to property in order to secure payment of an obligation, except by way of hypothec. (2) Any stipulation the effect of which is to preserve or confer a right to property in order to secure payment of an obligation is a stipulation of hypothec. (3) It may only preserve or confer a hypothec in favour of the creditor, subject to the formalities required for constitution and publication of hypothecs.

The second factor leading to rejection of the DCC was related less to notions of legal and conceptual integrity than to "facts on the ground." Because much of the Quebec commercial law of the 1950s to 1980s was contained in extra-codal statutes enacted as exceptions to the regime elaborated in the CCLC, at the time the DCC saw the light of day, Quebec private law legal culture was neither familiar with nor amenable to the assumptions underlying the CCRO proposals. That is, atavisms of Civil Law thinking, uninfluenced by decades of modernization in commercial legislation, colored the general professional reception of the DCC. On the basis that it constituted a radical departure from existing law, several jurists opposed the very idea of a regime of security on property aimed at facilitating consensual transactions where (1) the principle of *numerus clausus* of multiple distinctive transactions was not respected; (2) creditors would be permitted to take nonpossessory security over all manner of movable assets—corporeal and incorporeal, specific assets and universalities, present and future assets—granted by all manner of debtor (including those not carrying on an enterprise); (3) creditors could exercise self-help enforcement remedies; and (4) the supervisory role of courts would be *ex post facto*, rather than *ex ante*. Close comparison of the DCC with existing Quebec commercial practices, of course, belies each of these presuppositions.[54]

Not surprisingly, therefore, the CCQ remains an incomplete reform. The most glaring deficiencies can be located in two main areas. Most importantly, the regime governing title transactions remains poorly worked out. Although the DCC proposal to enact a presumption of hypothec was not pursued in the CCQ, the National Assembly could not simply ignore the problem posed by extensive use of title-security such as installment sales. So, using the blueprint that it sketched out in the CCLC, the National Assembly decided to maintain a distinction between title transactions and security devices and to overlay the former with a number of procedural mechanisms meant to protect a debtor's equity. But this approach was *ad hoc*, and no attempt was made to comprehensively think through the implications of this bifurcated approach. The CCQ does not conceptualize all title transactions as instantiations of one of four logical types: vendor title retention (e.g., sale under suspensive

54. For a detailed discussion, see Macdonald, *Norm Entrepreneurship*, *supra* note 33. Perhaps, strategically, the CCRO could have been more accommodating of these concerns. For example, it could have proposed a new term like *security right* to embrace the existing inventory of security rights denominated as pledges, hypothecs, trust deeds, fiduciary transfers of property-in-stock, conditional assignments, sales with a right of redemption, retention-of-title devices, and financial leases, rather than relabel all these devices as *hypothecs*.

condition, installment sale, or lease), vendor title resolution (e.g., revendication of thirty-day goods, or resolutory clauses), creditor acquisition and retention of title (e.g., sale with a right of redemption, double sales, or sale leaseback), and creditor title-suspensive acquisition or transfer of title (e.g., giving-in-payment clauses). Instead, it identifies the paradigmatic (and most familiar) device among the various specific transactions falling within each of these logical types, and imposes, apparently upon this device alone, certain procedural mechanisms. As a result, the legislature implicitly invited inventive parties to create transactions falling just outside the scope of the regulated type—a maneuver that, absent judicial sensitivity to excessive formalism, permits the regulatory regime to be easily subverted.[55] It would be possible to solve most of these problems by implementing a single functional approach for true security and a four-fold functional approach for title transactions falling within each of the four categories.

The second deficiency is that the CCQ was not conceived with the financing practices of a 1990s commercial economy in mind. One might say that the CCQ more closely resembles Article 9.1 of 1954 than it does Article 9.3. Thus, while the CCQ contemplates the hypothecation of share certificates, securities, negotiable instruments, incorporeal business assets, intellectual property, debentures, partnership shares, investment, and mutual funds and like assets, its regulatory regime is rudimentary. The CCQ contains no special priority rule like that found in Article 9, which privileges "publicity by possession" over "publicity by registration" in respect of negotiable instruments, securities, and documents; nor does it provide for "publicity by control" in respect of deposit accounts.[56] Another indication of the Code's uneasy relationship with contemporary commercial finance can be found in its enforcement regime. The procedures for realizing upon security are heavily laden with *ex ante* controls, reflecting the kinds of considerations that might properly come into play in relation to security on immovable property, but that are less appropri-

55. For example, even though sales under suspensive condition produce almost identical consequences to installment sales, the former are currently unregulated while the latter are closely assimilated to the hypothec for the purposes of registration, enforcement upon default by the purchaser, and priorities. C.C.Q. arts. 1745–49. A similar nominalistic legislative strategy was pursued in Articles 1040(a)–(e) of the CCLC (which was added in 1964 by An Act to Protect Borrowers Against Certain Abuses and Lenders Against Certain Privileges, S.Q. 1964, ch. 67, art. 1), with predictable consequences. It was only with the decision of a nine-member bench of the Quebec Court of Appeal in Nadeau v. Nadeau, [1977] C.A. 234 (Qué.), that courts stopped reading these Articles as a closed list of regulated transactions and began to interpret them as implying a general principle.

56. Part of this may be explained by commercial financing practices in Canada. *See* Cuming & Walsh, *supra* note 25.

ate in a regime of security on movables.[57] But, just as Article 9 has been subject to adjustment, one might presume that similar adjustments will occur with the CCQ.[58] Still, the story of its initial enactment has much to teach about how the metaphor of harmonization can illuminate (and occlude) the process of international commercial law reform.

B. The Logic of Harmonization

Let me now return to the rhetoric that underlies appeals to harmonization in international commercial law reform: unification is bad; harmonization is good.[59] As a legal pluralist, I have no difficulty with the first affirmation. But I should like to go further by marking the limits of the harmonization metaphor. With very few exceptions, global norm entrepreneurs believe that harmonization is an appropriate metaphor to describe the process of achieving comity in secured transactions law. Is it? What guidance does it really give as to how to effectuate international commercial law reform?

Consider the following illustration.[60] The key harmonic principles of Western music are derived from ratios: unison = 1:1; octave = 2:1; fifth = 3:2; fourth = 4:3; major third = 5:4. In theory, if you start with any note and tune through the circle of fifths, you should get back to where you began (e.g., A–E–B–F♯–C♯–A♭/G♯–E♭–B♭–F–C–G–A), and this progression of twelve fifths should produce the same note as seven octaves. However, it does not. 3:2 to the twelfth power equals 129.746; 2:1 to the

57. Currently, by contrast to the immediate possession regime of UCC Article 9, CCQ Article 2758 requires an enforcing creditor to give a twenty-day (or, in the case of consumer transactions, thirty-day) prior notice of an intention to exercise a hypothecary recourse against movable property. Where a debtor is carrying on an enterprise and the property is susceptible to rapid deterioration, the prior notice may be dispensed with altogether. In such cases, the notice would be post-possession and would be intended merely to inform the debtor and third parties of the specific realization recourse that the creditor intends to pursue.

58. So, for example, the National Assembly has just enacted amendments to the CCQ to provide for the third-party effectiveness of hypothecs over intermediated securities to be obtained by control. *See* An Act Respecting the Transfer of Securities and the Establishment of Security Entitlements, R.S.Q. 2008, c. 20, s. 136 (2008) (adding Articles 2714.1–14.7 to the CCQ).

59. For comprehensive studies grounded in this metaphor and published by the Department of Justice, Canada, see THE HARMONIZATION OF FEDERAL LEGISLATION WITH THE CIVIL LAW OF THE PROVINCE OF QUEBEC AND CANADIAN BIJURALISM, *available at* http://justice.gc.ca/eng/dept-min/pub/hfl-hlf/table.html. Compare this with the critical perspective of Arthur Rosett, *Unification, Harmonization, Restatement, Codification, and Reform in International Commercial Law*, 40 AM. J. COMP. L. 683 (1992).

60. The illustration is taken from ROSS W. DUFFIN, HOW EQUAL TEMPERAMENT RUINED HARMONY (AND WHY YOU SHOULD CARE) 15–45 (2007).

seventh power equals 128.000. The dissonance with octaves is worse if we take the progression cycle of major thirds.

To overcome these dissonances musicians developed the theory of temperament. That is, because the triad C–E–G♯ (an augmented chord in the key of C major) is not the same as the triad C–E–A♭ (an augmented chord in the key of A♭ major), a violin must be slightly retuned depending on the particular key in which a piece is being played. The four violin strings, if played open, will not sound exactly right in all keys. Yet, even though tuning to a particular key with a perfect instrument (for example, a stringed instrument that permits strings to be stopped precisely where a violinist wishes, by contrast with a fretted instrument like a guitar that predetermines where strings are stopped) will resolve most of these dissonances, it will never overcome the root dissonance produced when octaves are compared with major fifth and major third cyclical progressions. With nonperfect instruments such as pianos, the problem is worse since each note is given a fixed cycles per second regardless of the key in which one plays. That is, even though pianos are constructed so that C♯ and D♭ are played by touching the same key, neither is an exact reflection of, say, the major fifth in the key of G♭ (D♭) or the major third in the key of A (C♯).

This accommodation to the practical limits of the piano does not mean, however, that the tonal difference, for example, between C and C♯/D♭, C♯/D♭ and D, D and D♯/E♭, needs to be the same. Dividing the octave into twelve equally-spaced tonal units (equal temperament) is only one way of tuning an instrument. Over the past half a millennium, some 150 different methods for tempering instruments have been devised. None are exact.[61] And none can overcome the dissonance produced because the mathematical ratios by which we produce octaves, major fifths and major thirds cannot be reconciled, even when an instrument is tuned for a single key. While something akin to perfect harmony may be imagined in a single key (except for the discords at either end of the circle of major fifths or generally in relation to major thirds), and an instrument tuned to play almost perfect harmony within a narrow octaval range,[62] it can be

61. A pianist can tell by hearing, for example, "Mary Had a Little Lamb" played successively in the keys of D♭ and G what adjustments to equal temperament the piano tuner had made. For example, the tuner may have slightly modulated the note F♯/G♭ so that it shades towards the F♯, with the consequence that when the song is played in D♭ it sounds slightly more discordant than when the piano is tuned so that the F♯/G♭ note is equidistant from F and G.

62. That is, the small differences that appear when a full cycle of fifths or thirds is compared with octaves are barely perceptible when a piece is played entirely within a two- or three-octave range.

neither played nor imagined where a piece changes keys. In fact, the only perfect harmonies available are those of unison and its mirror, octave.

The central question for international law reformers who like the musical metaphor, therefore, is not simply one of harmonization.[63] It is also one of temperament: what tuning (legislative) compromises do we make in order to achieve something like harmony, and why do we make these choices in the places that we do? Before we naively throw around metaphors that sound good when stripped of their complexity in the field from which they arise, or conversely, before we abandon these metaphors because they do not seem to provide the simple rhetorical punch we wish, we should consider whether those field-specific complexities may actually *help* us to better understand the law reform project to which we are applying the metaphor. More precisely, a richer understanding of the metaphor of harmonization enables us to attend to three important temperament variables: instrument, key, and range.

I believe that these variables, and the fundamental hypotheses about secured transactions law reform in relatively developed commercial economies they illuminate, are nicely illustrated by the CCQ reform process. A first point is this: there can never be perfect harmony regardless of how closely two States may resemble each other. Each State is an *instrument*, with its particular manner of tuning and its particular built-in harmonic compromises. The more stable the political and legal environment (as in a fretted or valved instrument), the more the doctrinal atavisms of conservative legal scholarship and traditional legal practice are able to derail reforms that threaten acquired intellectual capital by invoking the specter of unification and by purporting to defend the presumed essence of the existing legal order. The rejection of the presumption of hypothec in Quebec can be seen as evidence that imperfect instruments (fretted guitars, valved trumpets, or holed clarinets) should not be transformed into perfect instruments (unfretted violins, or slide trombones), since tuning compromises are inherent to the instruments themselves.[64]

63. I adopt fully the critique of harmonization as a goal for law reform advanced by Boodman, *supra* note 37, and pursue the general logic of that critique in developing the idea of temperament.

64. This is not to say that no accommodation is possible. Experienced players can retune their instruments or more pragmatically stretch strings to modulate pitch. Experienced law reformers can do likewise, in the manner suggested in the paragraph following this footnote. In Quebec, a useful comparison might be drawn between two monographs written by and for practicing commercial lawyers, and two monographs written by professors for students. For the former, see JOHN B. CLAXTON, SECURITY ON PROPERTY AND THE RIGHTS OF SECURED CREDITORS UNDER THE CIVIL CODE OF QUEBEC (1995); LOUIS PAYETTE, LES SÛRETÉS RÉELLES DANS LE CODE CIVIL DU QUÉBEC [SECURITY ON PROPERTY IN THE CIVIL CODE OF QUEBEC] (2d ed. 2001) (Can.). For the latter, see PIERRE CIOTOLA,

Secondly, the richest harmonies are often contrapuntal and call forth an extended *tonal range*. They work because they provide an alternative melody, which follows its own logic and thematic development. Unfortunately, the more that entrenched local norm entrepreneurs have successfully exercised political power in the past, the more likely it is that they will defeat proposals for legal reform that threaten to disrupt existing spheres of influence by opening up market sectors to new actors. The rejection of non-vendor purchase-money security interests can be seen as instantiating the point that the broader the tonal range of a legal concept, the less acute the contrapuntal harmonies may be.[65]

Thirdly, all temperaments privilege certain *keys* (whether major or minor), certain melodic progressions, and certain dominant instruments (for example, violins, trumpets, clarinets, guitars, and saxophones). Following the general themes of Donald Black,[66] even when legislative tempering *ex ante* fails to protect these previously dominant instruments, the choice of key can significantly influence the manner in which any particular piece of music is played and the relative harmonics of the performance. The rejection of an extensive proceeds rule is an example of the dialectical quality of true harmony reflected in different keys.[67]

From the perspective of 2009, the drafters of Book 6 of the CCQ managed to produce a remarkably successful law reform product. Without the benefit of any other civil law precedent, they were able to achieve

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DROIT DES SÛRETÉS [THE LAW OF SECURITIES] (3d ed. 1999) (Can.); DENISE PRATTE, PRIORITÉS ET HYPOTHÈQUES [PRIORITIES AND HYPOTHECS] (2d ed. 2005) (Can.). The former are much more attuned to experimentation and making things work in practice; the latter to explicating and defending the presumed intellectual heritage of Quebec civil law.

65. Article 2954 of the CCQ provides that the hypothec of the vendor of movables will outrank a prior registered hypothec over a universality of future property charging the type of asset sold, but does not extend the vendor's hypothec to nonvendor acquisition financiers. While Article 9 purportedly applies the temporal priority rule to all purchase-money security interests ("PMSIs"), in fact the primacy of title reemerges in Section 9-324(g), which gives vendor PMSIs priority over even prior-registered lender PMSIs.

66. DONALD BLACK, SOCIOLOGICAL JUSTICE (1989).

67. U.C.C. § 9-102(64) (2000) defines "proceeds" to include numerous items that in traditional civil law thinking would not be captured by the theory of real subrogation. Insurance monies, damages payments, replacement property, and receivables arising upon disposition (see paragraphs A, D, E) are of this character; but fruits, revenues, dividends, products, and the offspring of animals or of reseeded plants (see paragraphs B, C) are not. The approach of the CCQ permits debtors to fractionate new property from existing assets while maintaining the creditors' rights in initially encumbered assets, accessions, manufactured property, commingled property, and true proceeds. For a discussion of these distinctions in relation to security rights, see Roderick A. Macdonald, *Fruit Salad*, 38 REVUE GÉNÉRALE DE DROIT 405 (2008).

both modernization and rationalization of the law of secured transactions in a manner that embraced corporeal and incorporeal movable property, consensual and nonconsensual security, possessory and nonpossessory security, execution preferences, non-judicial enforcement, and a notice-filing publicity regime, while at the same time regulating the major title transactions deployed to secure the performance of obligations. If there are still unresolved issues, they do not revolve around the failure to implement the presumption of hypothec as recommended by the CCRO. Rather, they reflect a failure to recall the wisdom of temperament. Simply because the CCQ was tempered to preserve title security ought not to have meant that it had to be tempered so that harmony would be achieved only by certain instruments, played in certain keys over a limited tonal range.

II. TRANSPLANTATION: THE VULGARITY OF LEGAL HORTICULTURE

My second example, drawn from the process of secured transactions reform in Ukraine, illustrates the use and abuse of the metaphor of *transplantation* by international commercial law norm entrepreneurs.

Again, I begin by asking what exactly the metaphor of transplantation implies.[68] For most jurists it means reforming the law of one State by importing into it the law of another State. The assumption is that there is a relative autonomy of legal artifacts that permits them to be easily transferred from one context to another. Other jurists see the challenge as more contextual. As law is a product of social forces, there will always be the need for adaptation, whether *ex ante* or *ex post*. Here, the assumption is that acculturation is a central feature of successful legal adaptation. In both hypotheses, however, there is a presupposition that transplantation is beneficial and that the biological precautionary principle, which proposes that transplants may be harmful assaults on biodiversity, is inapplicable.[69]

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68. According to the Oxford English Dictionary, "transplantation" is "the action of transplanting"—meaning the removing of a plant from one place or soil and planting it in another. See Oxford English Dictionary, Transplantation, http://dictionary.oed.com/cgi/entry/50256486?single=1&query_type=word&queryword=transplantation&first=1&max_to_show=10 (last visited Apr. 12, 2009).

69. For an extended discussion, see William. Ewald, *Comparative Jurisprudence (II): The Logic of Legal Transplants*, 43 AM. J. COMP. L. 489 (1995); Pierre Legrand, *The Impossibility of "Legal Transplants,"* 4 MAASTRICHT J. EURO. & COMP. L. 111 (1997); J.M. Miller, *A Typology of Legal Transplants: Using Sociology, Legal History and Argentine Examples to Explain the Transplant Process*, 51 AM. J. COMP. L. 839 (2003); David Nelken, *Legal Transplants and Beyond: Of Disciplines and Metaphors*, *in* COMPARATIVE LAW IN THE 21ST CENTURY 19 (Andrew Harding & Esin Orucu eds., 2002).

A. The Development of the Charge Law in Ukraine

To test the utility of the transplantation metaphor, I begin with the efforts of the government of Ukraine since independence in 1989 to enact a modern secured transactions regime. In the 1990s, the Ukraine Ministry of Finance and the World Bank signed an agreement establishing the Rural Finance Project. This initiative went well beyond rural finance and was intended to provide Ukraine with a basic legislative infrastructure governing areas as diverse as mortgage law, land registration, secured transactions, debenture lending, insolvency, bankruptcy, corporate finance, securities regulation, and so on. In relation to security on movable property, the idea was to modernize the law along the lines of the core principles enunciated by the World Bank and the Model Law on Secured Transactions of the European Bank for Reconstruction and Development ("EBRD").[70] This modernization was to be accomplished by enacting a new secured transactions law that reformed the rules set out in both the Civil Code of Ukraine ("CCU") and a more recently adopted Pledge Law and that, for the first time, permitted debtor-in-possession pledges of movables.

Early in 2003, in a first reading the Ukraine Parliament adopted a secured transactions law prepared as part of the Rural Finance Project by the Center for the Economic Analysis of Law ("CEAL").[71] This law was largely a copy of a similar statute adopted in Romania several years earlier,[72] a law that was itself little more than a transcription of Article 9.[73]

70. *See* WORLD BANK, PRINCIPLES AND GUIDELINES, *supra* note 20; EUR. BANK FOR RECONSTR. & DEV., MODEL LAW ON SECURED TRANSACTIONS (2004), *available at* http://www.ebrd.com/pubs/legal/secured.pdf.

71. For further information about the legislative reform projects, see: Center for the Economic Analysis of Law, http://www.ceal.org (last visited Apr. 19, 2009).

72. Law Regarding Some Steps to Speed Up Economic Reform, Law No. 99, May 26, 1999. This law was a project of the Word Bank (International Bank for Reconstruction and Development), and is presented and discussed in Nuria De la Peña & Heywood W. Fleisig, *Romania: Law on Security Interests in Personal Property and Commentaries*, 29 REV. CENT. & E. EUR. L. 133 (2004). As well as serving as the model for the initial secured transactions law in Ukraine, Article 9 (as instantiated in Romanian law) inspired the Law Amending the Civil Code, Notarial Law and Other Laws, adopted by the Slovak Republic on August 19, 2002, and the Law on Registered Charges on Movable Assets, Law No. 57/2003, adopted by the Republic of Serbia on May 30, 2003, *available at* http://www.ebrd.com/country/sector/law/st/core/pledge/serbia.pdf (unofficial English translation provided by the Serbian Ministry for International Economic Relations). For discussion of the former law, see EUR. BANK FOR RECONSTR. & DEV., GUIDE FOR TAKING CHARGES IN THE SLOVAK REPUBLIC (2003), *available at* http://www/ebrd.com/pubs/legal/slovak.pdf.

73. It is important to signal that there are important differences of opinion about the possible role of Article 9 in international secured transactions reform. Some see in it a

After the first reading, broad consultations with relevant stakeholders revealed that the proposed legislation was unlikely to take root in Ukraine. In part, this was because it did not cohere with basic civil law principles. But a more important factor was that, in conception, style of drafting, scope, and ambition, it had little resonance with either Ukrainian legal culture or on-the-ground practices. The World Bank then contracted with two local lawyers to revise the law for presentation to the Parliament for a second reading in July. I was asked to comment on an early version of the revision and then to come to Kiev to assist the lawyers in fine-tuning the draft and to consult with other professionals—bankers, business leaders, public officials, and lawyers—who had taken a special interest in the project.[74]

These consultations led to a number of policy conclusions about the form and content of the redraft. Given that a second, post-socialist Civil Code had only recently been enacted, we felt we could not insert the reform directly into the CCU. Moreover, the Pledge Law that the Ukraine Parliament had also recently enacted modified many provisions of the Civil Code. Consequently, we determined that the new law would have to be drafted as a targeted overlay upon these two existing enactments and that it would only address a few key issues: the scope of security rights; certain *inter partes* and third-party effects of security; publicity; priorities; and enforcement.[75]

Second, given that broad contractual experimentation with all types of nonpossessory rights in movable property was rampant in the legal profession, even in domains well outside the traditional compass of secured transactions law, we felt that the new law should seek to provide some transparency about all nonpossessory rights in movables. Consequently,

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ready-made template; others, a flexible set of principles and institutions; still others, an inventory of "best practices" from which States might reasonably pick and choose depending on other law then in force. Much of the difficulty with the transplantation efforts of certain international organizations is that the "model laws" being proposed are, as in the case of Ukraine, typically offered on an all-or-nothing basis. *See* Gunther Teubner, *Legal Irritants: Good Faith in British Law or How Unifying Law Ends up in New Divergences*, 61 MOD. L. REV. 11, 31–32 (1998).

74. By the time I became associated with the project, it had already been decided that the North American regime of security on movable property to be imported as a model was that of Quebec and not Article 9. Indeed, my involvement (as an English-speaking Quebec professor of civil law as well as common law secured transactions) was probably predicated upon this basic policy decision.

75. While we took the approach of Article 9 as a general template, we did not purport to modify basic rules relating to the creation of security rights or the basic pre-default rights and obligations of parties, which continued to be governed by the CCU and the Pledge Law.

we proposed a publicity, priority, and enforcement regime to embrace not just traditional consensual security rights, title transactions, ordinary assignments, consignments, and long term leases, but also all nonconsensual security rights and all interests in movables that encumber an owner's rights (for example, usufructs) whether or not intended or deployed as security.[76]

Third, given a widespread perception of unreliability and delays within the civil justice process, we felt the need to provide for the possibility of a complementary (alternative) regime of private arbitration, which would also directly produce enforceable third-party effects and be combined with significant *ex ante* debtor-protection mechanisms to forestall aggressive foreclosures and realizations. Consequently, we concluded that (1) the term "court" should be defined broadly so as to include accredited private arbitrators, (2) creditors should be required to give prior notice of their intention to enforce their security, and (3) creditors should be entitled to enforce it judicially without having to proceed through the state execution service.[77]

Fourth, we felt that the primary need of Ukraine was for a regime that dealt with security over equipment, inventory, and receivables. Consequently, we thought that the legislative framework should be designed primarily with these assets in view. Even through drafted so as to govern security rights in all manner of movable property, it was not so finely tuned as to provide detailed regulation of security on second-generation incorporeal rights, negotiable documents, deposit accounts, and intellectual property.[78]

Taking these factors into account, while still attempting to accommodate concerns about imposing unknown legal concepts as a derogatory overlay to the CCU and the Pledge Law, we concluded that we could not simply "fix" the CEAL draft, but would have to begin afresh. An entirely

76. In coming to this decision we were mindful that, for analogous reasons, Section 9-109(a)(3)–(4) extended coverage to all consignment transactions, whether intended as security or not, and sales of payment intangibles. In the Canadian Personal Property Security Act law, the extension goes even further, embracing as well all "leases of more than [twelve] months." *See Personal Property and Security Act*, R.S.O. 1990, c. P-10, 2. 2(c).

77. Article 2 of the Charge Law, *supra* note 15, defines "court decision" as including a "decision, decree, and order of a court, a commercial court, an arbitration tribunal, a foreign court or arbitration." Article 27 provides for advance notice, and Article 30 provides for nonjudicial creditor enforcement.

78. *But see id.* art. 16 (on priority given to creditors in possession of securities subject to a security right); *id.* art. 33 (on enforcement against money or securities). Nor did the law seek to address security over immovables, or even basic principles governing immobilization (attachment) or mobilization (crops, trees, mines, oil and gas, etc.).

new law, entitled Law on Securing Creditors' Claims and the Registration of Charges ("Charge Law"), that was more in line with the existing conceptual structure of domestic law was drafted in June 2003, enacted in September 2003, and proclaimed in force in January 2004, and became fully effective when the computerized registry was made operational in August 2004.[79]

Because law reform through legal transplants is a common strategy in the field of secured transactions, especially when States are seeking not just to modernize or rationalize existing law, but to radically change an entire legal regime, it is possible to identify a number of particular features that shape success or failure in this endeavor. Indeed, the experience in Ukraine nicely illustrates why attending to economics, social practices, legal structures, and political decision-making is a prerequisite to successful commercial law reform and, concomitantly, why the metaphor of transplant needs to be understood more richly than is currently the case.

To begin, notwithstanding almost seven decades of "socialist legality," civil law conceptual distinctions between real rights and personal rights and between owing and owning remained central in legal thinking. In particular, jurists in Ukraine were not prepared to adopt a unitary "substance of the transaction rule" that would attenuate these distinctions for publicity and enforcement purposes. While the need to regulate title transactions was accepted, attachment to the idea of ownership, which had been suppressed for a long time, prevented its conceptual relativization for purposes of secured transactions law.[80] As a result, and in order to prevent strategic instrument choice by debtors and creditors, the Charge Law was elaborated around a newly-minted generic concept, "charge."[81] A charge was defined broadly to include traditional security rights in a debtor's assets (secured charges); other consensual limitations on an owner's rights, whether or not securing the performance of an obligation (contractual charges); and nonconsensual limitations on an owner's rights (public

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79. For a detailed discussion of the features of the law as it was enacted, see RODERICK A. MACDONALD, COMMENTARIES ON THE LAW OF UKRAINE: ON SECURING CREDITORS CLAIMS AND REGISTRATION OF ENCUMBRANCES, at pt. II (2004) (Ukr.) [hereinafter MACDONALD, LAW OF UKRAINE].

80. The reaction to the "law and economics" approach reflected in the initial proposals by CEAL is strong evidence that certain concepts have untouchable status in particular States at particular times: law is not simply an independent variable, and legal doctrine is not fungible. For an excellent analysis of this point, see Peer Zumbansen, *Comparative Law's Coming of Age? Twenty Years After Critical Comparisons*, 6 GERMAN L.J. 1073 (2005).

81. The Ukrainian word for "charge" is sometimes translated alternatively as "encumbrance," with no intended difference in meaning.

charges).[82] In addition, rather than explicitly denominating a single security device and repealing existing CCU and Pledge Law devices like possessory and nonpossessory pledges, the Charge Law simply provided for a number of mandatory rules relating to scope, publicity, priorities, and enforcement on various existing legal institutions.[83] Finally, although these formalities roughly track those of ordinary security, the charge regime differentiates certain rights and recourses according to the character of the transaction in question—that is, where title is located at any particular moment in the transaction—in order to acknowledge the specificity of conditional ownership and to ensure a functional equivalence of outcomes.[84] In other words, in keeping with its civil law heritage, the Ukraine Charge Law acknowledges the difference between title devices and security devices by conceptually grouping all manner of title transactions (installment sale, sale under resolutory condition, sale with a right of redemption, giving-in-payment clause) together on the one hand, and conceptually grouping all manner of security devices (pledges, rights of retention, hypothecs) together on the other. The Charge Law has the additional merit of comprehensively tracing out the specific consequences of this conceptual grouping within the framework of title transactions, rather than

82. Charge Law, *supra* note 15, art. 4 (Types of Encumbrances). Thus, the Charge Law has broader coverage than both Article 9 and the CCQ. Unlike Article 9, but like the CCQ, it includes nonconsensual security devices; unlike the CCQ, but like Article 9, it includes consignments, ordinary leases, and outright assignments of receivables; and unlike both Article 9 and the CCQ, it includes all limitations on an owner's rights, including lesser proprietary interests like usufructs and leases, and public encumbrances like servitudes and state liens.

83. Thus, the Charge Law conceives the concept of "charge" the way Article 9 conceives the concept of "security interest." The term is a linguistic shorthand for the recharacterization of disparate legal institutions for the specific purposes of the Charge Law, but does not imply the creation of a new legal institution for any other purpose (save perhaps bankruptcy, to the extent Ukraine bankruptcy law may later be amended to recognize the notion of a "charge").

84. Thus, one has to be careful with vocabulary in describing the effect of the Charge Law. Here is an example of an operational difficulty caused by the way that "chargor" and "chargee" are defined. In ordinary security, and in cases where a creditor has a contingent future ownership right, the chargor is the debtor; but where there is an installment sale or a lease, the chargor is the creditor, since the encumbrance falls upon the property of the creditor. It follows that if the seller were to sell under an installment sale, it would be a chargor, but if it were to transfer title and take a charge over the property sold, it would be a chargee. During deliberations about the law, it was suggested that the definitions should be linked to who has physical detention of the encumbered asset. But adopting this approach would mean that a pledge in possession would be a chargor, where a pledgee in cases where the pledgor retained possession would be a chargee. Given the decision to include all proprietary rights (including principal real rights) under the regulatory regime, these ambiguities of terminology are inevitable.

leaving some types of title security unregulated, some only partially regulated, and some confusingly regulated.[85]

A second issue facing law reformers was to decide the mechanics by which the Charge Law could be rendered operational. Some of the instincts and practices of a market economy and some of the basic conceptions of the rule of law were not reflected in Ukraine's property, contracts, and judicature regimes. Moreover, the uneven sophistication of the legal profession and judiciary in matters of secured financing argued against conferring substantial discretion upon courts to police *ex post* "good faith and commercial reasonableness" and argued in favor of *ex ante* "bright line non-waivable structuring rules" and mandatory, fill-in-the-blank contractual forms. Finally, it was important to account for how the enforcement system worked in practice. Considerable collateral reform was required in order to rework the system of judicature so as to permit consensual realization. Because it routinely took three to four years to obtain a money judgment and a further year to obtain enforcement, and because there was no expedited procedure to obtain interim and interlocutory orders, the law provided for alternatives to the public enforcement mechanisms.[86]

Notwithstanding this general overhaul of the law of security on movable property, the Charge Law remains an incompletely achieved reform. From a contemporary vantage point, there are probably two areas where further improvements might be made. As a stand-alone, first-generation secured transactions law, the Charge Law mainly targets basic business and consumer property—corporeal movables such as equipment and inventory, accounts receivable, and consumer durables. Once experience with the law accumulates, one might imagine that it will undergo an evolution similar to that of Article 9; rules relating to deposit accounts, intellectual property, letters of credit, and other specific transactions will be inserted into its general framework, and the entire law will probably be inserted into the UCC.

Moreover, it would probably be expedient for lawyers, registrars, and judges to become more familiar with the new regime, and to gradually replace the *ex ante* regulation of creditor recourses with a structure that gives greater scope for party autonomy, subject to *ex post facto* judicial review on a standard of good faith and commercial reasonableness. And

85. The points raised in this paragraph reflect important differences between the Quebec and Ukraine regimes that exhibit not only the different socio-economic-political-legal cultures of the two countries, but also the fact that the Charge Law is an improved, second-generation statute that irons out some of the wrinkles that persist in first-generation civil law modernization regimes like that of the CCQ.

86. Charge Law, *supra* note 15, art. 27.

in doing so, the law might streamline the publicity regime so that it is minimalist in its informational requirements and permits direct remote access for filing and searching. This said, in comparison with the pre-reform law and with the CEAL draft, the Charge Law must be counted as a success. Moreover, the story of its enactment offers many lessons about how the metaphor of transplantation can contribute to a better understanding of international commercial law reform. To these lessons I now turn.

B. The Logic of Transplantation

The transplantation metaphor is another favorite of those involved in international commercial law reform: for many the mantra is grafts are bad, transplants are good.[87] Here again, I have no difficulty with the first affirmation. But I find that the transplant metaphor is typically misapplied. In my view, it is better to talk of the "circulation" of legal ideas and the "irritation" they inevitably cause,[88] two metaphors that immediately suggest the paradoxes of inter-normative transfers.[89] Nonetheless, given the prevalence of the transplant metaphor, I should like to suggest how careful attention to the nuances of horticulture and botany might actually assist in understanding processes of international commercial law reform.

Recall the fundamental distinction in botanical sub-disciplines between those that consider a plant as an organism separate from the milieu in which it grows and those that see a plant as dependent upon its milieu.[90]

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87. As noted, the use of the metaphor in law can be traced to Watson, *supra* note 2. Since then it has had remarkable currency among comparative lawyers. The metaphor has not gone unchallenged, however, especially by "comparative functionalists" writing in the tradition of legal sociology. *See, e.g.*, Pierre Legrand, *What 'Legal Transplants'?*, *in* ADAPTING LEGAL CULTURES (David Nelken & Johannes Feest, eds., 2001); David Nelken, *Towards a Sociology of Legal Transplants*, *in* ADAPTING LEGAL CULTURES, *supra*; Edward M. Wise, *The Transplant of Legal Patterns*, 38 AM. J. COMP. L. SUPP. 1 (1990); William Twining, Generalizing About Law: The Case of Legal Transplants, The Tilburg-Warwick Lectures: General Jurisprudence (Nov. 2000–May 2001) 1, *available at* http://www.ucl.ac.uk/laws/jurisprudence/docs/twi_til_4.pdf. For brief histories of the debate, see Richard G. Small, *Towards a Theory of Contextual Transplants*, 19 EMORY INT'L L. REV. 1431, 1432–39 (2005).

88. Teubner, *supra* note 73, at 12.

89. For discussion of this theme, see Roderick A. Macdonald, *Les Vieilles Gardes*:. *Hypothèses sur l'émergence des normes, l'internormativité et le désordre à travers une typologie des institutions normatives* [*Old Guards: Thoughts on the Emergence of Norms, Inter-normativity and Disorder Through A Typology of Normative Institutions*], *in* SOLUBLE LAW, *supra* note 19, at 233, 233–72.

90. For brief introductions to the distinction, see generally JAMES D. MAUSETH, BOTANY: AN INTRODUCTION TO PLANT BIOLOGY 10–13 (4th ed. 2008) (on "Plants Versus

In the former group can be ranged anatomy, physiology, genetics, and taxonomy—or should we say legal concepts, legal institutions, legal rules, and legal classification? In the latter may be ranged elements of ecosystem analysis, soil, climate, existing flora and fauna, etc.[91] As applied to law, this type of analysis focuses on economic, legal, social, political, and pragmatic components of a functioning system.[92] While these analogies are helpful, much may also be gained by exploring how botany understands the mechanics of successful transplantation. Here the lexicon includes as exogenous objectives beauty and gene diversity; and as endogenous objectives photosynthesis, reproduction, symbiosis, and evolution. In law we translate these concerns by asking how acculturation can be facilitated through administrative precedents and formularies, case reports, doctrinal commentary, and formalized legal education.

And so arises the central question for international law reformers seeking to introduce countries that heretofore have not had economies in which security on movable property formed a significant part of the legal universe to the universe of Article 9: what counts as success in legal transplantation? To measure success, we should consider a more nuanced metaphor of transplantation that accounts for three key botanical variables: physiology and genetics, ecosystem analysis, and time.

Typically jurists have taken a reductionist approach to the question of success: either the transplant survives, or it dies. Botanists tell us, however, that a finer-grained evaluation framework is possible: (1) transplants can only be measured as successful or unsuccessful depending on the objectives sought to be accomplished through the transplant; (2) even when those objectives are fully attained, a transplant may produce pernicious consequences in other domains; (3) the perspectives and aspirations of the evaluator impact how the data is collected and interpreted; (4) the time period during which the evaluation takes place affects the assessment; (5) success or failure often depends on how one evaluates the transplant's subsequent adaptations to its milieu; and (6) different criteria are deployed depending on whether the transplantation is organic,

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the Study of Plants"); MURRAY W, NABORS, INTRODUCTION TO BOTANY (2004) (highlighting four major themes: plants and people, conservation biology, evolution, and biotechnology).

91. *See generally* WALTER LARCHER, PHYSIOLOGICAL PLANT ECOLOGY: ECOPHYSIOLOGY AND STRESS PHYSIOLOGY OF FUNCTIONAL GROUPS (4th ed. 2003) (examining the science of plant life as affected by various abiotic and biotic factors).

92. I have attempted to address each of these components in Macdonald, *Norm Entrepreneurship*, *supra* note 33; Roderick A. Macdonald, *Unitary Law Re-form, Pluralistic Law Re-substance: Illuminating Legal Change*, 67 LA. L. REV. 1114 (2007) [hereinafter Macdonald, *Illuminating Legal Change*].

natural, and voluntary, or disjunctive, artificial, and involuntary.[93] Once again, the inescapable conclusion is that, before we vulgarly take on board complex metaphors from other disciplines, or conversely, before we abandon these metaphors because they do not seem to provide the simple rhetorical punch we wish, we should attend to the deep theory of the disciplinary knowledge we seek to appropriate as our own.

With this theoretical background in view, I should now like return to the CCU. The central question for international law reformers who like the botanical metaphor, therefore, is not simply one of transplantation.[94] It is also one of acculturation: when selecting legal institutions to transplant, what *ex ante* compromises do we make, and what *ex post* adjustments are we willing to tolerate? And why do we make these choices in the places that we do? Before we naively throw around metaphors that sound good when stripped of their complexity in the field from which they arise, we should consider whether those field-specific complexities may actually help us to better understand the law reform project to which we are applying the metaphor. The richer understanding of the transplantation metaphor permits me to explore three hypotheses about secured transactions law reform in States with economies in transition.

First, all transplants imply more than the insertion of a clean species into new soil. Unlike the grafting of material from plant onto plant, transplanting involves attentiveness to physiology and genetics. Following the general themes of Geoffrey Samuels,[95] one might conclude that the more the legal architecture of the transplant resembles the architecture of cognate legal institutions, the greater the chances of survival and adaptation. However, even when commercial law reform is accompanied by *ex ante* reforms, for example, to bankruptcy law, debtor-creditor law, and sales law, the climate, the character of the ambient soil, and other features of the ecosystem will generate *ex post* adaptive strategies.[96] As applied to Ukraine, in order to overcome strategic behavior by creditors and debtors, it was necessary to define the generic category of "charge" to

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93. This inventory is derived from ROBERT LEO SMITH & THOMAS SMITH, ECOLOGY AND FIELD BIOLOGY (6th ed. 2001).

94. I adopt fully as a goal for law reform the critique of transplantation advanced by Nelken, *supra* note 69, and I pursue the general logic of that critique in developing the idea of acculturation.

95. Geoffrey Samuels, *Can Gaius Really Be Compared to Darwin?*, 49 INT'L & COMP. L.Q. 297 (2000) (differentiating legal and zoological structural taxonomies).

96. *See generally* Roderick A. Macdonald & Hoi Kong, *Patchwork Law Reform: Your Idea Is Good in Practice, But It Won't Work in Theory*, 44 OSGOODE HALL L.J. 11 (2006).

include all consensual and nonconsensual encumbrances on an owner's rights.

Second, there can never be a perfect transplant, regardless of how similar the political economies of two States may be. All transplants are exogenous. All require ecosystem analysis. The less the political and legal environment is stable, the less entrenched legal interests are likely to derail substantive reforms that threaten acquired intellectual capital.[97] That is, the greater the specific character of the climate, the soil, and native flora, the harder it is to neutralize local difference. In this light, it is impressive how quickly the legal profession and business and financial establishments have adapted to the new law, and how quickly pressure has arisen to develop detailed rules relating specifically to deposit accounts, intellectual property, letters of credit, and so on.

Third, and conversely, all transplants have consequences for surrounding flora and fauna. No transplant is limited in its effects to the soil immediately surrounding it. Some of these consequences are immediate; some make themselves felt through time. Much of the Western theory of secured lending is inapplicable to and unworkable in countries like Ukraine. Commentators who would make law subservient to market rationality tend to downplay the extent to which principles of domestic law—from the constitution, to rules of judicature and civil procedure, to family law, to tax law—influence the shape and operation of commercial law regimes. It is not possible to enact fine-grained legislation relating to security on movable property until there is broad consensus on and acceptance of the basic objectives and institutions of a modernized secured transactions regime. This said, it remains to be seen whether it will take Ukraine half a century and two major rewrites (as has been the case with Article 9) to achieve a secured transactions law that meets the strictures of critics.

From the perspective of 2009, the Charge Law can also be seen as a remarkably successful enactment. There is evidence that, as a modernized and rationalized regime of security on movable property, it has contributed to enhanced credit availability and commercial activity. As it is well adapted to the social, economic, political, and legal environment into which it has been projected, jurists suggest that the Charge Law has

97. While formally, the rejection of the CEAL draft in Ukraine and the rejection of the DCC in Quebec appear to be motivated by similar atavistic responses, the differences between the two processes were substantial. Most notably, even though expressed in the language of "preserving the purity of the civil law tradition," the Quebec rejection was actually more the rejection by the profession's conservative elements of the substance of the reform being proposed, than the rejection of the conceptual form in which it was presented. By contrast, the Ukraine rejection did not center upon the substance of the proposed reform, but its mode of expression.

taken root and has generated calls for further reforms to facilitate the granting of security over intangibles and other commercial instruments. The drafters were able to reform the law with minimum conceptual disruption to the existing legal regime. As such, the endeavor in Ukraine offers a model of how the logic of modernization can be pursued in civil law jurisdictions transitioning from socialist economies to market-based economies. If there are still unresolved issues, they do not revolve around the failure to adopt fully the model of Article 9 functionalism. Rather, these issues illustrate how a vulgar concept of transplantation can color our evaluation of a law reform's success of failure. Simply because the receiving ecosystem altered the *ex ante* physiology of the transplant, as reflected in the Charge Law, does not mean that, over time, these *ex post* adaptive strategies will not be successful in generating further reform.

III. VIRAL PROPAGATION: THE EPIDEMIOLOGY OF NORMATIVE PANDEMICS

I take my third example from the recent work of UNCITRAL's Working Group VI: Secured Transactions. This example is meant to illustrate the usefulness of a newer metaphor for the migration of international commercial law norms—viral propagation.

Once more, I begin by asking what exactly the metaphor of viral propagation implies. The relative novelty of the metaphor in international commercial law reform means both that it is not as well developed as other metaphors, and that strong counter-currents have not yet emerged.[98] For most jurists the viral metaphor connotes an unplanned and unconcerted mechanism by which norms self-perpetuate and self-propagate. In this version of norm migration, the memetic idea is directly applied to law and is subject to the same critiques as memetics.[99] Other jurists deploy the viral metaphor more as a rhetorical device than as a conceptual tool. Here, the assumption is that there are mappable affinities between

98. The viral propagation metaphor is occasionally deployed in other human fields, such as memetics and marketing. *See, e.g.*, RICHARD DAWKINS, THE SELFISH GENE 203–15 (1976); Jeffrey Rayport, *The Virus of Marketing*, FAST COMPANY, Dec. 1996, at 68, *available at* http://www.fastcompany.com/magazine/06/virus.html. The first usage is rhetorical, while the second use claims prescriptive bite and has, therefore, been subject to critique. *See* Mark Jeffreys, *The Meme Metaphor*, 43 PERSP. BIOLOGY & MED. 227 (2000).

99. While the legal literature is small, it is powerful. *See, e.g.*, Michael S. Fried, *The Evolution of Legal Concepts: The Memetic Perspective*, 39 JURIMETRICS 291, 302–16 (1999); Jeffrey Evans Starke, *Pushing Evolutionary Analysis of Law or Evolving Law: Design Without a Designer*, 53 FLA. L. REV. 875 (2001).

the transmission of viruses to human organisms and the transmission of ideas to legal systems.[100] Both hypotheses, however, presuppose that no matter how viral (that is, unplanned and self-perpetuating) international law reform may be, the relevant sites of normative transmission will always be the official law of States.[101]

A. The UNCITRAL Legislative Guide

To test the utility of the viral propagation metaphor I begin with the efforts of UNCITRAL's Working Group VI to produce a Legislative Guide on Secured Transactions ("Legislative Guide" or "Guide"), which is aimed at States seeking to modernize their secured transactions laws.[102] From the outset, the rationale for the project was stated in relatively uncompromising terms. Secured credit is a good thing, and therefore States should establish legal regimes to facilitate the growth of secured credit in their economies.[103] Initially, there was an (unstated) assumption that only certain countries would benefit from attending to the recommendations

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100. *See, e.g.*, Richard Michael Fischl, *The Epidemiology of Critique*, 57 U. MIAMI L. REV. 475 (2003) (discussing the critical legal studies outbreak); Gil Grantmore, *The Phages of American Law*, 36 U.C. DAVIS L. REV. 455 (2002) (using the biological analogy to describe terrorism and the American security and law enforcement response).

101. Even Waller, *supra* note 3, makes this assumption; compare it, however, with the work of Makela, *supra* note 1, who imagines deploying the metaphor to explore norm migration in a legal pluralist perspective. On the legal pluralist point, see also Macdonald, *Illuminating Legal Change*, *supra* note 91, at 1116, 1119–21 (exploring "several dimensions of law making in a global world" through the metaphor of light and color).

102. Between 1968 and 1980, UNCITRAL considered various projects to study security interests, propose core principles, and develop uniform rules for secured transactions, but all were abandoned because of a failure to achieve consensus as to their scope, utility, or feasibility. *See* UNCITRAL, Earlier Projects Relating to Security Interests, http://www.uncitral.org/uncitral/en/uncitral_texts/security_past.html (last visited Apr. 20, 2009). After Working Group VI completed its work on the Convention on the Assignment of Receivables in International Trade, G.A. Res. 56/81, U.N. Doc. A/RES/56/81 (Jan. 31, 2002), it was charged by the Commission to begin work on preparing a Legislative Guide to Secured Transactions. This Guide was meant to complement the work of other international organizations—e.g., the IMF, World Bank, EBRD, ADB, OAS, *L'Organisation pour l'Harmonisation en Afrique du Droit des Affaires* ("OHADA"), and UNIDROIT—many of which had already produced documents entitled "core principles of secured transactions," model laws, or international conventions, such as the UNIDROIT Convention on International Interests in Mobile Equipment (Nov. 16, 2001), *available at* http://www.unidroit.org/english/conventions/mobile-equipment/mobile-equipment.pdf.

103. The literature, particularly the law and economics literature, is extensive. *See, e.g.*, Ross Levine, *Financial Development and Economic Growth: Views and Agenda*, 35 J. ECON. LIT. 688 (1997); Anthony Saunders et al., *The Economic Implications of International Secured Transactions Law Reform: A Case Study*, 20 U. PA. J. INT'L ECON. L. 309 (2000).

of the Legislative Guide, although a broader framing of the project's utility emerged as the deliberations of the Working Group proceeded. Indeed, the final document provided in its first paragraph: "[t]he *Guide* is intended to be useful to States that do not currently have efficient and effective secured transactions laws, as well as to States that already have workable laws but wish to modernize these laws and harmonize them with the laws of other States."[104]

While delegates from most States broadly agreed with the proposition that inadequate access to business credit often impeded entrepreneurial activity, some were less convinced that *secured* credit as such was the primary palliative for this inadequacy. On the whole, concern was not expressed in the skeptical "not net efficiency" language of U.S. law and economics scholars,[105] but rather as uncertainty that secured commercial financing credit was a greater social good than employment insurance, health care, worker's compensation, pensions, and supplier-based trade credit.[106] More significantly, delegates from many States bristled at the paternalistic suggestion (often originating in delegations from States with so-called developed economies) that the point of the exercise was to allow States with economies "in course of development" to benefit from the experience, insight, and expertise on offer.[107] Other delegates (nota-

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104. UNCITRAL, LEGISLATIVE GUIDE ON SECURED TRANSACTIONS (2007) (final text submitted for publication), *available at* http://www.uncitral.org/pdf/english/texts/security-lg/e/final-final-e.pdf [hereinafter FINAL LEGISLATIVE GUIDE]. By the end of the deliberations of the Working Group, four main targets of legislative reform were identified: (a) developed economies with what were deemed to be relatively efficient, effective, and functioning regimes (e.g., Canada, New Zealand, the United States); (b) developed economies with what were deemed to be inefficient secured transactions regimes (e.g., Australia, France, Germany, the United Kingdom); (c) economies in the course of development with secured credit-unfriendly regimes (e.g., many Latin American States; many States in central Europe); (d) economies that are of all three above types but not based on "market principles" (e.g., many Islamic republics).

105. Since Alan Schwarz first raised the question whether secured transactions law was efficient, the debate has attracted continued scholarly interest. For one light-hearted contribution, see Richard L. Barnes, *The Efficiency Justification for Secured Transactions: Foxes with Soxes and Other Fanciful Stuff*, 42 U. KAN. L. REV. 13 (1993). *See also* David Carlson, *Secured Credit as a Zero Sum Game*, 19 CARDOZO L. REV. 1635 (1998).

106. For a discussion of the hedonistic logic of secured transactions in the frame of Aristotelian distributive justice, see Macdonald, *Counter-Reformation*, *supra* note 46. *But cf.* Ronald J. Mann, *Bankruptcy and the Entitlements of Government: Whose Money Is It Anyway?*, 70 N.Y.U. L. REV. 993 (1995).

107. The Final Legislative Guide addresses this concern by introductorily stating that it is designed to assist States at various stages of development. FINAL LEGISLATIVE GUIDE, *supra* note 104, ¶ 1. Looking ahead towards implementation, however, Vijay Tata, Chief Counsel at the World Bank, has cautioned that the Guide should not be used prescriptive-

bly those from civil law States with functioning, although not recently reformed, secured transactions regimes) also felt that the logic driving the project was insensitive to models of secured financing other than Article 9. In addition, some European States with modernized non-Article 9 regimes saw the project as an attempt to drive a wedge between them and their traditional "client States" in matters of law and trade. Finally, as the project drew near to completion, other European States perceived a threat to their predominance in financial markets and sought to modify the Legislative Guide to protect existing distributions of economic power. Throughout the Working Group process, these tensions and cleavages were never far from the surface.[108]

Despite these reservations, however, various macro-facts and macro-norms of international trade led delegates to Working Group VI to conclude that modernizing secured transactions regimes to produce efficient, effective, accessible, low-cost commercial credit was a worthwhile endeavor.[109] First, States that are resource rich are frequently cash poor; States that are cash rich are somewhat less frequently resource poor (or have more available cash than they do borrowers seeking credit for entrepreneurial purposes). Hence, legal regimes should facilitate economic cooperation among States under conditions of political equality. Second, the production of tradable goods often takes place in States with low labor costs, where local manufacturers do not own the intellectual property reflected in the products they produce. Hence, legal regimes should facilitate the cooperative engagement of production across trade boundaries even when the assets produced are themselves not destined for export. Third, much of international sales law involves the delivery of already charged assets into States lacking developed regimes of nonpossessory security over movable property. Hence, legal regimes should display sufficient

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ly as a proxy for a participatory, deliberative legislative process within States. Rather, "[t]he very complex debates about policies and the costs and benefits of various legislative designs that took place in Vienna and [New York] in the preparation of the Guide, will and should be replayed in greater detail and with greater specificity in the reforming countries." Vijay Tata, The Role of Multilaterals in the Promotion of Modern Securities Law, Remarks at the Congress to Celebrate the Fortieth Annual Session of UNCITRAL (July 10, 2007), *available at* http://www.uncitral.org/pdf/english/congress/Tata-revised.pdf.

108. This is, obviously, my own interpretation of interventions made at Working Group sessions reported in the sessions and related documents. For a complete accounting of the activities of Working Group VI on the Legislative Guide project, see 2002 to Present: Security Interests, *supra* note 16.

109. The current empirical literature appears to suggest that the effect of security is not primarily that it serves to reduce the *cost* of credit. Rather, the absence of effective security rights simply means that credit is *unavailable*. *See* SECURED TRANSACTIONS REFORM AND ACCESS TO CREDIT (Frédérique Dahan & John Simpson eds., 2008)

comity so that the cross-border delivery of assets does not comprise the security of an export creditor's rights. And finally, the international market for trade in securities and other incorporeal rights is often distinct from the international market for manufactured property. Hence, legal regimes need to facilitate the aggregation and disaggregation of securities and receivables so that they may be financed separately from the production at their origin.

These facts on the ground and the normative consequences they imply, along with my experience at UNCITRAL, convince me of the foundational principle that should drive the modernization of secured transactions law: internationalization is a two-way street. From this principle two corollaries may immediately be derived. First, a number of so-called advanced economies with so-called modernized secured transactions regimes (for example, the United States and Canada) will have to further reform their secured transactions laws (especially in connection with cross-border insolvencies) in order to be successful in the international sphere. The second corollary is that sellers and lenders from so-called developed economies need purchasers and borrowers from so-called developing economies just as much as these purchasers and borrowers need them. In brief, notwithstanding the rhetoric that "secured credit transactions" are a good thing because developing countries need capital inflows, it is equally the case that cash-rich developed economies need safe harbors for their capital outflow.[110]

When the Legislative Guide was first mooted in the late fall of 2001, there was a consensus among the group of experts convened by UNCITRAL that the Guide should begin with a restatement of the core principles of an efficient and effective secured transactions law. At that time, two members of the group were charged with drafting a brief presentation of these core principles. One argued for a set of key objectives and core principles that more or less tracked those already identified by other international organizations and that focused uniquely on the pro-

110. The point has not often been raised in connection with what is euphemistically characterized as the subprime crisis, although business debtors from developing countries are now paying the price for the profligacy of institutional lenders. On the one hand, the very existence of subprime mortgage loans is a classical example of the consequences of too much credit chasing too few good risks. On the other hand, the reckless repackaging of high-risk domestic receivables supposedly backed by appreciating assets has drawn investment away from entrepreneurs in States with under-developed secured transactions laws that, in fact, are less likely to default than domestic borrowers formally issuing apparently secured debt.

motion of secured credit.[111] The other proposed a more comprehensive set of principles meant to contextualize secured transactions within the general law relating to the compulsory performance of obligations.[112] Although the issues presented by both perspectives remained throughout the process of drafting the Guide, the group of experts quickly decided to recommend to the Working Group that it adopt a series of core principles based on existing documents in international circulation, and Working Group VI accepted this recommendation at the outset of its deliberations.

What, then, were the basic features of the UNCITRAL approach, and how were they actually put into practice? First the project was to develop a legislative guide, not a model law or a convention. In fact, however, Working Group VI hoped that its Guide might achieve uptake, and so its recommendations were quite detailed and cast precisely in the form of text that could be pasted without much difficulty into a draft law. Second, Working Group VI aimed to produce a legislative guide that would assist States with a broad range of economies, social practices, and political priorities. In fact, however, many of the Guide's proposals assumed a market economy with a number of correlative financial and judicial institutions typical of a North American economy. Third, the stated ambition of Working Group VI was to set out "best practices" for secured financing, wherever these were to be found.[113] In fact, however, the Guide by and large adopted the basic principles of modernization

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111. For examples of the core principles identified by other international organizations, see ASIAN DEV. BANK, 2 LAW AND POLICY REFORM AT THE ASIAN DEVELOPMENT BANK 2000 (2000), *available at* http://www.adb.org/Documents/Others/Law_ADB/lpr_2000_2.asp?p=lawdevt#contents_(comprising a major study on secured transactions law reform in India, Indonesia, Pakistan, the People's Republic of China, and Thailand); Frédérique Dahan & John Simpson, *The European Bank for Reconstruction and Development's Secured Transactions Project: A Model Law and Ten Core Principles for a Modern Secured Transactions Law in Countries of Central and Eastern Europe (and Elsewhere!)*, *in* SECURITY RIGHTS IN MOVABLE PROPERTY IN EUROPEAN PRIVATE LAW, *supra* note 7, at 98–116; Pascale DeBoeck & Thomas Laryea, *Development of Standards for Security Interests and Enforcement of Claims* (2003), http://www.imf.org/external/np/leg/sem/2002/cdmfl/eng/pdb.pdf; WORLD BANK, PRINCIPLES FOR EFFECTIVE INSOLVENCY AND CREDITOR RIGHTS SYSTEMS (REVISED DRAFT) (2005), *available at* http://siteresources.worldbank.org/GILD/Resources/FINAL-ICRPrinciples-March2009.pdf.

112. For a brief outline of this larger context, see *supra* text accompanying notes 25–32.

113. U.N. Conf. on Int'l Trade Law [UNCITRAL], Working Group VI on Sec. Interests, *Draft Legislative Guide on Secured Transactions*, ¶ 2, U.N. Doc. A/CN.9/WG.VI/WP.2/Add.1 (Feb. 12, 2002) [hereinafter Draft Legislative Guide] ("The focus of the Guide is on developing laws that achieve practical economic benefits for States that adopt them. The Guide seeks to rise above the differences among legal regimes to suggest pragmatic and proven solutions that can be accepted and implemented in States having divergent legal traditions.").

instantiated by Article 9: (a) a unitary, functional approach to scope; (b) nonpossessory security over present and future property; (c) an extended concept of proceeds; (d) a notice-filing registry system; (e) non-judicial enforcement; (f) equal protection for acquisition financing whether offered by sellers or lenders; and (g) special rules governing third-party effectiveness, priority, and enforcement of certain intangible assets, including receivables, bank accounts, independent guarantees, negotiable instruments, and negotiable documents.[114]

In view of these divergences between the ambitions of the Working Group and the manner in which these ambitions were actually translated into recommendations, it is worth reflecting on whether the initial statement of the Guide's core principles may have truncated discussion of alternatives to Article 9. Recall that the overall objective of secured transactions regimes was said to be promoting availability of low-cost credit in order to facilitate the successful operation and expansion of domestic businesses and improve their ability to compete domestically and in the global marketplace. Compare the "[k]ey objectives of an effective and efficient secured transactions law" as set out in Recommendation 1, taking note of the manner in which the title is phrased, with the draft proposal that the group of experts did not recommend to Working Group VI.[115] The key objectives expressed in the Legislative Guide focus on the design of an "efficient and effective" secured transactions law:

> (a) To promote low-cost credit by enhancing the availability of secured credit[;]
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> . . . .
>
> (b) To allow debtors to use the full value inherent in their assets to support credit[;]
>
> . . . .
>
> (c) To enable parties to obtain security rights in a simple and efficient manner[;]
>
> . . . .
>
> (d) To provide for equal treatment of diverse sources of credit and of diverse forms of secured transactions[;]
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> . . . .

114. *See* FINAL LEGISLATIVE GUIDE, *supra* note 104, at Recommendations 8–9; Recommendation 13; Recommendation 19; Recommendations 32–33; Recommendation 142; Recommendations 178, 187–88; Recommendations 23–28, 48–53, 101–09, 114–16, 117–30, 167–77, respectively.

115. *See supra* text accompanying note 17.

> (e) To validate non-possessory security rights in all types of asset[;]
>
> . . . .
>
> (f) To enhance certainty and transparency by providing for registration of a notice in a general security rights registry[;]
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> . . . .
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> (g) To establish clear and predictable priority rules[;]
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> . . . .
>
> (h) To facilitate efficient enforcement of creditors' rights[;]
>
> . . . .
>
> (i) To allow parties maximum flexibility to negotiate the terms of their security agreement[;]
>
> . . . .
>
> (j) To balance the interests of all affected persons[; and]
>
> . . . .
>
> (k) To harmonize secured transactions laws, including conflict-of-laws rules[.][116]

With the sole exception of principle (j), all of these objectives are internal to the logic of a secured transactions regime itself and aim at achieving transactional efficiency.

Consider how these key objectives and core principles might have been alternatively formulated had the ambition been to provide States with guidance on not only the secured transactions regime, but also how it should be successfully implemented. The following were presented to the group of experts in the fall of 2001, under the title "Core Principles of Modern Regimes of Security Rights," a title that did not explicitly refer to economic efficiency as an overriding value.[117] The principles aimed at several objectives:

> (1) To balance efficiency and justice, the regime should aim at making credit available at the lowest possible cost, in a manner that respects the fundamental political and social goals of the society in question.
>
> (2) To achieve coherence with public policy, the regime must reflect a fair balance between legitimate public policy goals being pursued by

116. FINAL LEGISLATIVE GUIDE, *supra* note 104, ¶¶ 46–59.

117. These alternative core principles were derived from the core principles guiding the reform of the secured transactions law in Ukraine. *See* MACDONALD, LAW OF UKRAINE, *supra* note 79, at 17–24.

States as reflected in their regulation of basic concepts of status, property, and obligations and the opportunistic goals of individual creditors and debtors as reflected in the idea of freedom of contract.

(3) To achieve a comprehensive regulatory framework, the regime of security should be comprehensive as to all the elements of the security nexus—debtors, creditors, obligations, collateral—in order to (a) minimize regulatory uncertainties or unfair inequality of access to the regime; (b) avoid creating inadvertent gaps; (c) ensure the best integration possible of competing regulatory regimes; and (d) promote competition on the cost of credit among purveyors of credit to businesses.

(4) To reflect a functional design, a regime capable of granting security, eligible collateral, pre-default rights and obligations, and secured creditors' recourses, and upholding a general theory of publicity of secured rights should apply, regardless of the origin or form of the security right in order to prevent debtors and creditors from artificially manipulating their status, the character of their obligation, or the legal nature of their assets so as to either escape or fall under the regulatory regime.

(5) To promote party autonomy, the logic of the regime should be as simple as possible, with the legislature deciding questions having to do with definition and distribution of entitlements in the regime from an "ideal-type" perspective that maximizes the efficiency potentialities of a consensual regime of secured transactions.

(6) To provide for intelligible rules, since the point of the regime is to permit debtors and creditors to plan their affairs in reasonable legal security, (a) the regime's rules should be drafted in a manner that is intelligible to non-lawyers; (b) imperative rules should limit or prohibit choices only for reasons of unfairness or perverse distribution of burdens upon the parties to the transaction or third parties; (c) the regime should avoid making superficial distinctions of form where there are essential identities of substance; (d) the regime should not mandate an implied intent either by creditors or debtors, and legal fictions should be purged; (e) the regime should not presume outcomes (e.g., a commercially reasonable price upon realization) that can actually by determined by the operation of market principles.

(7) To achieve internal coherence, the rights created should reflect the legitimate interests and expectations of debtors, creditors, and third persons, given the underlying logic of a regime of security on property, by (a) structuring incentives to encourage performance by debtors; (b) structuring incentives to encourage responsible behavior by creditors; (c) designing the regime to discourage illegitimate third-party interference.

(8) To maximize realization value, the regime should structure incentives so that the value of the collateral is maintained prior to default,

> and should be designed to avoid inefficient formalism in post-default enforcement by providing debtors, creditors, and third parties with incentives to maximize realization value.[118]

Of all the policy differences that were manifest throughout the deliberations of Working Group VI, two were present from the outset and preoccupied the Working Group up until its very final sessions. The first was the question of title security, including most pointedly the seller's retention-of-title transaction; the second, closely allied to this, was whether the Guide should recommend a comprehensive filing regime in order to obtain third-party effectiveness of nonpossessory rights.[119] Initially, delegates from many States expressed resistance to the functional approach of Article 9. As in the reform process in Quebec and Ukraine, they felt that title security was of a different genus than true security.[120] Over the course of its deliberations, however, the Working Group reached a consensus that the primary difficulty lay not with title security in general, but with the retention-of-title transaction specifically. The delegations came to accept that lender transactions, such as sales with a right of redemption, fiduciary transfers of title, retroactive giving-in-payment clauses, and foreclosure agreements, were in fact secured transactions and could properly be included within the Guide's general functional definition.[121]

Nonetheless, the process almost broke down over how to deal with retention-of-title transactions. In the end, the Working Group decided that it would adopt a dual approach. To begin, the overall frame of the Guide would be cast in the language of a functional approach; then, in so far as a particular type of security right was concerned, acquisition financing, two approaches were permitted: a unitary approach that tracked the Ar-

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118. *Id.*

119. In the chronological order of the Working Group sessions, the issue of registration actually came up for resolution first (in what is now Chapter IV), since consideration of retention-of-title transactions was deferred to acquisition financing (what is now Chapter IX). But the concern about registration was essentially about the necessity for registration of retention-of-title devices rather than an opposition to the concept of notice filing per se.

120. This concern was expressed primarily by many civil law States in Africa, Europe, and Latin America, although it also found resonance with delegations from States having other legal traditions, but not those from common law States (with the exception of the United Kingdom).

121. The deliberations of the Working Group are nicely tracked in the Commentary section of the FINAL LEGISLATIVE GUIDE, *supra* note 104. On title transactions generally, see *id.* ch. I, ¶¶ 45–112 (on "Scope of application, basic approaches to security and general themes common to all chapters of the Guide"), and for retention-of-title particularly, see *id.* ch. IX, ¶¶ 13–84 (on "Acquisition financing").

ticle 9 model, and a non-unitary approach that preserved not only the Article 9 model, but also separate retention-of-title type transactions (a seller's reservation of ownership and financial leases) as long as they produced functionally equivalent results.[122] Interestingly, this dual approach—assimilating lender title transactions to security rights and preserving retention-of-title transactions as a separate category—is also adopted by the just released Draft European Civil Code, Book IX on "Proprietary Security in Movable Assets."[123]

While some delegations regret the compromise over acquisition financing, all in all it must be said that the Legislative Guide is a significant achievement, judged both on its intellectual merit and as the output of a lengthy process of negotiation. This process, moreover, has much to teach about how the metaphor of viral propagation can assist in managing consensual, international commercial law reform such as that undertaken by UNCITRAL.

B. The Logic of Viral Transmission

Let me develop this point by exploring the nuances of the third metaphor deployed by international commercial law reformers, viral propagation.[124] The metaphor of virus provides a rich point of entry for examining how Article 9 thinking has become a pandemic in international commercial law reform. However, in order to derive the full benefit of the virus metaphor, it is important first to attend carefully to the subtleties of epidemiology. How do viruses actually propagate themselves?

One of the reasons why viruses have become such a powerful metaphor is their association with the technology of knowledge transmission through computer programs. Biological viruses are also found everywhere, constantly attaching themselves to host cells via their protein. At this point, the virus is able to exploit the nucleus of the host cell to assist its reproduction, which then migrates outwards to another host. Of course, to propagate themselves viruses need to be transmitted. Hence the importance of studying "vectors of transmission." Some viruses are relatively benign, but very easily transmitted—the common cold, for ex-

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122. *See id.* at Recommendations 8–9, 178–202.

123. *See* ULRICH DROBNIG, STUDY GROUP ON A EUR. CIVIL CODE, PROPRIETARY SECURITY IN MOVEABLE ASSETS 1–13 (2009) (elaborating on the Draft Common Frame of Reference, bk. IX, § 1: scope of application articles, IX-1:101 (general rule), IX-1:102 (security right), IX-1:103 (retention of ownership devices: scope), and IX-1:104 (retention of ownership devices: applicable rules)).

124. I use the viral metaphor purely descriptively and not normatively. In this usage, I follow Waller, *supra* note 3. Much of the account of the next four paragraphs relies upon this unpublished article and from Makela, *supra* note 1.

ample. Others are particularly vicious, but relatively difficult to transmit—the HIV virus, for example. But whether a virus becomes a pandemic also depends on the nature of the host population to which it is spread. If the host is relatively immune to such infections, even a malignant virus propagated by multiple effective vectors of transmission may not result in infection. The host's resistance to a virus may be founded on its own inherent biological properties or may be enhanced by inoculation with an effective vaccine.[125] As Guido Calabresi reportedly said in explaining why CLS had not infected Yale Law School, "[People] with Cow Pox do not contract Small Pox."[126] By contrast, if the immune system is weak, a virus may kill the host before it has the chance to reproduce itself and infect others.

A further structural factor influencing the spread of a virus is the context within which the host lives. So for example, the influence of the relative density of susceptible hosts is inversely proportionate to the strength of the transmission vectors. Isolated hosts are less susceptible to viral transmission than densely arranged hosts. Here is a final reflection. Because viruses are so active, they can often mutate, and host immune systems that have successfully resisted one viral strand can often fall prey to a new mutated strand. Alternatively, viruses may remain dormant for years following infection, before ultimately manifesting themselves in a variant form.

This brief canvass of viral epidemiology hardly scratches the surface of what might be learned from the metaphor and how the metaphor may be used to generate a model of norm migration. It does, nonetheless, suggest some variables that will affect international norm entrepreneurs' propagation of particular legal ideologies, such as Article 9.

First of all, a legal ideology will be most effectively propagated when it infects a field of law organized around a few broadly accepted assumptions. The barrage of essentially identical "key objectives" and "core principles" promulgated by well-endowed entrepreneurs since the mid-1980s can been seen as an essential precondition to UNCITRAL's decision to ask Working Group VI to take on the Legislative Guide project twenty years after the last of several failed attempts to move onto this terrain.

Second, a legal concept or regime is most likely to infect a decision-making body where authority (in particular, law-making authority) is highly centralized, hierarchically organized, and legislatively rather than

125. *See generally* TERI SHORS, UNDERSTANDING VIRUSES 140–89 (2008) (on host resistance to viral infections).

126. Fischl, *supra* note 100, at 478.

judicially driven. This is the case, for example, with Ukraine, but not Quebec, where competing legal professions prevent the State from imposing a singular law reform agenda and where, notwithstanding codification, courts play a role akin to that played by courts in common law jurisdictions.

Third, propagation will be most successful where there are multiple recombinant interests—vectors of transmission—to sustain contact in diverse settings: uniform law organizations; model laws; international agencies (e.g., UNIDROIT and UNCITRAL); international financial organizations with tied grants (e.g., the World Bank and IMF); treaties and conventions; regional trading blocs; vestiges of colonialism; scholarly round tables on best practices involving law professors, graduate students, and private economic actors; and the conscription of powerful interest groups.

Fourth, countries that are relatively isolated, geographically or intellectually, are less susceptible to viral transmission than densely arranged countries with relatively open intellectual frontiers. On the one hand, one may cite Albania, Myanmar, and Zimbabwe as States relatively unlikely to spread a law reform virus; on the other hand, one may cite most post-communist States of Central Europe, and States that belong to the OHADA, *Mercado Común Sudamericano*, and Association of Southeast Asian Nations as likely targets for explosive transmission once one State becomes infected.

Fifth, propagation is diminished where hosts have been ideologically inoculated against the virus, usually by precommitments said to be grounded in socio-cultural factors. These factors may be defensive (a strong host), or offensive (an inoculation by a modest form of the virus that successfully propagates itself in resistance to more virulent forms). Examples of the former would include the reaction of Germany to the acquisition financing regime of Article 9, and the latter would include the reaction of the United Kingdom to any proposal that threatens to diminish the role of the City in international finance, especially the financing of receivables.

How then might we understand the viral metaphor in relation to the UNCITRAL project? It is important to identify the ideological points of resistance among Member States. One was the reaction to an extended concept of proceeds combined with security on future assets and universalities, which led to a perceived overprotection of a first secured creditor's rights. Another was the attempt to restrain policy choices by States that had nonmarket-driven social welfare programs and that did not externalize the cost of excessive credit onto the bankruptcy market. A third was the suspicion of special rules designed to favor the purveyors of financial proxies for asset-backed lending, bank accounts, receivables, negotiable documents, and so on. And a fourth, where compromise was ultimately reached, involved recognizing the special character of retention of a vendor's ownership rights in relation to a financing lender's rights. Given these points of resistance and the States that were more vocal in articulating them, the viral metaphor suggests that the propagation of Article 9 ideology through the Legislative Guide may be less pandemic than desired. The viral metaphor also suggests that, had there been greater sensitivity to implementation in the articulation of key objectives (the legal, social, political, and economic contexts of law reform) and the necessary steps to ensure propagation (attentiveness to those especially vocal and organized in their interests), the chances of widespread infection would have increased. Finally, the viral metaphor points to a paradox in the processes of international agencies like UNCITRAL. Viral propagation presumes, at least initially, a one way migration: the infection of Working Group VI by the Article 9 virus. But viruses can also mutate. To the extent that a mutant virus may emerge in the new host, the initial host may be re-infected by the mutant strain. The conditions under which North American common law States are susceptible to re-infection will depend on the same considerations of viral propagation that initiated the original pandemic.

From the perspective of early 2009, and despite the cautionary remarks of the previous paragraph, the UNCITRAL Legislative Guide looks like it could be a relatively successful endeavor of international norm migration. I have argued above that the context of commercial law reform encompasses a broad range of factors besides the general structure of the domestic legal regime. For this reason, it is important to be clear about the economic, social, and political conditions presupposed by existing secured lending regimes, so that the policy goals sought to be achieved through modernization can be realized in practice. We must be modest in our claims, because we have only an incomplete understanding of which modernized secured transactions regimes are successful, and somewhat more troubling, because it is not at all clear that we possess the criteria that will enable us to judge whether a particular law reform project has succeeded or failed. In acknowledging the depth of our ignorance on these issues, we can appreciate why, ultimately, our choice of metaphors matters: metaphors (like core principles) frame analysis, exposing and occluding political choices, and defining possibilities for action as well as the sites where action is most likely to be effective.[127]

127. The discussion in C.S. Bjerre, *Mental Capacity as Metaphor*, 18 INT'L J. SEMIOTICS & L. 101 (2005), develops this point further.

CONCLUSION: VIRTUE ETHICS IN INTERNATIONAL LAW REFORM

My experiences with reforming secured transactions regimes in Quebec and Ukraine provided an important background for my later participation in UNCITRAL's Working Group VI: Secured Transactions. As the UNCITRAL project evolved over the past seven years, it seemed to me that Member States have learned an important foundational lesson. To the surprise of many who have hitched their wagon (intellectually, and more importantly, emotionally) to Article 9, there are no conceptual features of the civil law tradition preventing the enactment of a functionally-integrated secured transactions regime that achieves the same goals as Article 9 and does so in an equally efficient manner.[128] Further, there are no conceptual features of the Islamic law tradition or of any other legal tradition (including diverse chthonic legal traditions)[129] preventing the realization of a functionally-integrated secured transactions regime that achieves the same goals as Article 9 and does so in an equally efficient manner.

Of course, for many the learning curve has been steep. On the one hand, some from advanced commercial economies tend to be patronizing of States with advanced commercial economies that do not agree on the "perfection" of Article 9. Their learning curve is moral. Whatever U.S. jurists may think of American exceptionalism and the mission of the United States to bring about a commercial *pax Americana*, it is far from clear that this ambition is shared around the world. On the other hand, some from other States tend to be quite defensive about existing legal regimes and unwilling to question the legal "way it is," which they learned several decades earlier as law students. Their learning curve is also moral.

More generally, in accounts of modernization, it is now time to give up claims to universalism in favor of more differentiated analyses and prescriptions for particular times and particular places. We need to locate our evaluations of commercial law reform within a better understanding of how local entrepreneurial networks and credit institutions function on the ground. The history of successive revisions to Article 9 illustrates the point. Its initial design was meant to respond to a particular set of problems faced by common law jurisdictions in the middle decades of the

128. For a comparison of unreformed and reformed common law approaches to the definition of a security interest, with unreformed and reformed civil law approaches to the same issue, see Bridge et al., *supra* note 35.

129. On different Islamic approaches to secured transactions law, see Nicholas H.D. Foster, *The Islamic Law of Real Security*, 15 ARAB L.Q. 131 (2000); Mark J. Sundahl, *Iraq, Secured Transactions, and the Promise of Islamic Law*, 40 VAND. J. TRANSNAT'L L. 1301 (2007), especially sec. IV.

twentieth century, and the revisions since then have continued to be responsive to locally specific problems.[130]

These observations about Article 9 are not meant to sound a note of pessimism about the possibilities of international norm migration. Rather, they invite discussion about a larger ontological point. Much of our current thinking about generating international legal norms, especially as reflected in the metaphors of harmonization, transplantation, and viruses, follows from the manner in which Western legal culture conceives law. Central to both common law and civil law traditions is the belief that law is fundamentally propositional: law as rules and justice as following rules. Hence the commitment to law reform as a matter of simply, one, "enacting a regime of rules," and, two, "getting the rules right." My happy experience as President of the Law Commission of Canada and my equivocal experiences in other law reform settings suggest otherwise.[131] Reforming law by changing rules will never solve legal problems. The best one can hope for by changing the rules is to substitute a better class of questions for the suboptimal questions that might currently shape legal reflection.[132]

The attempts to modernize the law of secured transactions illustrate this larger point. The initial ambition of Article 9 was to achieve, as far as possible, a unitary and comprehensive regulation of consensual devices deployed to secure the performance of an obligation. As Grant Gilmore observed, the primary targets of the reform were inventory financing (where manifold title-based institutions were utilized) and receivables financing (where the law was still largely stuck in judge-made rules developed in the mid-nineteenth century).[133] The mechanism was the "sub-

130. For an argument that successive revisions to Article 9 have had the effect of making it even less universal in potential application, and consequently less suitable as a template for international law reform, see Macdonald, Exporting Article 9, *supra* note 11. *See also* Edward S. Cohen, *Constructing Power Through Law: Private Law Pluralism and Harmonization in the Global Political Economy*, 15 REV. INT'L POL. ECON. 770 (2008); Cuming & Walsh, *supra* note 25.

131. *Compare* Roderick A. Macdonald, *Recommissioning Law Reform*, 35 ALTA. L. REV. 831 (1997) (Can.), *and* Roderick A. Macdonald, *Jamais deux sans trois . . . Once Commission, Twice Reform, Thrice Law*, 22 CAN. J.L. & SOC'Y. 117 (2007), *with* Macdonald & Kong, *supra* note 95, *and* Macdonald, *Illuminating Legal Change*, *supra* note 92.

132. *See* Roderick A. Macdonald, *Triangulating Social Law Reform*, *in* DESSINER LA SOCIÉTÉ PAR LE DROIT [MAPPING SOCIETY THROUGH LAW] 119 (Ysolde Gendreau ed., 2004) (Can.).

133. Grant Gilmore, *The Good Faith Purchase Idea and the Uniform Commercial Code: Confessions of a Repentant Draftsman*, 15 GA. L. REV. 605, 620–21 (1981).

stance of the transaction principle."[134] Today, however, given the increasing specialization of rules relating to different types of collateral, it is far from certain that the idea of a general regime of security interests still exists under Article 9.3. In addition, the regime in Quebec reveals that it is possible to enact multiple functional regimes, distinguishing not only between true security and title security, but also among subsets of title security. And again, as the Charge Law of Ukraine reveals, it is possible to enact a dual functionality, regrouping all true security under one functional system and all title security under a single, complementary functional system. Finally, as the UNCITRAL Legislative Guide and the Draft Common Frame of Reference ("DCFR") reveal, it is possible to enact a regime that sweeps all true security and all title security into a single functional regime, with the exception of reservation-of-title transactions like financial leases and retention-of-title sales. Nothing about the idea of functionalism dictates which of these regulatory strategies is optimal. It is worth noting, however, the enactment dates in chronological order: Article 9.1, 1962; the Civil Code of Québec, 1994; Article 9.3, 2000; the Ukraine Charge Law, 2004; and both the UNCITRAL Legislative Guide and Book IX (Proprietary Security in Movable Assets) of the DCFR, 2008. To what extent do these differences reflect particularity—not only in space, but also in time? Perhaps now is the moment to abandon the quest for transcendent (good-for-all-places-and-all-times) law reform.

If this is the case, the central question then becomes the following: how does one achieve a better class of questions in law reform projects? In my view this is not a matter of propositional ethics, whether Kantian or utilitarian. It is a matter of what Aristotle called *phronesis*. *Phronesis* means "moral sensitivity, perception, imagination and judgment informed by experience."[135] For Aristotle the capacity to be sensitive to the particularities of a given situation is a necessary condition for moral agency. Even if universal moral principles were to exist, they would not be self-applying. The moral agent displaying *phronesis* is never relieved of the responsibility for making decisions. As moral agents we must therefore constantly reassess what it is we think we know. This, in turn, means cultivating openness to and reciprocity with others. One site of inter-subjective communication is allegory. The strength of allegory is that it captures the minutiae of moral life, permitting context to be con-

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134. *Id.* The development of Article 9's functional approach, defining security rights based on the economic substance of the transaction, is discussed at length in GRANT GILMORE, 1 SECURITY INTERESTS IN PERSONAL PROPERTY (1965) (1999), chs. 9–10.

135. Stanford Encyclopedia of Philosophy Online, Virtue Ethics, http://plato.stanford.edu/entries/ethics-virtue/ (last visited Apr. 19, 2009).

veyed, often with explicit metaphor referents.[136] It is, in this sense, a vehicle for *phronesis*, a form of expression that does not allow for a final, propositionalized message that is separable from the story itself, easily transmissible, formulaic, and universalized.

As law reformers (moral agents), how do we translate this sense of *phronesis* into actions and justifications for action in an inter-dependent world? In all my commercial law reform experiences over the past decades, Working Groups have conducted their affairs under "ideal-type" assumptions that States, businesses, and people are rational, "wealth-maximizing," economic actors. Of course, such assumptions are methodological hypotheses and should not be taken as "truth claims." Unfortunately, at times, these Working Groups (and I) lost sight of this and became prisoners of our own internal logic. As a consequence, we did not attend sufficiently to an important pragmatic question that normally drives law reform in bodies charged with enacting legal norms, whether the project involves is domestic legislation or transnational constructs like conventions, model laws, or legislative guides. The question is this: how should reform be designed so that it will receive broad uptake from as many countries as possible (and having been taken up, will actually work in these countries)? After thirty years, I have come to the conclusion that the objective is not to design a legal regime that is the equivalent of a high-performance F1 racing car, which requires expert drivers, expert mechanics, and relatively high maintenance costs. Rather, it is to design a legal regime that is the equivalent of the Volkswagen "Beetle"—a serviceable, predictable, easy to acquire, and easy to maintain vehicle that fulfills basic transportation purposes.

In making this claim I do not mean to insinuate that some States are "better" than others; nor do I even mean to insinuate that some legal regimes are, by definition, "better" than others. My claim is different and flows from the recognition that legal regimes are only partly autonomous from their socio-economic political contexts. Every State will aim to enact a regime that works best for it, with the consequence that if one wants to negotiate a secured transactions regime that works across the world, it cannot be based on the assumptions, practices, and economic structures of a very small set of States with developed commercial regimes.

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136. Allegory may be defined as "a narrative, whether in prose or verse, in which the agents and actions, and sometimes the setting as well, are contrived by the author to make coherent sense on the 'literal,' or primary, level of signification, and at the same time to signify a second, correlated order of signification." M.H. ABRAMS, A GLOSSARY OF LITERARY TERMS 5 (7th ed. 1998).

Let me now return to Aristotle and to virtue ethics. Moral perception is a precondition of moral judgment. The implication is that knowledge is a kind of sight: if we cannot see, we cannot know; likewise, if we cannot know, we cannot see. Moral knowledge depends on insight. Success in norm migration, like success in law itself, is open to different interpretations by different people at different times in different places. Law is not a hierarchically organized projection of power from law giver or judge to law subject; nor is it, in the international context, the projection of ideology by dominant States upon subordinated States. Law is both a constant process of interaction between citizens and officials, and in international affairs, a constant process of adjustment among States conceived in dyadic interaction. If we are genuinely committed to "generating international legal norms," then we can do no better than attend to Aristotelian wisdom: far from ruling the world, we will first be seeking to rule ourselves.

THE ADVANTAGES OF SOFT LAW IN INTERNATIONAL COMMERCIAL LAW: THE ROLE OF UNIDROIT, UNCITRAL, AND THE HAGUE CONFERENCE

*Henry Deeb Gabriel**

INTRODUCTION

In this Article, I suggest that the recent rise of nonbinding general principles ("soft law") in international commercial law, such as the International Institute for the Unification of Private Law ("UNIDROIT") Principles of International Commercial Law[1] and the United Nations Commission on International Trade Law ("UNCITRAL") Draft Legislative Guide on Secured Transactions,[2] serves two important functions not met in treaties, conventions, or other positive law.

Following a brief introduction to soft law principles, I discuss in Part II how nonbinding general principles can achieve the goal of uniform or, at least, harmonized law[3] by providing general principles that can more eas-

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1. UNIDROIT, PRINCIPLES OF INTERNATIONAL COMMERCIAL CONTRACTS (2004).

2. UNCITRAL, LEGISLATIVE GUIDE ON SECURED TRANSACTIONS (2008).

3. UNCITRAL notes the following distinction between harmonization and unification:

> "Harmonization" and "unification" of the law of international trade refers to the process through which the law facilitating international commerce is created and adopted. International commerce may be hindered by factors such as the lack of a predictable governing law or out-of-date laws unsuited to commercial practice. [UNCITRAL] identifies such problems and then carefully crafts solutions which are acceptable to States having different legal systems and levels of economic and social development.
>
> "Harmonization" may conceptually be thought of as the process through which domestic laws may be modified to enhance predictability in cross-border commercial transactions. "Unification" may be seen as the adoption by States of a common legal standard governing particular aspects of international business transactions. A model law or a legislative guide is an example of a text which is drafted to harmonize domestic law, while a convention is an international instrument which is adopted by States for the unification of the law at an international level. Texts resulting from the work of UNCITRAL include conventions, model laws, legal guides, legislative guides, rules, and practice notes. In practice, the two concepts are closely related.

UNCITRAL, FAQ—Origin, Mandate and Composition of UNCITRAL, http://www.uncitral.org/uncitral/en/about/origin_faq.html [hereinafter FAQ—UNCITRAL] (last visited Mar. 27, 2009). This distinction is important because many, including myself, see true internaily accommodate various legal traditions. In addition, because of their nonbinding effect, they can accommodate local law. This flexibility provides an easier basis for adoption in a given court or arbitration because there is less conflict between the international and the domestic law compared to a binding convention.

Second, as I discuss in Part III, because there is no need to have principles adopted by a given jurisdiction, the principles are more easily and readily available for use. Since these principles are not binding, their likely effect is more to set norms instead of hard and fast rules, but this still achieves the salutary goal of creating broad international standards.

The larger question posed is whether organizations such as UNIDROIT,[4] UNCITRAL,[5] and the Hague Conference on Private International Law

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tional unification as a goal that may not be possible, given the different legal traditions in the world. Harmonization, on the other hand, is a much more reachable goal.

For a discussion of how Restatements in the United States have not brought about uniformity within the domestic law, see, for example, Kristen David Adams, *Blaming the Mirror: The Restatements and the Common Law*, 40 IND. L. REV. 205 (2007); Kristen David Adams, *The Folly of Uniformity? Lessons from the Restatement Movement*, 33 HOFSTRA L. REV. 423 (2004).

4. UNIDROIT is an independent intergovernmental organization seated in Rome. The purpose of UNIDROIT is to study the needs and methods for modernizing and harmonizing private law, particularly commercial law, at the international level. UNIDROIT was created in 1926 as an auxiliary organ of the League of Nations. Following the demise of the League of Nations, UNIDROIT was reestablished in 1940 on the basis of a multilateral agreement. UNIDROIT: An Overview, http://www.unidroit.org/english/presentation/main.htm (last visited Mar. 27, 2009). This agreement is known as the UNIDROIT Statute, and the membership of UNIDROIT is restricted to States that have acceded to the statute. There are presently sixty-one Member States: Argentina, Australia, Austria, Belgium, Bolivia, Brazil, Bulgaria, Canada, Chile, China, Colombia, Croatia, Cuba, Cyprus, Czech Republic, Denmark, Egypt, Estonia, Finland, France, Germany, Greece, the Holy See, Hungary, India, Indonesia, Iran, Iraq, Ireland, Israel, Italy, Japan, Latvia, Lithuania, Luxembourg, Malta, Mexico, Netherlands, Nicaragua, Nigeria, Norway, Pakistan, Paraguay, Poland, Portugal, Republic of Korea, Romania, Russian Federation, San Marino, Serbia and Montenegro, Slovakia, Slovenia, South Africa, Spain, Sweden, Switzerland, Tunisia, Turkey, the United Kingdom, the United States of America, Uruguay, and Venezuela. "The Institute is financed by annual contributions from its Member States," with an additional annual contribution from the Italian Government. *Id.*; UNIDROIT: Membership, http://www.unidroit.org/english/members/main.htm (last visited Mar. 27, 2009)

As with other international organizations whose broad mandate is legal reform, UNIDROIT has tended to develop certain specializations in its work. UNIDROIT's basic statutory objective is to prepare modern and, where appropriate, harmonized, uniform rules of private law, and to a great extent, it has eschewed work in public law. In addition, its uniform rules are generally concerned with substantive rules and not with the conflict of law principles that would supplement them or work independently of them. Over the years, UNIDROIT has drafted both hard law (conventions) and soft law (model laws and suggested principles).

("Hague Conference")[6] should be spending their limited resources that come from their respective Member States to produce instruments other

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5. A subsidiary body of the U.N. General Assembly, UNCITRAL was established in 1966, under G.A. Res. 2205 (XXI), U.N. Doc. A/6396 (Dec. 17, 1966) and has a general mandate to harmonize and unify the law of international trade. *Id.* art I.

From its founding, "UNCITRAL has since prepared a wide range of conventions, model laws and other instruments dealing with the substantive law that governs trade transactions or other aspects of business law which have an impact on international trade." FAQ—UNCITRAL, *supra* note 1. A convention is a treaty that provides a set of international obligations that sovereign nations choose to undertake in their relations with one another. A model law is created as a suggested piece of domestic legislation.

UNCITRAL is made up of sixty-one Member States from five regional groups. *See* General Assembly, *Report of the United Nations Commission on International Trade Law on Its Thirty-Seventh Session*, ¶ 4, Supp. No. 17, U.N. Doc. A/59/17 (June 14–15, 2004).

> The current members of the Commission, elected on 16 October 2000 and 17 November 2003, are the following States, whose term of office expires on the last day prior to the beginning of the annual session of the Commission in the year indicated: Algeria (2010), Argentina (2007), Australia (2010), Austria (2010), Belarus (2010), Belgium (2007), Benin (2007), Brazil (2007), Cameroon (2007), Canada (2007), Chile (2007), China (2007), Colombia (2010), Croatia (2007), Czech Republic (2010), Ecuador (2010), Fiji (2010), France (2007), Gabon (2010), Germany (2007), Guatemala (2010), India (2010), Iran (Islamic Republic of) (2010), Israel (2010), Italy (2010), Japan (2007), Jordan (2007), Kenya (2010), Lebanon (2010), Lithuania (2007), Madagascar (2010), Mexico (2007), Mongolia (2010), Morocco (2007), Nigeria (2010), Pakistan (2010), Paraguay (2010), Poland (2010), Qatar (2007), Republic of Korea (2007), Russian Federation (2007), Rwanda (2007), Serbia and Montenegro (2010), Sierra Leone (2007), Singapore (2007), South Africa (2007), Spain (2010), Sri Lanka (2007), Sweden (2007), Switzerland (2010), Thailand (2010), the former Yugoslav Republic of Macedonia (2007), Tunisia (2007), Turkey (2007), Uganda (2010), United Kingdom of Great Britain and Northern Ireland (2007), United States of America (2010), Uruguay (2007), Venezuela (2010) and Zimbabwe (2010).

Id. "Members of the Commission are elected for terms of six years. The terms of half the members expire every three years." FAQ—UNCITRAL, *supra* note 1. The UNCITRAL Secretariat presently consists of only nineteen people. There are eleven professional and eight administrative support staff.

6. There are presently sixty-nine Member States of the Hague Conference on Private International Law: Albania, Argentina, Australia, Austria, Belarus, Belgium, Bosnia and Herzegovina, Brazil, Bulgaria, Canada, Chile, China, Croatia, Cyprus, Czech Republic, Denmark, Ecuador, Egypt, Estonia, European Community, Finland, France, Georgia, Germany, Greece, Hungary, Iceland, Ireland, India, Israel, Italy, Japan, Jordan, Latvia, Lithuania, Luxembourg, Malaysia, Malta, Mexico, Monaco, Montenegro, Morocco, the Netherlands, New Zealand, Norway, Panama, Paraguay, Peru, Poland, Portugal, Republic of Korea, Romania, Russian Federation, Serbia, Slovak Republic, Slovenia, South Africa, Spain, Sri Lanka, Suriname, Sweden, Switzerland, the former Yugoslav Republic of Ma-

than positive law. As I discuss in Part IV, I believe there are some specific uses of soft law that justify the allocation of resources to create soft law instruments.

Although my analysis should apply to any governmental or nongovernmental organization that produces soft law instruments, my particular concern is whether, given the limited resources available to the three international organizations most active in producing private international laws, UNCITRAL, UNIDROIT, and the Hague Conference, these organizations should be in the business of creating soft law.

I. "SOFT LAW"

Nonbinding legal principles are often referred to as "soft law." Defined by one commentator, "'soft law' is understood as referring in general to instruments of normative nature with no legally binding force and which are applied only through voluntary acceptance."[7] Soft law is generally established legal rules that are not positive and therefore not judicially binding. The various soft law instruments in international commercial law include model laws,[8] a codification of custom and usage promulgated by an international nongovernmental organization,[9] the promulgation

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cedonia, Turkey, Ukraine, the United Kingdom, the United States of America, Uruguay, Venezuela. HCCH Members, http://www.hcch.net/index_en.php?act=states.listing (last visited Mar. 27, 2009).

7. Michael Joachim Bonell, *Soft Law and Party Autonomy: The Case of the UNIDROIT Principles*, 51 LOY. L. REV. 229, 229 (2005).

8. *See, e.g.*, UNCITRAL, MODEL LAW ON INTERNATIONAL COMMERCIAL ARBITRATION (1985). The principle purpose of this instrument is to assist countries in reforming and modernizing their laws on arbitration. *Id.* art I(1). In this respect, the Model Law has been quite successful, and it has been enacted into law by a large number of jurisdictions, including Armenia, Australia, Austria, Azerbaijan, Bangladesh, Belarus, Bulgaria, Canada, Chile, Croatia, Cyprus, Egypt, Germany, Greece, Guatemala, Hong Kong Special Administrative Region of China, Hungary, India, Iran, Ireland, Jordan, Kenya, Lithuania, Macau Special Administrative Region of China, Madagascar, Malta, Mexico, New Zealand, Nigeria, Oman, Peru, Republic of Korea, Russian Federation, Singapore, Sri Lanka, Scotland, Tunisia, Ukraine, Zambia, and Zimbabwe, and within the United States of America by the states of California, Connecticut, Illinois, Louisiana, Oregon, and Texas. UNCITRAL, Status—1985 UNCITRAL Model Law on International Commercial Arbitration, http://www.uncitral.org/uncitral/en/uncitral_texts/arbitration/1985Model_arbitration_status.html (last visited Mar. 27, 2009).

9. For example, the International Chamber of Commerce ("ICC") has promulgated the UNIFORM CUSTOMS AND PRACTICE FOR DOCUMENTARY CREDITS (1993) (ICC Publ'n. No. 500), which sets out the rules and principles that govern letters of credit. The ICC, founded in 1919 in Paris, is a federation of business organizations and business people. It is a nongovernmental body, and it is neither supervised nor subsidized by governments. What Is the ICC?, http://www.iccwbo.org/id93/index.html (last visited, Mar. 27, 2009).

of international trade terms,[10] model forms,[11] contracts,[12] restatements by leading scholars and experts,[13] or international conventions.[14] Although soft law principles do not begin as positive law, they can of course become positive law either by courts, arbitral tribunals, or legislatures adopting them, or by transactional parties adopting them in their agreements. Often they are drafted with the intent of becoming positive law in the future.[15]

Of the three major international governmental organizations delegated the task of producing international commercial law instruments,[16] two of the organizations, UNIDROIT and UNCITRAL, have been quite active. These would include, for example, the UNIDROIT Principles on International Contracts and the UNCITRAL Arbitration Rules.[17] Both of these have been used extensively by tribunals as guidance. Recent examples of new soft law products include the UNIDROIT Principles and Rules of Transnational Civil Procedure and the new UNCITRAL Legislative Guide to Secured Transactions.[18] Unlike UNIDROIT and UNCITRAL,

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10. *See, e.g.*, the 2000 ICC, International Commercial Terms ("INCOTERMS"). "The ICC introduced the first version of [INCOTERMS] in 1936." Since then, they have acquired tremendous popularity and are the standard trade definitions universally used in international sales contracts. International Chamber of Commerce, Understanding Incoterms, http://www.iccwbo.org/incoterms/id3042/index.html (last visited Mar. 27, 2009).

11. *See* INT'L CHAMBER OF COMMERCE, MODEL CLAUSES FOR USE IN CONTRACTS INVOLVING TRANSBORDER DATA FLOWS (1998).

12. The Grain and Free Trade Association has more than eighty contracts covering cost, insurance, and freight, "free on board," and delivered terms. GAFTA Contract, http://gafta.com/index.php?page=contracts (last visited Mar. 27, 2009).

13. *See, e.g.*, UNDROIT, PRINCIPLES OF INTERNATIONAL COMMERCIAL CONTRACTS (2004); UNDROIT, PRINCIPLES OF INTERNATIONAL COMMERCIAL CONTRACTS (1994).

14. For a discussion of the appropriate use of each of these types of soft law instruments, see Roy Goode, *Reflections on the Harmonisation of Commercial Law*, 1991-I UNIF. L. REV. 54 o.s. (1991).

15. For example, this is the case with the COMM'N ON EUROPEAN CONTRACT LAW, EUROPEAN PRINCIPLES OF CONTRACT LAW (1998).

16. There are, of course, many organizations that create private international law. For example, within the United Nations itself, these include the U.N. Conference on Trade and Development and the U.N. Economic Commissions for Africa, Asia and the Pacific, Europe, and Latin America and the Caribbean, as well as specialized agencies of the United Nations such as the International Bank for Reconstruction and Development, the World Intellectual Property Organization, the International Maritime Organisation, and the International Civil Aviation Organization.

17. G.A. Res. 31/98 (Dec. 15, 1967).

18. UNIDROIT Principles and Rules of Transnational Civil Procedure, *available at* http://www.unidroit.org/english/principles/civilprocedure/ali-unidroitprinciples-e.pdf; U.N. Com'n on Int'l Trade Law [UNCITRAL], *Security Interests: Recommendations of the*

the third organization, the Hague Conference, has not historically produced soft law texts.

Because of their long involvement in specialized trade issues, other private organizations, such as the ICC, have a long history of drafting very successful soft law documents. In the case of the ICC, this would include the highly influential INCOTERMS, governing shipping terms, and the Uniform Customs and Practice for Documentary Credits, governing letters of credit.[19]

II. THE DIFFICULTY OF HARMONIZATION IS NOT PRESENT IN CREATING SOFT LAW

Harmonization of positive law has some inherent difficulties that do not arise in the creation of soft law. The list of challenges offered in this Section is not meant to be exhaustive; however, it does set forth the major concerns and difficulties that drafters of positive law will confront in their efforts to harmonize the law among different legal systems in international commercial law.

In an ideal world, the drafters of both international and domestic laws would take the best features of several bodies of law and meld them into a comprehensive legislative scheme. The world is not ideal, however, and attempts to harmonize, though successful in many cases, often run into obstacles such as differences in commercial practices as well as differences in legal theory and legal policies.[20] As I see it, there are four major challenges to harmonization that may be mitigated by soft law.

UNCITRAL Draft Legislative Guide on Secured Transactions, U.N. Doc. A/CN.9/631 (Mar. 16, 2007).

19. INT'L CHAMBER OF COMMERCE, UNIFORM CUSTOMS AND PRACTICE FOR DOCUMENTARY CREDITS (1993) (ICC Publ'n No. 500)

20. Thus, after twelve years of work revising the American Uniform Commercial Code, the fruits of attempting to harmonize the Uniform Commercial Code with the Convention on the International Sale of Goods ("CISG") were reduced to the following prefatory comment:

> When the parties enter into an agreement for the international sale of goods, because the United States is a party to the [CISG], the convention may be the applicable law. Since many of the provisions of the CISG appear quite similar to provisions in Article 2, the committee drafting the amendments considered making references in the Official Comments toprovisions in the CISG. However, upon reflection, it was decided that this would not be done because the inclusion of such references might suggest a greater similarity between the Article 2 and the CISG than in fact exists.

U.C.C. REVISED ART. 2, 2003 prefatory note (amended 2003 & 2005).

A. The Mandate

Generally, drafters of any statute or convention will be given a specific mandate for change. Although the mandate may include harmonization with other law, the mandate will inevitably also include modernizing existing law to suit contemporary business practices as well as correcting or clarifying ambiguities and mistakes that have arisen in the current law. Harmonization will be a minor part of the mandate; the major pressure is to keep existing law, to the extent possible, consistent with the mandate for change, and the subsidiary goal of harmonization is often greatly minimized in the drafting process.

This is likely to be exacerbated when an existing statute or code is being revised, as contrasted with the creation of a new convention or treaty. When the drafters confront the actual and perceived problems of an existing convention, the focus tends to be inward looking, and the focus is on the pre-existing convention. This draws attention away from the goal of harmonization. To the extent that the revision is designed to update the law for purposes of changing business practices or social goals, the goal of harmonization may well lose out to the goal of modernizing the law.

It is also often the case that those tasked with the revisions bring to the process expertise in the laws being revised, but have no particular expertise in the other laws with which the revisions are to be harmonized. In this case, attempts for harmonization quickly get lost in the process.

This is not the case in the drafting of a soft law instrument because prior law does not confine the final product. Thus, for example, given the freedom to create a new soft law legal instrument, drafters of the UNIDROIT Principles of International Commercial Law sought to draft the best law possible based on actual commercial practices, without the restraint of an existing international or domestic law guiding their work.

B. Harmonization Is Difficult to Achieve Among Different Legal Traditions

The harmonization of international legal rules needs to take into account the globalization of trade and economies. To the extent that this crosses different legal traditions, harmonization efforts are more difficult because of the differences both among the various legal traditions as well as among languages.[21]

21. For a general discussion of the incompatibility issues in attempting to reconcile domestic and international law, see Henry D. Gabriel, *The Inapplicability of the United Nations Convention on the International Sale of Goods as a Model for the Revision of Article Two of the Uniform Commercial Code*, 72 TUL. L. REV. 1995 (1998).

Although there have been many successful efforts to harmonize international commercial law, this success has largely been due to the fact that its principles have only to be compatible with international commercial practice, not with domestic laws based on civil law or common law traditions.[22]

Yet, when the process of crafting international legal rules begins, there is great pressure by the drafters to conform the international rules to their respective domestic laws. In this process, something has to be compromised, particularly when the drafters are coming from wholly different legal traditions. Either the international rules will not conform to the domestic rules, or the domestic rules will have to be redrafted to conform to emerging international law. The latter is rarely desired or achieved. Even if the goal of harmonization with other international or domestic legal systems is articulated, there is less incentive to make fundamental changes in one's domestic law to achieve this goal.[23] Moreover, to the extent that the law being revised is, or is based upon, the law of contract or property, the basic concepts and terms are not compatible. In addition, basic legal principles tend to work as a unified whole; thus, to selectively borrow a contract or property principle from another legal system runs the risk of destroying the balance and interplay with other rules.

This problem is greatly diminished with soft law principles in international commercial law because no domestic legal rules need to be accommodated.[24] There are also numerous examples of soft law instruments that straddle the civil law and common law traditions.[25]

C. Harmonizing Existing Laws Is Difficult If the Scope of the Laws Differs

It is easier to harmonize laws when the laws being compared have the same scope. To the extent that a given statute or code provides unified coverage of a given area of the law or is part of a broader unified code, there is likely to be an internally consistent structure in the law that will make harmonization with other law difficult if the other law does not

22. An obvious exception is the CISG. The CISG successfully straddles both the common law and the civil law, and avoids grappling with the major distinctions between the two. *See* HENRY DEEB GABRIEL, CONTRACTS FOR THE SALE OF GOODS: A COMPARISON OF U.S. AND INTERNATIONAL LAW 14 (2d ed. 2009).

23. *See* Gabriel, *supra* note 21, at 2003.

24. I am assuming that the law of the enforcing jurisdiction or applicable arbitration tribunal will provide for the application of the soft law principles under choice of law rules. This would appear to be the case in the United States, for example. *See* U.C.C. § 1-301, cmt. 2 (2008).

25. See Gabriel, *supra* note 21, at 2004.

have the same scope.[26] Soft law instruments do not have this limitation because they are not attempts to replicate an existing law or legal structure.

D. The Advantages of Soft Law Instruments as a Means to Harmonization of the Law

As discussed above, soft law instruments are not subject to the same pressure to be harmonized with existing law, as is the case with treaties, conventions, and other sources of positive law. Moreover, in the case of soft law instruments, it is not necessary to attempt to harmonize the entire area of law, and therefore it is easy to pick the provisions out of another law that fit a specific need in the law being drafted for selective harmonization. Selective borrowing also lends itself to borrowing from various sources. This process of picking and choosing affords systematic reflection on what should be the best result, not simply a possible result, for the issue being considered.

Because treaties and conventions must be fashioned in a way that encourages adoption by various States, in order to create a high comfort level with the appropriateness of the instrument, there is a strong tendency toward the creation of instruments that will reflect the legal traditions of the potential adopting States. This inevitably results in an attempt to reconcile the differing legal traditions. It creates problems in terms of both the time necessary to finish the instrument as well as the actual substance of the resulting convention.

Preparation of international commercial law conventions and treaties tends to be a long process, and the long length of time is partially attributable to incessantly searching for common principles and reconciling established principles from different legal systems and traditions. This need was in large part the reason why the CISG took over ten years to prepare.[27]

Moreover, and more importantly, the need to accommodate specific legal traditions locks the drafters into a straightjacket of limited possibilities that often prevents the examination of the best solution. This is often politically driven. For example, the late Professor Allan Farnsworth, who served as an American delegate for the CISG and as a member of the working group for the UNIDROIT Principles of International Commer-

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26. *Id*. at 2006.

27. G.A. Res. 35/51, U.N. Doc. A/RES/35/51 (Dec. 4, 1980). *See also* UNCITRAL, 1980—United Nations Convention on Contracts for the International Sale of Goods (CISG), *available at* http://www.uncitral.org/uncitral/en/uncitral_texts/sale_goods/1980CISG.html.

cial Contracts, characterized the work leading to these two instruments as follows: "While the atmosphere in UNCITRAL was political (because delegates represented governments, which were grouped in regional blocs), that in UNIDROIT was apolitical (because participants appeared in their private capacity)."[28] For this reason, the UNIDROIT Principles are viewed as "neutral" contract law principles in that they reflect a balance of interests and have not been formulated by any government.

III. THE LACK OF A NEED FOR RATIFICATION AS AN ADVANTAGE OF SOFT LAW

Once completed, a soft law instrument is ready for adoption by the parties as part of their agreement or ready for use as an interpretive document by courts and arbitrators. Soft law instruments, unlike treaties and conventions, are not subject to the lengthy process of ratification that can delay enforcement for years.[29] For example, one of the most successful international conventions in recent times, the U.N. Convention on the Recognition and Enforcement of Foreign Arbitral Awards ("New York Convention"), was completed in 1958, but not ratified by the United States until 1970.[30] Moreover, although the New York Convention has been very successful, this has not been the case with many recent international commercial law conventions.[31] In a federal system, such as the United States, Canada, or Mexico, ratification often entails complicated political maneuvering between the federal government and the state or provincial governments.[32]

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28. E. Allan Farnsworth, *The American Provenance of the UNIDROIT Principles*, 72 TUL. L. REV. 1985, 1989 (1998) (citations omitted).

29. This can be the case with domestic law as well. For example, four years following a thirteen-year revision of the sales provisions of the American Uniform Commercial Code, no state has yet adopted the new law.

30. UNCITRAL, Status, 1958—Convention on the Recognition and Enforcement of Foreign Arbitral Awards, http://www.uncitral.org/uncitral/en/uncitral_texts/arbitration/NYConvention_status.html (last visited Mar. 27, 2009)

31. *See* Sandeep Gopalan, *New Trends in the Making of International Commercial Law*, 23 J.L. & COM. 117, 153–55 (2004). Gopalan provides a detailed breakdown of the relative success of various conventions based on their ratification. Generally, many conventions passed since the 1964 Convention Related to a Uniformed Law on the International Sale of Goods have been ratified by only a handful of States. *Id.* The few exceptions to this pattern include "[t]he 1958 New York Convention on the Recognition of Foreign Arbitral Awards[,] . . . perhaps the most successful convention ever with 134 ratifications[,] . . . [and t]he 1980 Vienna Convention on Contracts for the International Sale of Goods[,] . . . ratified by sixty-two countries." *Id.* at 155.

32. Obviously a similar problem exists between the European Union and its Member States.

In the case of a treaty or convention, there is a strong desire by adopting jurisdictions to produce a treaty or convention consistent with the domestic law of the jurisdiction.[33] There is not a concomitant pressure to harmonize soft law instruments with domestic law because there is no need to ratify the soft law instrument, and therefore no need to justify it in relation to existing laws.[34]

It has been suggested that soft law instruments, such as the UNIDROIT Principles of International Commercial Contracts, have been successful

> precisely because they are not binding, have not been influenced by governments and do not pose any threat to national legal systems. Like the UNCITRAL Model Law on Arbitration they are designed to be a unifying influence and a resource, but it is left to legislatures, courts and arbitral tribunals to decide to what extent they assist in the solution of problems.[35]

IV. THE USES OF SOFT LAW INSTRUMENTS

Soft law may have advantages over positive law instruments in terms of both harmonization as well as the lack of a need for ratification. But unless the soft law instruments themselves produce benefits beyond those derived from positive law, there would still be the question of whether they justify expenditure of limited resources. I believe that there are in fact important practical uses of soft law that justify the efforts and resources necessary to produce them, and I outline these uses below.

A. The Basis for Further Work

Some soft laws, such as model laws, are specifically intended to be the basis for adoption by individual jurisdictions,[36] and many have been most

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33. *See, e.g.*, Henry Gabriel, *The Revision of the Uniform Commercial Code—How Successful Has It Been?*, 52 HASTINGS L.J. 653, 654 (2001) (comparing the structure and content of the UCC to the Uniformed Electronic Transactions Act to argue that it is preferable to introduce state, rather than federal, legislation to promote universal commercial legal principles in the fifty U.S. states).

34. This is not to say that various domestic or other international laws will not have a strong influence on soft law principles. For example, the UNIDROIT Principles of International Commercial Law were influenced by the laws of Algeria, Canada, Germany, the Netherlands, and the United States, among other sources. *See* Sandeep Gopalan, *The Creation of International Commercial Law: Sovereingty Felled?*, 5 SAN DIEGO L. REV. 267, 319–20 (2004).

35. Gopalan, *supra* note 31, at 159 & n.188 (citing Roy Goode, *Communication on European Contract Law*, *available at* http://ec.europa.eu/consumers/cons_int/safe_shop/fair_bus_pract/cont_law/comments/5.6.pdf).

36. For example, the UNCITRAL Model Law on Electronic Commerce, or legislation based on it, has been adopted in Australia, Bermuda, Colombia, France, Hong Kong Spe-

successful in setting international and domestic standards for legislation.[37] Nonetheless, model laws intended to be adopted as drafted or with minor revisions are often subject to the same political pressures of harmonization and the same need to conform to specific legal traditions as a treaty or a convention. Because the drafters of model law have the same concerns of ratification and coordination as drafters of domestic law, many model laws determined to be well drafted, such as the Model Law on Electronic Commerce, have been used for domestic legislation.[38] Moreover, model laws can be used as a template for related legislation. Thus, for example, the Model Law of Electronic Commerce was a source for the American Uniform Electronic Transactions Act, the Canadian Uniform Electronic Commerce Act, and the Australian Electronic Transactions Act.[39]

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cial Administrative Region of China, Ireland, the Philippines, Republic of Korea, Singapore, Slovenia, the States of Jersey (Crown Dependency of the United Kingdom of Great Britain and Northern Ireland) and, within the United States of America, the State of Illinois.

The countries that have implemented legislation influenced by the UNCITRAL Model Law on Electronic Commerce and the Principles include Canada and the United States. The Uniform Electronic Commerce Act was adopted in 1999 by the Uniform Law Conference of Canada, and enacted as federal Canadian legislation and Saskatchewan, Manitoba, Ontario, Nova Scotia, and Yukon. The U.S. legislation, the Uniform Electronic Transactions Act, was adopted in 1999 by the National Conference of Commissioners on Uniform State Law, and has been enacted in the following states: Alabama, Arizona, Arkansas, California, Delaware, the District of Columbia, Florida, Hawaii, Idaho, Indiana, Iowa, Kansas, Kentucky, Louisiana, Maine, Maryland, Massachusetts, Michigan, Minnesota, Mississippi, Montana, Nebraska, Nevada, New Hampshire, New Jersey, New Mexico, North Carolina, North Dakota, Ohio, Oklahoma, Pennsylvania, Rhode Island, South Dakota, Tennessee, Texas, Utah, Virginia, West Virginia, and Wyoming. UNCITRAL, Status, 1996—UNCITRAL Model Law on Electronic Commerce, http://www.uncitral.org/uncitral/en/uncitral_texts/electronic_commerce/1996Model_status.html [hereinafter Status—Model Law on Electronic Commerce] (last visited Mar. 27, 2009).

37. Of course, sometimes actual conventions can be useful for setting international commercial standards for further conventions. This was clearly the case with the 1964 UNIDROIT Convention Relating to a Uniform Law on the International Sale of Goods, which was the basis for UNCITRAL's CISG.

38. Status—Model Law on Electronic Commerce, *supra* note 36.

39. For a discussion on the history and development of the UNCITRAL Model Law of Electronic Commerce as well as its influence on and differences from the American Uniform Electronic Transactions Act, see Henry Gabriel, *The New United States Uniform Electronic Transactions Act: Substantive Provisions, Drafting History, and Comparison to the UNCITRAL Model Law on Electronic Commerce*, 54 UNIF. L. REV. 652 (2000). For a discussion on the influence of the Model Law of Electronic Commerce on Canadian and Australian legislation, see Henry Gabriel, *Fear of the Unknown: The Need to Provide Special Protections in International Electronic Commerce*, 50 LOY. L. REV. 307 (2004).

On the other hand, statements of principles such as the UNIDROIT Principles of International Commercial Contracts, the UNIDROIT/American Law Institute Principles of Transnational Civil Procedure, and the many American Law Institute Restatements of the Law have all been drafted without the express purpose of adoption and therefore are not drafted with the attendant structural limitations. As a result, they have frequently achieved a neutrality and balance that would not otherwise be possible. Once completed, model laws have often taken on a great influence and significance in the further development of positive law. This can occur simply because they are a convenient and ready source of law and therefore eliminate the difficulty of drafting new language.[40]

There can also be a more conscious adoption because it is thought that they represent the correct result. This would appear to be the case with the recent promulgation by the Organization for the Harmonization of Business Law in Africa of a new Uniform Law on Contracts, which is based on the UNIDROIT Principles of International Commercial Contracts. [41]

Of course, some of the most successful soft law instruments, such as the Uniform Customs and Practices for Documentary Credits and INCOTERMS, were specifically drafted for use by a large number of contracting parties because they reflect common, well-established business practices; for this reason they are the *de facto* legal standards for the transactions they govern. Thus, although not designed as models for further legislation, they have in fact become such. For example, this is the case with the letter of credit provisions of the American Uniform Commercial Code, which draws heavily from the Uniform Customs and Practice for Documentary Credits.[42]

Private organizations, particularly trade organizations, have a strong financial incentive to produce soft law instruments that benefit their constituencies. It has been questioned whether governmental organizations, especially international organizations, should be spending limited re-

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40. Describing the influence of the American Uniform Commercial Code and the Restatement (Second) of Contracts on the drafting of the UNIDROIT Principles of International Contracts, the late Professor E. Allan Farnsworth noted that unlike any other common lawyer, "I came with texts in statutory form: the Uniform Commercial Code and the Restatement (Second) of Contracts. No decision of a common law tribunal—not even the House of Lords—was as persuasive as a bit of blackletter text." Farnsworth, *supra* note 28, at 1990 (italics omitted).

41. Preparation by UNIDROIT of a Draft OHADA Uniform Act on Contract Law, http://www.unidroit.org/english/legalcooperation/ohada.htm (last visited Apr. 24, 2009).

42. Katherine Barski, Comment, *Letters of Credit: A Comparison of Article 5 of the Uniform Commercial Code and the Uniform Customs and Practice for Documentary Credits*, 41 LOY. L. REV. 735, 738 (1996).

sources on developing tools other than legislation intended for enactment. This critique, however, often does not take into consideration that by providing a template for possible legislation, model laws and restatements save the respective government the cost of having to produce a similar piece of legislation from scratch.

B. Guidance to Tribunals

Soft law instruments, such as principles and restatements, have been widely used by courts and arbitrations as a basis for forging new legal rules as well as interpreting existing ones. In the common law world, particularly the United States, courts have long relied upon as a source of law the various Restatements of the Law produced by the American Law Institute.[43] Moreover, arbitration tribunals, which are generally not bound by domestic choice of law restrictions, often adopt legal rules, such as the UNIDROIT Principles of International Commercial Law, because of the presumed neutrality of these rules.[44]

Moreover, soft law is often a basis for gap fillers when the otherwise applicable international or domestic law does not address a specific question. For example, as the UNIDROIT Principles of International Commercial Law have a broader scope than the CISG, the Principles have been used to resolve questions not addressed by the CISG.[45]

Whether this guidance is always useful may be questioned because, with the convenience of having existing rules in place, according to some, tribunals have a tendency to follow soft law principles blindly without any analysis of why the rules are appropriate or better suited for the issue than competing rules.[46] However, to the extent that the principles were drafted carefully and thoughtfully, this concern should be minimal. The courts, in effect, are likely to stumble upon the best rule.

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43. *See generally* Kristen David Adams, *The American Law Institute: Justice Cardozo's Ministry of Justice?*, 32 S. ILL. U. L.J. 173 (2007) (noting Justice Cardozo's support for the Restatements published by the American Law Institute).

44. MICHAEL JOACHIM BONELL, AN INTERNATIONAL RESTATEMENT OF CONTRACT LAW 208–09 (3d ed. 2005).

45. *See, e.g.*, Yoshimoto v. Canterbury Golf Int'l Ltd., [2004] 2000 N.Z.C.A. 350 (C.A.); SCEA GAEC Des Beauches Bernard Bruno v. Société Teso Ten Elsen GmbH & COKG, Cour d'appel [CA] Gernoble, Oct. 23, 1996, *available at* http://www.unilex.info/case.cfm?pid=2&id=638&do=case.

46. *See, e.g.*, Gregory E. Maggs, *Ipse Dixit: The Restatement (Second) of Contracts and the Modern Development of Contract Law*, 66 GEO. WASH. L. REV. 508, 512 (1998); Symeon C. Symeonides, *The Judicial Acceptance of the Second Conflicts Restatement: A Mixed Blessing*, 56 MD. L. REV. 1248, 1269 (1997).

C. Party Autonomy and Neutrality

Within the limits provided by choice of law rules and party autonomy, parties may choose to adopt specific rules embodied in nonbinding instruments. Some instruments, such as the Uniform Customs and Practice for Documentary Credits or the INCOTERMS,[47] are so commonly used and accepted that they often govern by default absent a contrary party agreement. Most soft law instruments, however, become a part of the parties' agreement by express or implicit adoption.

The parties may choose to do so because they believe the rules reflect their business relationship better than domestic or other international law or they seek a neutral principle that does not give one party an advantage. Between parties of unequal bargaining power, the stronger party may insist on the choice of its own domestic law. However, there are times when a party, although having sufficient bargaining power to impose its own domestic law, in practice prefers not to because of its own law's lack of predictability or for another reason, and instead opts for other governing law such as the UNIDROIT Principles of International Commercial Contracts.[48]

V. CAUTIONARY CONCERNS OF SOFT LAW INSTRUMENTS

There are two specific drawbacks to soft law instruments. First is the inability to meet the need for certainty of enforcement, and second is the concern that they have not been tested in the political process.

A. The Need for Certainty of Enforceability

In some areas of international commercial law, certainty of the law and the enforcement of the specific rules is a necessity. Because international

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47. INT'L CHAMBER OF COMMERCE, INCOTERMS (2000) (ICC Publ'n No. 560).

48. For instance, as pointed out by the President of the International Court of Arbitration of the Russian Federation, Alexander S. Komarov:

> [One] reason which may militate in favour of the wide use of the [UNIDROIT] Principles [in Russia] is the fact that Russian lawyers and business people do not seem to be as reluctant as their foreign counterparts to contemplate references to the Principles in place of the application of their domestic law on the ground that the former would not confer on them the advantages which parties to foreign trade contracts usually expect from the application of their own domestic law, namely the well-known and detailed regulation of business transactions to which they are accustomed.

Alexander S. Komarov, *The UNIDROIT Principles of International Commercial Contracts: A Russian View*, 1 UNIF. L. REV. 247, 250 (1996).

conventions are binding, once they are ratified they have the advantage of instant uniformity and enforceability.

Thus, for example, the recent Cape Town Convention on International Interests in Mobile Equipment[49] and the accompanying Protocol to the Convention on International Interests in Mobile Equipment on Matters Specific to Aircraft Equipment[50] give an enforceable basis for the secured financing of aircraft in the international market; it would be unreasonable to expect the international financing of multimillion dollar aircraft without the level of certainty and protection afforded parties by a clear, black letter, enforceable convention.[51]

An agreement to use a particular set of rules is not self-enforcing, but needs some domestic law to provide a basis for its enforcement.[52] This, in many circumstances, leads to uncertainty because the parties may not know in advance whether the governing terms of the agreement will be enforced according to their express wishes. However, this problem should not be overstated. A large proportion of international legal disputes are resolved in arbitration, and generally the party's choice of law will control in arbitration irrespective of the underlying substantive domestic law. Moreover, absent some direct conflict with domestic policy, most domestic laws provide for a strong rule of party autonomy.

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49. Convention on International Interests in Mobile Equipment (Cape Town, 2001), *available at* http://www.unidroit.org/english/conventions/mobile-equipment/main.htm.

50. Protocol to the Convention on International Interests in Mobile Equipment on Matters Specific to Aircraft Equipment (Cape Town, 2001), *available at* http://www.unidroit.org/english/conventions/mobile-equipment/main.htm#NR2.

51. For a discussion of the history of the Convention and the need for certainty in this area of international finance, see Sandeep Gopalan, *Harmonization of Commercial Law: Lessons from the Cape Town Convention on International Interests in Mobile Equipment*, 9 LAW & BUS. REV. AM. 255 (2003).

52. Domestic courts are obligated to apply their own national law, including the relevant conflict of law rules. Under the traditional and prevailing view, the choice of law applicable to international agreements is limited to the particular domestic law. This is the position of the European Union under the 1980 Convention on the Law Applicable to Contractual Obligations, Jun. 19, 1980, 19 I.L.M. 1492 (1993), which unifies the conflict of law rules for contracts within its Member States. Thus, even if parties expressly refer to soft law principles or rules as the law that governs their agreement, domestic courts are likely to conclude that soft law principles are incorporated into the contract. The law of the contract will therefore have to be determined separately on the basis of the conflict of law rules of the forum, and the incorporated terms will bind the parties only to the extent that they do not affect the domestic rules of law from which the parties may not derogate.

B. Untested in the Political Process of Adoption

With the drafting of conventions and treaties, political forces strongly influence the process at two stages. First, this occurs during the drafting process. Second, this occurs during the ratification process.

During the drafting, representative governments have a strong sense of what is in their best interests, and these interests will be strongly debated and lobbied for during the drafting process. Moreover, it is common in organizations, such as UNCITRAL, to have wide representation by industry and business organizations that will also press their concerns.

This process of vetting, compromise, and ultimate acceptance usually yields instruments acceptable to the various constituencies and, therefore, they are likely to result in a wide acceptance. This may not be the case with soft law instruments, which may have evolved through a more insular process. Moreover, conventions and treaties tend to reflect practical, specific problems that call for fact-specific rules, as opposed to abstract principles, and thus may be easier to apply and lend more certainty and less divergence in interpretation.

However, because of the various compromises for acceptable results, a convention may not reflect best practices but merely acceptable practices. In addition, they may lend themselves to a less flexible cherry-picking of rules. Moreover, irrespective of the proposed convention's quality, unless it is adopted, it has no force. That of course presupposes that the various constituencies do not bring the project to a standstill because of an inability of the various stakeholders to agree upon a final text at all.

CONCLUSION

This brings us back to our original question. Given the limited financial and human resources available to UNCITRAL, UNIDROIT, and the Hague Conference, should these organizations be in the business of producing soft law? This Article argues that they should. Given the increased globalization of the world economy, the development of international commercial law has had an exponential growth. For the reasons discussed in this Article, soft law has been an important part of this development.

The former Secretary General of UNIDROIT, Professor Herbert Kronke, recently addressed the question of whether it should be within the domain of government-financed international organizations to produce soft law instruments rather than concentrating solely on the production of specific conventions that confront specific problems.[53] He concludes, I think properly, that the answer should not be an all-or-nothing proposition. Instead, there is a proper role for both soft law and binding conventions in the development of international commercial law. There are advantages to both.

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53. *See* Herbert Kronke, *Methodical Freedom and Organizational Constraints in the Development of Transnational Commercial Law*, 51 LOY. L. REV. 287, 293–94 (2005). Kronke observes that

> [m]uch has recently been written about the "new" transnational commercial law, consisting of fact-specific *rules*, having taken over from the "old" law, consisting all too often of highly abstract *standards*, which are constantly in need of interpretation and are, therefore, threatened by erosion. Assuming that is correct, would it then not be a disservice to the constituencies of transnational commercial law to continue producing international instruments such as the UNIDROIT Contract Principles? As a result, should we not then concentrate all resources on narrow problem areas resolving those specific problems by practice-driven drafting of instruments such as the Cape Town Convention or the [U.N.] Receivables Financing Convention?
>
> The answer is "no" if the question were to suggest a radical "either-or" choice. For example, it is true that governments would be well-advised not to again discuss the concept of good faith in the context of developing rules for a *specific* transaction as they did in Vienna where they finally settled on papering over disagreements in article 7 CISG. We can make this assertion only now that we have discovered an alternative vehicle for the promotion of that concept: article 1.7 UNIDROIT Contract Principles. While it is equally true that a maxim of interpretation in good faith would sit awkwardly in the Cape Town Convention today, it would not today be used as an overarching and abstract principle on interpretation of any sophisticated domestic law concerning the taking of collateral either. Rather, it would be broken down into specific, mostly judge-made rules regarding the protection of the security provider or the lessee in specific circumstances.
>
> In other words, standards have not become irrelevant. They have found their proper, yet different, place within the widened spectrum of types of international instrument. In an ongoing intellectual exchange with academic debate and business, the intergovernmental organizations were able to identify their proper role and designate their proper place thanks to the freedom granted by governments.

Id.

THE EVOLUTION OF COMMERCIAL LAW NORMS: LESSONS TO BE LEARNED FROM ELECTRONIC COMMERCE

Amelia H. Boss[*]

INTRODUCTION

Commercial law in the United States is the product of centuries of development. For many years, apart from the common law influences of our mother country,[1] the development of commercial norms and commercial laws in the United States occurred with relatively little regard for international norms and international commercial law developments.[2] Indeed, for many scholars in the United States looking at the development of commercial law norms, the study of commercial law had been primarily inwardly focused, for example, on the role of entities such as the National Conference of Commissioners on Uniform State Laws and the American Law Institute in the process,[3] or the appropriate allocation of responsibility between the states and the federal government.[4]

The landscape has changed somewhat over the past two decades, however, as we have observed the emergence of an "International Uniform

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1. One might also note the origins of the Uniform Commercial Code in the British codification movement of the nineteenth century. *See generally* GERALD POSTEMA, BENTHAM AND THE COMMON LAW TRADITION (Tony Honoré & Joseph Raz eds., 1986). *See also* CHARLES M. COOK, THE AMERICAN CODIFICATION MOVEMENT: A STUDY OF ANTEBELLUM LEGAL REFORM 76–77 (1981); Charles Noble Gregory, *Bentham and the Codifiers*, 13 HARV. L. REV. 344, 356 (1900). Indeed, Bentham once wrote to President Madison volunteering to create a code for the New World. Jeremy Bentham, *Legislator of the World: Writings on Codification, Law and Education*, *in* THE COLLECTED WORKS OF JEREMY BENTHAM 20–21 (Philip Schofield & Jonathan Harris eds., 1998).

2. This is ironic, given the historical roots of commercial law in the *law merchant* or law of the itinerant merchant, which was law that had no geographic limitations.

3. *See, e.g.*, Peter A. Alces & David Frisch, *On the UCC Revision Process: A Reply to Dean Scott*, 37 WM. & MARY L. REV. 1217 (1996); Larry E. Ribstein & Bruce H. Kobayashi, *An Economic Analysis of Uniform State Laws*, 25 J. LEGAL STUD. 131 (1996); Steven L. Schwarcz, *A Fundamental Inquiry into the Statutory Rulemaking Process of Private Legislatures*, 29 GA. L. REV. 909, 921 (1995); Alan Schwartz, *The Still Questionable Role of Private Legislatures*, 62 LA. L. REV. 1147 (2002); Alan Schwartz & Robert E. Scott, *The Political Economy of Private Legislatures*, 143 U. PA. L. REV. 595 (1995). *But see* Paul B. Stephan, *The Futility of Unification and Harmonization in International Commercial Law*, 39 VA. J. INT'L L. 743 (1999).

4. *See, e.g.*, A. Brooke Overby, *Modeling UCC Drafting*, 29 LOY. L.A. L. REV. 645 (1996); A. Brooke Overby, *Our New Commercial Law Federalism*, 76 TEMP. L. REV. 297 (2003); Kathleen Patchel, *Interest Group Politics, Federalism, and the Uniform Laws Process: Some Lessons from the Uniform Commercial Code*, 78 MINN. L. REV. 83 (1993).

Commercial Code." The 1980 Convention on the International Sale of Goods,[5] which came into force a little over twenty years ago, is, of course, one of the core components of this emerging code; joining it are newer conventions such as the Cape Town Convention on International Interests in Mobile Equipment,[6] promulgated by the Institute for the Unification of Private International Law ("UNIDROIT"),[7] and the Hague Convention on the Law Applicable to Certain Rights in Respect of Securities Held with an Intermediary, promulgated by the Hague Conference on Private International Law in 2002.[8] Supplementing these "hard laws" are, of course, soft law products[9] such as the UNIDROIT Prin-

5. United Nations Convention on Contracts for the International Sale of Goods, Apr. 11, 1980, 1489 U.N.T.S. 3.

6. UNIDROIT Convention on International Interests in Mobile Equipment, Nov. 16, 2001, S. TREATY DOC. NO. 108-10, *available at* http://www.unidroit.org/english/conventions/mobile-equipment/mobile-equipment.pdf.

7. UNIDROIT is an independent intergovernmental organization founded in 1926 and presently composed of sixty-three Member States. The Institute's seat is located in Rome. UNIDROIT: An Overview, http://www.unidroit.org/dynasite.cfm?dsmid=84219 (last visited Apr. 3, 2009).

8. The Hague Convention on the Law Applicable to Certain Rights in Respect of Securities Held with an Intermediary, July 5, 2006, *available at* http://hcch.e-vision.nl/index_en.php?act=conventions.text&cid=72. *See also generally* James Steven Rogers, *Conflict of Laws for Transactions in Securities Held Through Intermediaries*, 39 CORNELL INT'L L.J. 285 (2006). There are other completed international commercial law instruments as well as others on the drafting tables of organizations such as UNCITRAL, UNIDROIT, and the Hague Conference; these are just illustrations of the phenomenon.

9. The following is a cogent description of the dichotomy between "hard law" and "soft law":

> *Soft law* means rules that do *not* emerge from an autonomous source of law and are not law in that sense. In the international commercial and financial sphere, soft law often means proposals or sets of principles from UNIDROIT, UNCITRAL or other such organizations, or from think-tanks that aspire to reflect the living law particularly at the transnational level. Academic opinion may also be part of soft law. If soft law reaches the level of treaty law, it will operate in that category and becomes, then, law. Soft law may also attain the level of law as custom or general principle. . . . To repeat, short of soft law emerging as custom or general principle, it is not law, and therefore not a norm that must be applied, although it may provide guidance (usually supplementary to hard law or as some manifestation thereof). The UNIDROIT and European Contract Principles are of this nature, as are many unratified UNIDROIT and UNCITRAL projects, and their model laws.

J.H. Dalhuisen, *Custom and Its Revival in Transnational Private Law*, 18 DUKE J. COMP. & INT'L L. 339, 355–57 (2008). For a discussion of the various types of international lawmaking, including "soft law" and "hard law," see ALAN BOYLE & CHRISTINE CHINKIN, THE MAKING OF INTERNATIONAL LAW 211–29 (2007).

ciples of International Commercial Contracts, which, like the Restatement of Contracts in the United States, can be used to fill the gaps left by the "harder" treaty-based law.[10] Model laws, drafted for States to use as guidance if they so desire, are another form of "soft law"[11] used in the international commercial arena.[12]

As these international conventions and products have evolved, however, interesting questions have been presented: how international norms take root; how they can be cultivated and the unique challenges they raise for policymakers; the interrelationship among the various methods of lawmaking (whether their final results are categorized as hard law or soft law); the relationship between international and national lawmaking bodies, and the relationship (in the United States) between federal and state lawmakers.

The more recent area of electronic commerce offers a unique opportunity to examine these issues. The opportunity is unique for several reasons. Unlike many (or most) areas of commercial law, the evolution of commercial law norms governing electronic communications and transactions is a relatively recent phenomenon. The speed with which electronic commerce has developed and spread throughout the world has placed a premium on the need to develop governing norms definitively and just as swiftly. As a result, what took generations to occur in areas such as sales or secured transactions has occurred in a matter of decades with electronic commerce.

The case study of electronic commerce reveals several important lessons. Some of these lessons mirror the experiences from other areas of commercial law. First, it is imperative that any legal structure be built upon and reflect commercial practices in order for there to be an accept-

10. For a helpful book on the UNIDROIT Principles, see MICHAEL JOACHIM BONELL, AN INTERNATIONAL RESTATEMENT OF CONTRACT LAW: THE UNIDROIT PRINCIPLES OF INTERNATIONAL COMMERCIAL CONTRACTS (1994).

11. A. Claire Cutler, Virginia Haufler & Tony Porter, *The Contours and Significance of Private Authority in International Affairs*, *in* PRIVATE AUTHORITY AND INTERNATIONAL AFFAIRS 333, 367–68 (A. Claire Cutler et al., 1999) ("Soft law includes statements of principles, guidelines, understandings, model laws[,] and codes, and declarations that . . . are 'neither strictly binding norms of law, nor completely irrelevant political maxims, and operate in a grey zone between law and politics.'").

12. Examples of model laws in the field include the U.N. COMM'N ON INT'L TRADE LAW, MODEL LAW ON INTERNATIONAL COMMERCIAL ARBITRATION 1985, U.N. Sales No. E.08.V.4 (2008), and the U.N. Comm'n on Int'l Trade Law [UNCITRAL], UNCITRAL *Model Law on International Credit Transfers*, *in Report of the United Nations Commission on International Trade Law on the Work of Its Twenty-Fifth Session*, U.N. GAOR, 47th Sess., Supp. No. 17, Annex 1, U.N. DOC. A/47/17 (May 22, 1992), *reprinted in* 32 I.L.M. 587 (1993).

able and viable system for trade. Second, while commercial practices are developing or in flux, it is crucial that any legal norms be sufficiently minimal and flexible to accommodate growth and change. This flexibility and adaptability, deemed important to many actors in the development of legal norms, can easily be lost, however; and harmonization can be defeated when these norms are adapted as part of "hard law" through the process of implementation. And thus a third, related lesson: where too high a premium is placed on speed in developing rules, the end product runs the risk of stultifying or jeopardizing future developments.

There are other lessons, however, that can be learned from electronic commerce, lessons that are not as apparent in other areas. Elsewhere in this Symposium Issue, Professor McDonald has critically examined three metaphors often used to describe international law reform activities, "harmonization," "transplantation," and "viral propagation."[13] Electronic commerce law reform activity is a good illustration of a different form of international lawmaking, the process of symbiosis. It is symbiotic in several respects: there is symbiosis between the domestic and the international development of norms; between and among countries; and between the legal world and the business world. A second and related key point: while elsewhere there may be discussions of the appropriate roles of "soft" and "hard" lawmaking, and the relative merits of these types of lawmaking, study in the area of electronic commerce demonstrates that what is important is not necessarily the form that the lawmaking product takes (treaty, statute, model law, model agreement), but the process that leads to its formulation. In other words, the process is in many ways as important if not more so than the product itself. Most important are the development and exchange of ideas, and the education that occurs during the drafting process.[14] A corollary is that one cannot really judge the success of either a soft law or a hard law project solely by its (intended) implementation or adoption by a state or nation state; rather, the impact must be assessed by the effect that the product and *the process* have on the development of the law more generally.

There are a few other final and more sobering lessons. One is that when there is the occasional "misstep" in the development of legal norms, where a product of questionable long-term value is developed, the

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13. Roderick A. Macdonald, *Three Metaphors of Norm Migration in International Context*, 34 BROOK. J. INT'L L. 603, 603 (2009).

14. The author would have to admit to a certain bias in favor of education, given her career in the field. It should be noted that there is a project within the United Nations Conference on Trade and Development ("UNCTAD"), the TrainForTrade programme, which focuses on training and capacity building in the field of electronic commerce. *See generally* TrainForTrade, http://learn.unctad.org/ (last visited Apr. 11, 2009).

same factors that contributed to the symbiotic development of law in the first place may similarly contribute to the propagation of this "misstep" in other jurisdictions. The end result may not be harmonization, but fragmentation. Correcting or containing that misstep becomes problematic. A related observation: as legal norms advance in their maturation, the process of symbiosis slows down as other differences emerge. It is too early to tell whether this lull in the symbiotic process signals its end.

Now on to the story.

I. THE BIRTH OF ELECTRONIC COMMERCE LEGAL NORMS

In the area of electronic commerce, in a short period of twelve years, we have seen (at a minimum) three instruments emerge from one international body, the United Nations Commission on International Trade Law ("UNCITRAL"),[15] in a process that has been called "vertical integration."[16] Other electronic commerce products have emerged from other U.N. bodies such as the United Nations Centre for Trade Facilitation and Electronic Business ("UN/CEFACT"),[17] from regional harmonization programs in electronic commerce (such as that within the Association of

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15. These three instruments are the UNCITRAL MODEL LAW ON ELECTRONIC COMMERCE, U.N. Doc. A/Res/51/162/Annex, U.N. Sales No. E.99.V.4 (1999); the UNCITRAL MODEL LAW ON ELECTRONIC SIGNATURES WITH GUIDE TO ENACTMENT 2001, U.N. Sales No. E.02.V.8 (2002); and the 2005 United Nations Convention on the Use of Electronic Communications in International Contracts, G.A. Res. 60/21, U.N. Doc. A/RES/60/21 (Dec. 9, 2005). The Convention was published with an accompanying explanatory note. U.N. CONVENTION ON THE USE OF ELECTRONIC COMMUNICATIONS IN INTERNATIONAL CONTRACTS, at 13–100, U.N. Sales No. E.07.V.2 (2007) [hereinafter SECRETARIAT'S EXPLANATORY NOTE].

16. Susan Block-Lieb & Terence C. Halliday, *Incrementalisms in Global Lawmaking*, 32 BROOK. J. INT'L L. 851, 854, 868–72 (2007) (speaking of the progression from the two model laws to the United Nations Convention on the Use of Electronic Communications in International Contracts as "*vertical* incrementalism," where "international organizations dig more deeply in a particular area over progressive rounds").

17. Formerly known as the United Nations Working Party on the Facilitation of International Trade Procedures (Working Party or W.P.4), it operates in Geneva under the auspices of the United Nations Economic Commission for Europe and is the international body responsible for developing international standards for electronic data interchange. *See* United Nations Centre for Trade Facilitation and Electronic Business, About Us, http://www.unece.org/cefact/about.htm (last visited Apr. 3, 2009). Another U.N. entity that has taken a role in the evolution of electronic commerce norms is the UNCTAD, which among other efforts publishes an *Information Economy Report* that "focus[es] on trends in information and communications technologies . . . , such as e-commerce and e-business, and on national and international policy and strategy options for improving the development impact of these technologies in developing countries." UNCTAD, Main Publications, http://www.unctad.org/Templates/Page.asp?intItemID=1717&lang=1 (last visited Apr. 1, 2009).

Southeast Asian Nations),[18] from industry groups,[19] and from efforts to accommodate electronic commerce within other substantive projects (in the area of secured transactions or maritime law, for example) by borrowing principles and rules from electronic commerce instruments.[20] Ultimately, within the area of electronic commerce, we have examples of a variety of soft law and hard law approaches to electronic commerce. Yet the three products produced by UNCITRAL, two model laws (which might be characterized as soft law) and a convention (hard law), provide a unique opportunity to examine the evolution of commercial law norms, an evolution in which UNCITRAL has played a key role. Two of these UNCITRAL products (one model law, one convention) contain strikingly similar if not identical provisions. A study of the evolution of these instruments and their success in achieving adherence or implementation gives us an opportunity to compare and examine the interrelationship between soft law and hard law products. Though the sample is small, this study enables us to examine questions such as whether the existence of soft law is a help or a hindrance to the development of hard law; whether soft law or hard law is more effective in achieving adoption; whether soft

18. For a description of the products of the Association of Southeast Asian Nations in the area of electronic commerce, see Chris Connolly, *Using the Electronic Communications Convention to Harmonize National and International Electronic Commerce Laws: An ASEAN Case Study*, *in* THE UNITED NATIONS CONVENTION ON THE USE OF ELECTRONIC COMMUNICATIONS IN INTERNATIONAL CONTRACTS: AN IN-DEPTH GUIDE AND SOURCEBOOK 315, 317 (Amelia H. Boss & W. Kilian eds., 2008) [hereinafter U.N. GUIDE TO ELECTRONIC COMMUNICATIONS].

19. The International Chamber of Commerce ("ICC"), for example, has produced its Electronic Uniform Customs and Practices ("eUCP"), a supplement to its Uniform Customs and Practices 500 ("UCP 500") that covers situations where electronic presentation of documents occurs, and General Usage for International Digitally Ensured Commerce ("GUIDEC") and GUIDEC II, which provide a legal framework for the use of digital signatures and certification authorities. *See* LORNA BRAZELL, ELECTRONIC SIGNATURES LAW AND REGULATION 84 (2004) (describing the goals and content of GUIDEC); Coastline Solutions, eUCP: Online Training in eUCP, http://www.coastlinesolutions.com/eUCP.htm (last visited Apr. 5, 2009) (describing the UCP 500 versus the eUCP). In addition, it has published eTerms 2004 for parties trading electronically, and an accompanying ICC Guide to Electronic Contracting explaining the use of those terms. *See* ICC's Commission on Commercial Law and Practice, http://www.iccwbo.org/policy/law/id279/index.html (last visited Apr. 5, 2009). *See also* Christopher Kuner, *ICC Perspectives on the United Nations Electronic Communications Convention*, *in* U.N. GUIDE TO ELECTRONIC COMMUNICATIONS, *supra* note 18, at 415, 415–21.

20. Two scholars examining the working agendas of all the UNCITRAL working groups during the year 2007 observed that five of the six working groups "are revisiting or revising existing international instruments to account for practical experience and technical developments since adoption." Block-Lieb & Halliday, *supra* note 16, at 873 n.53.

law or hard law is more effective in achieving harmonization (for, as Professor Macdonald observed, nations can adopt the same or similar products, but without tempering, the results would not necessarily be harmonious);[21] whether hard law is feasible without the earlier development of soft law; and the impact of drafting hard law without the prior existence of soft law.

II. Setting the Stage: The Evolution of Electronic Commercial Practices

The story of the evolution of electronic commerce norms begins well before UNCITRAL produced its first model law in 1996. Twenty-five years ago, the Internet as we know it today was a thing of science fiction, and the phrase "electronic commerce" was unheard of, yet the glimmers of electronic commerce were beginning to emerge. Banks and other businesses and institutions started to use computer technology to communicate and explored ways to harness the technology for a competitive advantage, though the use of these technologies was limited. Nonetheless, the thought that some type of legal framework might be needed began to take hold.[22] As early as 1984, the issue of the need for a legal structure to govern electronic commerce was articulated on an international level by UNCITRAL, although at that time the phrase used to describe the phenomenon was "automatic data processing."[23] Despite UNCITRAL subsequently calling upon all nations to review their legal rules affecting the use of electronic technologies in commerce,[24] there

21. Macdonald, *supra* note 13, at 623–24.

22. The banking industry, at the forefront of developing legal norms for electronic commerce, led the way with the formulation of products both domestically (e.g., UCC Article 4A) and internationally. *See* UNCITRAL *Model Law on International Credit Transfers*, *supra* note 12.

23. *See* UNCITRAL, *Report of the United Nations Commission on International Trade Law on the Work of Its Seventeenth Session*, U.N. GAOR, Supp. No. 17, ¶¶ 135–36, U.N. Doc. A/39/17 (1984). This followed receipt of a report by the Secretary-General on the legal aspects of automatic data processing. *See* Secretary-General, *Legal Aspects of Automatic Data Processing: Report of the Secretary-General*, U.N. Doc. A/CN.9/254 (1984). That report identified several legal issues involving electronic communications technology: the legal value of computer records as evidence, the requirement of a writing and its application in an electronic environment, authentication of the source and veracity of electronic transmissions, general conditions applied in electronic transactions, liability for erroneous or unauthorized transmissions, and electronic transmissions of bills of lading, which have traditionally been represented by a piece of paper. *Id.*

24. *See* UNCITRAL, *Report of the United Nations Commission on International Trade Law on the Work of Its Seventeenth Session*, *supra* note 23, ¶ 136. This recommendation was endorsed by the United Nations General Assembly. *See* G.A. Res. 40/71, ¶ 5, U.N. GAOR Supp. No. 17, U.N. Doc. A/40/17 (Dec. 11, 1985).

was virtually no response from governments around the world, on any level. In hindsight, that was probably a fortunate result, as over the next decade electronic commercial practices continued to grow and evolve. Indeed, electronic commerce practices began to develop at a time when no states, and no nation states, had laws tailored for electronic commerce.

During the late 1980s, the use of electronic technologies in commerce increased and continued to develop, morphing from "automatic data processing" ("ADP") into "electronic data interchange" ("EDI"),[25] and the legal challenges it presented began to attract greater attention. One of the first responders was the Nordic Legal Community, which suggested interchange agreements between private trading partners to govern their use of electronic technologies in the communication and contracting process. This initial idea resulted in the ICC adopting the Uniform Rules of Conduct for Interchange of Trade Data by Teletransmission ("UNCID Rules") in 1987.[26] The UNCID Rules were a small set of nonmandatory rules, which EDI users and suppliers of network services could incorporate into any agreement between parties using electronic communications technologies. Following the publication of the UNCID Rules, numerous model interchange agreements were developed—by user groups representing specific industries (such as Odette, representing the automotive industry, and the International Maritime Committee, representing the maritime industry), by industry groups (such as the U.K. EDI Association and the EDI Council of Canada), by attorney groups (such as the American Bar Association),[27] and by multinational organizations (such as the European Commission through its Trade Electronic Data Inter-

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25. "Electronic data interchange" has been defined as "the computer-to-computer interchange of strictly formatted messages that represent documents other than monetary instruments." NAT'L INST. OF STANDARDS & TECH., FED. INFO. PROCESSING STANDARDS PUBL'N 161-2, ANNOUNCING THE STANDARD FOR ELECTRONIC DATA INTERCHANGE (EDI) (Apr. 29, 1996), *available at* http://www.itl.nist.gov/fipspubs/fip161-2.htm. The shift from ADP to EDI is significant. ADP, which refers to computer assisted storing, manipulating or processing information with minimal or no human interaction, is most often used to describe internal uses of information technology within a business. Conversely, EDI encompasses using information technology to communicate with external parties such as suppliers and customers.

26. Int'l Chamber of Commerce [ICC], Special Joint Comm. UNIFORM RULES OF CONDUCT FOR INTERCHANGE OF TRADE DATA BY TELETRANSMISSION (UNCID), ICC Publ'n No. 452 (1988).

27. *See, e.g.*, Elec. Messaging Servs. Task Force, *The Commercial Use of Electronic Data Interchange—A Report and Model Trading Partner Agreement*, 45 BUS. LAW. 1645, 1647–48 (1990).

change Systems Programme).[28] These model interchange agreements were suggested for use by private parties who agreed to communicate electronically in their conduct of commercial transactions (generally purchase and sale transactions).

Cumulatively, these private law products, themselves a form of "soft law," were to have a profound impact. First, most of these model agreements were the results of collaboration between attorneys and industry participants; indeed, the agreements themselves dealt with both legal and business issues. Thus, they represent efforts to adapt the law to the practice, and the practice to the law. Second, groups in many geographic sectors, industries, and countries worked diligently in developing their own agreements, but not without studying agreements that had been produced in other sectors, industries, and countries. Thus, symbiosis was already at work, and norms were beginning to evolve both domestically and internationally. Third, the proliferation of different agreements on national, sectoral, and association levels put pressure on international organizations to come up with an international and harmonized approach to these issues. Indeed, the provisions of these different agreements offered a sound basis for future norm construction.

III. ACT ONE: UNICTRAL ENTERS THE STAGE WITH THE MODEL LAW ON ELECTRONIC COMMERCE[29]

UNICTRAL began consideration of potential work in electronic commerce in the early 1990s.[30] Among other possible projects, it considered drafting a model interchange agreement for electronic commerce; this proposal was ultimately rejected for two reasons. First, UNCITRAL recognized that as an international organization its primary focus was on the legal facilitation of international trade, and it might not have been as suited to the drafting of these types of agreements as other organizations whose constituents included businesspeople and technical people as well as lawyers.[31] Instead, UNCITRAL concluded that it was uniquely si-

28. S*ee* AMELIA H. BOSS & JEFFREY B. RITTER, ELECTRONIC DATA INTERCHANGE AGREEMENTS: A GUIDE AND SOURCEBOOK 4–5, 15–18, 24 (1993); Amelia H. Boss, *Electronic Data Interchange Agreements: Private Contracting Toward a Global Environment*, 13 NW. J. INT'L L. & BUS. 31, 40–41 (1992).

29. For the text of the Model Law, see UNCITRAL MODEL LAW ON ELECTRONIC COMMERCE, *supra* note 15.

30. *See generally* Amelia H. Boss, *Electronic Commerce and the Symbiotic Relationship Between International and Domestic Law Reform*, 72 TUL. L. REV. 1931, 1951–52 (1998).

31. Two groups were at the time involved in drafting such model interchange agreements. The first was the Working Party on the Facilitation of International Trade Procedures, now known as UN/CEFACT. *See supra* note 17. In 1995, UN/CEFACT published

tuated to undertake the formulation of positive legal rules (either in convention form or model law form) to assist countries in addressing the needs of electronic commerce in a harmonized manner, thereby eliminating barriers to international trade.[32]

Second, and more importantly, UNCITRAL rightly noted that the proliferation of model interchange agreements and the use of private ordering by the parties to electronic commerce transactions were not sufficient to address all of the *legal* issues revolving around the use of electronic commerce.[33] In this respect, it is clear that there are important limitations on the ability of such soft law products to resolve all the issues presented by these transactions. Even with the evolution of these interchange agreements, questions still remained as to the legality and enforceability of electronically formed transactions, questions that could only affirmatively be resolved by judicial decision or legislation.[34] Moreover, the transition from proprietary communications networks to the environment of the World Wide Web changed the commercial paradigm from one of trade between established trading partners to an increasing number of transactions between parties who had not had prior dealings with each other.[35] For these parties, legal norms in soft law products that in essence

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its Recommendation No. 26. Working Party on the Facilitation of Int'l Trade Procedures, *Recommendation No. 26: Commercial Use of Interchange Agreements for Electronic Data Interchange*, U.N. Doc. ECE/TRADE/WP.4/R.1133/Rev.1 (1995). The second body working on the development of a model agreement was the European Commission. It published its model interchange agreement in 1994. Commission Recommendation of 19 October 1994 Relating to the Legal Aspects of Electronic Data Interchange, 94/820/EC, 1994 O.J. (L 338) 98–117.

32. *See, e.g.*, UNCITRAL, Working Group on Int'l Payments, *Report of the Working Group on International Payments on the Work of Its Twenty-Fourth Session*, ¶ 1, U.N. Doc. A/CN.9/360 (Feb. 17, 1992). It should be noted that there were technical and business people present at the subsequent deliberations at UNCITRAL on electronic commerce, but they participated more as technical experts than as the crafters of the ultimate UNCITRAL products.

33. UNCITRAL MODEL LAW ON ELECTRONIC COMMERCE WITH GUIDE TO ENACTMENT 1996, ¶ 140, U.N. Sales No. E.99.V.4 (1999) [hereinafter ELECTRONIC COMMERCE GUIDE TO ENACTMENT].

34. For example, the law of many States required certain contracts to be in a writing signed by the parties in order to be enforceable. Though the parties themselves might agree that certain communications constituted writings and certain acts constituted signatures, there was no guarantee that any particular court might not disagree and proceed to apply its statute of frauds. Though some of the trading partner agreements used other tactics as well, such as agreements to waive the statute of frauds, those solutions did not provide the desired legal certainty.

35. ELECTRONIC COMMERCE GUIDE TO ENACTMENT, *supra* note 33, ¶ 140. On the limitations inherent in interchange agreements generally, see BOSS & RITTER, *supra* note 28, at 8–9, 20–26; Boss, *supra* note 28, at 65–68.

require parties to opt in (for example, by incorporating the products' terms into master agreements) are of limited utility. Soft law norms that operate independently of adoption by courts or legislatures have their limits. Thus, the challenge presented to UNCITRAL was to propose a legal structure for adoption by nations that would minimize the barriers to electronic commerce. Yet, having determined that the model trading partner agreements were of limited utility, the groundwork on which UNCITRAL proceeded to build its own legal structure was the body of norms that had begun to be articulated in the trading partner agreements themselves.[36]

The challenge for UNCITRAL in articulating the legal norms for electronic commerce was fundamentally different than what it had faced in other areas, such as sales (whether it be sales, carriage of goods, securities, or secured transactions). In many of these other areas, norms had already developed on a national basis. Thus, in some areas of international commercial rule-making development, the question was one of harmonization: how to take the laws of divergent nations (which in many cases had already developed their own norms and made them a part of their legal structures) and harmonize their provisions. In other areas, such as securities and secured transactions, there were some countries with very developed legal systems, and the question involved whether the legal structures that had evolved in these countries could be or should be adapted for other legal cultures for use on an international basis. Electronic commerce was different. This was an area where there was no positive "hard" law in any country. Countries such as the United States, where electronic commerce was beginning to burgeon, were starting to acknowledge the need for legal norms, as the industry itself began to ask for a legal rubric to support its transactions; in other countries, widespread use of electronic commerce was still in the future.[37] At the time, it was noted that

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36. The foundation of UNCITRAL's work in the body of business practices and norms that had begun to develop was fostered by the participation of the business community (along with the legal community) in UNCITRAL's deliberations in the area of electronic commerce. *See, e.g.*, ELECTRONIC COMMERCE GUIDE TO ENACTMENT, *supra* note 33, ¶ 19. ("Chapter III of part one [of the Model Law] contains a set of rules of the kind that would typically be found in agreements between parties, e.g., interchange agreements or 'system rules.'").

37. The concentration of electronic commerce use and revenues in those industrialized and developed countries with sophisticated technological infrastructures and its underutilization in developing countries is one aspect of what has been referred to as the great "digital divide." UNCTAD has documented the existence of this divide. *See* U.N. Conference on Trade & Dev. [UNCTAD], Secretariat, *Electronic Commerce and Information and Communication Technologies for Development: Selected Issues*, ¶¶ 5–8, U.N.

> as of yet, none of the developing and developed countries, common law and civil law countries, and countries of different cultural and legal heritages, have developed a comprehensive legal structure governing electronic commerce. Thus, the challenge is to take countries of divergent economic capabilities, legal heritage, telecommunications infrastructures, and needs, and bring them together to develop common analyses of, and approaches to, problems never encountered previously.[38]

As a result, when UNCITRAL began work on a model law on electronic commerce, many countries took up parallel drafting efforts to deal with the same issues. The existence of parallel projects in the same field (relatively unhampered by prior hard law on point), the overlap between the personnel staffing the domestic lawmaking processes and those participating in the international lawmaking setting, and the technological ability to instantaneously exchange information on new domestic and international developments created a law reform process that might best be described as "symbiotic," with the domestic lawmaking projects and the international lawmaking projects influencing and being influenced by the other. The synergies between the domestic and international lawmaking efforts created a process that worked to strengthen both.[39]

As has been noted, the approach UNCITRAL initially took, once it had rejected the concept of a model interchange agreement, was to draft "legal rules." This original charge to the UNCITRAL Working Group, the preparation of legal rules, was a charge flexible enough to allow the Working Group to use whichever form was deemed appropriate: convention or treaty, or model law. Other techniques to promote harmonization of international trade law include model treaty provisions, uniform rules for parties to adopt, and legal guides. Indeed, up until its work was finally completed, UNCITRAL was still contemplating whether it would produce a set of model rules, rather than a more coherent and principled text of a uniform law. Given the novelty of electronic commerce issues, the

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Doc. TD/B/COM.3/62 (Oct. 7, 2003). UNCTAD has also developed an index for assessing countries' development in the field. *See* UNCTAD, *The Digital Divide: ICT Diffusion Index 2005*, U.N. Doc. UNCTAD/ITE/IPC/2006/5 (2006). *See also* UNCTAD, *Information Economy Report 2007–2008: Science and Technology for Development: The New Paradigm of ICT*, U.N. Doc. UNCTAD/SDTE/ECB/2007/1, at 12 (2007) (*prepared by* the UNCTAD Secretariat) (characterizing the digital divide as still significant). Even developing countries, however, were involved in UNCITRAL's efforts in the areas of electronic commerce, viewing the establishment of a supportive legal regime as one aspect of their creation of a hospitable environment for the growth of electronic commerce.

38. Amelia H. Boss, *The Emerging Law of International Electronic Commerce*, 6 TEMP. INT'L & COMP. L.J. 293, 300–01 (1992).

39. *See* Boss, *supra* note 30, at 1958–63 (describing the symbiotic process at work in the evolution of standards for the attribution of electronic messages to purported senders).

differences that existed among the legal frameworks of the nation states, and the minimalist rules that it finally articulated, however, UNCITRAL ultimately did not venture to create a text that would bind the hands of the enacting State, choosing instead a "softer" approach, that of a model law:

> The Model Law is intended to provide essential procedures and principles for facilitating the use of modern techniques for recording and communicating information in various types of circumstances. However, it is a "framework" law that does not itself set forth all the rules and regulations that may be necessary to implement those techniques in an enacting State.[40]

The key attribute of the model law approach, which supported UNCITRAL's goal of providing merely a "framework law," was the flexibility it gave countries in their implementation of its provisions. States considering the Model Law on Electronic Commerce (or "Model Law") have the option of either enacting the Model Law as a single statute or incorporating the Model Law's various provisions into specific parts of their domestic law.[41]

The Model Law on Electronic Commerce was completed and adopted by the U.N. General Assembly in 1996, yet it began to influence the shaping of domestic electronic commerce laws even prior to its completion. This is not surprising, given that some domestic lawmaking efforts were proceeding on a parallel track at the same time, and as mentioned above, domestic and international efforts influenced each other. In the United States, drafting efforts to accommodate electronic contracting within the provisions of the Uniform Commercial Code were informed by the work on the Model Law, and these drafting efforts eventually contributed to the formulation of the Uniform Electronic Transactions Act ("UETA") in 1999.[42] Similarly, work was being undertaken in Canada on

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40. ELECTRONIC COMMERCE GUIDE TO ENACTMENT, *supra* note 33, ¶ 13.

41. At one stage, the working group considered describing its product as model statutory provisions rather than as a model law, noting that

> the text contained a variety of provisions relating to existing rules scattered throughout various parts of the national laws in an enacting State. It was thus a possibility that enacting States would not incorporate the text as a whole and that the provisions of such a "model law" might not appear together in any one particular place in the national law.

Id. ¶ 142.

42. For a fuller description of the intricate relationship between domestic law developments in the United States and the Model Law on Electronic Commerce, see Boss, *supra* note 30.

a Uniform Electronic Commerce Act,[43] but even before this act was passed, the provisions found their way into various aspects of Canadian law.[44] Singapore was another early adopter of provisions somewhat in accord with the Model Law.[45]

Though a soft law product, the success of the Model Law can be seen from its enactment by countries around the world, including the following: developing countries (Vietnam) and developed countries; common law countries (Australia) and civil law countries (France); countries in North America (Canada), South America (Venezuela), Asia (Korea and China), the Middle East (Jordan), Europe, both West (the United Kingdom) and East (Slovenia), and Africa (South Africa).[46] It has been used as the basis for domestic harmonization of e-commerce legislation in federal systems such as Canada[47] and the United States,[48] and as the basis for "hard law" harmonization projects by regional groups, such as the electronic commerce projects in the Southern African Development Community.[49]

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43. *See* John D. Gregory, *The UETA and the UECA—Canadian Reflections*, 37 IDAHO L. REV. 441 (2001) (discussing the drafting of the Canadian Uniform Electronic Commerce Act).

44. Terms of the draft Model Law were used as the basis for regulations permitting electronic filing of speeding tickets issued in a photoradar system. *See* John D. Gregory, *Electronic Documents in Ontario's Photoradar System*, 6 J. MOTOR VEHICLE L. 277, 281 (1995).

45. Electronic Transactions Act, No. 25, Cap. 88 (1998) (Sing.), *available at* http://statutes.agc.gov.sg/ (click "E" hyperlink; then follow "Electronic Transactions Act" hyperlink).

46. For a list of country enactments of the Model Law, see *Appendix F: Domestic Enactments of the UNCITRAL Model Law on Electronic Commerce*, *in* U.N. GUIDE TO ELECTRONIC COMMUNICATIONS, *supra* note 18, at 493. *See also* UNCITRAL Texts and Status, http://www.uncitral.org/uncitral/en/uncitral_texts.html (last visited Apr. 5, 2009) (providing a list of UNCITRAL products and the countries that have adopted each product). It should be noted that making any such list of enactments is difficult, since there is no requirement that countries report their use of the Model Law in designing and enacting domestic legislation.

47. The domestic enactment of the Model Law in Canada, the Uniform Electronic Commerce Act, was adopted by the Uniform Law Commission of Canada in 1999 and has since been implemented in every province but the Northwest Territories. *See* UNIF. LAW CONFERENCE OF CAN., STATUS OF UNIFORM ACTS RECOMMENDED BY THE COMMERCIAL LAW STRATEGY (2007), *available at* http://www.ulcc.ca/en/cls/CLS_Status_Acts_En.pdf.

48. The UETA has been enacted in forty-six U.S. states, the District of Columbia, and the U.S. Virgin Islands. *See* the Uniform Law Commissioners—A Few Facts About the Uniform Electronic Transactions Act, http://nccusl.org/Update/uniformact_factsheets/uniformacts-fs-ueta.asp (last visited Apr. 5, 2009) (listing states adopting the UETA).

49. *See* South African Development Community, www.sadc.int (last visited Mar. 31, 2009). *See also Harmonization of E-Commerce Legal Framework for Southern Africa*,

Why was the Model Law successful in bringing together countries "of divergent economic capabilities, legal heritage, [and] telecommunications infrastructures"?[50] The success of the Model Law is due in large part to the fact that it was "a unique instrument in a legal landscape where there was no existing body of law, whether uniform international law or national law, which comprehensively addressed the issues raised by electronic commerce."[51] As such, the Model Law has been "an instrument of 'preventive' or 'pre-emptive' harmonization: it led the process of development of law by providing universally acceptable solutions to the issues likely to arise, rather than being negotiated after practices and usage had already resulted in disparate laws and regulations."[52]

Of course, not all would agree that the Model Law on Electronic Commerce was successful. Professor Justin Hughes, for example, has argued that the convergence that emerged around the norms set forth in the Model Law "would have occurred at roughly the same pace with or without the UNCITRAL model."[53] It is true that the Model Law on Electronic Commerce was built on legal norms that were already developing, but Professor Hughes appears to completely discount the role that the Model Law had in legitimizing their development and contributing to their spread to countries, particularly developing countries, where there were no such norms. Indeed, the success of the Model Law should not be measured solely, or even primarily, by the number of countries that used the Model Law as the basis for their domestic enactments. It could be argued that the process itself had a greater impact than the product. Electronic commerce was so sufficiently new and unfamiliar to people that substantial time was spent in the negotiating sessions understanding the technologies and their use, as well as attempting to ascertain the manner in which existing law did or did not apply, or how it applied, to electronic transactions. The sessions were not characterized by political posturing or attempts to persuade other delegations to adopt particular positions. Critically important were the exchange of ideas and the education that occurred about the challenges faced by electronic commerce. Countries

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DOT-COMMENTS E-NEWSLETTER, Mar. 2007, at 19, *available at* http://www.dot-com-alliance.org/newsletter/article.php?article_id=30.

50. Boss, *supra* note 38, at 300–01.

51. José Angelo Estrella Faria, *Drafting and Negotiating History of the Electronic Communications Convention*, *in* U.N. GUIDE TO ELECTRONIC COMMUNICATIONS, *supra* note 18, at 17, 29.

52. *Id*.

53. Justin Hughes, *Of World Music and Sovereign States, Professors and the Formation of Legal Norms*, 35 LOY. U. CHI. L.J. 155, 177 (2003). Professor Hughes calls the evolution of electronic commerce norms an "environment-based emergence of legal norms" or "invisible hand convergence." *Id.* at 175.

could either be wary of these challenges and run from them, or embrace electronic technologies. The work of UNICTRAL encouraged them to do the latter by dispelling the fear of the unknown. The preparatory material along with the reports from each of the sessions were for many delegations a gold mine of information about business practices as well as legal issues.

Of course, not all countries adopted the Model Law on Electronic Commerce in a uniform manner. To some degree, this lack of uniformity in the adoption process was inherent in the choice of a model law format for the treatment of electronic commerce and in the needs of countries to conform the Model Law to their domestic law. But some of the nonuniformity arose for reasons that were not anticipated.

IV. ACT TWO: THE EVOLUTION OF DIGITAL SIGNATURE LEGISLATION

Even before the Model Law on Electronic Commerce was completed, problems began to surface. While the approach of the Model Law and its related siblings was one of enabling and supporting rather than regulating and guiding the use of electronic commerce, the argument was heard in some quarters that "more" was needed—more guidance, more regulation, more focus. Compounding this was the drafting in some states in the United States of digital signature statutes, which sought to enshrine in their provisions the recognition of a specific implementation and use of electronic technologies—digital signatures—and to establish public key infrastructures to support their use.

Digital signature legislation grew out of the pioneering work of a group within the American Bar Association that saw the benefits that could be achieved by adopting this type of technology.[54] While it is beyond the scope of this Article to delve into the intricacies of digital signatures and public key infrastructures, the following summary may be helpful. "Digital signatures" are an advanced form of cryptography used to guarantee the authenticity and integrity of electronic documents. However, their use between parties who do not deal directly with each other depends upon the existence of an infrastructure that allows the parties to determine the authenticity of the digital signatures themselves. Building a public key infrastructure that provides this ability in turn requires regu-

54. This movement had its genesis in the United States in the work of the American Bar Associations' Section on Science and Technology, which promulgated the Digital Signature Guidelines in 1996. These Guidelines set out policy issues that needed to be faced in order to implement a legal structure to support the use of digital signatures. AM. BAR ASS'N, DIGITAL SIGNATURE GUIDELINES: LEGAL INFRASTRUCTURE FOR CERTIFICATION AUTHORITIES AND SECURE ELECTRONIC COMMERCE (1996), *available at* http://www.abanet.org/scitech/ec/isc/dsgfree.html.

lating the rights and responsibilities of the parties involved in such an infrastructure.[55] Digital signature legislation attempted to further the adoption of these technologies by providing a mechanism for building the needed public key infrastructures and establishing the rights and responsibilities of the parties in that system. An early adopter of this approach was the state of Utah.[56]

Digital signature legislation in the United States, particularly the Utah statute, was not without its critics, who raised several major concerns. First, the critics were concerned that having legislation dictate the use of one technology to the exclusion of others would interfere with the ability of private parties to determine the type of technology suitable for their particular transactions. Indeed, government regulators would replace businesses in determining the level of security and the propriety of authentication techniques that businesses should use. Second, there was the concern that the technology as it then existed did not in fact deliver the level of security that it purported to, and that with the passage of time what was once secure would cease to be.[57] Third, there was the concern that having a scheme that enshrined one technology and its application in a statutory form would freeze the development of other technologies and other business practices.[58] This third concern reflected the view that the technology might not be implemented in the way that the early digital signature legislation foresaw, and that the technology itself might develop in ways that the statute did not anticipate.[59] Last, the balance struck in this digital signature legislation, particularly the risk allocation between

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55. For an overview of this technology and its application, see WARWICK FORD & MICHAEL S. BAUM, SECURE ELECTRONIC COMMERCE (2d ed. 2000); ONLINE LAW: THE SPA'S LEGAL GUIDE TO DOING BUSINESS ON THE INTERNET chs. 3–4, 31 (Thomas J. Smedinghoff ed., 1996); UNCITRAL MODEL LAW ON ELECTRONIC SIGNATURES WITH GUIDE TO ENACTMENT 2001, *supra* note 15, at 20–31, ¶¶ 31–62.

56. *See* UTAH CODE ANN. §§ 46-3-101 to -104 (1996), *repealed by* 2006 Utah Laws, ch. 21, § 13.

57. *See, e.g.*, Henry Gabriel, *The Fear of the Unknown: The Need to Provide Special Procedural Protections in International Electronic Commerce*, 50 LOY. L. REV. 307, 316 (2004) ("[A]ttempts to develop rules on standards and procedures to be used as substitutes for specific instances of 'signatures' have been unsuccessful as they have tied the legal frameworks to a given state of technical development.").

58. Zhang Chu & Lingfei Lei, *The Chinese Approach to Electronic Transactions Legislation*, 9 COMP. L. REV. & TECH. J. 333, 343 (2005) ("[W]hat may be an adequate technical solution today may cease to be adequate with advances in information technologies tomorrow.").

59. *See* Jane K. Winn, *The Emperor's New Clothes: The Shocking Truth about Digital Signatures and Internet Commerce*, 37 IDAHO L. REV. 353, 377–79, 381–82 (2001) (presciently predicting possible uses for digital signature technology).

users of the technology in the event of fraud,[60] was attacked as inappropriate.[61]

In response to the criticism that the Utah statute dictated or enshrined one technology to the exclusion of others, Illinois adopted an approach[62] (referred to as a "hybrid" or two-tiered approach) that combined the minimalistic provisions that were essential to both the Model Law on Electronic Commerce and the UETA and provisions that would support the technological choices made by private parties with additional protections given to those who chose to use electronic signatures. The Illinois act thus tried to retrieve the flexibility of the Model Law on Electronic Commerce while at the same time giving some certainty to the use of particular types of electronic technologies.

Both the Utah and Illinois legislation had an impact outside the United States. While some countries adopted legislation like that in Utah, which prescribed particular technology in the form of digital signatures (legislation known as digital signature legislation),[63] other countries, following Illinois, adopted hybrid legislation, which combined the supportive and minimalist provisions of the Model Law on Electronic Commerce (and its sibling the UETA) with the more regulatory provisions of digital signature legislation.[64] In the United States, Illinois stood alone among the states taking such a hybrid approach; others stuck with the familiar UETA. In-

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60. *See* Jane K. Winn, *The Hedgehog and the Fox: Distinguishing Public and Private Sector Approaches to Managing Risk for Internet Transactions*, 51 ADMIN. L. REV. 955, 962 n.18 (1999).

61. *See* Jane K. Winn & Song Yuping, *Can China Promote Electronic Commerce Through Law Reform? Some Preliminary Case Study Evidence*, 20 COLUM. J. ASIAN L. 415, 438 (2007) ("This problem was described in the U.S. in the 1990s as 'Grandma picks a bad password and loses her house.'").

62. Illinois Electronic Commerce Security Act, 5 ILL. COMP. STAT. 175/99-1 to -101 (West 2001). The Illinois Act was signed into law before the promulgation of the Uniform Electronic Transactions Act, but has provisions validating electronic records and signatures that are similar to some in the UETA. The Illinois Act aims to ensure the integrity of electronic records and the authenticity of electronic signatures by providing special evidentiary rules for proving the integrity of electronic records and the authenticity of electronic signatures if "secure" electronic records and "secure" electronic signatures are used. *Id.* 175/10-120.

63. Early examples included Germany and Malaysia.

64. This led to attempts to categorize national electronic commerce legislation into one of three categories: minimalist (based on the Model Law on Electronic Commerce); prescriptive or regulatory (directing use of digital signature technology in particular); and hybrid or two-tiered legislation. *See* MORRISON & FOERSTER LLP, & STEPTOE & JOHNSON LLP, AN ANALYSIS OF INTERNATIONAL ELECTRONIC AND DIGITAL SIGNATURE IMPLEMENTATION INITIATIVES: A STUDY PREPARED FOR THE INTERNET LAW AND POLICY FORUM (2000), *available at* http://www.ilpf.org/groups/analysis_IEDSII.htm [hereinafter ILPF ANALYSIS OF ELECTRONIC SIGNATURE INITIATIVES].

deed, within the United States, both the Utah and Illinois approaches were eschewed in the drafting of the federal Electronic Signatures in Global and National Commerce Act ("E-SIGN"),[65] which was passed in 2000. E-SIGN, like the UETA, was built on the principle of technology neutrality, and preempts any state statute setting forth alternative procedures or technologies for the use or acceptance of electronic signatures to establish the legal effect, validity, or enforceability of contracts unless that legislation does not "require, or accord greater legal status or effect to, the implementation or application of a specific technology or technical specification for performing the functions of creating, storing, generating, receiving, communicating, or authenticating electronic records or electronic signatures."[66] Digital signature legislation, which does accord greater legal status to digital signatures, appears to violate this principle and therefore to be preempted by E-SIGN. The Illinois approach is more problematic, for while it does not necessarily single out digital signatures for special treatment, it does establish a category of "qualified" signatures that are given greater legal significance. To this day, the debate still continues as to whether the laws of states that went beyond the UETA (such as Illinois) are or are not preempted by E-SIGN.[67]

Following the enactment of E-SIGN in the United States, the Illinois legislation and the Utah legislation, which began digital signature legislation, were unable to gain additional adherents within the United States. Indeed, Utah ultimately repealed its digital signature legislation.[68] Nonetheless, the approaches these two states advocated did gain international adherents.

On the international level, Singapore became the first country to enact the Model Law on Electronic Commerce, passing its Electronic Transactions Act on July 10, 1998.[69] This is the "good news." Though the Singapore legislation purported to enact the Model Law, it borrowed liberally as well from U.S. precedent. Many of its provisions are drawn from the Illinois Electronic Commerce and Security Act and the Utah Digital Sig-

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65. Electronic Signatures in Global and National Commerce Act, 15 U.S.C. §§ 7001–21 (2000).

66. *Id.* § 7002(a)(2)(A)(ii).

67. The creation in the Illinois Act of different categories of electronic signatures and records has been argued to violate the principle of technology neutrality and thus to be preempted by E-SIGN. At this stage, however, the preemption issues remain unresolved. *See generally* Jamie A. Splinter, *Does E-Sign Preempt the Illinois Electronic Commerce Security Act?*, 27 S. ILL. U. L.J. 129 (2002).

68. *See* UTAH CODE ANN. §§ 46-3-101 to -104 (1996), *repealed by* 2006 Utah Laws, ch. 21, § 13.

69. Electronic Transactions Act, No. 25, Cap. 88 (1998) (Sing.).

nature Act.[70] Singapore's action was not an isolated incident; others, such as Germany[71] and Malaysia,[72] followed suit. The European Union, in an effort to avoid diverse and incompatible electronic commerce regimes among its countries, adopted an electronic signature directive giving special weight and importance to digital signatures.[73]

The emergence of these types of digital signature legislation created a demand within UNCITRAL from countries that wanted more specific and detailed rules such as those in the digital signature legislation. There was an attempt (by the United States) to push for a convention based on the Model Law on Electronic Commerce, but work nonetheless proceeded first on electronic signatures.[74] The result was the Model Law on Electronic Signatures, completed by UNCITRAL in 2001 (or "Second Model Law").

As a key participant in its deliberations observed, "the negotiation of the [S]econd [M]odel [L]aw proved to be more difficult" than the negotiation of the earlier Model Law on Electronic Commerce.[75] The debates during the drafting of the Second Model Law reflected divergent views on whether countries should take a leading role in defining technologies to be used by private parties, the degree to which party autonomy was to be respected, whether the law should reflect or direct developments in electronic commerce, and the appropriate level of government regulation of security in private relationships.[76] The United States, where digital signature legislation was born, in many respects disinherited its child, and worked within UNCITRAL to keep the legislation as nonregulatory and permissive as possible.[77] Industry groups such as the Internet Policy

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70. *Compare id.*, *with* Illinois Electronic Commerce and Security Act, 5 ILL COMP. STAT. 175 (1999), *and* Utah Digital Signature Act, UTAH CODE. ANN. §§ 46-3-101 to -504 (1999).

71. Gesetz zur Digitalen Signatur [Signaturgesetz] [SigG] [German Digital Signatures Act 1997], Jun. 13, 1997, BGBl. I at 1870, 1872 (F.R.G.), *available at* http://net-law.de/gesetze/sigg.htm.

72. Digital Signature Act (1997) (Malay.), *available at* http://www.parlimen.gov.my/actindexbi/pdf/ACT-562.pdf.

73. A Community Framework for Electronic Signatures, Council Directive 1999/93, 2000 O.J. (L 13), 12 [hereinafter Council Directive 1999/93].

74. *See* UNCITRAL, Working Group on Elec. Commerce, *Proposal by the United States*, U.N. Doc. A/CN.9/WG.IV/WP.77 (May 25, 1998).

75. Faria, *supra* note 51, at 30.

76. For the "official" summary of some of those debates, see UNCITRAL MODEL LAW ON ELECTRONIC SIGNATURES WITH GUIDE TO ENACTMENT 2001, *supra* note 15, at 13, ¶¶ 18–19.

77. For the views of one of the American participants in the process, see *Do You Know Who You Are Doing Business with? Signatures in a Digital Age: Hearing Before the H. Comm. on Science Subcomm. on Tech.* (Oct. 28, 1997) (testimony of Stewart A.

and Law Forum,[78] joined by academics,[79] were critical of this digital signature legislation. But the pressure to do something beyond the Model Law on Electronic Commerce to provide added "security," combined with a fascination with the new technology and a desire to lead the way in the field, created momentum within UNCITRAL to move forward in the field.[80]

The final product, the Model Law on Electronic Signatures, was described in its accompanying Guide to Enactment as "[b]uilding on the fundamental principles underlying article 7 of the UNCITRAL Model Law on Electronic Commerce" with a "modest but significant addition" offering "practical standards against which the technical reliability of electronic signatures may be measured."[81] It purported to reflect the principle of "technology neutrality" as well.[82] The Guide to Enactment did recognize the argument that "some countries consider that the legal issues related to the use of electronic signatures have already been solved by the UNCITRAL Model Law on Electronic Commerce and do not plan to adopt further rules on electronic signatures until market practices in that new area are better established," but opined that those also adopting the Model Law on Electronic Signatures "may expect additional bene-

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Baker, Steptoe & Johnson LLP), *available at* http://wbenton.tripod.com/tech/digisig_testimony.htm.

78. ILPF ANALYSIS OF ELECTRONIC SIGNATURE INITIATIVES, *supra* note 64.

79. *See, e.g.*, C. Bradford Biddle, *Legislating Market Winners: Digital Signature Laws and the Electronic Commerce Marketplace*, 34 SAN DIEGO L. REV. 1225, 1226–27 (1997); Winn, *supra* note 59, at 357.

80. Contributing to the pressure was the fact that the European Union in 1999 adopted a digital signature directive. Council Directive 1999/93, *supra* note 73, at 14. The goal of the directive was to harmonize the law among the Member States, which had taken divergent directions to electronic commerce: Germany and Italy were great supporters of digital signature legislation, while States such as the United Kingdom shared the skepticism of many about the viability of such legislation, preferring instead the more flexible and technology-neutral approach exemplified in the UNCITRAL Model Law on Electronic Commerce. The existence of the directive, however, was an extremely influential factor in the debates leading to the evolution of the UNCITRAL Model Law on Electronic Signatures, as it was effectively viewed as the "law" and the position of all the EU Member States.

81. UNCITRAL MODEL LAW ON ELECTRONIC SIGNATURES WITH GUIDE TO ENACTMENT 2001, *supra* note 15, at 8, ¶ 4.

82. *Id.* art. 3. *See also id.* at 9, ¶ 5; *id.* at 18, ¶ 27; *id.* at 21, ¶ 34; *id.* at 33, ¶ 67; *id.* at 40, ¶ 88; *id.* at 48–49, ¶ 107. Nonetheless, the Guide to Enactment makes it clear that the purpose of the Model Law was to validate the use of one particular technology—digital signatures—and to provide a structure for its implementation. *Id.* at 18–19, ¶ 28 ("The Model Law thus provides common grounds for [public key infrastructure] systems relying on independent certification authorities and electronic signature systems where no such independent third party is involved in the electronic signature process.").

fits" in providing guidance in the establishment of public key infrastructures (although it was not necessarily limited to such systems).[83]

Despite this language about the relationship between the two model laws, the Model Law on Electronic Signatures represented an important departure in tone and direction from its older sibling. While the earlier Model Law merely provided that an electronic signature could satisfy the legal requirements of a signature if it was "as reliable as was appropriate," the Model Law on Electronic Signatures set out the circumstances under which an electronic signature was considered to be reliable.[84] It also set out rules for assessing the conduct of the signatory,[85] the relying party,[86] and any certification service provider,[87] as well as standards for determining the trustworthiness of systems, procedures, and human resources.[88] All of the detailed rules have one primary (or sole) application: the use of digital signatures in public key infrastructures.[89] The Model Law on Electronic Signatures was thus more specific, with less flexible rules, and gave more power to governments to set the rules for determining the acceptability of electronic signatures. More significantly, while the Model Law on Electronic Commerce had been acceptable to a wide variety of nations, the Model Law on Electronic Signatures was more controversial.

Once the Model Law on Electronic Signatures was completed (and even before then), it too began to have an impact. Or, in Professor Macdonald's words, depending upon one's view, the "virus" had begun to spread.[90] The Model Law on Electronic Signatures, though it did not receive the same reception as the Model Law on Electronic Commerce, did gain a number of adherents.[91] Just as the Model Law on Electronic

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83. *Id*.

84. *Id.* art. 6(3).

85. *Id*. art. 8.

86. *Id*. art. 11.

87. *Id*. art. 9.

88. *Id*. art. 10.

89. Indeed, a fair amount of the UNCITRAL Model Law on Electronic Signatures Guide to Enactment is devoted to explaining the operation of digital signatures and public key infrastructures. *See id.* at 20–31, ¶¶ 31–62.

90. *See* Macdonald, *supra* note 13, at 635–49 (discussing the viral propagation metaphor).

91. Though it is difficult to determine the extent to which the Model Law on Electronic Signatures has had favorable reception, as most of the digital signature legislation predates the Model Law on Electronic Signatures, the UNCITRAL website reports that legislation based on the UNCITRAL Model Law on Electronic Signatures has been adopted in China (2004), Mexico (2003), Thailand (2001), the United Arab Emirates (2006), and Viet Nam (2005), and that legislation influenced by the principles on which the Model Law is based has been enacted in Costa Rica (2005). UNICTRAL Model Law

Commerce has been used for regional harmonization projects, the Model Law on Electronic Signatures has been advanced as a template for regional harmonization projects on cyberlaw.[92]

Yet, in fashioning their own laws, some countries relied less on the Model Law on Electronic Signatures than on other digital signature legislation. An example is China, with its enactment of the Electronic Signatures Law and the Administrative Measure on Electronic Certification Service.[93] Other countries that jumped on the digital signature bandwagon include Dubai and Nepal.[94] One commentator has noted that cross-border recognition of signatures and their supporting devices, one of the primary goals of the Model Law on Electronic Signatures, "remains a largely unsettled issue,"[95] mainly because of the lack of worldwide implementation of common standards.

It should be noted, however, that most if not all of the countries that have recently adopted digital signature legislation have been developing

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on Electronic Signatures—Status, http://www.uncitral.org/uncitral/en/uncitral_texts/electronic_commerce/2001Model_status.html (last visited Apr. 5, 2009).

However, as noted, other countries, such as Germany, have independently adopted legislation more akin to the UNCITRAL Model Law on Electronic Signatures. *See* Minyan Wang, *A Review of Electronic Signatures Regulations: Do They Facilitate or Impede International Electronic Commerce?*, 156 ACM INT. CONF. PROC. SERIES 548 (2006), *abstract available at* http://portal.acm.org/citation.cfm?id=1151454.1151458#. Other countries have adopted legislation dealing specifically with and giving special treatment to digital signatures and their use in electronic commerce. *See* Jeff Hynick, *May I Borrow Your Mouse? A Note On Electronic Signatures in The United States, Argentina and Brazil*, 12 SW. J. L. & TRADE AM. 159, 174–75 (2005) (noting the lack of technology neutrality in the digital signature statutes in Argentina and Brazil, and their lack of flexibility to accommodate advances in technology).

92. *See, e.g.*, UNCTAD, E. Af. Cmty. Secretariat, *Report of the 2d Regional Taskforce Meeting on Cyber Laws*, U.N. Doc. EAC/TF/2/2008 (Jun. 23–25, 2008).

93. *See generally* Gao Fuping, *Implementation of the Electronic Communications Convention: A Chinese Perspective*, *in* U.N. GUIDE TO ELECTRONIC COMMUNICATIONS, *supra* note 18, at 385. *See also* Chu & Lei, *supra* note 58, at 342; Aashish Srivastava, *No Rice, No Wife to Cook: An Analysis of the Electronic Signatures Law of China*, 13 INT'L J.L. & INFO. TECH. 437, 438 (2005).

94. Other examples of countries with a required digital signature regime such as China's include Nepal and Dubai. Stephen E. Blythe, *On Top of the World and Wired: A Critique of Nepal's E-Commerce Law*, 8 J. HIGH TECH. L. 1 (2008). *See also* Stephen E. Blythe, *Azerbaijan's E-Commerce Statutes: Contributing to Economic Growth and Globalization in the Caucasus Region*, 1 COLUM. J. E. EUR. L. 44 (2007) (noting that Azerbaijan has a permissive digital signature regime); Stephen E. Blythe, *The Dubai Electronic Transactions Statute: A Prototype for E-Commerce Law in the United Arab Emirates and the G.C.C. Countries*, 23 J. ECON. & ADMIN. SCI. 103, 111, 114 (2007), *available at* http://jeas.cbe.uaeu.ac.ae/jeas2007_Jun/04_Stephen.pdf (explaining and analyzing Dubai's Electronic Transactions Law).

95. Faria, *supra* note 51, at 30.

countries. Moreover, most of the countries that have adopted digital signature legislation or even the hybrid version exemplified by the European Union have found that it has failed to promote the use of digital signature technology in electronic commerce. While the use of digital signatures has increased, it has not been in the business context that the digital signature legislation contemplated. Several studies in the European Union from 2002 to 2006 illustrate this point. The first, undertaken on behalf of the European Commission in 2002, found that there was "no natural market demand" for qualified certificates and related services,[96] and "low market uptake" of public key infrastructure technologies.[97] The report observed that the directive "focuses strongly on one business model which took center stage from 1998 to 2000, but which has since been replaced by a more heterogeneous and complex market."[98] A second study in the United Kingdom revealed similar results about the marketplace.[99] A final report issued by the Commission in 2006 on its electronic signatures directive found that private parties had not been using digital signatures in their private transactions with commercial parties,[100] and that there has been a "very slow take up" on the use of advanced or qualified electronic signatures, yet it also found that many other simpler electronic signature applications had become available.[101] The report advanced a number of theories for these findings: technical prob-

96. Interdisciplinary Ctr. for Law & Info. Tech., *The Legal and Market Aspects of Electronic Signatures: Legal and Market Aspects of the Application of Directive 1999/93/EC and Practical Applications of Electronic Signatures in the Member States, the EEA, the Candidate and the Accession Countries* (2003) (*prepared by* Jos Dumortier et al.), *available at* http://ec.europa.eu/information_society/eeurope/2005/all_about/security/electronic_sig_report.pdf.

97. *Id.* ¶ 5.1.

98. *Id.* ¶ 5.5.3.

99. RICHARD WILSHER & JANE HILL, DEP'T OF TRADE & INDUS., REPORT ON THE IMPACT IN THE UNITED KINGDOM OF THE EC ELECTRONIC SIGNATURES FRAMEWORK DIRECTIVE, 2003, Doc. DTI TFBJ/C/003/006 IX, 2003, at 7, *quoted in* Winn & Yuping, *supra* note 61, at 441 n.85 ("[T]he study uncovered a far greater degree of indifference, cynicism and lack of faith in private sector use of electronic signatures than it did enthusiasm and belief in a burgeoning market.").

100. *See Report on the Operation of Directive 1999/93/EC on a Community Framework for Electronic Signatures*, ¶ 5.2, COM (2006) 120 final (Mar. 15, 2006) [hereinafter *Report on the Operation of Council Directive 1999/93*]. *See also* Jane K. Winn & Brian H. Bix, *Diverging Perspectives on Electronic Contracting in the U.S. and EU*, 54 CLEV. ST. L. REV. 175, 180 (2006) (discussing substantive and procedural fairness in electronic contracting between individuals and commercial parties).

101. *Report on the Operation of Council Directive 1999/93*, *supra* note 100, ¶ 3.1. The use of digital signatures was found to be limited to the e-banking and e-government arenas. *Id.* ¶ 3.2.

lems in the market place, a lack of criteria for certification and mutual recognition, a lack of interoperability at national and cross-border levels, and the existence of isolated areas where certificates were used for a single purpose.[102] The Commission report noted that

> [t]he main reason for the slow take-off of the market is economic: service providers have little incentive to develop multi-application electronic signature[s] and prefer to offer solutions for their own services, for instance, solutions developed by the banking sector. This slows down the process of developing interoperable solutions. The lack of applications . . . might also prevent the development of a multi-purpose e-signature, which requires reaching a critical mass of users and usage.[103]

Some developing countries had adopted electronic commerce legislation with a hope that by eliminating the barriers to electronic trade they might promote greater electronic commerce by their businesses. What these studies were beginning to demonstrate is that hopes of building strong digital signature infrastructures were not even being realized in developed countries through digital signature legislation.[104]

Professor Jane Winn, a noted scholar in the field, predicted this result shortly after the Model Law on Electronic Signatures was completed:

> Some . . . believed that the E-Signatures Model Law was based on an outmoded idea of how digital signatures are likely to be used in Internet commerce and thought that the Model Law compounded this shortcoming by mandating risk allocation rules that are counter-intuitive and unproductive. In addition, the E-Signatures Model Law was promulgated by UNCITRAL after developed countries had already passed laws dealing with the same subject matter in quite different ways than the Model Law. Because it is unlikely any developed countries are going to repeal their current laws in order to enact legislation based on the Model Law, the Model Law is unlikely to achieve its objective of harmonizing law in this area. What it is likely to do, however, is encourage developing countries to pass laws that are out of step with actual commercial practice in Internet commerce, further disadvantaging their local businesses that try to compete in the global information economy.[105]

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102. *Id.* ¶ 3.3.2.

103. *Id.* ¶ 5.2.

104. *See, e.g.*, Winn & Yuping, *supra* note 61, at 417 (suggesting that "government efforts to promote the use of electronic commerce among local businesses will require much more than transferring legislative models created for developed market economies to transition economies such as China's if they are to succeed").

105. Jane Winn, *Electronic Commerce Law: 2001 Developments*, 57 BUS. LAW. 541, 550 (2001). Others knowledgeable in the field have agreed. *See* John D. Gregory, *Cana-*

Professor Winn's views, though they may be shared by many people in many countries, have not been universally adopted. The European Commission was not deterred by the failure of the market to adopt digital signatures; instead, it stated that it would continue to encourage the development of e-signatures services and applications, with an emphasis on interoperability and cross-border use.[106] So while the jurisdiction that pioneered it all, Utah, repealed its law, the first digital signature law, fifteen years after its passage,[107] with the observation that the legislation had been unsuccessful in encouraging the establishment of digital signature systems,[108] digital signature and electronic signature legislation continues to find fertile ground for propagation in other countries.

V. LESSONS FROM THE TWO MODEL LAWS

The two UNCITRAL Model Laws tell different stories. One, the Model Law on Electronic Commerce, though criticized for not doing enough, gained great acceptance throughout the world. The other, criticized for doing too much, has nonetheless also been utilized as a guide for countries wishing to adapt their laws for electronic commerce. Neither has been enacted uniformly, and variations exist in their implementation from country to country. Could it be said that one of the Model Laws is more successful than the other?

Judging from the goals of the two laws, the Model Law on Electronic Commerce is arguably more successful. Its main goal was the removal of legal barriers to electronic commerce, a goal it has to some degree achieved. The goal of the Model Law on Electronic Signatures was lof-

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dian and American Legislation on Electronic Signatures with Reflections on the European Union Directive (2001), http://droit-internet-2001.univ-paris1.fr/pdf/ve/Gregory_J.pdf ("[E]-commerce is global in scope, and neither country wants to take a seriously different approach from its major partners.").

106. Winn, *supra* note 105.

107. The bill repealing the Utah Digital Signature Act was signed into law in 2006. S.B. 20, 2006 Leg., Gen. Sess. (Utah 2006) (enacted). For the repeal of the Utah Digital Signature Statute Rules, see 22 UTAH BULL. 16 (Nov. 15, 2007).

108. *See* Wendy Leibowitz, *Utah Will Repeal Its Digital Signature Law, Never Used, as Tech, National Law Diverged*, 10 Electronic Com. & L. Rep. (BNA) No. 48 (Dec. 21, 2005), *available at* http://ipcenter.bna.com/pic2/ip.nsf/id/BNAP-6KCM2E?OpenDocument &PrintVersion=Yes (On March 10, 2006, Utah's Governor signed S.B. 20, *supra* note 107, repealing the Utah Digital Signature Act because no one was using digital signatures.). Although electronic commerce has not gone heavily into digital signatures and public key infrastructures, a number of governments in Europe use it for communications with the government in areas such as tax filings and identity cards. *See* DESIGNING E-GOVERNMENT: ON THE CROSSROADS OF TECHNOLOGICAL INNOVATION AND INSTITUTIONAL CHANGE (J.E.J. Prins ed., 2001).

tier: to set common standards for the recognition of electronic signatures in a way that allowed for cross-border recognition. As noted, that has not occurred. The differences, however, are greater. The Model Law on Electronic Commerce was built on prior business practices that had evolved internationally, and found much inspiration in the trading partner agreements that had been drafted over the years for use by commercial parties. The Model Law on Electronic Signatures was built on a technology that had not yet received widespread use, and was an attempt to guide the development of business practices and norms. And while the Model Law on Electronic Commerce gave great leeway to parties to determine their own levels of security in their business dealings, the Model Law on Electronic Signatures gave a greater role to governmental entities to determine the trustworthiness of signature technologies.

Arguably, while the Model Law on Electronic Commerce emphasized the common goal of many countries to accommodate electronic commerce to paper-based rules by establishing an equivalence between the two, the Model Law on Electronic Signatures emphasized the distinctions among countries based to a large extent on cultural predispositions. The first Model Law on Electronic Commerce resonated with societies where there was emphasis on a free marketplace with the maximum amount of party autonomy, where the thought was that practice should lead and the law should follow. The Model Law on Electronic Signatures, however, represented a different philosophy: that the law should lead and tell private commercial parties the manner in which they should do business. Although the Model Law on Electronic Signatures carefully tried to continue the emphasis on technology neutrality and party autonomy, it was readily adaptable (and has been adapted) in ways that undercut these basic notions.

The comparison of the Model Law on Electronic Commerce and the Model Law on Electronic Signatures vividly illustrates the point that not all "soft laws," though drafted by the same body on roughly the same subject matter, are equal. Though both Model Laws professed to be flexible in their implementation, the Model Law on Electronic Commerce may be characterized as setting forth general principles (e.g., an electronic signature may satisfy signature requirements if it is reliable), whereas the Model Law on Electronic Signatures attempted to lay out the standards by which the general principle was to be applied.[109] The Model

109. There is another example in electronic commerce demonstrating that attempts to develop rigid detailed rules for electronic commerce may be doomed, compared to attempts to develop more general principles that can be adapted to changes in technology and the evolution of practices. The UETA (adopted in 1999), consisting of only twenty-one provisions, has been adopted in forty-eight states and jurisdictions and become the

Law on Electronic Commerce is an example of principles-based harmonization, as opposed to rules-based harmonization exemplified by the Model Law on Electronic Signatures.

Of course, the success of the Model Laws should not be measured solely on the basis of the number of enactments; as noted above, enactments may or may not result in harmonization. Moreover, harmonization may not be the only criteria by which to measure success. Articulation of the legal issues by a body of the stature of UNCITRAL performs the important function of educating people about some of the legal ramifications of using electronic technologies: "[t]he Commission noted with satisfaction that the Working Group had become generally recognized as a particularly important international forum for the exchange of views regarding the legal issues of electronic commerce and for the preparation of solutions to those issues."[110]

Second, apart from its pure educational value, the Model Law serves as a framework for countries that wish to draft their own law on electronic commerce, rather than adopt in full the work of the United Nations. In some countries, such as Sweden, the Model Law may be used as a guide for reviewing existing legislation to determine whether it satisfies the principles laid out in the Model Law. It is noteworthy that the provisions of the Model Law on Electronic Commerce are even being used by UNCITRAL, which includes them in its other products in an attempt to

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foundation of federal legislation. Uniform Law Commissioners: The National Conference of Commissioners on Uniform State Laws, A Few Facts About the Uniform Electronic Transactions Act, http://nccusl.org/Update/uniformact_factsheets/uniformacts-fs-ueta.asp (last visited Apr. 3, 2009). The Uniform Computer Information Transactions Act ("UCITA"), completed the same year and consisting of some 121 provisions attempting to set forth rules covering all aspects of computer information transactions, was enacted in only two states. Uniform Law Commissioners: The National Conference of Commissioners on Uniform State Laws, A Few Facts About the Uniform Computer Information Transactions Act, http://nccusl.org/Update/uniformact_factsheets/uniformacts-fs-ucita.asp (last visited Apr. 3, 2009). The latter effort, however, laid the foundation for another "soft law" project, the Principles of Software Contracting, which will receive final approval by its sponsor, the American Law Institute, in May 2009. Maureen A. O'Rourke, *An Essay on the Challenges of Drafting a Uniform Law of Software Contracting*, 10 LEWIS & CLARK L. REV. 925, 926 (2006). It remains to be seen whether this "soft law" project will be any more successful than its predecessor, UCITA. What differentiates the two? One is a proposed law that, upon enactment, is "hard law"; the other consists of mere suggestions for either judicial or legislative adaptation, but does not purport to be a statute. One is a long, detailed set of rules and standards; the other is flexible principles. The Principles do not seek to restate the developing law. Rather, they seek to "identify . . . transactions giving rise to disputes and litigation because they do not fit well within existing law and . . . address them in a technology-neutral way." *Id*. at 931.

110. ELECTRONIC COMMERCE GUIDE TO ENACTMENT, *supra* note 33, ¶ 16.

accommodate electronic commerce.[111] Third, even in the absence of positive domestic law adopting the provisions of the Model Law, it is possible that when disputes arise in the international context, the Model Law may be used as an authoritative source of norms (even if not binding) in the application of relevant domestic legal principles.

In this respect, it is the process that is important: Who are the participants? What is the nature of the discussions? How are the debates framed? From the perspective of at least one participant in the process, there was a substantial difference between the negotiations on the Model Law on Electronic Commerce and the Model Law on Electronic Signatures. The former negotiations were populated by those who, struggling to understand the nature of electronic commerce, were open-minded as to possible solutions and were not advocates of a particular technology or position. As a result, there was substantial give and take among the participants and more learning resulted. By the time of the negotiations on the Model Law on Electronic Signatures, countries' views had solidified more around preferred approaches and desirable technologies; the participants were more often instructed by their governments on what positions to take, and there was more jockeying in trying to achieve ultimate goals. Academics and businesspeople were more common in the first set of negotiations, government functionaries and diplomats in the second. And, as has been observed, it is more difficult to produce detailed and precise rules (as the Model Law on Electronic Signatures attempted to do) than flexible, open-ended provisions that can accommodate diversity.[112]

VI. ACT THREE: THE UNCITRAL CONVENTION ON THE USE OF ELECTRONIC COMMUNICATIONS IN INTERNATIONAL CONTRACTS

The Model Law on Electronic Commerce was completed in 1996, and the Model Law on Electronic Signatures was completed in 2001. As UNCITRAL began to consider what other work, if any, to undertake in the area of electronic commerce, the concept that had surfaced earlier, preparing a convention as opposed to a model law, was resurrected. Although there were cogent arguments that the two model laws were sufficient to provide countries with a structure for electronic commerce, it was argued that a convention "could contribute to the legislative arsenal of means of increasing legal certainty or commercial predictability in electronic business transactions—alongside [the Model Law on Electron-

111. *See* Block-Lieb & Halliday, *supra* note 16, at 864.

112. Harry C. Sigman, Comments at the Dennis J. Block Center for the Study of International Business Law and the Brooklyn Journal of International Law Symposium: Ruling the World: Generating International Legal Norms (Oct. 24, 2008).

ic Commerce]."[113] Such a convention would apply to transactions under international conventions like the Convention on the International Sale of Goods, where the application of countries' domestic electronic commerce laws might be problematic, and since a convention was arguably easier for some countries to adopt than a model law, this type of convention would encourage wider adoption of electronic commerce rules.[114] But for some, the strongest argument was that the "hard law" of a convention would visibly demonstrate that the principles on which it is based are no longer tentative, but are viable, workable solutions that "deserve more legal force behind them."[115] An unarticulated hope for some participants was that a convention would encourage countries to abandon alternative approaches based on specific technology and represent a return to the technology-neutral, media-neutral principles on which the original Model Law on Electronic Commerce was based.[116]

The United Nations Convention on the Use of Electronic Communications in International Contracts ("Convention") has been described as building on the Model Law on Electronic Commerce.[117] The terminology used in the Convention is drawn from the Model Law on Electronic Commerce.[118] More importantly, many of the Convention's key provi-

113. John D. Gregory, *The Proposed UNCITRAL Convention On Electronic Contracts*, 59 BUS. LAW. 313, 317 (2003). *See also* SECRETARIAT'S EXPLANATORY NOTE, *supra* note 15, ¶¶ 21–25.

114. *See* Gregory, *supra* note 113, at 317.

115. *Id*.

116. "Legal analysis had shown, however, that, despite an acceptable degree of harmonization, 'many of the proposed and current laws are mutually exclusive; others disagree on basic principles, despite the stated desire to coordinate the drafting of domestic laws.'" Faria, *supra* note 51, at 31–32, (quoting Christopher T. Poggi, *Electronic Commerce Legislation: An Analysis of European and American Approaches to Contract Formation*, 41 VA. J. INT'L L. 224 (2000)).

117. José Angelo Estrella Faria, *The United Nations Convention of the Use of Electronic Communications in International Contracts—An Introductory Note*, 55 INT'L & COMP. L.Q. 689, 690 (2006).

118. More specifically, it adopts the vernacular of the UNCITRAL Model Law on Electronic Commerce of referring to "data messages." *Compare* 2005 UNITED NATIONS CONVENTION ON THE USE OF ELECTRONIC COMMUNICATIONS IN INTERNATIONAL CONTRACTS, *supra* note 15, art. 4(c), *with* UNCITRAL MODEL LAW ON ELECTRONIC COMMERCE, *supra* note 15, art. 2(a). *Compare also* 2005 UNITED NATIONS CONVENTION ON THE USE OF ELECTRONIC COMMUNICATIONS IN INTERNATIONAL CONTRACTS, *supra* note 15, art. 4(d), *with* UNCITRAL MODEL LAW ON ELECTRONIC COMMERCE, *supra* note 15, art. 2(c) (originator); 2005 UNITED NATIONS CONVENTION ON THE USE OF ELECTRONIC COMMUNICATIONS IN INTERNATIONAL CONTRACTS, *supra* note 15, art. 4(e), *with* UNCITRAL MODEL LAW ON ELECTRONIC COMMERCE, *supra* note 15, art. 2(d) (addressee); 2005 UNITED NATIONS CONVENTION ON THE USE OF ELECTRONIC COMMUNICATIONS

sions have their roots in the Model Law: the basic concept that communications or contracts shall not be denied validity or enforceability solely because of their electronic form;[119] the treatment of form requirements such as writing requirements,[120] signature requirements,[121] and requirements for an original; and the basic rules on time and place of dispatch and receipt of electronic communications.[122] Not all of the substantive provisions of the Model Law on Electronic Commerce were carried over into the Convention; dropped were those provisions that had been omitted from many domestic implementations of the Model Law.[123] Lastly, there were articles added to the Convention that were absent in the Model Law.[124] Significantly, several of the newer additions had originally appeared in domestic legislation that was based on the Model Law on Electronic Commerce, continuing the symbiotic process between interna-

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IN INTERNATIONAL CONTRACTS, *supra* note 15, art. 4(f), *with* UNCITRAL MODEL LAW ON ELECTRONIC COMMERCE, *supra* note 15, art. 2(f) (information system).

119. *Compare* 2005 UNITED NATIONS CONVENTION ON THE USE OF ELECTRONIC COMMUNICATIONS IN INTERNATIONAL CONTRACTS, *supra* note 15, art. 8, *with* UNCITRAL MODEL LAW ON ELECTRONIC COMMERCE, *supra* note 15, art. 5 (information shall not be denied legal effect, validity, or enforceability) *and id.* art. 11 (contract shall not be denied legal effect).

120. *Compare* 2005 UNITED NATIONS CONVENTION ON THE USE OF ELECTRONIC COMMUNICATIONS IN INTERNATIONAL CONTRACTS, *supra* note 15, art. 9(2), *with* UNCITRAL MODEL LAW ON ELECTRONIC COMMERCE, *supra* note 15, art. 6.

121. *Compare* 2005 UNITED NATIONS CONVENTION ON THE USE OF ELECTRONIC COMMUNICATIONS IN INTERNATIONAL CONTRACTS, *supra* note 15, art. 9(3), *with* UNCITRAL MODEL LAW ON ELECTRONIC COMMERCE, *supra* note 15, art. 7.

122. *Compare* 2005 UNITED NATIONS CONVENTION ON THE USE OF ELECTRONIC COMMUNICATIONS IN INTERNATIONAL CONTRACTS, *supra* note 15, art. 10, *with* UNCITRAL MODEL LAW ON ELECTRONIC COMMERCE, *supra* note 15, art. 15.

123. Notable absences are the following provisions of the UNCITRAL Model Law on Electronic Commerce: Article 9 on the admissibility and evidentiary weight of data messages; Article 13 on the attribution of data messages (a concept that was not always carried over into domestic laws; Article 14 regarding acknowledgement of receipt (which only applies if the parties themselves require such an acknowledgement); and the special rules in part two of the Model Law on the carriage of goods. The omission of the rules in part two bears emphasis: those rules were attempts to apply the general principles of the Model Law to the specific area of the carriage of goods, and were the most detailed and specific of the Model Law's rules.

124. The three key new sections are Article 11 (invitations to make offers); Article 12 (use of automated message systems for contract formation), and Article 14 (error in electronic communication). UNCITRAL MODEL LAW ON ELECTRONIC COMMERCE, *supra* note 15. The latter two sections were based on domestic legislation that had been enacted (e.g., the UETA in the United States), while the first responded to concerns about the legal status of offerings on websites and in other electronic communications.

tional and domestic efforts.[125] Throughout the Secretariat's Explanatory Note that accompanies the printed version of the Convention, there is repeated discussion of the Convention's roots in the Model Law on Electronic Commerce and comparison of the Model Law's provisions of that Model Law to those in the Convention. Thus, there appears to be a process of restatement (of those provisions that have worked),[126] refinement (of those provisions that need adjustment), rejection (of provisions deemed unneeded or ultimately unworkable), and reinforcement (through the addition of other related provisions). Notably absent in the Secretariat's Explanatory Note accompanying the Convention is any discussion of the other Model Law; in fact, there are only three passing references to the Model Law on Electronic Signatures.[127]

As of the date of this Article, almost four years after the final adoption of the Convention on the Use of Electronic Communications in International Contracts in 2005, it has been signed by eighteen countries (not including the United States)[128] but has received no ratifications. The rea-

125. Article 14 on errors in electronic communications is one such provision. *See* SECRETARIAT'S EXPLANATORY NOTE, *supra* note 15, ¶ 225 ("Recent legislation on electronic commerce, including some domestic enactments of the UNCITRAL Model Law, contain[s] provisions dealing with error . . . ."). Article 14 was "inspired by two statutes that aimed to implement the [U.N.] Model Law on Electronic Commerce, namely the Uniform Electronic Transactions Act . . . of the United States and the Uniform Electronic Commerce Act . . . of Canada." John D. Gregory & Joan Remsu, *Article 14: Error in Electronic Communications*, *in* U.N. GUIDE TO ELECTRONIC COMMUNICATIONS, *supra* note 18, at 198, 200. These pieces of domestic legislation were in turn based on trading partner or interchange agreements that frequently set forth error detection procedures and rules for assigning risk of error.

Article 12 on automated message systems also had its roots in domestic legislation. UNCITRAL, Working Group on Elec. Commerce, *Report of the Working Group on Electronic Commerce on the Work of Its Forty-Second Session*, ¶ 124, U.N. Doc. A/CN.9/546 (Dec. 8, 2003) ("A number of jurisdictions have found it necessary or at least useful to enact similar provisions in domestic legislation on electronic commerce."). This domestic legislation included acts in the United States, UNIF. ELEC. TRANS. ACT § 14(1) (2000); Canada, UNIF. ELEC. COM. ACT § 20 [ECA]; and the European Union, Council Directive 95/46, art. 15, ¶ 1, 1995 O.J. (L 281) 31.

126. The Convention could be viewed as a statement that the principles set forth in the Model Law had obtained sufficient consensus and support so that hard law treatment in a convention was possible and desirable.

127. See SECRETARIAT'S EXPLANATORY NOTE, *supra* note 15, ¶¶ 22, 287 (Convention taken up after UNCITRAL Model Law on Electronic Signatures); *id.* ¶ 150 (referring to the UNCITRAL Model Law on Electronic Signatures Guide to Enactment for a description of digital signatures).

128. The following countries are signatories to the Convention: Central African Republic, China, Colombia, Honduras, the Islamic Republic of Iran, Lebanon, Madagascar, Montenegro, Panama, Paraguay, the Philippines, the Republic of Korea, the Russian Federation, Saudi Arabia, Senegal, Sierra Leone, Singapore, and Sri Lanka. Status—United

son for the lack of action is unclear: do countries believe that there is no need for the Convention in light of the wide adoption of electronic commerce legislation? Or are countries waiting to see if the major proponent of the Convention, the United States, will enact it?

Efforts are underway in the United States to achieve ratification, but the internal problems involved in ratification as the result of our federalist system are significant.[129] There is a drafting committee within the Uniform Law Conference in the United States exploring possible mechanisms for implementing the Convention should it be ratified.[130] There are many reasons for the United States to implement the Convention. In its E-SIGN legislation, the United States adopted the principles of the Model Law on Electronic Commerce as part of its foreign policy. Part three of E-SIGN, which is directed to international developments, provides that the "Secretary of Commerce shall promote the acceptance and use, on an international basis, of electronic signatures,"[131] but more specifically, encourage governments to "[r]emove paper-based obstacles to electronic transactions by adopting relevant principles from the Model Law on Electronic Commerce adopted in 1996 by [UNCITRAL]."[132] E-SIGN, however, does not give the same approval to more specific legislation directed towards particular technologies.[133] Given the support of

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Nations Convention on the Use of Electronic Communications in International Contracts, http://www.uncitral.org/uncitral/en/uncitral_texts/electronic_commerce/2005Conventio_status.html (last visited Apr. 5, 2009).

129. *See* Amelia H. Boss, *The Future of the Uniform Commercial Code in an Increasingly International World*, 68 OHIO ST. L.J. 349, 352–58 (2007).

130. The Committee to Implement the U.N. E-Commerce Convention is chaired by Professor Henry Deeb Gabriel, Jr.; the reporter is Professor D. Benjamin Beard. Uniform Law Commission—National Conference of Commissioners on Uniform State Laws, http://www.nccusl.org/Update/DesktopDefault.aspx?tabindex=0&tabid=59 (last visited Apr. 3, 2009).

131. Electronic Signatures in Global and National Commerce Act, 15 U.S.C. § 7031(a)(1) (2000).

132. *Id.* § 7031(a)(2)(A). Three years earlier, the Clinton administration had specifically endorsed the work of UNCITRAL in the area of electronic commerce, saying "[t]he United States Government supports the adoption of principles along these lines by all nations as a start to defining an international set of uniform commercial principles for electronic commerce." William J. Clinton & Albert Gore, Jr., A Framework for Global Electronic Commerce, http://people.hofstra.edu/peter_j_spiro/cyberlaw/framework.htm (last visited Apr. 11, 2009).

133. Other principles are directly aimed at undermining digital signature-specific legislation. For example, permitting parties to a transaction "to determine the appropriate authentication technologies and implementation models for their transactions, with assurance that those technologies and implementation models will be recognized and enforced." 15 U.S.C. § 7031(a)(2)(B). Or, taking a "nondiscriminatory approach to electronic signatures and authentication methods from other jurisdictions." *Id.* § 7031(a)(2)(D).

the United States for the Model Law and its encouragement of the Convention within UNCITRAL, as well as the support the Convention has received from the legal community,[134] there is a possibility of its ratification. Failure of the United States to ratify the Convention, however, may be a disincentive for other countries to do so, and would therefore allow the proliferation of different types of electronic commerce legislation to continue.

If the Convention fails to achieve substantial (or any) ratifications, and fails to come into force, would this mean it was a failure? If one measures success solely in terms of numbers of ratifications, and if one believes that a convention can only be successful if it comes into force, the answer is yes. But if one considers not only the product, but the process as well, there may be another answer. The existence of the Convention has already provided the incentive to some countries to adopt its provisions as a matter of domestic law,[135] and one commentator has observed that the Convention "has become a useful legislative tool for many developing countries."[136] In addition, the Convention has been used as the template for regional electronic commerce harmonization projects.[137] The Convention arguably serves another important educational point: it reinforces and ratifies the principles upon which the original Model Law on Electronic Commerce was built. Those countries that have enacted digital signature legislation may find it necessary to reevaluate that legislation in light of the Convention's provisions.[138]

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134. The ABA House of Delegates at its 2006 Annual Meeting passed Resolution 303 recommending that the United States sign the Convention. Am. Bar Ass'n Annual Meeting, Resolution 303 (Aug. 6–7, 2006), *available at* www.abanet.org/leadership/2006/annual/dailyjournal/threehundredthree.doc. Two years later, it passed a second resolution recommending ratification. Am. Bar Ass'n Annual Meeting, Resolution 100 (Aug. 11–12, 2008), *available at* http://www.law.upenn.edu/bll/archives/ulc/ecom/2008aug11_resolution.htm. Similarly, the National Conference of Commissioners on Uniform State Laws has indicated its support for the Convention.

135. *See* Jayantha Fernando, *A Developing Country Perspective: The Impact of Electronic Communications Convention on Legislation in the South Asian Region*, *in* U.N. GUIDE TO ELECTRONIC COMMUNICATIONS, *supra* note 18, at 353, 355–73 (describing Sri Lanka's use of the Convention in its drafting of its own electronic commerce laws).

136. *Id*. at 355.

137. *See* Connolly, *supra* note 18, at 315 (describing the projects in Southeast Asia).

138. *See* Fernando, *supra* note 135 (comparing the degree to which the laws of Sri Lanka and India are in conformity with the Convention, and noting that while the Convention was taken into account in the drafting of the Sri Lankan legislation, it was not considered in the drafting of either the Indian legislation or proposed amendments to that legislation). As Fernando concludes: "[t]his review establishes that it is easier for a country to implement the Convention if it has adopted the Model Law on Electronic Com-

CONCLUSION

The law of electronic commerce has evolved significantly over the past two decades. The evolution of electronic commerce norms during that period reinforces the lesson in other areas of commercial law: it is imperative that any legal structure be built upon and reflect commercial practices in order for there to be an acceptable and viable system for trade. The Model Law on Electronic Commerce was successful for that reason; the Model Law on Electronic Signatures demonstrates the difficulties of attempting to encourage particular business implementation structures for the use of particular technologies where no prior foundation for them exists in commercial practice. Second, while commercial practices are developing or in flux, it is imperative that any legal norms be sufficiently minimal and flexible to accommodate growth and change. The inherent flexibility of the Model Law on Electronic Commerce may be objectionable because it fails to give specific guidance on how parties should manage business affairs, but that flexibility is its strength, as it will accommodate newer technologies and emerging uses. Thirteen years after its completion, it is now the basis for a new international convention. Yet the Model Law on Electronic Signatures, eight years after its completion, has not had the results its proponents sought and has failed to keep pace with changes in commercial practice that have occurred. Perhaps, beginning with the Utah digital signature legislation, too high a premium was placed on quickly producing a statute that represented the "new" technological face of government.

The products of the evolution of electronic commerce norms tell one story; the process by which they were developed tells another. The process was one of symbiosis: symbiosis between the domestic and the international development of norms; between and among the countries; and between the legal world and the business world. Throughout the process, huge advances were made in appreciation of the technologies themselves, their uses, and the legal framework surrounding them. The educational process, however, is not always straightforward: there will be false starts, missteps, mistakes. It is not always easy to know whether a given direction is the right one to take. The question is whether the symbiotic process, over time, results in the correction of these false starts, or whether these false starts result in fragmentation of approaches among the countries. The symbiotic process in the electronic commerce arena was successful in the beginning, when all the participants in the process had questions, but no one purported to have "the" answer. As

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merce, but it is more difficult if it has adopted the Model Law on Electronic Signatures." *Id*. at 383.

differing views emerged on the need for and role of standards in the area of electronic commerce, the symbiotic process began to slow down. But lawmaking is a constant process of action, reaction, and interaction. Let us hope that the lull in symbiosis is temporary, and that the synergies that contributed to the early developments in the field continue.

MODERNIZATION OF COMMERCIAL LAW: INTERNATIONAL UNIFORMITY AND ECONOMIC DEVELOPMENT

Boris Kozolchyk[*]

ABSTRACT

The universality of certain commercial legal institutions is not the product of chance or of cultural imperialism. Commercial legal institutions that are being used uniformly throughout the trading world earn their universality by incorporating best commercial practices. These are the practices that have proven their cost-effectiveness and fairness regardless of the marketplace in which they were first used. Those best commercial legal practices that become universal legal institutions have proven themselves as indispensable legal tools for significant and lasting economic development. By "institutions," I mean not only the concepts, rules, and principles of interpretation that inspire the "written" or "positive" commercial law of a given country or jurisdiction, but also the attitudes that shape the "unwritten" or "living" law, or the law as it is actually observed or practiced. This living law is, often as not, the one that determines why a legal institution that succeeds in one country or region fails or is less successful in another.

This Article examines why the law of secured lending based on personal property collateral, a key contemporary commercial legal institution and tool for the economic development of countries such as Canada and the United States, among other nations, is likely to succeed in Guatemala and Honduras. It will also show why it will not succeed in Mexico and Peru, unless it is redrafted and the underlying attitudes and practices of these two countries are changed.

Keywords: modernization of commercial law, best practices, the law of secured lending, economic development.

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I. THE INTERNATIONAL UNIFORMITY OF COMMERCIAL LAW, LEGAL INSTITUTIONS, AND LEGAL CULTURE

During the nineteen sixties, a good number of well-intentioned law professors were attracted by the then-fledgling field of "law and economic development"; unfortunately, very few were conversant with the legal systems and cultures of developing nations. Despite their meager understanding of these nations' laws and cultures, some warned against the modernization of their commercial law by what they described as attempts to "import" legal institutions from developed nations. I placed quotation marks around the word "import" because for many centuries, similar legal concepts, rules, principles of interpretation, dispute resolution procedures, and remedies were viewed by merchants throughout the trading world as *their* law. This was the so-called "law merchant" (or *lex mercatoria*), and it resulted from the commercial practices that national groups of internationally active merchants adopted as a result of their interaction with their foreign counterparts.[1]

Hence, the law merchant could not be properly characterized as an "imported" law because it embodied a uniform, reciprocal, and equal treatment of merchants by fair courts, consulates, and eventually, commercial courts, regardless of the provenance of the disputing merchants and the location of these courts.[2] Eventually, the law merchant was absorbed by the decisional, statutory, and codified law of common and civil law countries; yet, even when "comingled" with other types of law, it has continued to be largely shaped by what merchants deem their best com-

1. *See* Boris Kozolchyk, The Law of Commercial Contracts in a Comparative and Economic Development Perspective VIII-8 (2008) (printed class materials, on file with author) [hereinafter Kozolchyk, Printed Class Materials]. *See also* PAUL HUVELIN, ESSAI HISTORIQUE SUR LE DROIT DES MARCHÉS ET DES FOIRES 258 (1897), *cited in* Kozolchyk, Printed Class Materials, *supra*, at VIII-7. In Huvelin's words:

> Thanks to the fairs, groups of merchants could deal with each other governed by the same enforceable law and under the same tribunals. A central authority existed to which the merchants of all nations could demand, successfully in many cases, protection against overreaching attempts by other merchants intent on applying their local law. This is a fact whose historical importance is unsurpassed by any other in the development of the commercial law of the middle ages . . . .

Id. See also Boris Kozolchyk, *A Roadmap to Economic Development Through Law: Third Parties and Comparative Legal Structure*, 23 ARIZ. J. INT'L & COMP. L. 1 (2005) [hereinafter Kozolchyk, *Roadmap*]; Boris Kozolchyk, *Highways and Byways of NAFTA Commercial Law: The Challenge to Develop a Best Practice in North American Trade*, 4. U.S. MEX. L.J. 1 (1996) [hereinafter Kozolchyk, *Highways and Byways*]; Boris Kozolchyk, *Secured Lending and Its Poverty Reduction Effect*, 42 TEX. INT'L L.J. 727 (2007).

2. Kozolchyk, Printed Class Materials, *supra* note 1, at VIII-9.

mercial practices—both national and international. It also continues to rely on simple and expedited procedures and methods of adjudication.

The vitality and universality of a commercial law shaped by best practices are apparent in institutions that stretch back as far as the ancient Greek version of the maritime contract and security agreement (known in common law countries as the contract or bond of "Bottomry").[3] Other commercial legal institutions, albeit of a more recent vintage, continue to be used worldwide. Among these are the twelfth century Genoese *Lettera di Cambio* (bill of exchange or draft);[4] the fourteenth century Florentine double-entry bookkeeping;[5] the English seventeenth century Goldsmith's notes and receipts (eventually known around the world as the "checks"),[6] and the joint stock companies or corporations;[7] the German-Silesian eighteenth century mortgage notes;[8] the Anglo-American nineteenth and twentieth centuries' commercial letter of credit; and the U.S. standby letters of credit[9] and unitary security interest in personal property collateral.[10] All of these commercial law institutions reflect best practices because they incorporate not only practices that have proven themselves in everyday marketplace transactions as the most cost-effective, but also those perceived as most fair by the regular participants in these transactions.[11] By a commercial legal institution, then, I mean not only the con-

3. For a historical sketch of the Contract or Bond of Bottomry, see HUGH CHISHOLM, IV THE ENCYCLOPEDIA BRITANNICA DICTIONARY OF ARTS, SCIENCES, LITERATURE AND GENERAL INFORMATION 310–11 (11th ed. 1910).

4. For a brief history of the inception of the *Lettera di Cambio*, see Martin Körner & Jean-François Bergier, *Lettera di Cambio*, *in* DIZIONARIO STORICO DELLA SVIZZERA (2008), *available at* http://hls-dhs-dss.ch/textes/i/I26229.php.

5. *See* ALFRED W. CROSBY, THE MEASURE OF REALITY: QUANTIFICATION AND WESTERN SOCIETY 199–226 (1997). *See also* Radio broadcast: John H. Lienhard, Double-Entry Bookkeeping, Engines of Our Ingenuity, Episode No. 1229 (1997) (transcript *available at* http://www.uh.edu/engines/epi1229.htm).

6. *See generally* GLYN DAVIES, A HISTORY OF MONEY FROM ANCIENT TIMES TO THE PRESENT DAY (3d ed., Univ. of Wales Press 2002) (1994). *See also* BENJAMIN GEVA, BANK COLLECTION AND PAYMENT TRANSACTIONS 14, 15 (2001).

7. *See* C.E. Walker, *The History of the Joint Stock Company*, 6 ACCT. REV. 97 (1931).

8. For a brief account of the historical development of mortgage bond financing in Germany, see Tim Lassen, Association of German Mortgage Banks, 3rd Workshop on Housing Finance in Transition Economies: Development of Mortgage Bonds (Dec. 5–6, 2002), *available at* http://www.oecd.org/dataoecd/33/10/1844485.pdf.

9. *See generally* Boris Kozolchyk, *Letters of Credit*, *in* IX INTERNATIONAL ENCYCLOPEDIA OF COMPARATIVE LAW ch. 5 (1978).

10. Boris Kozolchyk & Dale Beck Furnish, *The OAS Model Law on Secured Transactions: A Comparative Analysis*, 12 SW. J. L. & TRADE AM. 235, 266, 276, 281 (2005).

11. Boris Kozolchyk, *Fairness in Anglo and Latin American Commercial Adjudication*, 2 B.C. INT'L & COMP. L. REV. 257 (1979) [hereinafter Kozolchyk, *Fairness*]; Boris

cepts, rules, and principles of interpretation that comprise or inspire the "written" or "positive" commercial law, but also the attitudes that shape the "unwritten" or "living" law, the law as it is actually observed or practiced.

For those of us engaged in commercial legal modernization, the attitudes toward commerce (especially its respectability as a profession) and toward law (especially the manner and extent of its observance) are as important as the positive or governmentally enacted legal institutions. Where commerce is widely regarded as a tricky or picaresque endeavor or as a "zero-sum game," or where for one of the contracting parties to win the other must necessarily lose, or where an equal commercial treatment is only accorded to a family member or close friend and not to third parties or strangers, a weak marketplace and a weak economy are inevitable. Similarly, where the written law is widely disobeyed or disregarded, the economic consequences could be equally negative. The living-law variable, then, is often what determines the success or failure of a commercial legal institution. And, together, the positive or written law and the living law, as well as the above-described attitudes are what I refer to as a nation's or region's "legal culture."

II. INTERNATIONALITY OF PRACTICE AND UNIFORM LEGAL INGREDIENTS OF COMMERCIAL TRANSACTIONS

Why does commercial law tend to be internationally uniform? First, because despite man's innate selfishness and drive for gain, he has learned that cooperation is indispensable in commerce, regardless of where it is conducted. Unlike war, and even unlike hunting and gathering, sustained, gainful commerce cannot be based upon theft, deceit, or variations thereof. A "zero-sum game" attitude toward commerce destroys trust, and with it, the viability of a marketplace. Second, because of the need for cooperation among the regular participants in commerce, the legal ingredients of the various types of contracts, as contrasted with the forms of these contracts, are not as open-ended or variable as is the imagination of the participating merchants. The need for cooperation imposes serious limits on both the operational and moral components of these ingredients.

This does not mean that commercial law should not be open to new types of contracts. Most certainly it must be open and especially to those practices prompted by commercial and financial needs and technological innovations. Thus once it became clear to Roman jurists that most of the

Kozolchyk, *The Commercialization of Civil Law and the Civilization of Commercial Law*, 40 LA. L. REV. 3 (1979) [hereinafter Kozolchyk, *Commercialization*].

transactions in the Roman marketplace consisted of informal sales, they made these transactions enforceable by the "mere consent of the parties" (*solus consensus obligant*).[12] And unlike the pre-existing law of formal sales which applied to highly valuable property (*res mancipi*), consensual sales governed the sale of everyday goods.[13] Moreover, consensual agreements had to be interpreted according to good faith and not based upon a strict or literal reading (*stricti iuris*).[14] Countless commercial sales later, the Roman insight continues to prove its universal wisdom. This is also why, in our time, consensual electronic transactions are gradually replacing many of their paper-based counterparts.

As suggested by the validation of Roman consensual agreements, the cost-effectiveness of a commercial practice results first from the choice of an appropriate transactional means, including its physical format. Any format that impeded the purpose of a transaction would be inappropriate. Consider, for example, the practice jokingly suggested by an English legal humorist who asked why a valid negotiable bill of exchange or draft could not be created by stenciling its standard binding language on the back of a cow.[15] Obviously, whoever chose a cow as a physical format for a bill of exchange or check ignored not only the mechanics but also the purposes of deposits, negotiations, and payments of these instruments.[16] These mechanics and purposes are inseparable from the rights, duties, and remedies incorporated into a bill of exchange or check, all of which require a compact, portable, standard, inexpensive, durable, and yet easily endorsable or transferable medium. It hardly needs saying that the difficulty of using a cow as a negotiable instrument would be the same regardless of the country or region where the issuers, depositors, banks, or negotiating parties of bills of exchange or checks were located.

Mutatis mutandis fairness (the other main component of a successful or best commercial practice) presupposes that the parties to a transaction (including third parties) must be treated in the same manner as they or regular participants in the marketplace would reasonably expect to be treated. To be a contractually fair party, then, one must place oneself in the position of the other contracting party and ask oneself what that party reasonably expects to get out of the contract, and if that intent is not clear, place oneself in the position of a collective "other," i.e., that of

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12. *See* Kozolchyk, Printed Class Materials, *supra* note 1, at III-14.
13. *See id*.
14. *See id*. at III-15.
15. *See* A.P. HERBERT, UNCOMMON LAW: BEING 66 MISLEADING CASES 112–17 (1935) (explaining the case *Board of Inland Revenue v. Haddock*).
16. *Id.*

regular participants in the marketplace, and ask the same question.[17] Commercial fairness, then, presupposes that each commercial legal institution contains a formula of rights, duties, and remedies that bring about a protection of market "otherness" and that these rights, duties, and remedies be inspired by principles without which commercial law and its practices could not discharge their economic development mission.

As I have noted in some of my earlier writings, what distinguished European commercial law during its emergence in the eighteenth and nineteenth centuries as a separate branch of private law was its adherence to a set of principles that I will enumerate in an illustrative and thus nonexhaustive fashion.[18] They are (1) the parties' ability to bind themselves in a manner consistent with their intent, including the finality and limitation of their liability as to time and amount; (2) the equal treatment of merchants by authorities and merchants, regardless of their country of origin, race, ethnicity, or religion; (3) the parties' and their adjudicators' ability to observe and apply best practices derived from standards of customary behavior as well as from the behavior of model or archetypal merchants; (4) the recognition of possession of movable property as equivalent of title to it; (5) the ability to convey better title to movable property, including commercial paper and documents of title, than that received from one's predecessor (the principle of negotiability); and (6) the protection of parties (contracting as well as third parties) who act in good faith.

Yet, despite the proven contribution of these principles to the viability of commercial and financial marketplaces, opponents of modernization still argue in favor of retaining autochthonous legal institutions that are inconsistent with these principles for the sake of preserving a national or regional "legal tradition."

III. POVERTY AND AN EXCLUSIVELY AUTOCHTHONOUS LEGAL MODERNIZATION

Some of these opponents regard the modernization of commercial legal institutions of developing nations as a product of intellectual arrogance or of cultural, legal imperialism. They doubt that developing nations would fare better with legal institutions inspired by what they believe are crassly commercial and materialistic legal cultures.

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17. *See* Kozolchyk, *Commercialization*, *supra* note 11, at 27–28; Kozolchyk, *Fairness*, *supra* note 11, at 233–35.

18. Boris Kozolchyk, *On the State of Commercial Law at the End of the Twentieth Century*, 8 ARIZ. J. INT'L & COMP. L. 1, 7–10 (1991). I have rephrased the original formulation of these principles in later publications. The formulation in the principal text reflects their latest version.

Despite the difficulty of pinning down the meaning of crass materialism, what some of these skeptics truly object to is the prevalence of capitalistically-inspired commercial values. They continue to cling to Marxist-inspired models of economic development, despite undisputable signs of the failure of these models in countries as diverse as China, Cuba, Russia, and those in Eastern Europe. Other skeptics, especially during the nineteen sixties and seventies, seemed under the spell of the bucolic, "return-to-nature" movement of those years. They believe that far from "exporting" their legal institutions, developed nations should learn from developing nations' ability to live with much less and enjoy life as much, if not more, than in capitalist societies. I remember asking one such "neo-Marxist" (who sported the expensive Ivy League tweed jacket and aromatic pipe *de rigeur* among senior "protest" academics of the nineteen sixties) if he had ever discussed his version of life's enjoyment with a poor parent in a developing nation unable to feed, let alone cure, his parasitically bellied child. He had not. I then suggested that had he ever discussed such a topic, he would have quickly learned how heartily that parent would have welcomed any legal institution that provided improvement to such sad living conditions, regardless of the institution's provenance.

Another variation on the theme of exclusively autochthonous solutions to economic development through modernization of commercial law was expressed by a Mexican government official during the North American Free Trade Agreement negotiations. I suggested to him that the Mexican law of secured transactions should be harmonized with Canadian and U.S. laws to be able to provide credit to small and medium-sized Mexican businesses; otherwise, these businesses could not compete on equal terms with their Canadian and U.S. counterparts, which had access to credit at much lower rates of interest. His reply was, "Why should Mexico harmonize its law with that of Canada and the United States and not the other way around?" I told him that his question could only be answered if it was rephrased. What he should have asked was, "Does Mexico want access to credit for its small and medium-sized businesses on the same terms and conditions enjoyed by Canadian and U.S. businesses?" If it did, then, as the old saying goes, "there are only so many ways to skin that cat," and relying on institutions intended for a nineteenth-century world, where, among other principles, real estate was the most valuable asset and movable property was "vile" property, is not the answer.[19]

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19. *See generally* Boris Kozolchyk, *What to Do About Mexico's Antiquated Secured Financing Law*, 12 ARIZ. J. INT'L COMP. L. 523 (1995).

IV. SOME OF THE MAIN CAUSES OF UNREMITTING POVERTY: LACK OF RESOURCES AND FAILURES OF THE OFFICIAL AND LIVING LAW

Some of the causes of the poverty of our archetypal developing-nation parent are not hard to identify. Nations that lack essential physical and human resources find it much harder to feed their hungry than do nations endowed with such resources. Yet even assuming the presence of a modicum of physical and human resources, as is the case with many a developing nation, the main causes of unremitting poverty are legally institutional in nature, as I, among others, have argued for a considerable period of time.[20] A 2006 Report by the World Bank amply confirms this conclusion.[21] It studies comprehensively the monetary estimates of the range of 120 countries' resources (which it refers to as "assets"), including both the "natural, and intangible—upon which development depends."[22] In answer to the question, "[w]hat are the key assets in the generation of well-being?"[23] the authors of the Report emphatically reply: "[m]ost of a country's wealth is captured by what we term intangible capital."[24] This is so because "the development process primarily entails growth in . . . [the] sectors of manufacturing and services, which depend heavily on more intangible forms of wealth."[25]

Thus, "in most countries *intangible capital* is the largest share of total wealth,"[26] and this measure of capital includes human capital, the skills and know-how embodied in the labor force. It encompasses social capital, that is, the degree of trust among people in a society and their ability to work together for common purposes. It also includes those governance elements that boost the productivity of the economy. For example, if an

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20. *See, e.g.*, BORIS KOZOLCHYK, LAW AND THE CREDIT STRUCTURE IN LATIN AMERICA (1966) [hereinafter KOZOLCHYK, LAW AND THE CREDIT STRUCTURE]; Kozolchyk, *Commercialization*, *supra* note 11; Kozolchyk, *Fairness*, *supra* note 11; Kozolchyk, *Highways & Byways*, *supra* note 1; Boris Kozolchyk, *Law and Social Change in Latin America: The Alliance for Progress*, 44 HISP. AM. HIST. REV. 491 (1964); Kozolchyk, *Roadmap*, *supra* note 1; Boris Kozolchyk, *Toward a Theory of Law in Economic Development, the Costa Rican USAID ROCAP*, 4 LAW & SOC. ORDER 681 (1971) [hereinafter Kozolchyk, *Toward a Theory on Law*]. *See also* the pathbreaking essays in CULTURE MATTERS: HOW VALUES SHAPE HUMAN PROGRESS (Lawrence E. Harrison ed., 2001); LAWRENCE HARRISON, THE CENTRAL LIBERAL TRUTH: HOW POLITICS CAN CHANGE A CULTURE AND SAVE IT FROM ITSELF (2006).

21. *See* THE WORLD BANK, WHERE IS THE WEALTH OF NATIONS? MEASURING CAPITAL FOR THE 21ST CENTURY (2006).

22. *Id*. at XIII.

23. *Id.* at XVII.

24. *Id*.

25. *Id.* at XVIII.

26. *Id*. at 87.

economy has a "very efficient judicial system, clear property rights, and an effective government, the result will be a higher total wealth and thus an increase in the intangible capital residual."[27] As pointed out by National Law Center for Inter-American Free Trade ("NLCIFT") research fellow *Licenciado* Octavio Sánchez, one of the most important features of this study is its quantification of what an effective legal system can contribute to economic development. The Report concludes that of the world's total wealth, seventy-eight percent is intangible capital, and of this capital, fifty-seven percent is the direct result of an effective legal system and thirty-six percent of a sound educational system.[28]

The failures of official and living-law institutions—substantive, procedural, administrative, or judicial—are most clearly reflected in the distrust in which these institutions are held by those who should be able to rely on them.[29] A host country's inability to employ, educate, and feed its hungry suffers when investors are unwilling to invest because of their founded fears that governmental entities or private parties will breach their promises with impunity. Similarly, the lenders' unwillingness to lend because of their inability to collect or repossess collateral in a timely and inexpensive manner contributes to the failure to overcome poverty. Nowhere is such a failure more apparent than with respect to the absence of credit for micro-, small-, and medium-sized businesses in the developing world, particularly in Latin American countries.

A 2008 study by the NLCIFT on commercial credit in Honduras revealed that even a bank that specializes in micro and small business loans rejects seven out of ten applications for such loans.[30] An earlier study on secured commercial credit in Mexico showed that this credit was mostly unavailable to small- and medium-sized businesses, and when available, the rates of interest were simply unaffordable.[31] Meanwhile, the Central Bank of Brazil established that during 1999 in Brazil, the risk of uncertainty of collection was the most important factor (one-third) in the

27. *Id*.

28. *Id*. at 4 tbl.1.1, 96 fig.7.2. *See also* Octavio Sanchez Barrientos, Culture and Legal Dogmatism in an Era of Immaterial Wealth 3 (unpublished manuscript, on file with author).

29. Kozolchyk, *Toward a Theory on Law*, *supra* note 20, at 740–45.

30. BORIS ROSEN & GEORGE A. GULISANO, DIAGNOSTIC ASSESSMENT OF CURRENT ACCOUNTING, BUSINESS, BANKING, LENDING AND TAX PRACTICES OF INDIVIDUALS AND SMALL TO MEDIUM-SIZED BUSINESSES AND ANALYSIS OF SECTORS WHICH ARE CANDIDATES FOR PARTICIPATION IN THE PROPOSED HONDURAN SECURED TRANSACTIONS PROGRAM 8 (Dec. 2008) (on file with author).

31. *See* TODD NELSON & BORIS KOZOLCHYK, HARMONIZATION OF THE SECURED FINANCING LAWS OF THE NAFTA PARTNERS: FOCUS ON MEXICO 15–38, 119–20 (1995).

steepness of interest rates paid for commercial loans (around forty percent per annum).[32]

Furthermore, commercial legal uncertainties have a way of triggering highly uncooperative and economically damaging commercial behavior at times uncontrollably. In a study I conducted during the nineteen sixties for the RAND Corporation in Argentina (a study which included other Latin American nations), I described how negotiable instruments such as drafts and checks that were unlikely to be paid at maturity continued to be taken as payments for goods or services by Argentine merchants and bankers.[33] To my question, "[w]hy would you take such an uncertain instrument as payment of obligations?"[34] the answer of merchants and bankers was

> because of the false money psychology[;] i.e., the seller takes it because of his need to sell and hopes that he will be able to pass on that bad check or draft to someone else, as if it were a false coin or bill that regularly comes into and leaves his cash register.[35]

And when asked why that "someone else"—who was as likely to be aware of the poor quality of that quasi-money as the transmitter—would still take that doubtful instrument, the answer was equally picaresque:

> [T]he price of goods or services likely to be paid with that bad money would also be highly inflated and the required down payment in cash would cover the cost of the goods or services plus a small profit; the collection of the remainder would be the seller's gamble . . . .[36]

Thus, the socio-economic cost of a legal uncertainty, nourished by a living law of defaults and a "false money" commercial psychology, sharply increased the already inflated prices of a hyperinflationary marketplace in Argentina.[37]

The lack of trust in merchants and legal institutions is countered by the merchants' distrust of those borrowers who are not well known to them because they are not members of their families or are not part of their close circle of friends. Hence, distrust continues to be at the root of the present lack of commercial credit in Latin America. This was apparent when I visited Mexico and Central America two years ago (prior to the

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32. *See* Departamento De Estudios E Pesquisa, Banco Central Do Brasil, *Juros E Spread Bancario no Brasil* (1999) (on file with author).

33. Kozolchyk, *Law and the Credit Structure*, *supra* note 20.

34. Transcript of Questionnaire Prepared by Boris Kozolchyk, for Argentine Retail (Apr. 12, 1965) (unpublished, on file with author).

35. *Id*.

36. *Id*.

37. Kozolchyk, *Law and the Credit Structure*, *supra* note 20, at 25.

present world financial crisis and collapse of lending sources). I was told by banks, government officials, and central bank economists that banks had ample lending capital at their disposal, yet very few were willing to lend to small businesses unless their owners were very well known to the banks and could supply their "personal" signatures and "good" real estate mortgages as collateral.

The remainder of this Article will analyze how legal institutional cures for the lack of commercial credit have fared and are faring in developing Latin American nations. My hope is that the lessons learned from this experience can improve the chances of success of modernized commercial legal institutions in Latin America and in other developing regions.

V. INSTITUTIONAL CURES FOR THE LACK OF COMMERCIAL CREDIT

As relied on by banks in developed financial centers for approximately two centuries, and more recently in some developing nations, the requirements of "safe and sound" commercial lending are the result of universally tried and tested business and legal practices.[38] From a business standpoint, the borrower must be trustworthy and able to convince the banker that he or she has the ability and willingness to repay the loan and that he or she is in possession of a reliable source of repayment. Unlike real property loans, whose principal collateral is land or buildings and whose value is steady and often increases over time (except in crises such as the present one), commercial loans rely on assets and sources of repayment that are movable and mutable in value. The number and value of commercial assets fluctuate depending upon variables such as the volume of inventory sales, the amounts owed by accredited customers, the market value of intangibles like the business' goodwill, or other intellectual property rights.

As first experienced by English bankers and merchants during the eighteenth century, this type of loan functions best when it can be repaid with the proceeds from the sales of goods, whose acquisition it made possible. From a business standpoint, then, the best commercial loan is one that I have described as "self-liquidating" or that "pays for itself."[39] This fact requires the bank to allow the borrower to remain in possession of the loan-repaying collateral and establish realistic ratios of required collateral in proportion to the amount(s) lent. It also requires that the

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38. *See generally* Boris Kozolchyk, *Introduction*, *in* NAT'L LAW CTR. FOR INTER-AM. FREE TRADE, TRANSPARENCY AND TRUTH IN LATIN AMERICAN BANKING (Boris Kozolchyk ed., 2001).

39. *See* Kozolchyk & Furnish, *supra* note 10, at 243–44; Boris Kozolchyk & John M. Wilson, *The Organization of American States Model Inter-American Law on Secured Transactions*, 36 UCC L.J. 15, 20 (2002).

loans be carefully monitored to assure that, among other things, the ratios of collateral and amounts lent continue to be realistic.

At the other end of the spectrum of requirements is the creditor's ability to repossess and resell the collateral as quickly and inexpensively as possible if his or her debtor fails to repay the loan in time.[40] Side by side with these requirements inspired by best business practices are those derived from the best supervisory practices of national central bankers and their colleagues in public international banking institutions. During the last three decades, these regulators have formulated rules on the adequacy of banking capital that stress the importance of safe and sound risk assessment, collateralization, and transparent reporting practices.[41]

Meanwhile, international legislative bodies such as the Organization of American States ("OAS") and the U.N. Commission on International Trade Law ("UNCITRAL") have enacted, respectively, a Model Law of Secured Transactions for the Americas[42] ("OAS Model Law") and the 2008 UNCITRAL Legislative Guide on Secured Transactions.[43] Another such an enactment is the 1994 Model Law on Secured Transactions for Eastern European countries.[44] What follows is a summary description of the NLCIFT's work in helping to bring about the uniformity of secured transactions law and practice in the Americas by relying on the OAS Model Law as its drafting basis.

VI. THE NLCIFT WORK ON A UNIFORM SECURED TRANSACTIONS LAW IN THE AMERICAS

While the official and living law of secured transactions in the United States and Canada is largely uniform, the rest of the hemisphere, with the

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40. Kozolchyk & Furnish, *supra* note 10, at 256–57; Kozolchyk & Wilson, *supra* note 39, at 88.

41. *See* BANK FOR INT'L SETTLEMENTS, BASEL COMM. ON BANKING SUPERVISION, BASEL II: INTERNATIONAL CONVERGENCE OF CAPITAL MEASUREMENT AND CAPITAL STANDARDS: A REVISED FRAMEWORK (2005), *available at* http://www.bis.org/publ/bcbs118.pdf?noframes=1; BASEL COMM. ON BANKING SUPERVISION, BASEL I: INTERNATIONAL CONVERGENCE OF CAPITAL MEASUREMENT AND CAPITAL STANDARDS (1988, revised 1998), *available at* http://www.bis.org/publ/bcbsc111.pdf?noframes=1. *See also* TRANSPARENCY AND TRUTH IN LATIN AMERICAN BANKING, *supra* note 38, at 180–83.

42. ORG. OF AM. STATES, MODEL INTER-AMERICAN LAW ON SECURED TRANSACTIONS (2002), *available at* http://natlaw.com/seminar/doc12.pdf [hereinafter OAS MODEL LAW].

43. U.N. COMM'N ON INT'L TRADE LAW, LEGISLATIVE GUIDE ON SECURED TRANSACTIONS (2008), *available at* http://www.uncitral.org/pdf/english/texts/security/combined legislative %20guide.pdf.

44. EUROPEAN BANK FOR RECONSTRUCTION & DEV., MODEL LAW ON SECURED TRANSACTIONS (1994), *available at* http://www.ebrd.com/country/sector/law/st/core/model/model law.pdf.

exception of Guatemala and, hopefully soon, Honduras, lacks such a modern uniform law. Hemispheric uniformity had an auspicious beginning with the above-mentioned OAS Model Law. It inspired Guatemala's enactment of Decree 51-2007 of October 24, 2007,[45] as well as the likely enactment of a Honduran counterpart statute[46] and implementing legislation. In 2006, Peru also enacted a law inspired by the OAS Model Law,[47] but it contains serious substantive and registry law deficiencies that have made it basically an inoperative law at this time. Mexico enacted partial versions of the OAS Model law as well, first in 2000,[48] and subsequently in 2003.[49]

A. The Drafting of the OAS Model Law

1. The Mexican SECOFI Draft and the NLCIFT Principles of Secured Transactions Law

The OAS Model Law benefited considerably from the earlier drafting of a secured transactions law for Mexico, a task that was started in 1996, and concluded in 2003.[50] At the direction of Mexico's then-President Ernesto Zedillo, the Secretariat of the Economy and Industrial Development ("SECOFI") became the drafting agency, and it invited the

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45. *Ley de Garantías Mobiliarias*, Decree 51-2007, enacted Oct. 24, 2007, published in the Official Gazette on Nov. 16, 2007 (Guat.), *available at* http://natlaw.com/hndocs/stgubk00033.pdf [hereinafter Guatemalan, *LGM*].

46. Honduran Law on Secured Transactions (working draft), *available at* http://www.natlaw.com/hndocs/sthnbk-drjul08.pdf (last visited Feb. 17, 2009).

47. *Ley de la Garantía Mobiliaria*, Law 28677, enacted Feb. 10, 2006, published in the Official Gazette on Mar. 1, 2006 (Peru), *available at* http://natlaw.com/interam/pe/pp/st/stpepp00001.htm [hereinafter Peruvian, *LGM*].

48. *Decreto por el que se Reforman, Adicionan y Derogan diversas disposicones de la Ley General de Títulos y Operaciones de Crédito, del Código de Comercio y de la Ley de Instituciones de Crédito* [Decree to Enact Secured Transactions Law], Diario Oficial de la Federación [D.O.], 23 de Mayo de 2000 (Mex.), *available at* http://natlaw.com/interam/mx/pp/dc/prmx31.htm [hereinafter *Mexican Decree of 2000*].

49. *Decreto por el que se reforman, adicionan y derogan diversas disposiciones de la Ley General de Títulos y Operaciones de Crédito, del Código de Comercio, de la Ley de Instituciones de Crédito, de la Ley del Mercado de Valores, de la Ley General de Instituciones y Sociedades Mutualistas de Seguros, de la Ley Federal de Instituciones de Fianzas y de la Ley General de Organizaciones y Actividades Auxiliares del Crédito* [Decree to Reform Mexico's Secured Transactions Law], Diario Oficial de la Federación [D.O.], 13 de Junio de 2003 (Mex.), *available at* http://natlaw.com/interam/mx/pp/dc/dcmxbk23.htm [hereinafter *Mexican Decree of 2003*].

50. For a short account of the drafting of this law and its subsequent equally incomplete reforms, see Kozolchyk & Furnish, *supra* note 10, at 278–94.

NLCIFT to participate in the drafting effort.[51] The draft was fully discussed with and approved by the Mexican Bankers Association and members of the management and legal staff of BANAMEX, S.A (at that time Mexico's largest bank). It was also reviewed and endorsed by some of Mexico's most respected commercial law scholars, such as Professor Raúl Cervantes Ahumada and Dean Miguel Acosta Romero of the National University of Mexico Law School. In addition, it was the subject of thorough discussions at the College of Public Notaries that involved highly qualified practitioner-scholars.[52]

The Mexican notaries submitted a number of questions to the NLCIFT and suggested that joint meetings be held on the topic of "How Compatible Is the Proposed Law with Mexican Legal Institutions: Which Institutions Are Incompatible and Why?" In preparation for these sessions, I used a set of principles first employed when briefing Mexican government officials and legislators (these principles underwent subsequent revisions until a final version was published by the NLCIFT in 2006).[53] As will be discussed shortly, these principles proved helpful for didactic and drafting purposes, especially in connection with the subsequent secured lending statutes for Guatemala and Honduras. They can be found in Appendix 1, and the reader is encouraged to review them at this time.

As drafting tools, the NLCIFT Principles proved helpful because (1) they provide summaries of the best practices for secured lending, and they also provide good starting points for the drafting of many rules; (2) they facilitate the search for compatible and incompatible local legal institutions by allowing questionable provisions to be compared with applicable principles; (3) they help to select rules that must be made mandatory in light of inconsistent local law and practice; (4) they contribute to a draft's internal coherence by enabling checks for consistency between or among rules that appear to be in conflict with one another and their supporting or excluding principles; (5) as statements of the rational bases of technically complex rules, they help explain these rules to local legislators, judges, registry officials, or practicing lawyers who lack the

51. The NLCIFT staff members who participated in the drafting efforts with SECOFI were *Licensiado* Francisco Ciscomany, John Molina Wilson, Esq., presently Legal Counsel at the OAS (at that time a Project Coordinator for the NLCIFT), and Boris Kozolchyk.

52. Especially, the highly qualified practitioner-scholar, the then-President of the College of Public Notaries, *Licensiado* Adrian Iturbide and his colleagues, *Licensiado* Miguel Alessio and *Licensiado* Javier Arce Gorgollo.

53. *See* NAT'L LAW CTR. FOR INTER-AM. FREE TRADE, NLCIFT 12 PRINCIPLES OF SECURED TRANSACTIONS LAW IN THE AMERICAS (2006), *available at* http://www.natlaw.com/bci9.pdf [hereinafter 12 PRINCIPLES]. *See also id.* app. 1. The drafting group for the 12 Principles consisted of Mariana Silveira, Dale Beck Furnish, Marek Dubovec, and Boris Kozolchyk.

necessary transactional background; and (6) their international nature helps to bridge the perceived conflicts between the civil and the common law systems by showing how Roman law (at the root of both) provided conceptual bases applicable to these two systems and their secured transactions laws.

Consider, for example, NLCIFT Principle 2:

> A security interest is a preferential right to possession or control of personal property. As such, it does not require that the debtor who grants the interest have title to the personal property collateral; his right to its possession, even though co-existent with other possessory rights in the same property by other creditors and debtors, will allow the creation of the security interest.[54]

Consider also Uniform Commercial Code ("UCC") section 9-202, whose heading is "Title to Collateral Immaterial." This provision validates rights and obligations of the parties to a secured transaction "whether title to the collateral is in the secured party or the debtor."[55] At first sight, this is sheer heresy to a civil lawyer brought up with the Roman law axiom *regula iuris—nemo plus iuris in alium transferre potest quam ipse habet*, also known as *nemo dat quod non habet*. That is, "no one can convey what he does not have" and thus a debtor cannot grant a security interest in property he does not own. Yet, as set forth by NLCIFT Principle 2, the right granted to the creditor by the debtor is not one of ownership, but rather, of possession. As long as the debtor has a right to the possession of the collateral, whatever its lawful source, he or she can convey such a right to the creditor, much as the Romans conveyed possessory rights in the things of others (*jura in re aliena*).[56]

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54. *Id.* princ. 2.

55. In its relevant part, this provision states: "[e]xcept as otherwise provided . . . the provisions of this Article with regard to rights and obligations apply whether title to collateral is in the secured party or the debtor." U.C.C. § 9-202 (2000).

56. For more on this concept, see Kozolchyk & Furnish, *supra* note 10, at 247.

> Roman law lawyers referred to as possessory rights or *iura in re aliena*. These are also rights in property owned by others, and even though they were lodged below the exalted level of dominium, or absolute ownership, they were also lodged above the level of rights of detention or of physical, albeit legitimate, control of real or personal property.
>
> Among the rights in rem in property that belonged to others were the Roman usufruct, which could be granted for the life of its beneficiary or for the life of third parties and the predial servitudes. However, unlike the English common law, which regarded "time in the land" rights as transferable and saleable by their holders, Romans, as a rule, regarded the usufruct and analogous rights as personal to their beneficiary and therefore non-saleable.

Thus, neither NLCIFT Principle 2, nor the rules that rely on what are essentially possessory rights to create a security interest, violate the above quoted Roman and civil law maxim or *regula iuris.* The ability to demonstrate the compatibility between U.S. security interests, and the Roman civil law and Mexican possessory rights enabled SECOFI and NLCIFT to secure the endorsement of highly influential Mexico City notaries, among other respected Mexican jurists.

Upon completion of the SECOFI draft, it was forwarded to the Office of the Presidency, which referred it to the Office of the Legal Advisor to the Secretary of the Treasury. At this office, the draft was considerably altered without consultation with the original drafters and its, by then, numerous and important constituencies. While in some respects the final text represented an advance over preexisting law, in most others it was a retrocession. As reformed in 2000,[57] this law contained several provisions that were contrary to the tried and true banking practices reflected in the NLCIFT Principles. For example, in the event of the debtor's default, it limited the amount of the creditor's recovery to the value of the repossessed or resold collateral.[58] This requirement did not take into account that the type of collateral involved in commercial loans generally depreciates and does so quickly. Faced with such an artificial limit, the lender was forced to either lend much less or require much more collateral in order to retain a realistic ratio between the amount lent and the supporting collateral. Similarly, the law retained a regime of secret liens by allowing a number of existing security interests that did not require public notice to continue to be used side by side other security interests that did require such notice.[59] In 2003, the Mexican Ministry of the Treasury tried to correct some of these mistakes and others it made by reinserting some of the SECOFI draft provisions, but in doing so, it retained other problems, especially those that preserved the regime of secret or disguised liens for such massive secured loans as disguised ("simulated") financial leases.[60]

Despite the absence of key requirements, such as the elimination of the regime of secret liens, a perceived improvement in the certainty of collection prompted by the amendments' extrajudicial repossession and resale of collateral caused a significant increase in commercial and consumer lending during the two years that followed their enactment.[61] Yet,

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Id.

57. *See Mexican Decree of 2000*, *supra* note 48.
58. *Id*. art. 379.
59. *See* Kozolchyk & Furnish, *supra* note 10, at 280.
60. *See id.* at 280–94.
61. *Id.* at 239–40.

once lenders realized the continuing secrecy of a number of liens and the delays of extra-judicial enforcement, the volume of secured lending fell again. As of the time of this writing, Mexico's secured lending law remains largely ineffective, awaiting what is hopefully its final revision and implementation.

2. The OAS Model Law

In December 1998, the OAS Permanent Council convened a meeting of experts to establish the topics for its forthcoming treaty/model law sessions.[62] It approved discussion of using a joint Mexican-U.S. Draft of a Model Inter-American Law on Secured Transactions as the working document. This document contained rules responsive to the NLCIFT Principles, SECOFI's draft law, as well as to the rules in UCC Article 9, the Canadian Personal Property Security Act, and the United Nations Convention on Assignment of Accounts Receivable in International Trade.[63] The OAS delegates agreed to study this draft at two subsequent experts' meetings.[64] Finally, delegates and experts appointed a drafting committee headed by the delegations from Mexico and the United States, which produced an annotated draft of the Model Law in 2000.[65]

Ironically, the draft that Mexico and the United States submitted to the General Assembly of the OAS for its approval retained most of the provisions from the same SECOFI draft that was discarded by Mexico's own Office of the Legal Advisor to the Secretary of the Treasury a few months earlier. As just noted, this OAS draft of a Model Law for the Americas was carefully studied by the OAS Group of Experts, comprised of highly respected jurists and commercial law specialists from the entire hemisphere.[66] After a thorough examination, it was approved and submitted to the General Assembly of the OAS for a final vote. During this vote, OAS delegates made some changes, particularly to the provisions on extrajudicial enforcement. The final vote was unanimous in favor of recommending its adoption by Member States.

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62. *See* Org. for Am. States [OAS] P.C. Res. 1173/98, OAS Doc. CP/RES. 732 (Oct. 21, 1998).

63. For a detailed description of the drafting and adoption processes at the OAS, see Kozolchyk & Wilson, *supra* note 39, at 22–35, 40–42, 59.

64. OAS G.A. Res. XXVIII-O/98, OAS Doc. AG/RES. 1558 (June 2, 1998).

65. Among the participants in Washington, D.C., were, on behalf of Mexico, Alejandro Ogarrio, Jorge Sánchez Cordero, Leonel Pereznieto, and José Luis Siqueiros, and on behalf of the United States, José Astigárraga, Boris Kozolchyk, and John M. Wilson. *See* Kozolchyk & Wilson, *supra* note 39 (opening sentiments of gratitude).

66. *See* Boris Kozolchyk, *Meeting of OAS-CIDIP-VI Drafting Committee on Secured Transactions Conference Transcript*, 18 ARIZ. J. INT'L & COMP. L. 321 (2001).

B. Adoptions by OAS Member States

In addition to the above-described partial and incomplete adoption by Mexico in 2000 and 2003, the OAS Model Law has been adopted by Peru and Guatemala and is expected to be adopted by Honduras in May or June of 2009. El Salvador continues to debate its adoption and the Costa Rican and Ecuadorean governments have recently expressed an interest in doing the same. The following are brief reviews of the existing and likely adoptions.

1. Peru

Peru adopted its version of the OAS Model Law in 2006.[67] Unfortunately, many of its provisions contradict the OAS Model Law and misinterpret the NLCIFT Principles and practices that inspired them. As a result, this law is already being criticized by Peru's bench, bar, and commentators.[68] Several provisions illustrate its poor quality.[69]

Article 7 allows the perfection of successive security interests in the same collateral, but requires that a notary public give notice to the holder of the "first" security interest (presumably the secured creditor who recorded first).[70] This provision misunderstands the principle of functional notice as set forth in NLCIFT Principles 6 and 7. As stated by NLCIFT Principle 7, in relevant part: "[r]egistration should be inexpensive and should take place in a public registry easily accessible to third parties regardless of nationality or economic sector, if at all possible by electronic means . . . ."[71] By requiring a notarial notification where, for some unexplained reason, the only party to be notified appears to be the holder of the first recorded security interest, a costly and incomplete notice is introduced.

Article 9 precludes the co-existence of, say, a possessory security interest in goods warehoused and in transit, with the security interest in a

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67. Peruvian, *LGM*, *supra* note 47.

68. For an illustration of some of the criticism, see Crítica a Ley de Garantías Mobiliarias, http://vlex.com.pe/tags/critica-a-ley-garantias-mobiliarias-466469 (last visited Apr. 12, 2009).

69. This section is based on a Memorandum submitted to the Peruvian *Superintendencia Nacional de Registros Públicos*. Boris Kozolchyk, Memorandum, *Comentarios a la Ley de Garantías Mobiliarias del Perú* (May 1, 2009), *available at* http://www.natlaw.com/interam/pe/bk/sp/sppebk 00002.pdf.

70. Peruvian, *LGM*, *supra* note 47, art. 7. "Successive Security Interests. During the term of effectiveness of a security interest, the grantor [of the security interest] may create a subsequent security interest with lower priority over the same movable property, by giving notarial notice to the senior secured creditor." *Id.* (author's translation).

71. *See* 12 PRINCIPLES, *supra* note 53, princ. 7.

document of title covering the same warehoused or transported goods.[72] This provision ignores the long-standing and important practice of providing a carrier or warehouseman with a statutory lien or right of retention of the goods for the unpaid freight or storage fees, while allowing the creation of a contractual security interest in the document of title that covers the same goods. There is no reason for these security interests not to co-exist as long as a clear priority rule is provided for them as is done by the OAS Model Law.[73]

The second paragraph of Article 15 misunderstands what proceeds are in the context of manufactured goods and how they are used as collateral. These misunderstandings create a costly and outside-of-the-registry system of notarial notice. This paragraph states that

> [i]f the debtor transforms personal property collateral [an original good or raw materials] into a second good, such a good will be subject to the security interest. The debtor[, however,] is obligated to notify the secured creditor within a period of five days by means of a notarial communication de [sic] date during which the transformation took place and features of the new movable property. In such a case the secured creditor shall record in the corresponding registry that security interest over the new movable property, cancelling the preexisting security interest.[74]

Note the limitation placed upon proceeds when they are referred to as a "second good." It would seem, then, that only a first generation of

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72. Peruvian, *LGM*, *supra* note 47, art. 9.

> Security interests in documents of title over movable property. When, pursuant to the provisions of this Law, a security interest is granted in a document of title over movable property, it shall not be possible to create a direct security interest over the movable property covered by such document of title.

Id. (author's translation).

73. *See* OAS MODEL LAW, *supra* note 42, art. 26, ¶ 2 ("A security interest in documents may coexist with one on the movable property covered by it; the latter will have the priority given to it by Article 51.").

74. *See* Peruvian, *LGM*, *supra* note 47, art. 15.

> If the debtor transforms the movable property granted as security interest into additional movable property, the security interest will cover the new movable property. The debtor must give notice to the secured creditor of the date in which the movable property was transformed and the characteristics of the new movable property resulting from the transformation, [notice must be given] by means of a notarial letter and within [five] days. In this case, the secured creditor must register the security interest in the new movable property at the Registry, freeing it from the security interest previously created.

Id. (author's translation).

proceeds is allowed as collateral and presumably based upon a separate proceeds' filing. Yet, the Peruvian law's own definition of "inventory," defective though it is,[75] authorizes the inclusion of "second" goods as components of such inventory collateral. In addition, what Article 15 refers to as a "second good" bears the same conceptual restriction of collateral referred to as "products" in early twentieth-century agrarian pledge laws in Latin America; that is, goods that replaced earlier goods had to be of the same kind as those replaced or manufactured with the same raw material as collateral.[76] Needless to say, such a restriction makes the Peruvian concept of "second goods" considerably narrower than that of proceeds in both the NLCIFT Principles and the OAS Model Law.[77]

Some of the dysfunctional, costly, and uncertain consequences of Article 15 can be illustrated in the following everyday transaction. "M," a manufacturer of furniture, purchases lumber on credit from "S," M expects to manufacture thousands of individual chairs, tables, etc., secured by loans from S and M's bank, "C." S and C rely on the same raw materials, inventory, and proceeds as their collateral. Article 15 requires that by means of a notarial communication, M notify S (and presumably C as well) of the date(s) the furniture was manufactured and of the new furniture's features, conceivably even the features of each new desk or chair. Moreover, it does not clarify whether S and C's priorities on the pieces of furniture and other proceeds will depend upon when each creditor received notice of their manufacture or upon the dates of their respective filings; nor does it even clarify whether the original filings on "raw materials and inventory" or their floating lien (*garantía abierta*) will retain

75. *Id*. art. 2(10) ("Inventory: a set of moveable goods in the possession of a person for its consumption, transformation, sale, exchange, lease or any other commercial transaction in the ordinary course of its commercial activity."). It should be noted that the inclusion of consumer goods as part of inventory for goods, while part of an inventory, are not supposed to be consumed by whoever holds them as such. They become consumer goods once they are bought and taken out of a commercial inventory.

76. *See* Kozolchyk & Furnish, *supra* note 10, at 257; Kozolchyk & Wilson, *supra* note 39, at 37.

77. Notice that NLCIFT Principle 3 makes it clear that a security interest may be created in assets, present or future, tangible or corporeal, and all types of intangible or incorporeal, including rights to the same, as well as in the proceeds of this collateral, whether in their first or future generations. This principle assumes that personal property collateral is open in number (*numerus apertus*) and that a security interest may be created in any personal property susceptible to monetary valuation. 12 PRINCIPLES, *supra* note 53, princ. 3. For illustrations of proceeds included in the OAS Model Law that are not included as proceeds in the Peruvian law category of "second goods," see OAS MODEL LAW, *supra* note 42, arts. 2, 3(V), 25, 51(III).

their respective priorities based upon the dates of their original recordings. Finally, it does not answer the question of why S and C should have to undertake the notarial notifications and additional recordings if the Peruvian law allows security interests in collateral, generically described as "raw materials and inventory," and allows an open-ended floating lien, referred to as an "open security interest" (*garantía abierta*).[78]

Articles 17 and 19 leave the impression that what must be filed in Peru to give notice to third parties and affect their rights in the collateral is not merely the simple and terse financing statement required by the OAS Model Law, but actually the security agreement itself, or the *acto jurídico constitutivo de la garantía*.[79] This requirement contradicts the abovementioned NLCIFT Principles 7 and 8 of a "functional notice" or notice filing. It also subjects the filing of the agreement, in lieu of a standardized financing statement, to possible actions on nullity, because the agreement itself may lack the formalities required by Peru's civil or commercial code, or it may contain an invalid "cause" (*causa*). It also forces the registry to become an evaluator of the legal soundness of security agreements, rather than an automated custodian of financing statements with only ministerial responsibility for the completeness of the filings.

To compound this confusion, Article 19 requires additional elements in the security agreement. After listing data such as the identification and domicile of the grantor of the security agreement, signature, and "in the case of unrecorded personal property, an affidavit by the grantor that he is the owner of the property subject to the security interest," it indicates that the grantor shall "assume the civil and criminal liability derived from the falsity of such a declaration."[80]

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78. Peruvian, *LGM*, *supra* note 47, art. 3(3.4) (provision on open security interests).

79. *Id.* art. 17 (stating, in its relevant part, that the relationship between the parties to a security agreement is created by means of a bilateral or multilateral contract, which it alludes to as the *acto jurídico constitutivo* and goes on to say that it must be recorded in the appropriate registry).

80. *Id.* art. 19.

> Content of the legal contract (*acto jurídico constitutivo*) creating the security interest. The contract creating the security interest must contain, at least: (1) Information to identify the grantor [of the security interest,] secured creditor and debtor, including their domicile, as well as written or electronic signature of the grantor. (2) In the case of collateral that is not subject to registration, an affidavit by the grantor stating that s/he is the owner of the movable property granted as security interest. The grantor will be civil and criminally liable for deceit or inaccuracy of this statement.

Id. (author's translation).

Consider the predicament of a Peruvian secured transactions lawyer having to advise his client-debtor-grantor of the security interest on his civil and criminal liability flowing from an affidavit of ownership. Assume that the collateral pledged by the secured debtor are inventory goods subject to a retention of title agreement until the full purchase price is paid to the seller or to another secured lender (an agreement that is as common in Latin America and Europe as it was in the United States until the nineteen fifties and the adoption of Article 9 of the UCC). Even though his client, the secured-debtor, has possessory rights in that collateral, and thus should be able to use them to secure a loan in a manner compatible with the retention of title by the seller, he must advise her not to do so, lest his client risk a jail sentence.

This is one of the reasons why the above-mentioned NLCIFT Principle 2 as well as OAS Model Law Article 2 make it clear that title to the collateral is immaterial and can be in the hands of the secured creditor or debtor, among others. A similar requirement of secured debtor ownership of the collateral appears or is implied from the language of Articles 21–24 of Peru's law.

These are not the only problems to which Articles 17 and 19 of the Peruvian law give rise. When Article 36 sets forth the duties of the registrar of security interests in movable property, it notes that his evaluation of the filed transaction's legality and formal validity and of the contracting parties' capacity is "limited only to what appears in the pre-printed form (financing statement) and its certification . . . . The registrar shall, in no case, request the filing of the security agreement (*acto juridico constitutivo de la garantia mobiliaria o generador del acto inscribible*)."[81] So, what needs to be filed to "affect the rights of third parties"—the security agreement or the financing statement? Or is it perhaps both, because as will now be discussed, there are two registries created by this law, one for the movable property collateral and the other for contracts or security agreements?

Article 32 provides a list of recordable juristic acts or transactions in two distinct registries:

81. *Id*. art. 36.

> The evaluation made by the Registrar as to the legality and validity of the registered transaction and the capacity of the parties [to such transaction] will be limited only to the content of the Registration Form and its certification. The Registrar must evaluate the legal authority [of the parties], if applicable. The registrar may under no circumstances request the filing of the contract creating the security interest or the contract that generated the registration.

Id. (author's translation).

(1) Security interests, their creation, perfection, amendments or eventual assignment;

(2) Judicial or administrative decrees and arbitral awards as related to this law;

(3) The juristic acts enumerated hereafter for purposes of their notice, priority and ability to raise them against the contracting or third parties, whatever their form, if they have an effect upon moveable property or rights thereto, whether they are determined or determinable, subject to terms or conditions or not, including: a) assignment of rights; b) trusts; c) ordinary leases; d) financial leases; e) consignment agreements; f) pre-trial cautionary proceedings; g) preparatory agreements; h) options; and i) other juristic acts that create rights in moveable property.[82]

When the recordable acts or transactions referred to in this Article involve movable goods already registered in the Registry of Movable Property ("RMB"), they are recorded in the appropriate section of that Registry. If they do not, they are recorded in the Registry of Security Agreements ("RMC"). Recordable acts or transactions that involve future movable property shall be recorded in the RMC, where they remain even after they cease to be future goods, with the exception of movable goods certain to come about, which shall be registered in the RMB, whose recorded acts shall be transferred to the corresponding registry.[83]

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82. *Id.* art. 32.
83. *Id.*

Acts that may be registered.

The following contracts related to movable property listed under article 4 of this Law may be registered: (1) The security interest to which this Law refers and contracts related to its effectiveness, amendment or possible assignment. (2) Judicial, arbitral or administrative decisions related to security interests governed by this Law. (3) With respect to their priority, effectiveness against third parties and publicity, the legal contracts listed below, regardless of their form, nomenclature or nature, [and] whose object is to affect movable property or rights of all natures, present or future, determined or determinable, [and] whether they are subject or not to a formality, including: (a) assignment of rights; (b) trusts; (c) leases; (d) financial leases . . . . When the contracts listed in this article affect movable property registered at a Property Registry, these [contracts] will be registered in their relevant registry sheet. Otherwise, they will be registered at the Registry of Movable Contracts. Contracts related to future movable property will be registered at the Registry of Movable Contracts and will remain there even when they are no longer future movable property, except for real movable property that must be registered at the Property Registry, [in which case] these registered contracts will be transferred to the relevant registry.

If the reader is puzzled about the meaning and consequences of this provision, he or she is in good company. At a recent hemispheric Rule of Law Conference held in Mexico City in June 2008, I moderated a panel of Latin American chief justices, and Chief Justice Francisco A. Tavara Cordova of the Supreme Court of Peru wasted no time in inquiring, with evident concern, if the NLCIFT or I had anything to do with this law, and in particular with Article 32. I quickly disabused him of any notion of NLCIFT involvement.

To begin with, this Article directs the filing of the security interest in personal property to two ill-defined, possibly overlapping and thus competing registries. In addition, Article 32 does not clarify the relationship, if any, between or among these registries and other possible registries, such as those for airplanes and aircraft parts, railroad equipment and tracks, fixtures, and crops. For example, where does a security interest in fixtures and crops have to be filed, in the Article 32 registries or in the Real Property Registry? If in the latter, in the case of, say, fixtures, the number of registries to check in Peru would have to be at least three. The possibility of conflicting results on the perfection and priority of the various recordings looms large in Peru—and so does endless litigation.

And as if all of the above were not enough, Article 36 requires the two registries mentioned in Article 32 to engage in a legal evaluation of the filers' powers of attorney to enter into the security agreement, as well as the presence of an interrupted chain of title to the movable property collateral (as if it were possible in the majority of instances).[84] These two

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Id. (author's translation).

84. *Id*. art. 36.

> In case of movable property subject to registration [at a property registry], the Registrar shall also verify that the content of the Registration Form is consistent with the registry's information . . . . In this case, the filer, the person granting the security interest or any of the parties related to the filing, may file before the Registrar, additional documentation as needed, including the contract creating the security interest or contract related to the registration. In case of [filing of] the latter documents, the Registrar will limit is evaluation only to what is necessary to make the Form consistent with the registry information . . . .
>
> In case that the Registrar finds that the filing has a . . . defect that may be corrected, [the Registrar] will make a precautionary notation of the relevant filing for ninety (90) business days . . . . If the defect is corrected within such term, the Registrar will register the filing, converting the precautionary notation into a definite registration. Otherwise, the precautionary notation will be terminated by law. The term previously mentioned[] may be modified by the SUNARP by means of a regulation.

Id. (author's translation).

requirements, among others, are responsible for serious delays in the filing of security interests in Peru, thereby negating the functional notice required by Principles 7 and 8 of NLCIFT and implemented by Articles 42–46 of the OAS Model Law.

2. Guatemala

(a) The Law and Some of Its Goals

On October 24, 2007, the Guatemalan Congress approved the country's law of secured transactions and Latin America's first statute fully congruous with the purposes and text of the OAS Model Law as well as the NLCIFT Principles.[85] It took Guatemala approximately three years of drafting, followed by intensive lobbying of numerous constituencies, including the congressional representatives of commercial and farming interests; official and unofficial leaders of small businesses and farmers; chambers of commerce and chambers of exporters and importers; banking associations and central bankers; and other high government officials, such as legislators and judges. In its official news release, the Head of Public Affairs of the Guatemalan Congress stated:

> By means of Decree 51-2007 the Plenum of the Congress of the Republic approved the "Law of Secured Transactions on Personal Property" (*Ley de Garantías Mobiliarias*) whose purpose is to enable access to credit to small producers who will be able to provide their tools, equipment, crops and harvests, and other assets as securities. Access to credit by means other than real estate mortgages implies a sensible increase in the working capital of small producers thereby increasing their productive capacity.[86]

This news release's emphasis on agricultural credit was neither accidental nor mistaken. Even though the law enabled the collateral and security interests to take on an open-ended nature that favored all types of small- and medium-sized businesses, the small farmers and their cooperatives were the ones who most actively campaigned in favor of this law. Contrary to my expectations, the members of the bankers' association, whom I had envisioned as beneficiaries of this law, were not among its initial supporters. They were unwilling to assume the risks of lending to small businesses and farmers even if secured by valuable assets, albeit

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85. *See* Guatemalan, *LGM*, *supra* note 45; OAS MODEL LAW, *supra* note 42; 12 PRINCIPLES, *supra* note 53.

86. Héctor Solis, Departamento de Comunicación Social, Congress of the Republic of Guatemala, *Cosechas u Otros Activos* (Oct. 24, 2007), *available at* http://www.congreso.gob.gt/gt/ver_noticia.asp?id=4377.

with which they had little experience. After all, theirs was a stable and profitable industry. Why take risks that in their eyes endangered the safety and soundness of their traditional assets? Conversely, the small farmer and businessperson had never had access to asset-based credit and were only too willing to campaign for this law.

The need for a sound secured transactions law had been identified by *Fundación para el Desarrollo de Guatemala* ("FUNDESA"), one of Guatemala's premier private sector associations. As pointed out by a FUNDESA 2002 study,[87] while eighty percent of developed countries' credit transactions were secured by business assets of one type or another, only thirty-five percent of Guatemalan banks' loan portfolios were secured by assets in general, and only four percent of all of their total loans were secured by business assets of any kind.[88] Accordingly, the FUNDESA study confirmed the bankers' reticence to lend to small- and medium-sized businesses on the security of their business assets.

In earlier decades, this reticence might have quickly caused a congressional rejection of the proposed law of secured transactions. Yet times had changed; twenty-first-century Guatemala is a more pluralistic country. Surely, the Guatemalan Congress was willing to listen to bankers, its traditional interlocutors in financial matters, but it was also willing to listen to farmers, farming cooperatives, small business associations, and their supporters inside the State's Monetary Council (Guatemala's most influential governmental body in financial and economic decision making).

(b) How to Attain the Law's Goals

i. Participants and Tasks

Even the shortest of summaries of this landmark statute's enactment must mention the work of the Vice Minister of the Economy, Carlos Herrera, a man endowed with innate wisdom, courage, humility, unshakable honesty, and concern for the "little people" of Guatemala. In the absence of bankers willing to participate, he appointed a Drafting Commission ("Commission") comprised of distinguished former public and private banking lawyers who were also sympathetic to the plight of Guatemala's

87. FUNDESA-BID-CIEN, *Análisis de los Impedimentos a la Competividad en Guatemala: Garantías Financieras* 3 (2003) (Guat.) (on file with author) [hereinafter *FUNDESA Study*].

88. *Id.* at 3 n.1.

small businesses.[89] Jorge Molina was the coordinator of the Commission. *Licenciado* Molina was a nonlawyer but had been a superintendant of banks; in that position he acquired a firm grasp of the preconditions of a modern commercial credit system and came to regard the NLCIFT Principles as "the spirit of the law." I acted as the technical advisor of the Commission.

Prior to drafting, the Commission arrived at a consensus on observing the NLCIFT Principles as, in *Licenciado* Molina's words, the "guiding spirit" behind the OAS Model Law and Guatemala's future law. The next decision was to prioritize the sectors most deserving of protection by the law. The first sector chosen was agriculture. Given its economic importance for Guatemala, the financing of agricultural production for local and international consumption had to be given special attention. Hence, attention was paid to the rules that governed security interests in seeds, fertilizers, equipment, and present and future crops, whether warehoused or transported, whether covered by paper-based or electronic documents of title. The law's focus on commercial credit at reasonable rates of interest aimed to replace the usurious practices of those who bought small farmers' crops for fractions of their market value and resold them at many times their purchase price.

Other sectors similarly chosen for protection were the small urban and rural shop owners, and professionals who would also be able to use their inventories, fixtures, equipment, contract rights, and accounts receivable as collateral, however informally recorded or documented.

ii. The Drafting

Unfortunately, much of the initial generous funds made available by the Inter-American Development Bank ("IADB") to Guatemala had been spent on workshops concerning the advisability of a law of secured financing and on poorly drafted projects. By the time I joined this project, only meager funds were left, and none were available for field research on contemporary market conditions and practices or on the crucial design of a secured transactions registry. Commission members had to rely on their own knowledge of these conditions and practices. Later drafts benefitted from the participation of *Licenciada* María del Pilar Bonilla, an able banking and commercial lawyer and law professor who quickly and firmly grasped the "spirit" of this law. Her presence as one of the drafters

89. The drafting commission was formed by *Licensiado* Daniel Orlando Cabrera García, Secretary; Jorge Molina, Coordinator; Augusto René Ramírez Hernández; Arturo Martínez Gálvez; and Gustavo Antonio de León Asturias.

made the final drafting style more "Chapin" like ("Chapin" is a popular expression in Guatemala to denote what is peculiarly Guatemalan).

a. The Problem of Consistency with French-Inspired Civil Codes

One of the first warnings I received from members of the Drafting Commission was the need to avoid, whenever possible, the abrogation of Guatemalan Civil Code provisions. I was aware of the importance of civil codes in the private law of civil law nations, where they often act as the "constitutions" of their private law by providing basic definitions, general principles, and default rules that fill the gaps in their companion commercial codes, among other private law statutes.[90] I was also aware, however, that many of the nineteenth-century French-inspired civil codes were not supportive of commercial legal institutions in particular or of profit making through commerce and related endeavors. After all, unlike commercial codes, civil codes governed "civil," meaning "not for profit," transactions. This attitude was responsible for the characterization of the professional, albeit profit-making, activities of physicians, lawyers, accountants, and engineers as those of not-for-profit "civil law associations."[91] In addition, civil codes of the French extraction tended to ascribe greater certainty to agreements entered into with costly formalities such as *actes authentiques* (public or notarial deeds) and to "typified" and classified contracts than to those agreements concluded by means of the informal communications common to everyday commerce.[92] These codes also lacked provisions for contracts entered into *inter ausentes* or by parties at a distance from one another, and for the protection of third parties who lent or purchased relying on what appeared in France's first and highly uncertain land registry.[93] Their requirement of both a legal and moral cause (*causa*) as one of the pillars of a valid contract, such as a loan agreement, endangered the rights of third parties, such as subsequent and innocent holders of negotiable instruments issued by the original debtors. This was especially true where the underlying loan agreement was deemed usurious; however loosely defined, usury automatically embodied an illegal or immoral cause. And where a registrar had to evaluate such a cause to determine the validity of an underlying contract, as is the case of the Peruvian law discussed earlier, the results could be equally as damaging.

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90. *See* FREDERICK HENRY LAWSON, A COMMON LAWYER LOOKS AT THE CIVIL LAW: FIVE LECTURES DELIVERED AT THE UNIVERSITY OF MICHIGAN, NOVEMBER 16, 17, 18, 19 AND 20, 1953, at 167 (1955).

91. *See* Kozolchyk, *Commercialization*, *supra* note 11, at 4.

92. *See id.* at 6–17. *See also* Kozolchyk, Printed Class Materials, *supra* note 1, at IX-7.

93. *See* Kozolchyk, *Commercialization*, *supra* note 11, at 6, 12.

Another harmful feature of the French Code Civil, where commercial legal institutions were concerned is its Aristotelian-scholastic style for drafting definitions and classifications, especially in the sections on obligations and contracts. Consider, for example, the manner in which the term "contract" is defined and classified in Articles 1101, 1102, and 1103 of the Code Civil:

> A contract *is* an agreement which binds one or more persons, towards another or several others, to give, to do, or not to do something.
>
> A contract *is* synallagmatical or bilateral when the contractors bind themselves mutually some of them towards the remainder.
>
> It *is* unilateral when it binds one person or several towards one other or several others, without any engagement being made on the part of such latter.[94]

Following the Aristotelian method of definition, the Code identifies what it treats as the essential feature of the defined object, i.e., the feature that is peculiar or unique to the species of agreements known as contracts, the voluntary creation of obligations or engagements. The purpose of this feature was to distinguish contracts—permanently and universally—from other agreements that extinguish or modify previous obligations, but do not form engagements. This interest in classification and taxonomy, surely an Aristotelian legacy, is responsible for the assumption of many an interpreter of this type of code that only what has been defined or classified can exist (and at times physically exist) as a contract. The "is" part of the definitions appeals to the universality and thus to the permanence or immutability of the concept. This feature explains why there are so many enumerations of legal institutions "closed in number" (*numerus clausus*) such as those for movable goods and security interests. Having in mind precisely this *numerus clausus* feature of the Code Civil and its progeny, NLCIFT Principle 3 states:

> The security interest may be created in any personal property susceptible to monetary valuation whether present or future, tangible or intangible including rights to the same, as well as in the proceeds of this collateral, whether in their first or future generations. Thus, personal property collateral, as well as security interests in them are open in number (*numerus apertus*), and these security interests are not limited to preexisting devices such as the pledge, with or without dispossession of the

94. CODE CIVIL [C. CIV.] ch. I, arts. 1101–03 (1804) (Fr.), *reprinted in* CODE NAPOLEON (1827) (trans. George Spence), *available at* http://www.napoleon-series.org/research/government/code/book3/c_title03.html (emphasis added).

> collateral, chattle mortgages, retention of title or conditional sales, etc.[95]

During the drafting discussions on Guatemala's law, I pointed out to the Commission that some civil codes, such as Germany's *Bürgerliches Gesetzbuch* ("BGB" or "Civil Code") of 1900, are more supportive of commerce than the French and Spanish Civil Codes. The latter codes are responsible for the slow development of crucial commercial legal institutions such as "sales with retention of title" or "conditional sales," or of pledges without the debtor's dispossession. The French and Spanish codes rely on definitions of sales contracts as "consensual" and thus on the transfer of title from the seller to the buyer from the moment of the agreement.[96] This makes the title retention by the seller hard to justify. They also require that the pledgor transfer his possession of the collateral to the pledgee-creditor.[97]

b. Incompatible Features of the Guatemalan Civil Code

Despite its late twentieth-century extraction (1963), the Guatemalan Civil Code still evidences traces of French and Spanish civil code influence. It opted for a system with the following features: (1) formally created pledges (whether in a public or private deed); (2) a highly detailed description of the collateral in the security agreement;[98] (3) a closed number of movable goods that can be used as collateral[99] and en-

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95. 12 PRINCIPLES, *supra* note 53, princ. 3.

96. *See* C. CIV. art. 1583 (1804). This provision provides that the sale is perfected and ownership is acquired by the purchaser from the moment that there is agreement on the subject matter and price of the sale. *Id.*

97. *Id.* art. 2071. Additionally, Appendix 2 of this Article contains comparative charts of two archetypal civil codes, the French Code Civil of 1804 and the German. Despite the fact that the latter is also a civil code, it is more commercial, or less hostile to commerce, than the former. The goal of these charts is to illustrate how different attitudes toward commerce are reflected in provisions such as those on the formalities of contracts and protection of third parties, among others. The reader is encouraged to review these charts at this point.

98. GUATEMALAN CIVIL CODE art. 884 (1963) (on file with author).

99. *Id*. art. 451 (providing an enumeration of moveable property).

> Art. 451 Movable property are[]
>
> Property that can be transferred from one location to another without detriment to such property or to the immovable property in which they are located;
>
> Temporary buildings on land property of a third party;
>
> Natural resources that may be taken in possession;

forcement for only the allowed security interests; (4) a strictly judicial collection, repossession, and foreclosure remedies;[100] and (5) a limitation of the successful creditor's recovery to the value of the recovered collateral.[101]

c. Guatemala's New Law, the NLCIFT Principles, and the OAS Model Law

Article 3 of Guatemala's new law of secured transactions on personal property collateral ("GSTL") echoes both the OAS Model Law and the NLCIFT Principles by defining a security interest

> as an *in rem* security right created by a secured debtor in favor of a secured creditor to secure performance of one or several obligations of the secured debtor or a third party. It is the preferential possessory right, including the right to enforce the collateral granted to the secured creditor . . . .[102]

It also adopts the open number (*numerus apertus*) approach to the available security interests by providing that

> [t]he concept of security interest also includes those contracts, agreements or clauses commonly used to secure obligations with respect to movable property, such as [] retention[s] of title, guarantee trusts (*fideicomisos*), floating liens over business establishments, [sales and] discounts of [accounts] receivable[] . . . in the creditor's books, financial leases and any other security in movable property regulated prior to the adoption of this law.[103]

The GSTL enables the creation of both possessory and nonpossessory security interests[104] for individual credit extensions or for "line of credit

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> Shares or stock and obligations of stock companies, even when they are incorporated for the purpose of acquiring immovable properties, or for construction or other type of business in relation to this type of property;
>
> Rights to receivables related to movables, cash or personal services; and,
>
> Copyrights or patents of literary, artistic or industrial property.

Id. (author's translation).

100. *Id*. art. 882 (concerning the nullity of the *Pactum Commissorium* or clause enabling the creditor to repossess and foreclose on the collateral without judicial intervention).

101. *Id.* art. 881. This provision is not found in either France's or Spain's civil codes, but has been advocated by consumer protection commentators in these countries.

102. Guatemalan, *LGM*, *supra* note 45, art. 3. *See also* OAS MODEL LAW, *supra* note 42, art. 2; 12 PRINCIPLES, *supra* note 53, princs. 2–3.

103. Guatemalan, *LGM*, *supra* note 45, art. 3. *See also* OAS MODEL LAW, *supra* note 42, art. 2.

104. Guatemalan, *LGM*, *supra* note 45, art. 5; OAS MODEL LAW, *supra* note 42, art. 2.

agreements" with their corresponding "after acquired debts" and "after acquired collateral" clauses.[105] It lists the statutory liens present in Guatemalan law for the purpose of providing certainty to secured creditors and bona fide purchasers of the collateral.[106] In a pathbreaking manner for Latin American law, it adopts for the first time a unitary and unifying approach to the concept of the security (*garantía mobiliaria*). In the same manner initiated by UCC Article 9, GSTL Article 7 provides that

> the term security interest will include all guarantees in movable property, including, but not limited to, civil or traditional pledges; agricultural, cattle and industrial pledges; pledges over warehouse receipts [and] asset-backed bonds [and] bills of lading or ocean bills of lading, factoring, mortgage bonds, notes, certificates of deposit, trust certificates, negotiable instruments, deposits in checking accounts and claims to proceeds of an insurance policy[, among others].[107]

The creation (or "attachment," in UCC Article 9 parlance) of a security interest requires that an agreement, except for possessory security interests, be granted in writing, whether in a public deed, private document with certified signatures, or electronic form, or by any other means that leaves a permanent record of the parties' consent to the creation of the security interest. Unlike the Peruvian law, the description of the collateral may be in generic or detailed fashion. In addition, it reminds the parties that if they wish to avail themselves of a private, extrajudicial enforcement of the security interest, the security agreement is a good place for it.[108]

As with UCC Article 9, the OAS Model Law, and NLCIFT Principles, perfection of the security interest is acquired by the creditor's or his agent's possession when the security interest is possessory; in the case of a nonpossessory security interest, perfection is acquired by public notice in a registry or by the control of the collateral by a designated third party acting on behalf of the secured creditor.[109] Unlike the Peruvian law discussed earlier, the Guatemalan law is clear on the use of a financing statement instead of the security agreement and on the essentially automated, nonevaluative functions of the registrar. It also provides for a public, easily accessible, and nationally and internationally interconnected registry.[110]

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105. Guatemalan, *LGM*, *supra* note 45, art. 5.
106. *Id.*
107. *Id*. art. 7.
108. *See id.* art. 12(d), (g), (j).
109. *See id*. art. 15; 12 PRINCIPLES, *supra* note 53, princs. 5–7; OAS MODEL LAW, *supra* note 42, art. 10.
110. Guatemalan, *LGM*, *supra* note 45, arts. 40–41.

In a sharp departure from the drafting methodology of UCC Article 9, but in accordance with that of the OAS Model Law, the GSTL adopted a segmented approach to the rules on perfection and priority of the security interests in the major types of collateral. This was done to facilitate the application of concepts, rules, remedies, and principles of interpretation new to most of their users, even at the expense of some repetition. Thus, perfection and priority rules are provided for security interests in proceeds (Article 16); purchase money security interests (Articles 17, 45, and 55); accounts receivable (Articles 19–24, and 56-c); nonmonetary claims such as contract rights (Articles 25–26); documentary credits and their proceeds (Articles 27–30); negotiable instruments and documents of title (Articles 31 and 56-b); paper-based or electronic nonnegotiable documents (Article 32 and 56-a); control of goods in possession of bailees (Articles 34 and 56-e); control of bank and investment accounts (Articles 35 and 56-e); inventory (Article 36); intellectual property rights (Article 37); and fixtures (Article 56-d).[111]

d. Enforcement

Finally, the enforcement provisions are a novel combination of the UCC Article 9 self-help-without-breach-of-peace remedies,[112] the OAS Model Law judicial and extrajudicial remedies,[113] and Guatemala's own arrangement of judicial, extrajudicial, and expedited procedures:

> Article 65. Voluntary enforcement. The secured creditor and secured debtor may agree in the security agreement or at any time, before or during the judicial enforcement procedure established in this law, that the enforcement against the collateral will be performed privately under the terms and conditions that they may freely agree on.
>
> They may agree on the delivery or repossession of the collateral, the form and conditions of sale or auction, and any other matter, provided that they do not infringe the parties' and third parties' constitutional rights.
>
> In case of chattel mortgage bonds and guarantee trusts, the parties may agree that enforcement is done in accordance with the Law of Warehouses and the Code of Commerce, as the case may be.

111. *See generally id.*
112. *See, e.g.*, U.C.C. § 9-609 (2004).
113. OAS MODEL LAW, *supra* note 42, arts. 53–66. (Article 61 is particularly informative.)

> Article 66. Secured debtor's right. In any event, the secured debtor will retain the right to claim damages for the abuse of rights by the secured creditor.[114]

e. The Registry

Unfortunately, the lack of funds with which to set up the type of registry contemplated by the GSTL and the OAS Model Law has resulted in the creation of a temporary registry, which will hopefully be redesigned soon and set in full motion with the support of the IADB. Despite the rudimentary nature of the current registry, a Guatemalan daily recently reported on the warm reaction by the business community (lenders and borrowers) to the presence of this registry under the auspices of the GSTL.[115] Hopefully, a registry such as the one contemplated by the GSTL and being built in Honduras as of this writing will also be in operation in Guatemala in the near future with IADB support.

3. Honduras

The NLCIFT signed its contract with the Millennium Challenge Account—Honduras ("MCA—Honduras") in October 2007.[116] This contract enabled the NLCIFT to put together an ambitious but feasible plan of action to bring commercial credit to small- and medium-sized businesses in a developing nation that truly needs them. Having established the state of Honduran law and practice under previous contract work with Booz Allen Hamilton and the United States Agency for International Development, the NLCIFT's plan for the MCA—Honduras work consisted of first establishing the conditions under which local and foreign lenders could commit to providing corporate and individual merchants' lines of credit for the various sectors of the Honduran economy.[117]

With this in mind, the NLCIFT invited Michael Quinn of J.P. Morgan Chase, among other prominent U.S. bankers, to a preliminary meeting with Honduran public and private sector representatives. One of the purposes of this meeting was to evaluate the type of secured lending that Mr. Quinn's bank was willing to undertake in Honduras and other Central American countries, as well as in Mexico, either directly or with local

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114. Guatemalan, *LGM*, *supra* note 45, arts. 65–66.

115. Cristóbal Veliz, *Diez Empresas se Adhieren al RGM, Siglo XXI* (Feb. 10, 2009), http://www.sigloxxi.com/noticias/26460.

116. Contract for Consulting Services Between MCA—Honduras and National Law Center for Inter-American Free Trade (NLCIFT) (Oct. 9, 2007) (on file with author) [hereinafter Contract].

117. U.S. AGENCY FOR INT'L DEV. & BOOZ ALLEN HAMILTON, FINAL REPORT, TRADE AND COMMERCIAL LAW ASSESSMENT—HONDURAS (2005) (on file with author).

banks. After listening to the various presentations by Honduran exporters and U.S. importers of Honduran products, Mr. Quinn stated that depending upon the volume, timeliness, and quality of the products and effective security interests in them, his bank was willing to consider extending credit to Honduran exporters and their U.S. importers on the basis of "supply chain financing," i.e., acquiring the accounts receivable owed to the Honduran exporters by acceptable U.S. importers, and securing them with a UCC Article 9-like statutory provision and an easily accessible, reliable, and inexpensive registry system that would enable perfection and priority on the collateralized accounts and their proceeds, both in the United States and in Honduras.[118] These preconditions were helpful because they confirmed that a certain segment of the Honduran export market could be financed at reasonable rates of interest by a respectable and reliable U.S. source.

From there, the project moved to Honduras. Having established the state of Honduran law and legal practice, the NLCIFT had to accomplish seven different but related objectives: (1) determine the conditions under which local bankers would be willing to lend in a manner similar to that which decided J.P. Morgan Chase's likely participation; (2) reactivate the drafting of a Honduran law inspired at this point by not only the NLCIFT Principles and the OAS Model Law, but also the just-enacted Guatemalan law; (3) create a working group of U.S. and Honduran or other Latin American experts to plan the design and operation of the Honduran secured transactions registry, including its networking with other local, regional, and international registries; (4) establish the business and accounting practices of small- and medium-sized Honduran businesses and the type of collateral they could offer to the satisfaction of their local and foreign lenders; (5) prepare standard accounting and lending forms, including those to be filed as financing statements; (6) create a regulatory working group formed by Honduran bankers and bank regulators as well as foreign experts in the regulation of secured loans; and (7) provide training sessions for bankers, banking lawyers, judges, and law professors.[119] In order to accomplish these objectives, a group of NLCIFT researchers traveled to Honduras to interview local bankers (big and small), farmers, small-shop owners or operators, importers and exporters, cattle ranchers, fishermen, and their cooperatives, professionals, and artisans.

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118. First Regional CAFTA Implementation Meeting, MCA—Honduras and National Law Center for Inter-American Free Trade (NLCIFT), in Tegucigalpa, Honduras (Feb. 28–29, 2008).

119. *See* Contract, *supra* note 116.

The object of this field study was to find out not only what the local lenders required by way of security, but also what their actual or potential borrowers could offer by way of collateral.[120] And if, say, central market stall operators (by the hundreds) and taxi drivers (also by the hundreds) presently offered as collateral to their very expensive lenders the licenses or franchises (*fichas*) used to operate their respective businesses, would bankers and other less expensive lenders be willing to take the same collateral, and if so, under what conditions? How about accounts receivable—would a very rudimentary form of accounts accompanied by simple bookkeeping records suffice to procure a line of credit geared to the borrower's volume of sales, rather than to the threat of losing an operator's license? And then what would the lenders like to monitor, and would any of the monitoring be possible with filings in the future registry, as "attachments" to the filings or otherwise? Or, if subsistence farmers in Honduras had to sell their crops for a fraction of their market worth (as they did in Guatemala) simply because they lacked a simple vehicle to transport their produce to the market, would a micro- or small-business bank be willing to finance the cost of acquiring such a vehicle with the security of the proceeds of the sales of produce?

The purpose of this extensive research was to be able to write a better law by taking advantage of the findings on Honduras' living law of business and accounting practices or on lenders' relied-upon collateral (such as the above-mentioned licenses). It was also completed in order to design a truly certain but also flexible and dynamic registry, one that accommodated the need for reliable information on collateral and available assets with a highly efficient, automated, and eventually fully electronic filing, search, and interconnected database system. Once the official law component is in place, including an effective secured transactions law, registry regulations, and bankruptcy law, commercial lending could start, and its results upon the Honduran economy could be measured, month by month.

I am happy to report that the final draft of the secured transactions law has been approved by the Honduran Supreme Court and sent to the Honduran Congress for a vote, which will possibly take place in May or June 2009. The registry software is about to be tested in April 2009, and the registry regulations will be completed shortly thereafter. Meanwhile, accounting practices and suggested registry forms are being tested. The

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120. Nat'l Law Ctr. for Inter-Am. Free Trade, Report, Consulting Services for the Implementation of the Honduran Secured Transactions Law: Roadmap Documents (Mar. 2008) (unpublished confidential report, on file with author). This report was provided to MCA—Honduras. *Id.*

intrinsically transparent nature of both a modern registry and modern accounting practices will indeed challenge Honduras' culture of non-payment of taxes. In such a tax-avoidance culture, there is an obvious disincentive to record liens, maintain accurate business records, and abandon secrecy in business and commercial dealings. Such a scenario invariably presents itself in all such secured transactions modernization reform efforts in the developing world.

As the project further progresses, a U.S. banking regulator will be meeting with his Honduran counterparts, and hopefully risk management and safe and sound secured lending lessons learned from the U.S. (and the world's) financial meltdown can be applied in Honduras. Last but not least, a computerized, interactive teaching manual on the law of secured transactions is about to be completed as well.

CONCLUSIONS

As I reflect upon the failures and successes of the efforts to facilitate economic development in Latin America by enacting statutes patterned after the OAS Model Law on Secured Transactions, I must conclude that the reason why Mexico and Peru have yet to properly modernize their secured lending laws and practices and experience their undisputed economic benefits is because responsible policymakers have failed to ask the right questions.

There are still politicians and bureaucrats in Mexico who continue to ask themselves variants of the same question I was asked during the NAFTA negotiations, "Why us?" Or who remain convinced of the validity of the autochthonous slogan: "[w]hy should we change our law if it is the one that best reflects our legal culture?" On the other hand, other influential lenders echo the same autochthonous slogan but know better than to take the slogan seriously. The real question they ask themselves is "[w]hy should those of us who are doing well under the present non-transparent legal regime want to give up its secrecy and our priority?"

In Peru, an effective reform effort will require that drafters and implementers of its secured transactions law and registry regulations ask the following: What is the purpose of the statute we are about to enact? Who are its intended beneficiaries, and why? Who must it protect for it to function effectively? What are its essential concepts, rules, and principles of interpretation, and why? What is a truly functional registry? How could the substantive, procedural, and registry requirements best be implemented by encouraging best business, administrative, and judicial practices? Do we also need to modernize our bankruptcy law to prevent it from becoming a prime device to enable evasions of the secured transactions' law while at the same time becoming a tool for the rehabilitation of deserving debtors?

In sharp contrast, Honduran and Guatemalan legislators, judges, and constituent small- and medium-sized borrowers and supporting agencies such as MCA—Honduras and the IADB asked the questions in the preceding paragraph and concluded that the satisfactory answer was to modernize the laws involved by modernizing and harmonizing them with those that reflect the best secured lending, notice, and accounting and business practices.

Clearly, the enactment of good laws and registry regulations are only the first step of a long process of day-to-day implementation. The success of these and other developing nations in accessing commercial and consumer credit at reasonable rates of interest will only be attained if they rely on both the "top-down" and "bottom-up" approaches to the modernization of their commercial law. The top-down approach presupposes the implementers' ability to select the most effective official legal institutions, as tested in the most active and efficient secured lending markets and as accompanied by a sufficient understanding of how to adjust them to local law and practice.

This is the understanding that led the Guatemalans to avoid the pitfalls of relying on institutions inspired by the French and Spanish Civil Codes, which are contrary to the purposes of the desirable law and which would only produce retrogressive judicial or administrative decisions. It is also this understanding that enables the inviolate preservation of the fundamental constitutional protections of debtors and creditors alike.

The bottom-up approach, consists of identifying those living law institutions that can best help attain the goals of a modernized official law, including commercial, banking, bookkeeping, accounting, registry filing and searching, and taxpaying customs and practices. Once the helpful living-law institutions have been identified, the next step is both crucial and delicate: incorporate those local customs and practices into official legal institutions, such as laws or regulations, or into official or unofficial compilations of best practices and explain and evaluate them in thoughtful, academic-doctrinal, yet nondogmatic, commentaries.

When properly carried out, this selection of best practices would distinguish between those practices that can best function in, say, a highly active, trusting, and sophisticated marketplace from those required by a much smaller, unsophisticated, and distrusting marketplace. Thus practices associated with the former marketplace, such as a preponderant reliance on electronic records and filings by only one of the parties (usually the creditor), may have to be modified to accommodate for the filing of some paper-based documents and signatures by both parties as well as for other "trust-inducing" practices. These trust-inducing practices may also require legitimizing those filings that involve unusual collateral (by developed-country standards) such as governmental licenses or permits that enable the operation of small businesses ranging from market stalls, artisans and craftsmen's shops, and taxis, to rudimentary bookkeeping entries in grocery shops' "booklets" (*libretas*).

At the end of the day, the top-down and bottom-up methods of modernization of commercial law must be combined to reflect what is internationally uniform or universal and what is the best local practice. In doing this, the result must always be consistent with the above-discussed seminal principles of commercial legal institutions in general, as well as those that inspire the institution in question. It is not an easy task, but I am convinced that it is the only one that can succeed when using modernized commercial law as the prime tool of economic development: it is in some markets and can be in others.

APPENDIX I

NLCIFT 12 PRINCIPLES OF SECURED TRANSACTIONS LAW IN THE AMERICAS[121]

1. Secured commercial and consumer credit is an effective tool for economic development because it allows the debtor's use, transformation, sale or barter of collateral (mobilization). The mobilization of these assets leading to their sale or disposition makes possible the payment or self-liquidation of the loan. A single security interest can support a series of loans whose amount and collateral can vary during the life of the loan or loans. By executing a single security agreement and by giving public notice of the loan or line of credit, the secured creditor establishes his priority in the collateral over third parties without having to enter into new credit extension agreements or having to make successive filings. Self liquidation can take place only when the following corollary principles are implemented by legislators, the parties, registries and courts.

1. Las garantías mobiliarias del crédito comercial y del consumo propician el desarrollo económico porque permiten al deudor el uso, transformación venta o permuta de los bienes garantizadores (movilización de los activos). El producto de la venta o disposición de estos activos o de sus bienes derivados o atribuibles hacen posible la auto-cancelación o pago del préstamo. La ejecución de un solo acuerdo de garantía y su publicidad registral efectuada desde el momento de ese acuerdo puede garantizar a una serie de préstamos o "línea de crédito" cuyo monto y cantidad o valor de bienes garantizadores pueden fluctuar durante la vida de ese préstamo o préstamos. Publicitada la garantía, el acreedor establece su prioridad respecto a terceros sin necesidad de acuerdos o registros sucesivos. La auto-cancelación de las garantías mobiliarias requiere que los siguientes principios, corolarios de la misma, se implementen por los legisladores, las partes, los registros y las cortes.

2. A security interest is a preferential right to possession or control of personal property. As such,

2. La garantía mobiliaria es un derecho de posesión o de control preferente sobre bienes muebles.

121. 12 PRINCIPLES, *supra* note 53.

it does not require that the debtor who grants the interest have title to the personal property collateral; his right to its possession, even though co-existent with other possessory rights in the same property by other creditors and debtors, will allow the creation of the security interest.

Como tal, no requiere que el deudor garante sea el propietario del bien mueble garantizador; su derecho a la posesión del mismo bien, así sea coetáneo con otros derechos posesorios de otros acreedores o deudores, permitirá la creación de la garantía mobiliaria.

3. The security interest may be created in any personal property susceptible to monetary valuation whether present or future, tangible or intangible including rights to the same, as well as in the proceeds of this collateral, whether in their first or future generations. Thus, personal property collateral as well as security interests in them are open in number (*numerus apertus*), and these security interests are not limited to pre-existing devices such as the pledge, with or without dispossession of the collateral, chattel mortgages, retention of title or conditional sales, etc.

3. La garantía mobiliaria se puede constituir sobre cualquier bien susceptible de valoración pecuniaria, sean ellos presentes o futuros, corporales o incorporales, incluyendo derechos sobre los mismos, así como sobre los bienes derivados o atribuibles a la venta o permuta de estas garantías, ya sea en una primera o ulterior generación de tales bienes derivados o atribuibles. Por tanto, los bienes garantizadores al igual que las garantías sobre los mismos son de número abierto (*numerus apertus*) y no se encuentran limitadas a figuras preexistentes tales como las prendas con o sin desplazamiento o las hipotecas mobiliarias, o ventas con reserva o retención de dominio, etc.

4. Security interests may be created by contract or by law. The effectiveness of a security interest between the secured creditor and debtor arises from their contract or from a statutory or judicial imposition without any additional formality. Nevertheless, third party rights, including the rights of judgment creditors and trustees in bankruptcy, will not be affected by the se-

4. Las garantías mobiliarias pueden ser creadas mediante contrato o en virtud de la ley. La efectividad de una garantía mobiliaria entre el acreedor garantizado y el deudor se origina por el contrato entre los mismos por imposición de la ley o decisión judicial, sin necesidad de formalidades adicionales. Sin embargo, los derechos de terceros, incluyendo los de los acreedores

curity interest unless proper notice of it is provided to third parties.

quirografarios con sentencias de embargo o remate y los de los síndicos, no quedarán afectados a menos que la garantía mobiliaria haya sido debidamente publicitada.

5. A principal goal of a secured transactions public notice system is to eliminate secret liens. Public notice can either be attained by the creditor's or designated third party's possession or control of the collateral, or by registration. A perfected security interest in personal property can merge with a negotiable instrument, in which case it will become a negotiable security interest and, thus, an "abstract" undertaking, independent of rights and equities associated with the underlying transaction, thereby allowing its "true sale" or unrestricted negotiation to a *bona fide* purchaser.

5. Uno de los objetivos principales del sistema de publicidad de las garantías mobiliarias es el de eliminar los gravámenes ocultos o secretos. La publicidad (perfeccionamiento) se puede lograr ya sea mediante registro público o por la posesión o control del bien garantizador en manos del acreedor o de un tercero designado por éste. La garantía mobiliaria perfeccionada sobre un bien mueble podrá fusionarse con un documento negociable, en cuyo caso se convertirá en una garantía mobiliaria negociable y, en consecuencia, en una obligación abstracta, independiente de los derechos y obligaciones de la transacción subyacente, permitiendo así su venta autónoma (*true sale*) o negociación sin limitaciones a un tercero de buena fe.

6. Effective public notice by a specialized registry occurs when all known or future legal mechanisms with the effect of guaranteeing the payment of a debt against personal property are treated as a unitary security interest. The effect of such a recorded security interest, including its priority, upon third parties (such as other secured creditors and purchasers) commences from the time of its filing, irrespective of the time of its creation.

6. La publicidad efectiva por parte del registro especializado se logra cuando todos los mecanismos legales, presentes y futuros, cuyo efecto consiste en garantizar el pago de una deuda a través de bienes muebles, son tratados como un derecho de carácter unitario. El efecto de dicha garantía mobiliaria registrada (incluyendo su prioridad) ante terceros (tales como otros acreedores garantizados y compradores) da comienzo a partir

de su inscripción, independientemente del momento de su constitución.

7. Registration should be inexpensive and should take place in a public registry easily accessible to third parties regardless of nationality or economic sector, if at all possible by electronic means. The filing, in standardized fashion, should contain only the essential data to identify the parties, the amount of the loan or line of credit and collateral, consistent with the needs of actual and potential third parties to discover all recorded liens against the debtor's assets. Generic descriptions of collateral such as "inventory" or "accounts receivable" should suffice. The registry should be indexed generally by the debtor''s name and, only exceptionally, by the serial number of the goods.

7. El registro de la garantía deberá ser lo más económico posible y deberá realizarse en un registro público fácilmente accesible a terceros sin distinción de giro comercial o nacionalidad, y, de ser posible, en forma electrónica. La inscripción deberá contener los datos más esenciales, en forma estandardizada, a efectos de identificar a las partes, el monto del préstamo o línea de crédito y los bienes garantizadores, en forma coherente con las necesidades de información de terceros, actuales o potenciales. Resultarán suficientes las descripciones genéricas de los bienes garantizadores, como ser "inventario" o "cuentas por cobrar." El índice deberá organizarse en general con base al nombre del deudor y, excepcionalmente, en base al número de serie de los bienes.

8. A "purchase money," or "acquisition" security interest should take priority, to the extent that the credit provided is used directly to acquire the collateral, over prior existing perfected security interests in the same kind of collateral, as an incentive to those wishing to provide timely, valuable and needed loans and as a safeguard against the monopolization and immobilization of the collateral available by one or more secured creditors. Perfection of a purchase money secu-

8. En la medida en que el crédito proporcionado en base a una garantía mobiliaria de "adquisición" o de "compra de bienes específicos" se utilice directamente para la compra de los bienes garantizadores, dicha garantía tendrá prioridad sobre otras garantías mobiliarias pre-existentes que cubran la misma clase de bienes, creando así un incentivo para quienes deseen proporcionar los préstamos necesarios y oportunos, y una protección en contra del monopolio e inmoviliza-

rity interest should require, in addition to the appropriate filing, a special notice to pre-existing security interests.

ción de los bienes garantizadores disponibles por parte de uno o más acreedores garantizados. Además de la inscripción correspondiente, para el perfeccionamiento de la garantía mobiliaria de adquisición se requerirá un aviso especial a los acreedores pre-existentes.

9. A buyer in the ordinary course of business takes free of a perfected security interest created by his seller, even when the buyer may know of that security interest. If the sale occurs outside the ordinary course of business, then the buyer takes subject to the security interest even if he pays a fair purchase price.

9. El comprador en el curso ordinario de los negocios adquiere los bienes libres de cualquier garantía mobiliaria perfeccionada anteriormente por el vendedor, incluso en los casos en que el comprador pueda tener conocimiento de su existencia. Si la venta ocurre fuera del curso ordinario de los negocios, entonces el comprador se encuentra sujeto a la garantía mobiliaria, incluso cuando haya pagado un precio de compra justo.

10. Self liquidation of the security interests requires that repossession of the collateral and foreclosure take place by means of a contractual, rescissory and extrajudicial enforcement that confers upon the creditor or agreed-upon fiduciary the power to repossess or retain and foreclose on the collateral privately or by means of a highly expeditious judicial foreclosure.

10. La auto-cancelación de las garantías mobiliarias exige que la reposesión de las garantías y su ejecución se puedan realizar a través de mecanismos de resolución contractual y de ejecución extrajudicial, confiriéndole al acreedor o a quien se haya acordado habrá de actuar como fiduciario la potestad de tomar posesión o retener y hacer ejecutar la garantía ya sea de manera privada o a través de un proceso judicial altamente expedito.

11. Whenever possible—and until such time as a perfected and modern bankruptcy system that duly protects debtor and creditor

11. En la medida de lo posible—y hasta el momento en que rija un sistema moderno en materia de quiebras que proteja en forma ade-

rights has been adopted—the perfected security interest should not become part of bankruptcy proceedings and the law of bankruptcy or any other branch of the law should not become a tool to delay, avoid and evade secured obligations. Exceptionally, where the bankruptcy takes the form of a business reorganization, collateral may become part of the bankruptcy estate, subject to the exclusive jurisdiction of the bankruptcy court to confirm the perfection of the security interest and establish its priority against the claims of other creditors, to determine the extent and value of the security interest and ultimately to decide whether the collateral is essential to a feasible reorganization that shall protect valid security interests.

cuada los derechos de los acreedores y deudores—la garantía mobiliaria perfeccionada no deberá formar parte de los procedimientos de quiebra, y las leyes relativas a quiebra o a otras ramas del derecho no habrán de convertirse en un vehículo para retrasar, evitar y evadir el pago de las obligaciones garantizadas. De manera excepcional, si los procedimientos corresponden a un concurso preventivo, los bienes garantizadores pueden pasar a integrar la masa de la quiebra, sujetos a la jurisdicción exclusiva del tribunal de quiebras, a efectos de confirmar el perfeccionamiento de las garantías mobiliarias así como su prioridad con respecto a los reclamos de otros acreedores, de determinar el alcance y valor de las garantías y, en última instancia, para decidir si los bienes garantizadores son esenciales para el éxito de un concurso preventivo que habrá de proteger a las garantías mobiliarias válidas.

12. The harmonization of secured transaction laws—including conflict of law rules—is essential in order to promote cross-border extension of credit.

12. La armonización de las leyes sobre garantías mobiliarias—incluyendo las normas de conflicto de leyes—resulta esencial a los efectos de promover la disponibilidad del crédito transfronterizo.

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APPENDIX II

RULES THAT ENCOURAGE OR DISCOURAGE THE COMMERCIALIZATION OF CONTRACTS CIVIL CODE OF FRANCE AND THE GERMAN B.G.B.

Civil Code—France[122]	B.G.B.—Germany[123]
Formality: only authentic acts (notarial deeds) and documents under private signature—i.e., documents formally acknowledged by the signing party—are given evidentiary value as literal (full) proof of the obligation. (Articles 1317–32.)	Lesser formality: where the law requires a writing, a signature is required; informal contracts can be signed without formal acknowledgment of signatures. Telegraphic communications can be binding, and contracts by exchanges of letters are also binding; however, authentication of signatures may be required. (§§ 126–27.)
No Comparable Provisions. Generally, enforceable contractual promises require the acceptance of the promisee (as Pothier's pollicitations).	Promises can be enforceable without the expressed acceptance of a promisee. *See* executory promises (formally *nuda pacta*), § 780 (*Abstract Promise*), § 781 (*Acknowledgment of a Debt*), § 787 (*Payment Instruction*), §§ 793–94 (*Bearer Instruments*), and § 657 (*Public Offer of a Reward*).
Promises are unenforceable unless they contain a lawful and valid underlying cause. (Articles 1108 and 1131.)	Abstract promises are enforceable regardless of the underlying cause. (§§ 780–82.)
Mortgage is a causal contract, and its certificate cannot be made out to "bearer" as in 1195 of the BGB. (Articles 2124, 2127, and 2115–16.)	Provisions on the *Grundschuld* or Territorial Debt. Mortgages can be abstract contracts and be made out to "bearer." (§§ 1191–98.)

122. C. CIV. (1804).
123. Bugerliches Gesetzbuch [BGB] [Civil Code] Jan. 1, 1975, *translated in* THE GERMAN CIVIL CODE (Ian S. Forrester, Simon L. Goren & Hans-Michael Ilgen trans., 1975).

No regulation for contracts *inter-ausentes*.	Express regulation of contracts *inter-ausentes* (§ 130) including offers binding during a time specified by the offeror and others made during auctions (§§ 147–56 and 158–63).
Restrictive provisions on the enforcement of contracts for the benefit of third parties. (Articles 1165 and 1121.)	Liberal enforcement of contracts for the benefit of third parties. (§ 328.)
No comparable provisions are found in the Code Civil.	Simplifies claims by third-party beneficiaries by applying rules on the interpretation of contracts and the use of assumptions. (§ 330.)
Contracts for the sale of land can be rescinded if the seller sells for a price lower than 7/12th of market value (objective lesion), third parties' rights notwithstanding. (Article 1674.)	A loss suffered while selling land below its market value is not protected unless in cases of subjective lesion (§ 138). Third parties who purchase land based on the land registry records are protected (§ 892).
Ownership of goods/raw materials determines ownership of the processed final goods unless the value of the workmanship is surpassed by much of the value of raw materials/goods. (Articles 570–71.)	The value of the work invested in processing or transforming another's goods/raw materials determines ownership of the final goods, if the value of the latter is not substantially less than the value of former. (§ 950.)
In an agency contract, the principal is not bound to perform if the agent exceeds the principal's instructions. (Article 1998.)	Ostensible authority binds the principal under certain circumstances. (§ 166.)
Only regulates Civil or Non-Profit Associations. (Articles 1832–73.)	Regulates Civil or Non-Profit Associations, as well as Commercial or Profit Associations. (§ 21 et seq.)

REFLECTIONS ON THE ROLE OF THE OECD IN DEVELOPING INTERNATIONAL TAX NORMS

Hugh J. Ault[*]

INTRODUCTION

On September 8–9, 2008, the Organisation for Economic Co-operation and Development ("OECD") held a Special Conference commemorating the 50th Anniversary of the OECD Model Tax Convention ("Model Convention" or "Model").[1] The Conference was attended by over 650 participants from the private sector and the government, representing over 100 countries. Both the level of participation[2] and the geographical diversity represented at the conference would seem concrete evidence of the perceived importance of the role of the OECD in developing international tax norms. In his remarks opening the conference, the OECD Secretary General noted that the success of the OECD Model was based on three elements: "the capacity to adapt international tax rules to the changing business environment, the enhanced participation of the business community and the progressive involvement of non-member countries."[3] His observations about the Model Convention are more generally applicable to all of the OECD's work in the tax area.

In this paper, I would like to focus on the process through which the OECD works, as reflected in several of the projects in which the OECD could be said to be developing international tax norms. Hopefully, a better understanding of how the OECD functions at a practical level will help to inform the fascinating theoretical academic scholarship that has focused on the OECD tax work.[4]

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1. *See* Joann M. Weiner, *OECD Celebrates 50th Anniversary of Model Tax Convention*, 51 TAX NOTES INT'L 997 (2008).

2. The conference was sold out within a few weeks of its announcement.

3. Angel Gurría, OECD Secretary-General, Remarks at Conference on the 50th Anniversary of the OECD Model Tax Convention (Sept. 8, 2008).

4. *See, e.g.*, Allison Christians, *Sovereignty, Taxation and Social Contract*, 18 MINN. J. INT'L L. 99 (2009); Arthur J. Cockfield, *The Rise of the OECD as Informal 'World Tax Organization' Through National Responses to E-commerce Tax Challenges*, 8 YALE J.L. & TECH.136 (2006); Diane M. Ring, *What's at Stake in the Sovereignty Debate?: International Tax and the Nation-State*, 49 VA. J. INT'L L. 155 (2008).

I. LEGAL STRUCTURE AND ORGANIZATION OF THE OECD

The OECD was formed in 1961 as the successor to the Organization for European Economic Co-operation, which was set up in 1948 to coordinate Marshall Plan relief.[5] It is based on the Convention of December 14, 1960.[6] The OECD Council is the principal decision-making body of the organization and is composed of representatives from the thirty Member countries, which send Ambassadors to the OECD as well as staff national delegations. Decisions must be made on a consensus basis, and any country has the right to veto any proposed action at the Council level. The substantive work of the OECD is carried out in specialized Committees working in various areas: economics, trade, financial markets, labor, public governance, and the like. There are about 200 Committees, working groups, and expert groups in all. Some 40,000 senior officials from national administrations come to OECD Committee meetings each year to request, review, and contribute to work undertaken by the OECD Secretariat. The Committees meet regularly to come to decisions on issues and submit proposals to the Council for approval.

While the founding Convention provides for "decisions" that are binding on Member States,[7] this form of an OECD Act is not often used. The most frequently used form of an OECD Act is the Council Recommendation. Under the OECD's procedures, a Recommendation represents the strong political commitment of a country to follow the Recommendation in its domestic policy. Recommendations are often composed of a general statement of principle with an Annex setting out more detailed rules and entitled "Guidelines." The OECD also issues Reports, which are not legal instruments but written analyses of particular issues. They can be adopted at the Committee level as well as at the Council level.[8] Before final action is taken by the OECD in the area of taxation, the work is of-

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5. OECD, History, http://www.oecd.org/pages/0,3417,en_36734052_36761863_1_1_1_1_1,00.html (last visited Apr. 20, 2009).

6. Convention on the Organisation for Economic Co-operation and Development, Dec. 14, 1969, 12 U.S.T. 1728, 888 U.N.T.S. 179 [hereinafter OECD Convention]. Interestingly, it was viewed as the economic counterpart to the North Atlantic Treaty Organization.

7. *Id.* The Code on the Liberalization of Capital Movements is an example.

8. For example, the report "The Application of the OECD Model Tax Convention to Partnerships" was first presented as a report with suggested changes to Commentary and then changes in the Commentary were implemented in a Recommendation as part of the 2000 Model update. *See* OECD, 2 *Model Tax Convention on Income and on Capital* R(15-1) (Apr. 2000) (*current version available at* www.oecd.org/dataoecd/43/57/42219418.pdf).

ten published for public comment as a Discussion Draft.[9] The OECD also publishes statistical analyses and other descriptive information in the various fields in which it operates. The Economics Directorate publishes Economic Surveys of both Member and non-Member countries, often with quite prescriptive policy analyses in many areas, including tax.

Funding for the OECD is provided by the Member States. A portion of the budget is funded by contributions based on relative GDP and another portion based on individual country contributions. In 2008, the United States provided nearly 25% of the budget of EUR 303 million, and Japan contributed 14%. Iceland contributed 0.1%.[10]

The original membership of the OECD has expanded over the years, most recently with the admission of Mexico (1994), the Czech Republic (1995), Hungary (1996), Korea (1996), Poland (1996), and the Slovak Republic (2000).[11] Thus, while the OECD is often characterized as the "rich man's club," in fact the Member country economies vary substantially.[12] Currently, an accessions process leading to membership is under way with Chile, Estonia, Israel, Russia, and Slovenia. Discussions are also underway with Brazil, China, India, Indonesia, and South Africa on enhanced engagement programs with a view to possible membership.[13] In addition, a number of countries have Observer status on various Committees. For example, Argentina, Chile, China, Russia, India, and South Africa are Observers on the Committee on Fiscal Affairs.[14]

The activities of the Committees are supported by the Secretariat and led by the Secretary General, who also chairs Council meetings, thus providing a link between the staff input and the Member countries. The

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9. *See* OECD, *OECD Aims to Improve International Tax Disputes Mechanisms* (Mar. 13, 2006), http://www.oecd.org/document/28/0,3343,en_2649_37989739_36271004_1_1_1_1,00.html.

10. OECD, Scale of Members' Contributions to the OECD's Core Budget-2009, http://www.oecd.org/document/14/0,3343,en_2649_201185_31420750_1_1_1_1,00.html (last visited Apr. 24, 2009).

11. OECD, Ratification of the Convention on the OECD, http://www.oecd.org/document/58/0,3343,en_2649_201185_1889402_1_1_1_1,00.html (last visited Apr. 20, 2009).

12. For example, both Mexico and Korea have basic tax policies that reflect strong interests as source countries.

13. OECD, OECD Member Countries, http://www.oecd.org/countrieslist/0,3351,en_33873108_33844430_1_1_1_1_1,00.html (last visited Apr. 20, 2009).

14. OECD, *China, South Africa to Participate in Work of OECD's Committee on Fiscal Affairs* (June 6, 2004), http://www.oecd.org/document/21/0,3343,en_2649_34897_32074069_1_1_1_1,00.html; OECD, *OECD Countries Welcome Chile's Participation in the OECD's Taxation Work*, http://www.oecd.org/document/33/0,3343,en_2649_34897_36339297_1_1_1_1,00.html (last visited Apr. 20, 2009); OECD, *OECD Invites India to Participate in Its Committee on Fiscal Affairs*, http://www.oecd.org/document/9/0,3343,en_2649_34897_37131209_1_1_1_1,00.html (last visited Apr. 20, 2009).

Secretariat is organized around Directorates, which provide support for the various Committees. The current professional staff is about 700. Some of the staff are international civil servants associated with the OECD on a long-term basis, and others are secondees from national administrations, typically spending several years at the OECD.

II. ORGANIZATION OF TAX ANALYSIS AT THE OECD

Most work in the tax area is done by the Committee on Fiscal Affairs ("CFA"). The Committee meets twice a year in Paris. Country representatives are generally high-level officials in national treasuries and tax administrations. The United States typically sends the International Tax Counsel and the Deputy Assistant Secretary for International Tax. Other Treasury and Internal Revenue Service officials may attend depending on the items on the agenda. The Chair of the CFA is currently from Italy;[15] recent past chairs have been from Sweden, the United States, the United Kingdom, and Canada. Currently, in addition to representatives of the thirty Member countries, Observers are sent from Argentina, Chile, China, India, Russia, and South Africa.

According to the CFA's Mission Statement, its goals are

> to provide a forum for tax policymakers and administrators to discuss current policy and administration issues; to assist OECD countries and non-OECD [countries][16] to improve the design and operation of their tax systems; to promote co-operation and co-ordination among them in the area of taxation; and to encourage non-OECD economies to adopt taxation practices which promote economic growth through the development of international trade and investment.[17]

Much of the preparatory work for the CFA meetings is done by the CFA Bureau, an executive Committee that meets periodically between the CFA plenary meetings. The Bureau develops the agenda for the CFA meeting and often prepares Recommendations for particular issues, which have a great deal of presumptive weight in the discussions. Often, at impasses in the CFA meeting discussions, the Bureau will meet separately and prepare compromise solutions. The CFA approves the Pro-

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15. OECD, *New Chair of the OECD's Committee on Fiscal Affairs*, http://www.oecd.org/document/20/0,2340,en_2649_34897_36396500_1_1_1_1,00.html (last visited Apr. 20, 2009).

16. OECD documents typically refer to "Non-Member Economies" rather than Non-Member Countries because of the participation of some dependent territories that have fiscal autonomy (e.g., Hong Kong) or to avoid political issues (e.g., Taiwan). Here, I will use the less awkward Non-OECD Member.

17. ORG. FOR ECON. COOPERATION & DEV., OECD'S CURRENT TAX AGENDA (2008), *available at* http://www.oecd.org/dataoecd/38/17/1909369.pdf.

gram of Work and gives mandates to various subsidiary bodies to carry out the work. Topics for the work usually come from the subsidiary bodies themselves, based on proposals by Member countries, businesses, or the Secretariat, and the proposals are subsequently approved by the CFA.

The most important subsidiary bodies are structured as follows: Working Party 1 deals with tax treaty and related issues; Working Party 2 covers tax policy analysis and statistical work; Working Party 6 deals with the taxation of multinational enterprises, including transfer pricing; Working Party 8 investigates how Member governments can cooperate to minimize the extent of tax evasion and avoidance; Working Party 9 examines consumption taxes.[18] In addition to the Working Parties, the Forum on Harmful Tax Practices advances the OECD's work on harmful tax practices, and the Forum on Tax Administration provides a forum to improve taxpayer service and compliance.

The CFA also sponsors a number of events aimed at pursuing a dialogue and sharing expertise with non-Member countries at its Multilateral Tax Centres in Austria, Hungary, Korea, Mexico, and Turkey and at its in-country Centres in Moscow and Yangzhou, China.[19] Individual events are also provided. For example, four events are held each year in India at the Indian National Academy of Direct Taxes in Nagpur. These meetings cover a broad range of topics including tax treaty policy and negotiation, transfer pricing, tax policy including modeling and the use of incentives, auditing, and value added tax compliance. Over sixty events, each typically lasting one week, are staged each year.

Another important mechanism through which the OECD carries on its dialogue with Non-OECD Members in the tax area is the Global Forum on Taxation, which are large international meetings held to cover a variety of subjects. The composition of the Global Forum generally varies depending on the topics covered. The annual Global Forum Meeting on Tax Treaties, which has the broadest country participation, typically attracts several hundred participants from over ninety countries.

The CFA's work is supported by the Centre for Tax Policy and Administration, a Directorate within the Secretariat. The Centre is divided into Divisions that serve the various working parties and other subsidiary bodies. Some of the staff of the Centre are on long-term or indefinite contracts, and others are seconded to the Centre for more limited periods

18. The odd numbering arrangement comes from the fact that when Working Parties achieve their mandate, they go out of existence but the continuing Working Parties are not renumbered.

19. ORG. FOR ECON. CO-OPERATION & DEV., CTR. FOR CO-OPERATION WITH NON-MEMBERS, THE OECD'S GLOBAL RELATIONS PROGRAMME (2007–08), *available at* http://www.oecd.org/dataoecd/57/5/39109041.pdf.

of time by the Member countries. The Centre staff play a key role in the CFA's work and represent the organization, not any particular country. While procedures vary from topic to topic, typically the responsible Division prepares the initial drafts of the documents on the matter in question. The drafts are first discussed in smaller working groups or directly at the Working Party or Forum level and then discussed on a line-by-line basis by the delegates. Proposed changes and redrafted text are put forward by the delegates. The Chair of the meeting usually summarizes the results of the discussion. The text is then redrafted by the staff and reviewed by the delegates for final approval. In some cases, additional changes are made in the final drafting by the Secretariat and are approved by written communication. Thus, the skill of the staff in dealing with delegates in reaching (and in some cases possibly creating) a consensus on the substantive issues is extremely important. Depending on the complexity and political sensitivity of the issues involved, the drafting process can take a few weeks or more than a decade (e.g., as has been the case for the recently approved Report on Attribution of Profits to Permanent Establishments).

Private sector input into the CFA's work comes from several sources. The Business and Industry Advisory Committee ("BIAC") and, to a lesser extent, the Trade Union Advisory Committee ("TUAC") comment on documents both while they are being prepared and after they have been issued. In addition, it is common to issue a Discussion Draft for public comment and, in some cases, to hold a Consultative meeting attended by both government and private sector representatives to review the Discussion Draft.[20] Dialogue with the private sector at the inception of a project may take the form of a Centre for Tax Policy and Administration Roundtable, such as those held in recent years on business restructuring and the tax treaty treatment of collective investment vehicles. There are also a variety of ways in which dialogue can be conducted throughout the course of a project, either by having private sector representatives participate in the drafting groups, which was done with the e-commerce work in the 1990s and the current projects on collective investment vehicles and real estate investment trusts, or by having them act as advisory groups to the governmental delegates, which was done with the revisions to the OECD Model Commentary on international transportation income.

Some general observations can be made about the process through which the CFA deals with tax matters. In the first place, the consensus principle is extremely important and taken very seriously by the participants. The lengthy discussions, skillfully led by the Chair and the Secre-

20. *OECD Aims to Improve International Tax Disputes Mechanisms*, *supra* note 9.

tariat, can often lead to agreements and compromises that were not at all evident when the discussions began. In addition, the process is an iterative one, with the same parties, both in terms of countries and in terms of persons, often having a wide range of issues to consider over a number of years. Countries are reluctant to be too intransigent on a particular issue, as they may need the support of other Members on a subsequent question where they have more at stake. Peer pressure and the perceived status of various individuals, especially those with a long history at the institution, also play a role.

Sometimes the pressure for consensus can lead to difficulties if the pressure to agree on language generates too much ambiguity and leads to differences in subsequent interpretation and implementation. There is a danger that striving for consensus can result in agreement on "principles" at such a high level of generality that they do not in fact advance matters. While creative ambiguity can at times be useful, masking important differences with bland platitudes is not helpful. As a delegate once observed, if country A says the world is flat and country B says the world is round, and after a long discussion, the OECD issues a report that says the world is an attractive shape and declares a consensus has been reached, it is difficult to call that real progress in establishing international norms. On the other hand, "parking" a contentious question in ambiguous language while reaching agreement on other related issues can leave open the possibility of revisiting that issue for "clarification" at another time.

These aspects of the OECD process are discussed below in the context of more concrete developments in the tax area.

III. THE PROCESS AT WORK: SOME SELECTED TAX "NORMS" AND THE OECD INVOLVEMENT

A. Harmful Tax Competition[21]

It is commonplace that increased globalization of trade and investment has made countries' economies and policies more interconnected. In the tax area, that has meant that policies that have been historically developed in a closed economy now have increasingly important impacts on other countries, as economies have become more open. This has led to concerns about "harmful tax competition," where one country's tax system can have a potentially negative impact on those of other countries. In

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21. Reuven Avi-Yonah's Article looks at the harmful tax competition project after ten years; my focus here is to look back at the process through which the project developed. *See* Reuven S. Avi-Yonah, *The OECD Harmful Tax Competition Report: A Retrospective After a Decade*, 34 BROOK. J. INT'L L. 783 (2009).

particular, this increased openness has resulted in the appearance of special tax regimes and practices aimed at attracting mobile activities and capital from other jurisdictions through legislative and administrative tax breaks tailored to attract foreign investment. These problems attracted a great deal of concern among Member States and in 1996, after much internal discussion, the OECD Ministers charged the organization to "develop measures to counter the distorting effects of harmful tax competition on investment and financing decisions and the consequences for national tax bases, and report back in 1998."[22] The OECD proposal was supported by the G7 at their Summit in Lyon in 1996, where they urged the OECD to "vigorously pursue its work in [tax competition] aimed at establishing a multilateral approach under which countries could operate individually and collectively to limit the extent of these practices."[23]

The work was initially carried out in a so-called "Special Session," an ad hoc organizational form that cuts across divisional lines to deal with a particular problem. The Special Session fulfilled its mandate by the 1998 deadline provided by the Ministers and issued the report "Harmful Tax Competition: An Emerging Global Issue" ("Report" or "1998 Report").

The first issue to be considered in the Special Session was the development of a framework for determining when and in what circumstances tax competition can be appropriately characterized as "harmful."[24] This issue has been the subject of a long and ongoing debate in the economic literature about the benefits and detriments of tax competition. Some see tax competition as a good and healthy thing—it keeps the Hobbesian Leviathan in check, limits the State's tendency to expand, promotes more efficient government and governmental services, and limits political pandering to domestic interest groups, purposes that are all very much public choice and Buchannan oriented.

On the other side, there are those who see tax competition as resulting in a destructive "race to the bottom." Tax competition has a number of potential negative effects: it causes "bidding wars" in the competition for mobile activities, ultimately resulting in no tax at all on mobile capital; it makes redistributive, benefits-based income taxation impossible; it may require States to shift to other revenue sources, taxing less mobile activities and taxing labor, in particular, more heavily; it may force a reduction

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22. ORG. FOR ECON. CO-OPERATION & DEV., HARMFUL TAX COMPETITION, AN EMERGING GLOBAL ISSUE 3 (1998), *available at* http://www.oecd.org/dataoecd/33/0/1904176.pdf [hereinafter HTC REPORT].

23. *Id.* at 7.

24. The HTC Report made a distinction between harmful tax competition in the form of harmful preferential regimes, which are discussed here, and the issue of tax havens, which are discussed *infra* at note 35. *See* HTC REPORT, *supra* note 22, at 19–21.

in public expenditures to a suboptimal level; it may prevent the implementation of democratically arrived at tax policy decisions as to tax mix and tax level, and generally leave everyone worse off.[25]

There was substantial attention paid to theoretical work in the Special Session discussions. There was wide agreement that the general international movement in the direction of a broader tax base with fewer preferences and lower rates, which was in part a result of the "competitive" reaction to changes in the U.S. and U.K. systems in the mid-1980s, was a good thing.[26] It forced the elimination of wasteful and inefficient tax preferences and excessively high marginal rates, and it generally increased efficiency. This approach is consistent with the basic market orientation of the OECD.

It is also clear, though, that some kinds of tax practices can have more negative effects than positive ones, and the issues facing the Special Session were how to identify those situations and how to develop some kind of consensus on a distinction between "fair" and "harmful" tax competition.[27]

As one could imagine, reaching international agreement on a definition of harmful tax competition was a difficult and contentious process. Some countries—as would be expected of typically high-tax countries—started out from the tentative position that any country that had a low rate of tax and could potentially attract investment through that rate was engaging in harmful tax competition. And in some senses that was true, viewed solely from the national perspective of the high-tax country, since the other

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25. Reuven S. Avi-Yonah, *Globalization*, *Tax Competition, and the Fiscal Crisis of the Welfare State*, 113 HARV. L. REV. 1573, 1576 (2000).

26. *See generally* HTC REPORT, *supra* note 22.

27. Much of the economic literature on tax competition is in the subnational area and is generally positive about tax competition. The argument goes something like this: local taxes tend to be benefits-based taxes, and there is substantial mobility of both individuals and business activities. Thus, competition will result in different tax/benefit mixes, which actors will respond to by moving, and the results will force local governments to be more efficient in the provision of public services, and people will sort themselves out according to preference. *See generally* Charles M. Tiebout, *A Pure Theory of Local Expenditures*, 64 J. POL. ECON. 416 (1956). This is the so-called efficient Tiebout equilibrium. Obviously, things in the international setting are different. In the first place, mobility is different, though it might be similar with respect to mobile service activities. More important, from a theoretical point of view, national-level taxes have a redistributional function beyond being simply benefits based. This is the classic Musgrave model in which local units provide services and the National government provides nonspatially limited public goods and transfer payments. It is not clear how much the subnational analysis, to the extent the OECD comes to the conclusion that tax competition is uniformly good, is relevant in the international context.

jurisdictions with low rates were capable of attracting investment away from the high-tax country.

On the other hand, the issues of what general rate of income tax to impose, or whether or not a State should even have an income tax at all, are basic questions of national policy and sovereignty, which every country, at least historically, has been able to decide for itself. So, while a low rate of tax may be potentially harmful, this cannot be enough—at least at this stage of international cooperation—to constitute harmful tax competition.

The Report issued by the Special Session distinguishes between a general low rate, which applies to all taxpayers and activities in a jurisdiction, and a special regime or practice, which is limited to mobile activities.[28] The special regime is combined with some other features that make it likely that the effect and, in all probability, the purpose of the regime were simply to attract investment from elsewhere with no other impact on the domestic economy. The first situation is not covered by the Report, and the second constitutes harmful tax competition.[29] So to take two extreme examples, if a country introduces a general, nondiscriminatory, across-the-board 12.5% corporate tax rate, this would be viewed as an appropriate policy choice under the approach adopted by the OECD. In contrast, it would constitute harmful tax competition if the country has a special zero-tax regime for corporations engaged in offshore banking where (1) only foreign investors can invest; (2) those corporations cannot do business in the domestic economy; and (3) the country will not exchange information about the income of such corporations with the investors' home country (so that the latter country could try to continue to tax its residents on the income arising in the regime). For cases in between these extremes, the Report emphasizes that the decision is to be made on the basis of all the factors taken together in context.[30]

The articulation of these principles was an important first step in creating a framework that can preserve the benefits of "fair" competition while restraining the negative effects of other forms. However, the actual implementation of these ideas requires some sort of international institutional framework through which the principles can be developed and monitored. Countries dealing with issues of tax competition are, to use a game theory concept, in a prisoner's dilemma situation. If all cooperated, all would be better off than if no one cooperated, but if some cooperated

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28. HTC REPORT, *supra* note 22, at 20–21.

29. One could see this as recognition of some sort of "sovereign duty" not to utilize a tax practice that has the sole purpose of negatively impacting another jurisdiction. *Cf.* Christians, *supra* note 4.

30. HTC REPORT, *supra* note 22, at 21.

and others did not, the defectors who did not play by the rules could actually be the winners. What was needed was an institutional framework both to develop the principles and to establish a monitoring mechanism that, if necessary, would sanction those countries that were tempted to stray. The beginning of such a structure was developed in the OECD work through the establishment of the Forum on Harmful Tax Practices and the Global Forum on Taxation.

The Report established a new subsidiary body within the OECD, the Forum on Harmful Tax Practices, which, since 1998, has administered a set of guidelines on tax practices setting out certain obligations on countries that adopted the Report. Under these guidelines, which the Report implemented, the countries agreed to carry out a self-review process of their domestic measures in light of the criteria set out in the Report and to eliminate within a stipulated period of time those measures found to constitute harmful tax competition, as defined by the Report. In addition, they agreed not to introduce any new measures that would constitute harmful tax competition. The self-review process presented the countries with a classic prisoner's dilemma. Each country was looking over its shoulder to try to decide whether to cooperate or not. All of them recognized that they would be better off if they cooperated, but they would be worse off if they listed their regimes as harmful while other countries did not. Conversely, they could be better off if they did not list themselves as harmful while others did.

However, there is another mechanism that strengthens discipline: a peer review process that begins after the initial self-review period. Under this procedure, a country can ask the Forum to review a measure of another country not listed in the self-review, and the Forum can give an opinion as to whether or not the regime constitutes harmful tax competition. If a measure is found to be harmful under the criteria of the Report, the offending Member State is obligated under the Report to remove it.

What does this mean in practice? This question involves the legal nature of the measures contained in the Report. As a formal matter, the Report deals with "Recommendations," a defined term of art in the OECD treaty; as indicated above, these are not binding international law commitments. Under the Treaty, countries undertake to make a strong political commitment to follow the Recommendations, but the Treaty expressly recognizes that there may be circumstances in which a country is unable to fulfill its commitment or needs to delay compliance. This "soft" international undertaking is not legally binding but creates substantial peer pressure to act in accordance with the Recommendation. This process has been extremely effective in bringing countries to eliminate regimes found to be harmful under the criteria of the Report. Of the forty-seven preferential tax regimes that had been identified as potentially harmful in 2000, none of the regimes are deemed harmful at the present time.[31] A number of regimes have been abolished, others have been amended to remove their potentially harmful features, and still others were found not to be harmful on further analysis of their actual impact. Here, the actual details of the results are less important than the process by which they were reached. Countries were able to establish a cooperative process through which they could escape the logic of the prisoner's dilemma. In addition to the consultative process foreseen in the Report, the Report also provided for so-called "co-ordinated defensive measures" against harmful tax practices. These are, in general terms, measures that can counteract the effects of the harmful tax competition in various ways. For example, if the residence country can directly tax the income that arises in the offshore regime, this can have the effect of discouraging its taxpayers from taking advantage of that regime in the first place. Any country can unilaterally introduce such measures, but they are more effective if done on a coordinated basis, the course recommended by the Report. Similarly, in some cases, harmful tax competition is the result of the utilization of favorable provisions in a tax treaty. A Recommendation urges countries to modify treaties to exclude from treaty benefits the income and entities benefiting from measures found to constitute harmful tax competition. Given the requirement of action by consensus, the likelihood that the OECD would ever actually approve of a defensive measure against a Member country is doubtful, but in any event the issue has not been tested because all regimes previously identified as harmful have been eliminated.

The Recommendation on harmful tax competition was approved by the Council with the abstentions of Switzerland and Luxembourg. In annexes to the Recommendation, these countries objected to two basic aspects of the Report: (1) its focus was only on geographically mobile activities and did not include "bricks and mortar" investments, and (2) its stress on the importance of the elimination of bank secrecy.[32] From a process point of view, however, the interesting thing is that neither country elected to veto the project as it could have done under the OECD operating rules. This

31. ORG. FOR ECON. CO-OPERATION & DEV., REPORT TO THE 2000 MINISTERIAL COUNCIL MEETING AND RECOMMENDATIONS BY THE COMMITTEE ON FISCAL AFFAIRS, TOWARDS GLOBAL TAX CO-OPERATION (2000), *available at* http://www.oecd.org/data oecd/9/61/2090192.pdf; ORG. FOR ECON. CO-OPERATION & DEV., CTR. FOR TAX POL'Y & ADMIN., THE OECD'S PROJECT ON HARMFUL TAX PRACTICES: 2006 UPDATE ON PROGRESS IN MEMBER COUNTRIES, www.oecd.org/dataoecd/1/17/37446434.pdf (last visited Apr. 20, 2009).

32. HTC REPORT, *supra* note 22, at 73.

would seem to indicate a judgment that the impact of a veto on this important and high-visibility project would have had a significant negative impact on these countries' abilities to work in the future with the organization. In addition, both countries in fact participated in the Forum on Harmful Tax Practices, submitted their potentially harmful regimes for review and, in the case of Switzerland, ultimately made the changes necessary to have their regime taken off the list of harmful tax regimes.[33]

A second aspect of the harmful tax competition project involved the treatment of tax havens. This work has been described elsewhere (with varying degrees of accuracy),[34] and I would like to focus primarily on some aspects of how the work evolved. The 1998 Report made a distinction between countries that collected "significant revenues" from income tax and those that did not. With respect to the first category, a "harmful preferential regime" was present if the regime involved no or low tax and either "ring-fencing," (that is, limiting the tax to foreign investors), lack of transparency, or lack of exchange of information. Tax havens, on the other hand, which by definition did not have significant revenues, also involved no or nominal tax rates, and lack of transparency and exchange of information, in addition to the lack of any requirement of "substantial activity" (that is, it was possible to set up a "letter box" or "booking centre" in the jurisdiction). This requirement was parallel to the "ring-fencing" requirement for other jurisdictions, as it stipulated that there be some real connection between the low-taxed activity and the jurisdiction.

Applying these criteria, the OECD, in 2002, listed thirty-five jurisdictions that met the technical tax haven criteria and began discussions with those jurisdictions focused on getting from them "commitments" to eliminate the "harmful features" from their tax systems.[35] At the same time, the Council instructed the Forum to prepare a list of "uncooperative tax havens," those havens that did not agree to make the necessary commitments. While the OECD process was taking place, there was a change of Administration in the United States, and after six months, during which time he apparently thought about what reaction to take, Paul O'Neill, incoming U.S. Secretary of the Treasury, made the following announcement:

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33. The situation involving the Luxembourg 1929 Holding Company regime is more complicated and involves the application of the EU state aid disciplines.

34. *See generally* J.C. SHARMAN, HAVENS IN A STORM: THE STRUGGLE FOR GLOBAL TAX REGULATION (2006); Lorraine Eden & Robert T. Kudrle, *Tax Havens: Renegade States in the International Tax Regime?*, 27 LAW & POL'Y 100 (2005).

35. OECD, *The OECD List of Unco-operative Tax Havens—A Statement by the Chair of the OECD's Committee on Fiscal Affairs, Gabriel Makhlouf* (Apr. 18, 2002), http://www.oecd.org/document/28/0,3343,en_2649_33745_2082460_1_1_1_1,00.html.

> Although the OECD has accomplished many great things over the years, I share many of the serious concerns that have been expressed recently about the direction of the OECD initiative. I am troubled by the underlying premise that low tax rates are somehow suspect and by the notion that any country, or group of countries, should interfere in any other country's decision about how to structure its own tax system. I also am concerned about the potentially unfair treatment of some non-OECD countries. The United States does not support efforts to dictate to any country what its own tax rates or tax system should be, and will not participate in any initiative to harmonize world tax systems. The United States simply has no interest in stifling the competition that forces governments—like businesses—to create efficiencies. . . . In its current form, the project is too broad and it is not in line with this Administration's tax and economic priorities.[36]

The O'Neill announcement, despite its substantial mischaracterization of the thrust behind the OECD project, appeared on its face to be a dramatic withdrawal of support by the United States, previously a key player in the tax competition work.[37] In fact, it had much less impact on the progress of the project than was initially anticipated. In 2001, the OECD revised its criteria for tax haven status by eliminating the "no substantial activities" requirement, which had been of very little significance in practice.[38] In addition, it agreed not to apply defensive measures to tax havens any sooner than it applied them to Member country regimes. This was largely meaningless because, by this time, it was clear that the Member countries themselves would have eliminated the harmful features of the regimes. In 2002, the OECD published its list of seven "uncooperative tax havens," which has subsequently been reduced to three.[39]

The harmful tax competition exercise raises some interesting process points. While the OECD did have an extensive dialogue with the havens in connection with the commitment process, the process still had a confrontational tone. In its later forms, the tone is more conciliatory. The former havens that have made commitments to transparency and exchange of information are now called "Participating Partners"; they are working together with Member countries in the context of an OECD

36. Press Release, Paul O'Neill, Sec'y of the U.S. Dep't of the Treasury, PO-366 (May 10, 2001) [hereinafter O'Neill Press Release].

37. The U.S. International Tax Counsel was the first Co-Chairman of the Forum on Harmful Tax Practices.

38. OECD, *The OECD's Project on Harmful Tax Practices: The 2001 Progress Report* 9, http://www.oecd.org/dataoecd/60/28/2664438.pdf (last visited Apr. 20, 2009).

39. These are Andorra, Liechtenstein, and Monaco. *See* OECD, Centre for Tax Policy and Administration, List of Unco-operative Tax Havens, http://www.oecd.org/document/57/0,3343,en_2649_33745_30578809_1_1_1_1,00.html (last visited Apr. 20, 2009).

Global Forum on Taxation to develop uniformity in rules on transparency and exchange of information.[40] Cooperative efforts have also generated a Model Exchange of Information Agreement,[41] which has been successfully used in bilateral and multilateral negotiations. However, one can wonder how much of the later cooperation would have developed if the initial phases of the project had not been as prescriptive as they were. In addition, while a number of exchange agreements have been concluded,[42] there is an increasing concern about "foot dragging" on the part of some jurisdictions that have made commitments and avoided the initial listing process, but have taken no real steps toward implementation since then. Consideration may then turn again to defensive measures, for example, perhaps a list of "Committed but Uncooperative Jurisdictions" suggesting that "establishing international norms" in some cases must involve the combination of cooperation and enforcement mechanisms.

It is also interesting to note that the focus of much of the later work in this area is on exchange of information generally, not just exchange in connection with the narrowly defined activities of geographically mobile financial services covered by the 1998 Report. For example, the Exchange of Information Agreements that have been entered into with the havens are not limited to information concerning geographically mobile services but cover exchange generally. In addition, they are not limited to exchange in criminal conduct, but cover civil exchange as well.[43] Thus, somewhat ironically, from one perspective, the U.S. "withdrawal" from the project had no impact at all on the elimination of ring-fenced regimes in Member countries. Actions by countries that eliminated ring-fenced regimes in response to the OECD Recommendations involved the recognition by those countries of a substantive international obligation not to construct regimes aimed entirely at the tax base of other countries, a clear example of the OECD's "interfering with [an]other country's decision about how to structure its own tax system," which O'Neill found so objectionable.[44] At the same time, the increased attention that the U.S.

40. OECD GLOBAL FORUM ON TAXATION: A PROCESS FOR ACHIEVING A GLOBAL LEVEL PLAYING FIELD 1 (June 3–4, 2004), http://www.oecd.org/dataoecd/13/0/31967501.pdf.

41. OECD, *Agreement on Exchange of Information on Tax Matters*, http://www.oecd.org/dataoecd/15/43/2082215.pdf (last visited Apr. 20, 2009).

42. For a list of the exchange agreements, see OECD, *Model Agreement on Exchange of Information on Tax Matters, Developed by the OECD Global Forum Working Group on Effective Exchange of Information*, http://www.oecd.org/document/7/0,3343,en_2649_33767_38312839_1_1_1_1,00.html (last visited Apr. 20, 2009).

43. *See, e.g.*, Agreement on Assistance in Civil and Criminal Tax Matters Through Exchange of Information, F.R.G.-Isle of Man, Mar. 2, 2009, *available at* http:www.oecd.org/dataoecd/57/5/42262036.pdf.

44. *See* O'Neill Press Release, *supra* note 36.

position brought to the importance of exchange of information seemingly aided in establishing an international norm or benchmark for exchange, which includes civil tax matters and goes far beyond O'Neill's references to "tax evaders" and "prosecution of illegal activity."

While non-Member countries were not directly involved in developing the analytical framework of the 1998 Report before it was adopted, substantial effort was made to bring non-Member countries into the dialogue. In many cases, their concerns with harmful tax competition were greater than those of Member countries because they were less able to protect their tax bases unilaterally. Three regional seminars were held in Mexico, Singapore, and Turkey while the Report was being drafted.[45] At this time, the issues raised by harmful tax competition were discussed and the views of non-Member countries were expressed. After the Report was published and the Forum on Harmful Tax Practices set up, a number of multilateral meetings were held in conjunction with the Southern African Development Community, the Asian Development Bank, and the Inter-American Center of Tax Administrations. After the issuance of "Towards Global Tax Co-operation: Progress in Identifying and Eliminating Harmful Tax Practices" ("2000 Report"), which listed preferential regimes in Member countries and provided the initial list of tax havens, an international symposium to discuss the global implications of harmful tax practices was held in Paris and attended by twenty-seven non-Member countries.[46] The purpose of these meetings was to encourage non-Member countries to associate themselves with the 1998 Report. The Global Forum on Taxation has also held events dealing with harmful tax practices and the need for a "level playing field" with regard to transparency and exchange of information. These efforts can be seen as part of the wider move by the OECD to be more inclusive.

B. Dispute Resolution and Arbitration

As international trade and investment increase, so too do the possibilities of disagreements among countries as to the appropriate application of international tax rules. These disputes may involve transfer pricing issues, differing characterization rules for income, disagreement about whether a permanent establishment exists, or more generally, the appropriate exercise of potential taxing rights by the source-country jurisdiction.

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45. *The OECD's Global Relations Programme*, *supra* note 19.

46. *The OECD's Project on Harmful Tax Practices: The 2001 Progress Report*, *supra* note 38, at 7.

The OECD Model Convention and bilateral treaties based on the Model provide a procedural mechanism, the Mutual Agreement Procedure ("MAP"), for resolving these types of disputes where the interpretation and application of a treaty is involved. Article 25 of the Model Convention, implemented in existing bilateral treaties, provides that if the taxpayer believes that the actions of one or both of the countries result in taxation "not in accordance with the convention," he can present the case to the "competent authority" of the country of which he is a resident.[47] If that country cannot resolve the problem unilaterally, it has the obligation under the treaty to undertake discussions with the other country to "endeavor" through the MAP to resolve the issue. This procedure usually results in a "mutual agreement" that provides a resolution to the issue regarding the treaty. If, after "endeavoring" to agree, the two countries are in fact unable to agree, however, the taxpayer is potentially left with unrelieved double taxation, thus thwarting the principal purpose of the treaty, to avoid double taxation.[48]

The lack of a mechanism to achieve a solution to these issues under tax treaties has become more and more striking as nontax barriers to trade and investment are eliminated and tax issues assume greater and greater importance. Competing trade[49] and investment disciplines[50] already provide institutional structures to resolve disputes in their fields of competence, and the lack of such a mechanism in the tax area is highlighted.

For many years, there have been proposals to have unresolved treaty issues dealt with by some form of arbitration procedure.[51] A number of existing treaties contain a provision for *optional* arbitration, but as a practical matter, the provisions have not been used; as both competent authorities must agree to go forward, it is possible for one of the authorities to block the arbitration when the taxpayer requests the proceeding. In order to ensure some kind of consistent and binding arbitration decision, it would be necessary to provide for the *mandatory* arbitration of unresolved cases after a certain period of time has passed. There have been

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47. OECD, Model Convention with Respect to Taxes on Income and on Capital art. 25, para. 5, July 17, 2008, *available at* http://www.oecd.org/dataoecd/14/32/41147804.pdf [hereinafter Model Tax Convention].

48. *Id.*

49. *See, e.g.*, Reuven Avi-Yonah, *The WTO, Export Subsidies, and Tax Competition*, *in* WTO AND DIRECT TAXATION 115 (Michael Lang, Judith Herdin & Ines Hofbauer eds., 2005).

50. *See, e,g.*, Thomas Walde & Abba Kolo, *Investor-State Disputes: The Interface Between Treaty-Based International Investment Protection and Fiscal Sovereignty*, 35 INTERTAX 424 (2007).

51. *See, e.g.*, GUSTAF LINDENCRONA & NILS MATTSSON, ARBITRATION IN TAXATION (1981).

several proposals modeled on commercial arbitration from private sector groups providing for mandatory arbitration in tax matters.[52] These proposals essentially deal with the arbitration of tax disputes as an *alternative* to the existing MAP procedures.

Not unexpectedly, countries' reactions to proposals for mandatory arbitration in taxation have historically been muted. From a theoretical perspective, giving up the power to determine the tax liability of a taxpayer to a nongovernmental body could be viewed as an unacceptable intrusion on the State's sovereignty. From a practical point of view, the competent authorities charged with deciding the case could object to having the case taken out of their hands. Nonetheless, the practical need for some kind of mechanism to resolve disputes grew increasingly clear. At the same time, there were complaints from the private sector about the functioning of the existing MAP procedure. The procedure took too long and was not transparent; it was costly and expenses were incurred with no assurance of an acceptable outcome.

The recognition early on that effective dispute resolution mechanisms were essential to the functioning of the OECD led to an OECD project to develop them. As the Committee of Fiscal Affairs observed in describing the background of the work of the Joint Working Group charged with developing the dispute resolution proposals:

> [P]roviding an effective dispute resolution mechanism for tax disputes is closely connected to the basic OECD approach to its work. The OECD is a consensus organization and does not typically generate "hard law" but principles and guidelines. Working in this way, it is unavoidable that differences in interpretation and application will arise. It is thus an important responsibility of the Organization to make every effort to ensure that there is a well-functioning procedural mechanism to deal with these disputes when they do arise. This is true both with regard to relations between Member countries, but also, and in some ways more importantly, in relations between the OECD Member countries and Non-OECD Economies . . . .
>
> The starting point for the [Joint Working Group's] work was a detailed examination of the existing MAP process. It is clear that the MAP process will continue to be the basic mechanism for the resolution of international tax disputes. The existing MAP process has provided and will continue to provide a generally effective and efficient method for dealing with these issues. . . . [However] it remains the case that the existing procedures do not ensure that in all cases a final resolution of in-

52. ORG. FOR ECON. CO-OPERATION & DEV., CTR. FOR TAX POL'Y & ADMIN., IMPROVING THE PROCESS FOR RESOLVING INTERNATIONAL TAX DISPUTES, app. at 40–54 (July 27, 2004), *available at* http://www.oecd.org/dataoecd/44/6/33629447.pdf.

> ternational tax disputes can be achieved. Thus the JWG has considered in some detail a range of Supplementary Dispute Resolution . . . techniques which can help to ensure that international tax disputes come to a satisfactory conclusion.[53]

The focus of the OECD dispute resolution work was thus on improving the MAP process generally and providing *supplementary* mechanisms to make the MAP work more effectively. In this way, the proposal for mandatory arbitration could be considered together with other changes and improvements in MAP generally and not a (threatening) free-standing proposal. This approach was carried forward in the structure of the arbitration proposal developed by a Joint Working Group and ultimately adopted as part of the 2008 amendments to the Model Convention.[54] Arbitration was not presented, as in previous proposals, as an alternative to MAP, but as a means of supplementing MAP. Rather than taking the entire unresolved case away from the competent authorities, the proposed arbitration procedure referred unresolved *issues* to the arbitrators. When the arbitrators' decisions on those issues were reached, the case was returned to the competent authorities to establish an agreed solution to the entire case. This solution went far to assuage countries' sovereignty concerns and, at the same time, left the competent authorities with an important role in the final resolution of the case.

A remaining issue was the relation of the arbitration procedure to the taxpayer's domestic law remedies. Under the original proposal, the taxpayer was required to give up his rights to domestic legal remedies as a condition to entering into the arbitration process. When this structure was presented in the initial Discussion Draft,[55] it was met by skepticism from the private sector. There was objection to waiving domestic rights in a situation where the process remained a government-to-government one, the taxpayer had no right to be directly represented, and there was no assurance that double taxation would in fact be relieved. There were also concerns that such waivers might not be legally enforceable in some countries.

In response to these concerns, the procedure was subsequently modified to provide that submission to arbitration did not require waiver of domestic rights. The unresolved issue would be submitted to arbitration; the arbitral decision would then be incorporated into a mutual agreement,

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53. *Id.* at 3.

54. Model Tax Convention, *supra* note 47.

55. ORG. FOR ECON. CO-OPERATION & DEV., CTR. FOR TAX POL'Y & ADMIN., PROPOSALS FOR IMPROVING MECHANISMS FOR THE RESOLUTION OF TAX TREATY DISPUTES 9 (Feb. 2006), *available at* http://www.oecd.org/dataoecd/5/20/36054823.pdf.

which would be presented to the taxpayer as an agreed solution giving a uniform interpretation or application of the treaty. If the taxpayers affected by the case agreed, the case could be resolved; if not, as is the normal procedure in mutual agreement cases, any taxpayer affected by the case could reject the MAP and be left with domestic remedies.[56] In this way, the arbitration functioned to supplement MAP and allowed the case to be resolved. This approach was in general satisfactory to governments since it minimized the intrusion of nongovernmental actors in the dispute resolution process and was also responsive to private sector concerns by providing for the mandatory resolution of the dispute issues without unduly compromising the ultimate recourse to domestic remedies. Thus, by moving from an approach that viewed arbitration as an alternative to traditional procedures, to dealing with arbitration as part of a general process of improving dispute resolution, a satisfactory resolution of the various concerns was achieved.

Article 25.5 of the Model Convention now contains a procedure for mandatory arbitration following the structure outlined above, and a sample mutual agreement contained in the Commentary includes a substantial discussion as to the details of the procedure.[57] It provides for a number of "default" provisions to deal with situations where one of the parties to the arbitration is stalling or refusing to cooperate. For example, if one of the competent authorities does not appoint an arbitrator within the stipulated time frame, the Director of the Centre for Tax Policy and Administration is authorized to make the appointment, thus allowing the process to go forward. It is not expected that many cases will in fact require arbitration. Even under prior procedures, the vast majority of MAP cases were satisfactorily resolved, and the possibility of arbitration at the end of the two-year period provided should likely increase the competent authorities' efforts to reach a successful conclusion to the case.[58]

The new paragraph is accompanied by a footnote, which provides:

> In some States, national law, policy or administrative considerations may not allow or justify the type of dispute resolution envisaged under this paragraph. In addition, some States may only wish to include this paragraph in treaties with certain States. For these reasons, the para-

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56. In practice, it is very rare for an agreed MAP solution to be rejected because it can cause the taxpayer to face the possibility of conflicting national decisions and the resulting double taxation.

57. Model Tax Convention, *supra* note 47.

58. The prophylactic effect of the existence of an arbitration procedure should encourage the competent authorities to reach a decision to avoid having to refer the case to arbitration. As was observed in the process of the dispute resolution work, "The best arbitration is no arbitration."

> graph should only be included in the Convention where each State concludes that it would be appropriate to do so . . . .[59]

The inclusion of the footnote was important for some countries that were still hesitant about the arbitration procedure, and it allowed them to approve the procedure in principle while still retaining some flexibility in its application.[60] It was clear in the nearly ten-year process leading to the adoption of the new article that it took countries some time to understand and become comfortable with arbitration. In that process, it was important to move from a generalized discussion of whether countries were "for" or "against" arbitration to looking at the details of a concrete proposal, which could then be modified in a nuanced way to take specific concerns into account. The use of the footnote technique was part of that evolution.

It remains to be seen how the dispute resolution process will work in the future. Article 25.5 in the Model, even accompanied by the footnote, establishes the principle that an arbitration procedure is important in the proper functioning of the treaty, and the extensive Commentary offers solutions to many of the structural problems involved in making arbitration function. The United States has recently ratified three new treaties containing mandatory arbitration procedures: Protocol to the Germany-United States treaty (signed June 1, 2006), the new Belgium-United States treaty (signed November 27, 2006), and the 5th Protocol to the Canada-United States treaty (signed September 21, 2007). In addition, other important recent treaties contain mandatory arbitration provisions along the lines of the OECD Model.[61] Thus, it may take some time before arbitration is a standard provision in bilateral treaties. However, as an "international norm," the provision in the Model will certainly speed up the process.

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59. Model Tax Convention, *supra* note 47.

60. *See id.* at 7 n.1. The footnote technique was also used in connection with the adoption of Article 27 dealing with assistance in the collection of taxes, an issue that also raises some sensitive issues.

61. The recently signed Netherlands-U.K. treaty contains an arbitration provision that tracks very closely the provision in the OECD Model. *Compare* Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and on Capital Gains, Neth.-U.K., art. 25(5), Sept. 26, 2008, *available at* http://www.minfin.nl/dsresource?objectid=59016&type=pdf, *with* ORG. FOR ECON. CO-OPERATION & DEV., CTR. FOR TAX POL'Y & ADMIN., THE 2008 UPDATE TO THE MODEL TAX CONVENTION, para. 1 (July 17, 2008), *available at* http://www.oecd.org/dataoecd/20/34/41032078.pdf.

C. Services Permanent Establishment

One of the principal functions of tax treaties is to relieve double taxation by allocating taxing jurisdiction between the source and resident States. This is technically accomplished by reducing the source country's taxing claims in some situations and requiring the residence country to give double tax relief for the source country tax in cases where the source country has retained the right under the treaty to tax the income.

Under this set of rules, in order for the source country to have the right to tax business profits, the OECD Model requires a certain level of economic penetration in the source country, a so-called "permanent establishment." While the treaty definition of permanent establishment is complex, it generally requires some sort of "fixed place of business" through which the business of the enterprise is carried on.[62] As a result of this definition, the provision in the source country of personal services not attributable to a permanent establishment generally does not give the source country the right to tax.[63] The 2008 update of the OECD Model confirms the OECD's basic policy conclusion that its provision of personal services should not constitute a permanent establishment. However, the Commentary to Article 5 now provides for an "alternative provision" whereby countries that do not share the policy conclusion could allow the taxation of profits from the provision of personal services if the period in which the personal services are performed in the source country exceeds 183 days over a twelve-month period, even in the absence of a fixed place of business.[64] The public Discussion Draft that presented the Report of the Working Group that developed the proposal set forth the background of the proposal:

> The report of the Working Group concluded that no changes should be made to the provisions of the OECD Model Tax Convention and that services should continue to be treated the same way as other types of business activities. Under the applicable rules of the OECD Model, the profits from services performed in the territory of a Contracting State by an enterprise of the other Contracting State are not taxable in the first-mentioned State if they are not attributable to a permanent establishment situated therein (as long as they are not covered by other Articles of the Convention that would allow such taxation). This result,

62. The OECD work on establishing an international consensus on how this principle would apply in the case of electronic commerce has been extensively discussed in the literature. *See, e.g.*, Cockfield, *supra* note 4, at 144.

63. The U.N. Model contains a services permanent establishment provision. U.N. Model Double Taxation Convention Between Developed and Developing Countries art. 5(3)(b), U.N. Doc. ST/ESA/102 (Jan. 1, 1980).

64. Model Tax Convention, *supra* note 47, at 102–03.

> under which these profits are only taxable in the State of residence of the enterprise, is supported by various policy and administrative considerations. . . . The report acknowledged, however, that some States are reluctant to adopt the above principle of exclusive residence taxation of services that are not attributable to a permanent establishment situated on their territory but that are performed on that territory and noted that these States propose alternative provisions to preserve source taxation rights, in certain circumstances, with respect to the profits from such services.
>
> The Working Group considered that it was important to circumscribe the circumstances in which States that did not agree with its conclusion could, in a bilateral treaty, provide that profits from services performed by a foreign enterprise could be taxed by them even if not attributable to a permanent establishment situated on their territory. In particular, the Group considered that it was important to stress that a State should not have source taxation rights on income derived from the provision of services performed by a non-resident outside that State, that only the profits from services, as opposed to the gross payments for these services, should be subjected to tax and that it was appropriate, for compliance and other reasons, not to allow a State to tax the profits from services performed on their territory in certain circumstances (e.g. when such services are provided during a very short period of time).[65]

IV. WHAT IS THE "MODEL"? WHAT IS THE "NORM"?

This brief exposition of a few recent activities of the OECD in the tax area is by no means exhaustive and is intended only to review several representative projects.[66] It does allow, however, some modest conclusions about the OECD's role in the "formation of international norms."

It is clear that the OECD has become much more open and inclusive in its work. The accession project for new Members, the increased role of Observers in Committee activities, the proposal for enhanced engagement, the extensive activities in the Multilateral Centres, and the activities of the Global Forum on Taxation have all brought different voices to the discussions of international tax issues. In addition, business representatives are consulted more frequently, as it is important that the tax policy makers understand the commercial settings in which the tax rules will

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65. ORG. FOR ECON. CO-OPERATION & DEV., CTR. FOR TAX POL'Y & ADMIN., THE TAX TREATY TREATMENT OF SERVICES: PROPOSED COMMENTARY CHANGES 2–3 (Dec. 8, 2006), *available at* http://www.oecd.org/dataoecd/2/20/37811491.pdf [hereinafter TAX TREATY TREATMENT OF SERVICES].

66. For a description of the ongoing work at the Centre for Tax Policy and Analysis, see ORG. FOR ECON. CO-OPERATION & DEV. CTR. FOR TAX POL'Y & ADMIN., CURRENT TAX AGENDA (2008), *available at* http://www.oecd.org/dataoecd/38/17/1909369.pdf.

apply. All States have an interest in designing workable rules, and including private sector representatives in the process (e.g., through the use of Discussion Drafts prior to final decisions) helps to focus on these issues.

This expansion of scope, however, has increased the difficulty of reaching consensus on some questions. The OECD has been most successful where it works to establish principles of sufficient specificity to be helpful in channelling policy formulation, but not principles so detailed as to be too restrictive of the ways in which the countries can implement them. Thus, with respect to dispute resolution, the basic principle of the need for arbitration as a means to resolve treaty disputes has been established, but the details have been left open.[67] In addition, the footnote concerning the possibility that some countries may not wish to use arbitration in all cases also makes the Model less prescriptive, but at the same time, it keeps the basic principle as part of the Model.

A similar situation exists in the case of reservations and observations to the Model.[68] By allowing countries to indicate reservations with respect to particular narrow issues, agreement can be reached on the basic structure and approach of the provision in question. The discussions and peer pressure to come to a consensus conclusion on as much of the treaty and commentary text as possible work to narrow the areas of disagreement. Thus, the OECD work can provide the basic structure for technical rules on which all agree, leaving other issues for further, usually bilateral, negotiation. In other cases, the use of alternative provisions in the Commentary to the Model can preserve the basic principle in the Model while allowing countries "reluctant" to accept the majority view to have their position expressed. At the same time, this allows a process in which variation from the Model can be "circumscribed" and made to work technically.[69]

Not all view these developments as favorable. The BIAC comments from the business community indicated that it was very "concerned"

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67. Note, for example, that details of the arbitration procedure are set forth in an Annex.

68. *See* Model Tax Convention, *supra* note 47, at 14–15.

69. For example, the changes in the commentary make it clear that if personal services are to be taxed in connection with a personal services permanent establishment, they must be taxed on a net basis, allowing a deduction for associated costs, and not on a gross basis, thus disapproving of the approach taken by some countries and establishing net-basis taxation as the norm. *Tax Treaty Treatment of Services*, *supra* note 65, at 6.

about the use of alternative provisions.[70] A former Chair of the Committee on Fiscal Affairs recently observed:

> In terms of the model tax convention, in my view, in many ways it no longer reflects consensus because of all of the reservations and observations the convention and the commentary now contain. More importantly, some of the diverging views are now presented in areas that go beyond reservations and observations. For example, the commentary to the latest update to the model includes an alternative position on the taxation of services in the article on permanent establishments (article 5). How can consensus be maintained if the commentary provides alternative positions? A similar situation arises in the article on assistance in the collection of taxes (article 27). The article contains a footnote saying that in some countries, national law, policy, or administrative considerations may not allow or justify the type of assistance envisaged under this article and therefore indicates that this article only applies where countries agree. In my view, if the country's law does not allow for collection assistance as provided in this article, then the country should change its law. Because the model convention increasingly allows countries to cherry-pick among their favorite provisions, the model really no longer is a model.[71]

Thus, in taking its work forward, the challenge for the OECD will be to develop techniques that can not only establish agreement on policy principles and technical rules to the extent possible, but at the same time provide for adequate "escape valves" on certain issues to facilitate agreement on others. While the OECD is certainly not a "Ruler of the World," by taking advantage of its expanded institutional structure and its high technical standards, going forward it seems to be well-placed to contribute to the development of international tax norms.

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70. Letter from Patrick J. Ellingsworth, Chair, Bus. & Indus. Advisory Comm. on Taxation & Fiscal Affairs, to Jeffrey Owens, Dir., Ctr. For Tax Pol'y & Admin. (Feb. 20, 2007), *available at* http://www.biac.org/statements/tax/Final-07-01-22-services-tax-treaty-treatment.pdf.

71. Joann M. Weiner, *Inteview with Joseph Guttentag*, 51 TAX NOTES INT'L 1024 (2008). Guttentag was Deputy Assistant Secretary of the Treasury (International) in the Clinton Administration.

THE OECD HARMFUL TAX COMPETITION REPORT: A RETROSPECTIVE AFTER A DECADE

*Reuven S. Avi-Yonah**

INTRODUCTION: TWO VIEWS OF THE OECD REPORT

Eleven years ago the Organisation for Economic Co-operation and Development ("OECD") published its report "Harmful Tax Competition: An Emerging Global Issue"[1] ("OECD Report" or "Report"). The Report identified for the first time two problem areas facing international income taxation of geographically mobile activities: tax havens and harmful preferential tax regimes.[2] It sought to initiate activities to eliminate both types of problems.[3]

Over a decade has passed, and it is now time to consider the following: have the OECD Report and its progeny achieved anything useful? There have been two recent but contradictory answers to this question. On the one hand, J.C. Sharman concluded in his book on tax havens that the OECD effort was unsuccessful: "[b]y 2002 the small [S]tate tax havens had prevailed, and the campaign to regulate international tax competition had failed."[4] On the other hand, Vaughn James argued as early as 2002 that the policy driven by the OECD Report has "robbed . . . Caribbean countries of their sovereign right to determine their tax and economic policies."[5]

These two views obviously cannot both be true. Either the tax havens have prevailed, or they have been crushed. Which view is correct? This Article will argue in Parts I and II that, overall, the OECD effort has been a success. The principal ground for this argument is data showing no decline in individual or corporate tax revenues in OECD member countries

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1. COMM. ON FISC. AFF., ORG. FOR ECON. CO-OPERATION & DEV., HARMFUL TAX COMPETITION: AN EMERGING GLOBAL ISSUE (1998), *available at* http://www.oecd.org/dataoecd/33/1/1904184.pdf [hereinafter OECD REPORT].
2. *Id.* ¶ 4.
3. *See id.* ¶ 90.
4. J.C. SHARMAN, HAVENS IN A STORM: THE STRUGGLE FOR GLOBAL TAX REGULATION 1 (2006).
5. Vaughn E. James, *Twenty-First Century Pirates of the Caribbean: How the Organization for Economic Cooperation and Development Robbed Fourteen CARICOM Countries of Their Tax and Economic Policy Sovereignty*, 34 U. MIAMI INTER-AM. L. REV. 1, 2 (2002).

over the past decade, in contrast with a decline in corporate tax revenues in non-OECD countries over the same period, as a result of tax competition among them and their failure to collect individual income taxes from the rich due to tax evasion.

However, more work remains to be done, and Part III of this Article argues that the OECD members could advance the objectives of the Report in two key ways: imposing a coordinated, refundable withholding tax on all payments to nontreaty jurisdictions; and strengthening tax rules for controlled foreign corporations ("CFCs") to combat preferential regimes in non-OECD countries.

I. THE OECD REPORT AND ITS PROGENY[6]

The original OECD Report focused on two issues. First, it identified "tax havens" as jurisdictions with (a) no or nominal income taxes and (b) at least one of three characteristics: lack of effective exchange of information, lack of transparency, and lack of substantial activities by taxpayers.[7] Second, it identified "preferential regimes" as regimes offering (a) a no or low effective tax rate and (b) at least one of the following: ring fencing, lack of transparency, and lack of effective exchange of information.[8] The OECD Report condemned both tax havens and preferential regimes as "harmful tax competition."[9]

Following publication of the Report, the OECD began efforts to curtail preferential regimes in OECD member countries and to force tax havens to cooperate. In 2000, the OECD published a second report, focused in particular on how bank secrecy laws in many tax havens impeded their cooperation with international tax information requests.[10] This report stated that all OECD countries should "permit tax authorities to have access to bank information, directly or indirectly, for all tax purposes so that tax authorities can fully discharge their revenue raising responsibilities and engage in effective exchange of information."[11]

6. This section is based on a 2008 report by the U.S. Senate Permanent Subcommittee on Investigations. STAFF OF S. COMM. ON HOMELAND SEC. & GOV. AFF., PERM. SUBCOMM. ON INVESTIGATIONS, 110TH CONG., REPORT ON TAX HAVEN BANKS AND U.S. TAX COMPLIANCE 26–29 (2008), *available at* http://hsgac.senate.gov/public/_files/071708PSIReport.pdf [hereinafter SENATE REPORT].

7. OECD REPORT, *supra* note 1, ¶ 23.

8. *Id.* ¶ 27.

9. *See id.* ¶ 4.

10. COMM. ON FISC. AFF., ORG. FOR ECON. CO-OPERATION & DEV., IMPROVING ACCESS TO BANK INFORMATION FOR TAX PURPOSES (2000), *available at* http://www.oecd.org/dataoecd/3/7/2497487.pdf [hereinafter OECD BANK INFORMATION REPORT].

11. *Id.* ¶ 20.

As a result of these two reports, in mid-2000, the OECD published a list of thirty-five offshore jurisdictions that it planned to include in a subsequent list of "uncooperative tax havens" unless the countries agreed to remove "the harmful features of preferential regimes" by April 2003, and fully eliminated taxpayers' benefits under such regimes by December 2005.[12] Echoing the Report, in this document the OECD defined a "tax haven" as a country with (a) no or nominal taxation and (b) one or both of the following: ineffective tax information exchange with other countries, and a lack of transparency in its tax or regulatory regime, including excessive bank or beneficial ownership secrecy.[13]

Many countries did not want to appear on either the OECD's list of thirty-five offshore jurisdictions or its subsequent list of uncooperative tax havens. To avoid being included on the former, six jurisdictions, Bermuda, the Cayman Islands, Cyprus, Malta, Mauritius, and San Marino, gave the OECD signed commitment letters in April and May 2000, promising to provide effective tax information exchange by the specified deadlines.[14] In response, the OECD omitted these countries from the list of thirty-five.[15] To avoid appearing on the list of uncooperative tax havens, other countries provided similar commitment letters to the OECD later in 2000 and in 2001, and the OECD agreed to omit them from the updated list of uncooperative tax havens.[16]

Despite wavering support from the United States for the OECD effort, by 2002, twenty-eight of the original thirty-five offshore jurisdictions identified by the OECD had committed to offering effective information

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12. COMM. ON FISC. AFF., ORG. FOR ECON. CO-OPERATION & DEV., TOWARDS GLOBAL TAX CO-OPERATION: PROGRESS IN IDENTIFYING AND ELIMINATING HARMFUL TAX PRACTICES ¶¶ 4, 17–19 (2000), *available at* http://www.oecd.org/dataoecd/9/61/2090192.pdf [hereinafter 2000 PROGRESS REPORT].

13. *Id.* The OECD 2000 Progress Report did, however, omit from the definition the "lack of substantial activities by taxpayers," which would have limited the ability of taxpayers to set up pure shell corporations in tax havens. *Compare id.* ¶ 7, *with* OECD REPORT, *supra* note 1, ¶ 23. For a critique of this change, see Michael C. Webb, *Defining the Boundaries of Legitimate State Practice: Norms, Transnational Actors and the OECD's Project on Harmful Tax Competition*, 11 REV. INT'L POL. ECON. 787–827 (2004).

14. *See* COMM. ON FISC. AFF., ORG. FOR ECON. CO-OPERATION & DEV., THE OECD'S PROJECT ON HARMFUL TAX PRACTICES: THE 2001 PROGRESS REPORT ¶ 17 (2001), *available at* http://www.oecd.org/dataoecd/60/28/2664438.pdf [hereinafter 2001 PROGRESS REPORT].

15. *See id.*; 2000 PROGRESS REPORT, *supra* note 12, ¶ 17 (excluding these six jurisdictions from the list of thirty-five jurisdictions deemed "uncooperative tax havens").

16. *See* 2001 PROGRESS REPORT, *supra* note 14, ¶ 22 ("Since the issuance of the 2000 Report, [five] jurisdictions have made commitments to eliminate harmful tax practices. They are Aruba, Bahrain, the Isle of Man, the Netherlands Antilles, and the Seychelles.").

exchange in criminal and civil tax matters by the given dates.[17] The result was that only seven jurisdictions were ultimately named on the OECD's official list of uncooperative tax havens, made public in mid-2002.[18] Over time, four of the seven made the required commitments, so that, by 2008, the OECD's list had shrunk to just three countries: Andorra, Liechtenstein, and Monaco.[19] To date, these three countries have persistently refused to provide tax exchange information with other jurisdictions in civil and criminal matters.[20]

While it was developing the lists of offshore jurisdictions and uncooperative tax havens, the OECD took a number of steps to advance global tax information exchange. In 2001, it established the Global Forum on Taxation, with participants drawn from OECD member countries and nonmember offshore jurisdictions, to discuss transparency and tax information exchange issues.[21] In 2002, the OECD issued a model Agreement on Exchange of Information on Tax Matters that States could sign on a bilateral or multilateral basis to meet their commitments to tax information exchange.[22] In 2004, to further promote the OECD's work, the G20 Finance Ministers issued a communiqué supporting the OECD's tax information exchange initiative and model agreement.[23]

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17. *See* OECD, *The OECD Issues the List of Unco-operative Tax Havens* (Apr. 18, 2002), http://www.oecd.org/document/19/0,3343,en_2649_33745_2082323_1_1_1_1,00.html (listing Andorra, the Principality of Liechtenstein, Liberia, the Principality of Monaco, the Republic of the Marshall Islands, the Republic of Nauru, and the Republic of Vanuatu as the remaining "unco-operative tax havens").

18. *See id.*

19. OECD, List of Unco-operative Tax Havens, http://www.oecd.org/document/57/0,3343,en_2649_33745_30578809_1_1_1_1,00.html (last visited Mar. 7, 2009).

20. Liechtenstein, however, is currently under pressure and has agreed to cooperate with the OECD. *See* EUbusiness.com, *Liechtenstein Says Must Shed Tax Haven Image*, Feb. 18, 2009, http://www.eubusiness.com/news-eu/1234957621.46/ ("Liechtenstein is ready to work with the OECD to overcome tax fraud, as the principality seeks to shed its image of an uncooperative tax haven . . . .").

21. *See* OECD, *OECD Pursues a Global Dialogue on International Taxation* (Oct. 1, 2001), http://www.oecd.org/document/23/0,3343,en_2649_33745_2367319_1_1_1_1,00.html.

22. *See* OECD, Agreement on Exchange of Information on Tax Matters, *available at* http://www.oecd.org/dataoecd/15/43/2082215.pdf (last visited Mar. 7, 2009). *See also* OECD, OECD Releases Model Agreement on Exchange of Information in Tax Matters (Apr. 18, 2002), http://www.oecd.org/document/4/0,3343,en_2649_33745_2082244_1_1_1_1,00.html.

23. G20, Meeting of Finance Ministers and Central Bank Governors: Communiqué, at 9 (Nov. 21, 2004), *available at* http://www.g20.org/Documents/2004_germany.pdf ("The G20 therefore strongly support the efforts of the OECD Global Forum on Taxation to promote high standards of transparency and exchange of information for tax purposes and to provide a cooperative forum in which all countries can work towards the establishment of a level playing field based on these standards.").

In 2006, the OECD issued a new report assessing the legal and administrative frameworks for tax transparency and tax information exchange in eighty-two countries.[24] The purpose of this assessment was to help the OECD determine "what is required to achieve a global level playing field in the areas of transparency and effect exchange of information for tax purposes."[25] In October 2007, the OECD updated its eighty-two-country assessment.[26] The OECD summarized its findings as follows:

> Significant restrictions on access to bank information for tax purposes remain in three OECD countries (Austria, Luxembourg, Switzerland) and in a number of offshore financial centres (e.g. Cyprus, Liechtenstein, Panama and Singapore). Moreover, a number of offshore financial centres that committed to implement standards on transparency and the effective exchange of information standards developed by the OECD's Global Forum on Taxation have failed to do so.[27]

OECD-led efforts to promote tax information exchange are ongoing. In March 2007, the OECD sponsored a series of meetings among more than one hundred tax inspectors from thirty-six countries to discuss aggressive tax planning schemes within their jurisdictions.[28] According to top OECD officials, the meetings indicated that key elements in most of these tax dodges could be traced to tax havens.[29] In January 2008, the OECD held discussions among its members on taking "defensive measures" against tax havens that refuse to cooperate with tax information requests.[30] Some OECD members have also recently called for expanding the list of uncooperative tax havens to include countries that, despite a written commitment, have failed to provide tax information upon request in criminal and civil matters.[31]

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24. GLOBAL FORUM ON TAXATION, OECD, TAX CO-OPERATION: TOWARDS A LEVEL PLAYING FIELD (2006).

25. *Id.* at 7.

26. GLOBAL FORUM ON TAXATION, OECD, TAX CO-OPERATION: TOWARDS A LEVEL PLAYING FIELD (2007).

27. OECD, *OECD Reports Progress in Fighting Offshore Tax Evasion, but Says More Efforts Are Needed* (Dec. 10, 2007), http://www.oecd.org/document/48/0,3343,en_2649_201185_39482288_1_1_1_1,00.html.

28. *See, e.g.*, Richard Highfield, *OECD Meeting with Mexican Legislators on Fiscal Policy and Finance: Tax Administration and the Reform Process*, Mar. 27, 2007, http://gaceta.diputados.gob.mx/Gaceta/60/2007/jun/InfOCDE/Anexos.ppt/Archivo11.ppt.

29. *See Offshore Financial Centers Playing Key Role in Aggressive Tax Plans, OECD Official Says*, BNA DAILY REPORT FOR EXECUTIVES, Mar. 27, 2007.

30. *OECD Signals Plan to Renew Efforts Against Non-Cooperative Jurisdictions*, BNA DAILY REPORT FOR EXECUTIVES, Oct. 15, 2007.

31. *See Testimony of Jeffrey Owens, Senate Finance Committee Hearing on Offshore Tax Evasion* (2007).

II. THE DATA

The theoretical and practical basis for the concerns expressed in the OECD Report is laid out in detail elsewhere,[32] so I will only summarize it here. In the last two decades, an increasing number of countries have competed for inbound investment by offering foreign corporate investors tax holidays.[33] Multinational companies can with relative ease relocate production facilities in response to variations in foreign tax rates. Multinationals use such "production tax havens" to derive the bulk of their foreign income free of host country taxation.[34] Furthermore, wishing not to damage the competitiveness of their multinational firms against multinationals based in other countries, the United States and most other developed countries balk at directly taxing foreign-source business income.[35] If multinationals' foreign-source income were taxed by their home jurisdictions, new firms would migrate towards jurisdictions that leave such income effectively untaxed,[36] creating a regime where corporate income earned abroad would largely be free of both host- and home-country taxation.

For example, as a large multinational corporation, Intel Corporation has facilities in many countries that grant tax holidays: the company's major wafer fabrication facilities are in Ireland and Israel, and it also has assembly lines in China, Costa Rica, Malaysia, and the Philippines.[37] Intel does not pay current U.S. tax on income from its foreign operations; according to U.S. law, income earned by U.S. multinationals' foreign

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32. For an extensive discussion, see Reuven S. Avi-Yonah, *Globalization, Tax Competition, and the Fiscal Crisis of the Welfare State*, 113 HARV. L. REV. 1573 (2000) [hereinafter *Fiscal Crisis*]. *See also* Reuven S. Avi-Yonah, *Bridging the North/South Divide: International Redistribution and Tax Competition*, 26 MICH. J. INT'L L. 371 (2004) [hereinafter *International Redistribution*].

33. *See* RAYMOND VERNON, IN THE HURRICANE'S EYE: THE TROUBLED PROSPECTS OF MULTINATIONAL ENTERPRISES 32 (1998); U.N. CONF. ON TRADE & DEV., WORLD INVESTMENT REPORT 1996: INVESTMENT, TRADE AND INTERNATIONAL POLICY ARRANGEMENTS 180 (1996).

34. *See* Rosanne Altshuler & T. Scott Newlon, *The Effects of U.S. Tax Policy on the Income Repatriation Patterns of U.S. Multinational Corporations*, *in* STUDIES IN INTERNATIONAL TAXATION (Giovannini et al. eds., 1993); James R. Hines, Jr. & Eric M. Rice, *Fiscal Paradise: Foreign Tax Havens and American Business*, 109 Q. J. ECON. 149 (1994).

35. *See* Robert J. Peroni, *Back to the Future: A Path to Progressive Reform of U.S. International Income Tax Rules*, 51 U. MIAMI L. REV. 975 (1997).

36. *See* James R. Hines, Jr., *The Flight Paths of Migratory Corporations*, 6 J. ACCOUNTING, AUDITING & FIN. 447, 451–52 (1991).

37. Intel Corp., Annual Report (Form 10-K), at 7 (Dec. 29, 2007), *available at* http://media.corporateir.net/media_files/irol/10/101302/2007annualReport/common/pdfs/intel_2007ar.pdf.

subsidiaries is taxed only after it is repatriated in the form of dividends, which Intel can defer indefinitely.[38] Intel's effective tax rate on foreign-source income is therefore considerably lower than 35%, the nominal rate at which U.S. corporations are taxed.

Should income derived from capital avoid the income tax net, the tax effectively becomes a tax on labor. In fact, as a number of empirical studies suggest, the effective tax rate on income from capital nears zero in some developed countries, and tax rates on capital have tended to noticeably decline since exchange controls were relaxed in the early 1980s.[39] Jurisdictions that had previously relied on income tax revenues must resultantly supplement their tax revenue by raising more regressive taxes.

In OECD member countries, for example, consumption and payroll taxes, both more regressive than the income tax, have expanded the fastest: as a percentage of total revenues, consumption taxes rose from 12% in 1965 to 18% in 1995, and payroll taxes increased from 19% to 27% during the same thirty-year span.[40] Personal and corporate income taxes, however, failed to grow markedly as a percentage of total revenues between 1965 and 1995,[41] the personal income tax comprising 26% compared to 27% and the corporate income tax accounting for 9% versus 8%, in these two years respectively.[42] Additionally, between 1965 and 1994, total tax revenue as a percentage of developed countries' gross domestic product ("GDP") increased sharply—from 28% to almost 40%.[43] This increase was mainly due to the increases in consumption and payroll tax rates.[44] Evidence also suggests that as an OECD member economy becomes more open, taxes on labor tend to rise, but taxes on capital tend to fall.[45]

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38. *See* Reuven S. Avi-Yonah, *International Taxation of Electronic Commerce*, 52 TAX L. REV. 507, 517 (1997) (discussing the "Single Tax Principle" under which foreign-source income is taxed in the residence jurisdiction at the tax rate for investment income).

39. *See, e.g.*, DANI RODRIK, HAS GLOBALIZATION GONE TOO FAR? 63–65 (1997); Jeffrey Owens, *Emerging Issues in Tax Reform: The Perspective of an International Bureaucrat*, 15 TAX NOTES INT'L 2035, 2042–47 (1997).

40. Owens, *supra* note 39, at 2038–40.

41. *Id.*

42. *Id.*

43. INT'L MONETARY FUND, TAX POLICY HANDBOOK 289–94 (Parthasarathi Shome ed., 1995).

44. *Id.*

45. *See* Enrique G. Mendoza et al., *Effective Tax Rates in Macroeconomics: Estimates of Tax Rates on Factor Income and Consumption*, 34 J. MONETARY ECON. 297, 321 (1994); Enrique G. Mendoza et al., *On the Ineffectiveness of Tax Policy in Altering Long-Run Growth* (Ctr. for Econ. Pol'y Research Discussion Paper No. 1378, 1996). Insofar as the income tax is placed on capital and labor, its stability may conceal this trend.

Similar trends may also be noted in countries that are not OECD members or located in the Middle East. These States' total revenues as a share of their GDP increased from an average of 18.8% between 1975 and 1980, to 20.1% between 1986 and 1992.[46] This growth, however, was principally financed through an increase in another revenue source—the value-added tax ("VAT"), which grew from 25.5% to 31.8% of total revenues over the 1980s.[47] During this same period, individual and corporate income tax revenues remained flat, or even declined.[48]

A study by Keen and Simone illustrates both the extent of this problem and its impact on developing countries.[49] Keen and Simone show that, from 1990 to 2001, corporate tax rates declined in both developed and developing countries.[50] However, while in developed countries this decline in the rates was matched by a broadening of the tax base, so that no decline in revenues can be observed,[51] in developing countries, the same period witnessed a decline of corporate tax revenues by about 20% on average.[52] This decline is particularly important in light of the larger share of tax revenues produced by the corporate tax in developing countries (an average of 17%) as opposed to developed countries (an average of 7%).[53] Keen and Simone attribute most of this decline to the spread of targeted tax incentives for multi-national enterprises ("MNEs"). From 1990 to 2001, the percent of developing countries granting tax holidays to MNEs grew from 45% to 58%, and similar trends can be seen for tax breaks for exporters (32% to 45%), reduced corporate rates for MNEs (40% to 60%), and free trade zones (17.5% to 45%).[54] These figures are particularly important because a companion paper by Altshuler and Grubert shows that the evolution of effective tax rates between 1992 and 1998 seem to have been driven by tax competition, and that U.S. manufacturers are becoming increasingly sensitive to tax considerations in determining the location of their investments.[55]

46. TAX POLICY HANDBOOK, *supra* note 43, at 295–303, 307–12.

47. *See id.* at 5.

48. *Id.* at 295–303, 307–12.

49. Michael Keen & Alejandro Simone, *Is Tax Competition Harming Developing Countries More Than Developed?*, 34 TAX NOTES INT'L 1317 (2004).

50. *See id.* at 1320.

51. *See* Rachel Griffith & Alexander Klemm, *What Has Been the Tax Competition Experience of the Last 20 Years?*, 34 TAX NOTES INT'L 1299, 1301 (2004).

52. *See* Keen & Simone, *supra* note 49, at 1318.

53. *Id.* at 1318–21.

54. *Id.*

55. Rosanne Altshuler & Harry Grubert, *Taxpayer Responses to Competitive Tax Policies and Tax Policy Responses to Competitive Taxpayers: Recent Evidence*, 34 TAX NOTES INT'L 1349 (2004).

However, as Griffith and Klemm point out, there is no evidence that tax competition had a negative effect on OECD member countries, even if it led them to reduce tax rates.[56] In fact, in those countries, both individual and corporate tax revenues have been remarkably stable on average from 1975 to 2006. Total tax revenue as a percentage of GDP in OECD countries was 29.4% in 1975, and 35.9% in 2006.[57] Of this, individual taxes on income were 11.2% of GDP in 1975, and 13% in 2006.[58] Corporate taxes were 2.2% of GDP in 1975, and 3.9% in 2006.[59] Thus, while consumption taxes account for most of the increase in tax revenue in the era of globalization, there is no indication that either individual or corporate tax revenues have gone down in OECD countries as a result of tax competition.

It can be argued that these overall statistics are misleading, and that they represent a shift from income taxes paid by the rich on mobile capital to income taxes paid by salary earners who are less mobile. However, this argument does not explain the stability of the corporate tax, since most corporations do have the option of earning their income overseas. Moreover, the fact that in non-OECD countries the effects of tax competition are apparent in the data and lead to a decline in corporate tax revenue suggests that there is something occurring in the OECD countries that prevents such a decline from taking place.[60] Similarly, it is striking that OECD countries succeed in taxing the rich through the income tax far more than developing countries.[61]

In my opinion, the OECD effort to curtail harmful tax competition has something to do with this achievement. As far as the corporate tax is concerned, the effort to cut back on preferential regimes in OECD mem-

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56. Griffith & Klemm, *supra* note 51, at 1299.

57. ORG. FOR ECON. CO-OPERATION & DEV., REVENUE STATISTICS 1965–2007, at 19 (2008).

58. *Id.* at 20.

59. *Id.* at 21. In the EU, the trends are similar: total tax revenue was 39.6% of GDP in 1995 and 39.9% in 2006; the implicit tax rate on capital (the most important part of which is the corporate tax) was 25.8% in 1995, and 33.3% in 2006, despite a decline in the corporate tax rate from 35.3% in 1995, to 23.6% in 2006. *See* TAXATION TRENDS IN THE EUROPEAN UNION (European Comm'n 2008), *available at* http://epp.eurostat.ec.europa.eu/cache/ITY_OFFPUB/KS-30-08-421/EN/KS-30-08-421-EN.PDF.

60. This also addresses the critique that the reason corporate tax revenues are stable is the high profitability of corporations. Presumably, multinationals are just as profitable in developing countries, so without limits on preferential regimes, there would be a decline in profits in OECD countries as well.

61. *See* Richard M. Bird & Eric M. Zolt, *Redistribution via Taxation: The Limited Role of the Personal Income Tax in Developing Countries*, 52 UCLA L. REV. 1627 (2005).

ber countries, plus an increased vigilance on transfer pricing and a concerted effort to lower the permanent establishment ("PE") threshold, have all prevented a decline in corporate tax revenues that would otherwise have taken place.[62]

The U.S. corporate tax shelter saga is a good indication that these kinds of efforts can have a real impact on the numbers. From 1993 to 2003, there was a surge in corporate tax shelters in the United States, the consequence of which was a real decline in corporate tax revenues from 3% to 2% of GDP.[63] In 2003 (following the Enron scandal and a Senate Hearing), the Internal Revenue Service ("IRS") began a serious crackdown on tax shelters, involving in particular an assault on the intermediaries (i.e., accounting firms and law firms) that were essential to devising and marketing the shelters. The result was a remarkable recovery in revenues to 4% of GDP, a level not seen since just after the 1986 Tax Reform Act (which significantly broadened the corporate tax base).[64] This shows that crackdowns like the OECD harmful tax competition initiative can have a material effect on the macro revenue data.

With respect to individual income taxation, the recent stories from Liechtenstein and Switzerland demonstrate that, despite the OECD Report, there is still a lot of revenue lost to tax havens.[65] The Senate Permanent Subcommittee on Investigation estimated the total amount of lost revenue for the United States alone at $100 billion a year; other estimates are lower (i.e., $50 billion) but still quite high.[66] However, the question is not how many people cheat, but how many more would have cheated but for the pressure on tax havens and the negative publicity generated by the OECD effort. In my opinion, if the OECD did not put pressure on tax havens, many more citizens of OECD countries would have transferred their funds to tax havens than the admittedly large numbers that currently do so. To the extent that OECD countries succeed in taxing the rich more

62. *See* Reuven S. Avi-Yonah, *Tax Competition and E-Commerce*, 23 TAX NOTES INT'L 1395 (2001). On lowering the PE threshold, see, for example, Jean Pierre Le Gall, *Can a Subsidiary Be a Permanent Establishment of Its Foreign Parent?*, 60 TAX L. REV. 179 (2007); Lee Sheppard, *Revenge of the Source Countries*, 2006 TNT 200-3 (Oct. 17, 2006).

63. *See* REUVEN S. AVI-YONAH, SENATOR MCCAIN'S CORPORATE TAX PROPOSALS: A CRITICAL EXAMINATION 8 n.7 (2008), *available at* http://www.americanprogressaction.org/issues/2008/pdf/avi-yonah_paper.pdf.

64. *See id.*

65. *See* SENATE REPORT, *supra* note 6, at 32–114.

66. *See id.* at 1; Joseph Guttentag & Reuven Avi-Yonah, *Closing the International Tax Gap*, *in* BRIDGING THE TAX GAP: ADDRESSING THE CRISIS IN FEDERAL TAX ADMINISTRATION 99, 101 (Max B. Sawicky ed., 2005).

than developing countries, and all the evidence shows that they do, this is in large part because of efforts like the OECD Report.

III. THE FUTURE

Nevertheless, it is clear, and the OECD would not dispute, that the OECD's current efforts are not enough. What more can be done? In the corporate arena the answer is clear. While tax competition among OECD countries is on the wane, in large part because of OECD efforts, tax competition continues unabated among non-OECD countries, and in my view that is to their own detriment.[67] The obvious solution is to strengthen the CFC rules. Since 90% or more of MNEs are headquartered in OECD countries, if all OECD jurisdictions abolished deferral, there would be no incentive for developing countries to engage in tax competition. New MNEs might be established in developing countries, but that is not necessarily a bad thing. The major impediment to adopting and strengthening CFC rules has been the fear of harming "your" MNEs in the face of competition from other MNEs.[68] But if all OECD countries acted together, source-based taxation by developing countries could be saved with no harm to competitiveness.[69]

For taxation of individuals' income, the problem is similarly a matter of coordination.[70] A principal problem of dealing with tax havens is that if even a few countries do not cooperate with information exchange, tax evaders are likely to shift their funds there from cooperating jurisdictions, thereby rewarding the noncooperating ones and deterring others from cooperation. Thus, some jurisdictions have advertised their refusal to cooperate with OECD efforts. Recent accounts about Liechtenstein illustrate this point.

However, if the political will existed, the tax haven problem could easily be resolved by rich States through their own actions. The key observation here is that funds cannot remain in tax havens and be productive; they must be reinvested into the prosperous and stable economies of the world (which is why some laundered funds that need to remain in the tax havens earn a negative interest rate). If the rich countries could agree, they could eliminate the tax havens' harmful activities overnight by, for example, imposing a refundable withholding tax (e.g., at 35%) on pay-

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67. *See International Redistribution*, *supra* note 32, at 9–12.

68. This fear has led numerous countries, including the United States, to relax their CFC rules. *See* Reuven S. Avi-Yonah, *Back to the Future? The Potential Revival of Territoriality*, 62 BULL. FOR INT'L TAX'N 471 (2008).

69. *See* Reuven S. Avi-Yonah, *Tax Competition and Multinational Competitiveness: The New Balance of Subpart F*, 18 TAX NOTES INT'L 1575 (1999).

70. *See* Guttentag & Avi-Yonah, *supra* note 66.

ments to noncooperating tax havens, or more broadly, to all nontreaty countries, and insisting on effective exchange of information with treaty countries. The withholding tax would be refunded upon a showing that the income was reported to the residence country.

The financial services industry would no doubt lobby hard against such a step, on the grounds that it would induce investors to shift funds to other OECD member countries. However, the EU and Japan have both committed themselves to taxing their residents on foreign-source interest income. The EU Savings Directive, in particular, requires all EU members to cooperate in exchange of information or impose a withholding tax on interest paid to EU residents.[71] Both the EU and Japan would like to extend this treatment to income from the United States. Thus, this would seem an appropriate moment to cooperate with other OECD member countries by imposing a withholding tax on payments to tax havens that cannot be induced to cooperate in exchanging information, without triggering a flow of capital out of the OECD.[72]

CONCLUSION

In the last decades of the twentieth century, there were frequent predictions that the income tax would be dead in the era of globalization. The distinguished Canadian economist Richard Bird wrote in 1988 that "the weakness of international taxation calls into question the viability of the income tax itself. . . . If something is not done to rectify these problems soon, the future of the income tax is bleak."[73] Other authors wrote papers with titles such as, "Can Capital Income Taxes Survive in Open Economies?"[74] and "Is There a Future for Capital Income Taxation?"[75] and I wrote one entitled "Globalization, Tax Competition, and the Fiscal Crisis of the Welfare State."[76]

These obituaries for the income tax have proven premature. Within the OECD, income taxation is alive and well. In my opinion, part of this suc-

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71. *See generally* Council Directive 2003/48, 2003 O.J. (L 157) (EC).

72. For a discussion of this proposal in a U.S. context, see Reuven S. Avi-Yonah, *A Coordinated Withholding Tax On Deductible Payments, Shelf Project Proposal*, TAX NOTES (June 2, 2008). Note that, for the United States, the authority to impose such a tax on interest payments already exists, so no change in the law is needed. *Id.*

73. Richard Bird, *Shaping a New International Tax Order*, 42 BULL. FOR INT'L FISCAL DOCUMENTATION 292, 303 (1988).

74. Roger H. Gordon, *Can Capital Income Taxes Survive in Open Economies?*, 47 J. FIN. 1159 (1992).

75. Jack Mintz, *Is There a Future for Capital Income Taxation?*, 42 CANADIAN TAX. J. 1469 (1994).

76. *Fiscal Crisis*, *supra* note 32.

cess story is due to the OECD Report and its progeny. However, there are serious problems in non-OECD countries, and anecdotal evidence like the recent Senate Report confirms the continued existence of problems in OECD countries as well. If left unchecked, the dire predictions of a twenty-first century world based on the VAT, while perhaps premature, could in time still be borne out.

The OECD Report and its progeny represented a useful beginning. To complete the work, two steps are needed, both of which can be taken by the OECD countries if the political will exists: eliminate the ability of non-OECD countries to offer preferential tax regimes by eliminating deferral for all CFCs, and eliminate tax evasion by OECD residents by imposing a refundable withholding tax on payments to nontreaty countries while requiring real exchange of information by treaty countries. If these steps are implemented, the income tax can survive well into the next century.

FISCAL TRANSPARENCY: GLOBAL NORMS, DOMESTIC LAWS, AND THE POLITICS OF BUDGETS

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INTRODUCTION

Since the early 1990s, the issue of fiscal transparency has attracted increasing attention from international institutions, governments, and nongovernment actors concerned with budgets and fiscal policy reform. The Organisation for Economic Co-operation and Development ("OECD") has described the budget as "[t]he single most important policy document of governments, where policy objectives are reconciled and implemented in concrete terms."[1] In the last decade, the OECD and International Monetary Fund ("IMF") have embarked on significant programs to develop standards and codes of conduct on budget transparency and to assess country practices in this area.[2] Nongovernmental organizations ("NGOs") have developed their own indices to measure and compare fiscal transparency internationally.[3] At the domestic level, where budgeting takes place, some governments have enacted legislation to formalize their commitments to fiscal disclosure.

This Article seeks to address two major questions that have received very limited attention from researchers: (1) What is fiscal transparency

1. Org. for Econ. Co-operation & Dev., *OECD Best Practices for Budget Transparency*, 1(3) OECD J. ON BUDGETING 2001, at 7 [hereinafter *OECD Best Practices*].

2. *See id.*; INT'L MONETARY FUND, CODE OF GOOD PRACTICES ON FISCAL TRANSPARENCY (2007), *available at* http://www.imf.org/external/np/pp/2007/eng/051507c.pdf [hereinafter 2007 IMF CODE]. *See generally* INT'L MONETARY FUND, MANUAL ON FISCAL TRANSPARENCY (2001), *available at* http://www.imf.org/external/np/fad/trans/manual/manual.pdf [hereinafter 2001 IMF MANUAL]; INT'L MONETARY FUND, MANUAL ON FISCAL TRANSPARENCY (2007), *available at* http://www.imf.org/external/np/pp/2007/eng/101907m.pdf [hereinafter 2007 IMF MANUAL].

3. In the late 1990s the Institute for Democracy in South Africa ("IDASA") collaborated with the International Budget Project ("IBP"), based in Washington, D.C., to develop a survey questionnaire for evaluating budget transparency that was then applied to South Africa. *See* ALTA FÖLSCHER ET AL., TRANSPARENCY AND PARTICIPATION IN THE BUDGET PROCESS—SOUTH AFRICA: A COUNTRY REPORT (Dec. 2000). This methodology has been adapted for studies of several other countries. *See* Int'l Budget P'ship, *Index of Budget Transparency in Five Latin American Countries: Argentina, Brazil, Chile, Mexico and Peru*, Jan. 10, 2002, http://internationalbudget.org/resources/LAbudtrans.pdf [hereinafter *Index of Five Latin American Countries*]. The Center on Budget and Policy Priorities, a nongovernment organization based in Washington, D.C., launched its Open Budget Index in 2006 with the goal of scrutinizing fiscal transparency practices in different countries around the world. Open Budget Initiative, About the Open Budget Initiative, http://www.openbudgetindex.org/index.cfm?fa=about (last visited Apr. 8, 2009). For information on the history and goals of the Open Budget Index, see Int'l Budget P'ship, Transparency and Participation in the Budget Process: Why Focus on Budget Transparency and Participation, http://www.internationalbudget.org/themes/BudTrans/index.htm (last visited Apr. 20, 2009) [hereinafter Transparency and Participation in the Budget Process].

for? That is, what different meanings can be ascribed to this concept, and what political economic purposes does it advance? And, (2) what is the role of law and legal institutions in securing different visions of fiscal transparency?

On the first point, a central argument of this Article is that the concept of fiscal transparency is not a neutral public good, but one that is open to a range of definitions that serve different interests. As has frequently been said about taxation, the (re)distribution of benefits and burdens through budgeting or fiscal policy processes is inherently political.[4] Sustainable budgeting requires negotiation of a legitimate, fair, and relatively stable fiscal compact or bargain.[5]

This Article offers a critical analysis of the meaning and purposes of fiscal transparency in light of developing international norms. It is argued that fiscal transparency norms as they are currently promulgated by most governments and international institutions focus primarily on fiscal discipline and on providing information to establish credibility for financial markets, international lenders, and aid donors. While these aspects of transparency are obviously important, they tend to ignore the political nature of the budget in both domestic and international contexts. In particular, this Article examines whether and to what extent fiscal transparency norms enable distributive justice and democratic participation in budget decision making by legislative and civil society actors. We find that these dimensions of transparency have been widely neglected in the design of prevailing norms. As a result, we argue, the "best practices" that currently dominate this field will be of limited help in generating the political consensus needed to ensure equitable development. These distributional and democratic deficits should concern all of us, but may be especially problematic for developing countries, for which issues of poverty reduction and economic sovereignty are most pressing. This Article also examines some alternative definitions of fiscal transparency that address these issues in a more meaningful way.

Regarding our second key question, the role of law or legal institutions in securing different visions of fiscal transparency, we emphasize the

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4. U.N. DEP'T OF INT'L ECON. & SOC. AFFAIRS, WORLD ECONOMIC AND SOCIAL SURVEY 1997: TRENDS AND POLICIES IN THE WORLD ECONOMY, at 64–65, U.N. Doc. ST/ESA/256, U.N. Sales No. E/1997/50 (1997); Nicholas Kaldor, *Will Underdeveloped Countries Learn to Tax?*, 41 FOREIGN AFF. 410, 418 (1963).

5. MARGARET LEVI, OF RULE AND REVENUE 181 (1988). *See generally* SVEN STEINMO, TAXATION AND DEMOCRACY: SWEDISH, BRITISH, AND AMERICAN APPROACHES TO FINANCING THE MODERN STATE (1993); Mick Moore & Lise Rakner, *Introduction: The New Politics of Taxation and Accountability in Developing Countries*, 33 INST. OF DEV. STUD. BULL. 1 (2002).

potential importance of fiscal transparency norms in empowering citizens to participate in establishing a fair and legitimate fiscal policy in their country, both through their representatives in a democratic legislature and more broadly. Here, we draw on theories of deliberative democracy in which laws play the important role of establishing the rules of engagement in the decision-making process.[6] As we see the budget as central to political decision making about taxing and spending, we advocate for the expansion of budget transparency laws to fulfill this deliberative role, and we identify the shortcomings of current fiscal codes and norms in addressing transparency and accountability. We also inquire as to the practical role that law has played thus far in the spread and reform of budget transparency norms and in the establishment of "transparency" as an identifiable measure of good governance (however it be defined). This is a subset of a broader set of questions about the role of law in development.[7] We examine the importance of the "rule of law" and "good governance" in the fiscal context and consider what role budget transparency laws might play in a particular country's "development" process. We identify a wide diversity of laws and practices concerning fiscal transparency in national and international contexts and ask to what extent it matters whether budget norms are "hard law" compared to "soft law" norms, administrative practices, or market incentives.

The discussion of these overarching themes is organized into six Parts. In Part I, we analyze the reasons why fiscal transparency has surfaced so widely and insistently as a law reform issue at this particular juncture. Part II tracks the paths and networks by which these norms have been developed and transmitted globally, through initiatives at various international and domestic levels. Part III takes a closer look at the content of fiscal transparency, according to the dominant model associated principally with the IMF. Part IV examines how various fiscal transparency codes and statutes deal with (or ignore) issues of distributive impact and politics. Part V analyzes democratic participation in the budget process. Part VI concludes with a discussion of the implications of this analysis for the broader project of "ruling the world," including the role of law or norms and the implications for national and global governance. Recog-

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6. *See generally* Philip Pettit, *Depoliticizing Democracy*, 17 RATIO JURIS 52 (2004).

7. The relationship between law and development has begun to be critically analyzed by many scholars after nearly two decades of "law reform," which has frequently been unsuccessful. *See, e.g.*, Kevin Davis & Michael Trebilcock, *The Relationship Between Law and Development: Optimists Versus Skeptics*, 56 AM. J. COMP. L. 895 (2008); David Kennedy, *The 'Rule of Law' as Development*, *in* LAW AND DEVELOPMENT: FACING COMPLEXITY IN THE 21ST CENTURY 17, 22 (John Hatchard & Amanda Perry-Kassaris eds., 2003).

nizing that nation states remain the primary actors in formulating fiscal policy, we emphasize the need to design transnational fiscal norms that foster inclusive, democratic institutions at the country level, although we also identify the beginnings of an architecture that could provide an inclusionary framework for taxing and spending in the global context.

I. THE ROOTS OF FISCAL TRANSPARENCY DISCOURSE

Budgeting is a process for organizing government fiscal activities and, as such, it is as old as government taxing and spending. Prudence in fiscal management—in some commonsense way, matching expenditures to revenues—is the essence of budgeting. Just as budgeting has a long tradition, the basic principle of fiscal transparency, the notion that governmental fiscal activities should be subject to public scrutiny, is not new. In this context, a central purpose of budgeting has been to ensure a degree of transparency, and therefore accountability, regarding the nature and quantum of public spending and taxation.[8] The institutional and procedural framework for raising, appropriating, spending, and accounting for public funds is typically laid out in a country's constitution and financial management legislation, and supplemented by longstanding convention. In many developing countries, the "organic finance laws" are based on administrative practices that became entrenched during colonial times. They have generally been in place for several decades, though in practice these formal rules may not be fully implemented.[9]

In the last decade, the term "fiscal transparency" has obtained currency as the banner for a host of policy initiatives designed to regularize budgeting practices and mandate the disclosure of specific information by governments around the world. In this Part, we explore the roots of this discourse on fiscal transparency, which has emerged so forcefully since the mid-1990s. We suggest it is linked to two broader trends that have affected both developed and developing countries: (i) the neoliberal turn in economic policy, which emphasizes fiscal discipline, and (ii) the movement to reform institutions to promote good governance.

8. *See* Aaron Wildavsky, *A Budget for All Seasons? Why the Traditional Budget Lasts*, 38 PUB. ADMIN. REV. 501, 502 (1978).

9. Mike Stevens, *Institutional and Incentive Issues in Public Financial Management Reform in Poor Countries* 5 (World Bank, Working Paper No. 35106, 2004), *available at* http://www.wds.worldbank.org/external/default/WDSContentServer/WDSP/IB/2006/027/000090341_20060207162350/Rendered/PDF/351060Institutional0issues.pdf.

A. Fiscal Transparency and Fiscal Discipline

As a defining aspect of the neoliberal turn in the 1980s, governments lost authority as economic decision makers and were subjected in various ways to more intensive forms of market discipline, in particular, reducing budget deficits.[10] This included the discipline of credit-rating agencies, which directly impacted the cost to governments of financing a deficit, and the discipline of market analysts, who influenced where mobile capital would be invested. In developing countries, such market pressures were reinforced by explicit conditions imposed on concessional lending and aid. A review of IMF-supported fiscal reforms during the 1990s indicates that their key elements were reducing government spending, downsizing the State, shifting expenditures from current to capital accounts, and some provisions on safety net expenditures.[11] In order to establish credibility with these increasingly powerful external audiences and allow them to assess investment risks, governments had to be more forthcoming with detailed information about country finances.

In developed countries, the constraints on government action in economic matters first became apparent in relation to monetary policy. Developed States have fashioned various methods of institutionalizing monetary policy in such a way that, at least to some extent, it is taken out of the hands of elected governments.[12] This is commonly done by delegating the determination of interest rates to an independent central bank, now also a key plank of IMF recommendations for developing countries, because it is seen as a vital way to control inflation.[13] Monetary policy also may be implemented through controls on exchange rates imposed in many developing countries (for example, countries may peg their curren-

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10. *See, e.g.*, Peter A. Hall, *Policy Paradigms, Social Learning, and the State: The Case of Economic Policymaking in Britain*, 25 COMP. POL. 275, 285 (1993) (identifying a "shift" in the "locus of authority over macroeconomic issues" away from the Treasury and Keynesian economics towards monetarism, cemented under Margaret Thatcher and institutionalized through the 1980s and 1990s). *See also* Carl Emmerson, Chris Frayne & Sarah Love, *Updating the U.K.'s Code for Fiscal Stability* (Inst. for Fiscal Studies, Working Paper No. 04/29, 2004).

11. Int'l Monetary Fund, *Fiscal Reforms in Low-Income Countries* 4, Occasional Paper No. 160, Mar. 31, 1998 (led by George T. Abed). *See also* Allen Schick, *The Role of Fiscal Rules in Budgeting*, 3(3) OECD J. ON BUDGETING 2003, at 7–8.

12. Emmerson, Frayne & Love , *supra* note 10, at 4.

13. The IMF monitors monetary transparency and practices as well as fiscal transparency. In 1999, it released the Code of Good Practices on Transparency in Monetary and Financial Policies: Declaration of Principles. INT'L MONETARY FUND, CODE OF GOOD PRACTICES ON TRANSPARENCY IN MONETARY AND FINANCIAL POLICIES: DECLARATION OF PRINCIPLES (1999), *available at* http://www.imf.org/external/np/mae/mft/code/ [hereinafter IMF PRINCIPLES].

cy to the U.S. dollar, or establish currency boards or capital import or export limits). Governments sought to establish the independence of this decision making, so as to credibly influence market expectations and thus "create conditions favorable to that level of inflation being realized."[14] For our purposes, what is most interesting about this institutional transformation is the need for governments to establish "credibility" with markets and their loss of authority as economic decision makers.[15]

New Zealand was a pioneer in legalizing central bank control over interest rates, during its massive economic liberalization in the 1980s. The Reserve Bank of New Zealand Act 1989 established an independent bank and a "transparent" process of implementing interest rates "without interference from Government, Treasury, or anybody else," which was claimed to have "no exact parallels anywhere else in the world."[16] Five years later, the same philosophy was applied to fiscal policy:

> [T]he key is transparency—indeed, chronologically it was the transparency in the Reserve Bank Act which inspired the idea of attempting something similar for fiscal policy. Government's hands are tied only by the need to make policy intentions absolutely unambiguous to the public—surely a fundamentally sound principle.[17]

Governments have not formally delegated their powers to set fiscal policy as they have for monetary policy. However, in the last decade, governments have placed a range of hard and soft law constraints on their own fiscal decision making. Why governments—in particular, elected governments—should agree to constrain themselves in this way is not obvious.[18] The evidence suggests that for fiscal policy, as for mon-

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14. *Id. See also* 2007 IMF MANUAL, *supra* note 2, at 26 (discussing monetary policy and central bank independence).

15. The financial crisis of 2008 and the global recession have shifted the balance of authority back to government decision makers in the short-term. However, we suggest that market mechanisms will remain dominant in the long-term.

16. Specifically, the goal of this Act was to "Muldoon-proof" monetary policy, a reference to the previous long-standing Prime Minister of New Zealand. Donald T. Brash, Governor of the Reserve Bank of N.Z., New Zealand's Remarkable Reforms, Address to the Fifth Annual Hayek Memorial Lecture at Institute of Economic Affairs, London (June 4, 1996) [hereinafter Brash Speech] (also discussing the New Zealand fiscal responsibility reforms in depth). Begun in 1955, the Institute of Economic Affairs bills itself as rightwing and as "the U.K.'s original free-market think-tank." Inst. of Econ. Affairs, About the IEA, http://www.iea.org.uk/record.jsp?type=page&ID=23 (last visited Apr. 8, 2009).

17. Brash Speech, *supra* note 16.

18. *See* Emmerson, Frayne & Love, *supra* note 10, at 4–6; Schick, *supra* note 11, at 8 (asking, "Why have democracies accepted or imposed fiscal limits on themselves, and

etary policy, the desire to strengthen credibility vis-à-vis external audiences has been the driving factor and credibility regarding deficit constraint a constant theme.[19] Trends to increase legislative control over budgeting, including the imposition of fiscal rules and other measures, have been identified as a reaction to concerns about "precarious" fiscal balances and about "losing the confidence of world credit markets."[20]

Schick claims that, prior to World War II, "virtually all democratic countries embraced the balanced budget rule, including some that often breached the rule or did not have any legal constraint on unbalanced budgets."[21] More recently, many States legislated fiscal caps that expressly require a balanced budget or place limits on permissible spending or borrowing, sometimes with schedules for deficit elimination. Examples include the expenditure ceilings introduced in many developed countries, such as Finland, Japan, Spain, Sweden, and Switzerland.[22] In the European Union, the Maastricht Stability and Growth Pact ("Pact") was established in order to stabilize and support the euro currency union.[23] It requires Member States to "avoid excessive government deficits" defined as planned or actual deficits above three percent of gross domestic product ("GDP") and government debt above sixty percent of GDP.[24] Article 104 of the Pact sets out the consequences for Member States that breach this requirement, which escalate in severity: completion of a confidential Commission report, a Council recommendation, publicity requirements, constraints on borrowing from the European Investment Bank, a required deposit with the Community, and fines.[25] A

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why should we expect these limits to be effective when they run counter to the preferences of voters and politicians?").

19. There have been a few suggestions to make fiscal policy "more like" monetary policy—a lever to be pulled in response to economic conditions—and thereby take some of the "politics" out of setting tax rates. *See* Nicholas Gruen, *Greater Independence for Fiscal Institutions*, 1(1) OECD J. ON BUDGETING 2001, at 89. So far, this path has not been taken up by either the international institutions or country governments.

20. Paul Posner & Chung-Keun Park, *Role of the Legislature in the Budget Process: Recent Trends and Innovations*, 7(3) OECD J. ON BUDGETING 2007, at 83; Schick, *supra* note 11.

21. Schick, *supra* note 11, at 15.

22. Isabelle Joumard et al., *Enhancing the Cost Effectiveness of Public Spending: Experience in OECD Countries*, 37 OECD ECON. STUD. 2004, at 120–23.

23. The Pact (establishing the European Community) creates a framework under which Member States "shall regard their economic policies as a matter of common concern" and hence submit themselves to "multilateral surveillance" by the European Commission and through it, by each other. Maastricht Treaty art. 103, Feb. 7, 1992, O.J. 1992 C191/6.

24. *Id.* art 104(c); Protocol annexed to the Pact, art. 1.

25. *Id.* art 104(c).

set of detailed procedural norms concerning data release and acquiescence to economic surveillance is laid down in resolutions, codes of conduct, and the conclusions and recommendations of the Economic and Financial Affairs Council.[26]

However, experience with hard fiscal caps during the 1990s was often negative. Many studies demonstrate that these numerical restraints were frequently too rigid and were ignored, or worse, that they encouraged gaming, as governments tried to hide noncompliance through accounting changes or off-budget spending.[27] The IMF has criticized the "perverse incentives" that such rules may generate if they are not backed by transparent reporting "such that non-compliance can be easily detected and addressed."[28]

The IMF Code does not advocate the adoption of substantive fiscal caps. Instead, the Code discusses such fiscal rules as one possible element of an overall policy of fiscal transparency, stating that this discussion "should not be taken as an endorsement of the practices themselves."[29]

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26. All of the resolutions and legal texts on the Stability and Growth Pact are available at European Commission, Economic and Financial Affairs, http://ec.europa.eu/economy_finance/other_pages/other_pages12638_en.htm (last visited May 7, 2009).

27. At least some of this research took place inside the IMF, whose preoccupation with budget deficits is indicated by Alberto Alesina and Roberto Perotti. *See* Alberto Alesina & Roberto Perotti, *Fiscal Discipline and the Budget Process*, 86 AM. ECON. REV. 401, 403 (1996); Alberto Alesina & Roberto Perotti, *The Political Economy of Budget Deficits* (Nat'l Bureau of Econ. Research, Working Paper No. 4637, 1994), *available at* http://www.nber.org/papers/w4637. *See also* James L. Chan, *Major Federal Budget Laws of the United States*, *in* BUDGET DEFICITS AND DEBT: A GLOBAL PERSPECTIVE 17 (Siamack Shojai ed., 1999); 2007 IMF MANUAL, *supra* note 2, at 40–42; INT'L MONETARY FUND, ANNUAL REPORT 1998, at 40 (1998) [hereinafter IMF 1998 ANNUAL REPORT]; Miguel Braun & Nicolás Gadano, *What Are Fiscal Rules for? A Critical Analysis of the Argentine Experience*, 91 CEPAL REV. 53 (2007); Org. for Econ. Co-operation & Dev., *Fiscal Sustainability: The Contribution of Fiscal Rules*, 72 OECD ECONOMIC OUTLOOK 117 (2002), *available at* http://www.oecd.org/dataoecd/6/2/2483962.pdf [hereinafter OECD, *Fiscal Sustainability*]; Lisa Philipps, *The Rise of Balanced Budget Laws in Canada: Legislating Fiscal (Ir)responsibility*, 34 OSGOODE HALL L.J. 681 (1996); Charles Wyplosz, *Fiscal Policy: Institutions Versus Rules*, 191 NAT'L INST. ECON. REV. 70, 74–76 (2005); Allan Drazen, Fiscal Rules from a Political Economy Perspective 13–17 (June 9, 2002) (Paper presented at the IMF World Bank Conference on Rules-Based Fiscal Policy in Emerging Market Economies, Oaxaca, Mexico, Feb. 14–16, 2002); George Kopits & Jon Craig, *Transparency in Government Operations* 2 (Int'l Monetary Fund, Occasional Paper No. 158, 1998).

28. 2007 IMF MANUAL, *supra* note 2, at 41. Similarly, the OECD suggests that more coercive fiscal rules, such as balanced budget laws or spending caps, may be ineffective unless accompanied by transparency rules that prevent governments from hiding certain expenditures off budget. Joumard et al., *supra* note 22.

29. 2007 IMF MANUAL, *supra* note 2, at 14–15.

Even the Pact's strict three-percent fiscal deficit rule is dominated in practice by the various "soft" procedures for enforcement; the Council of the European Union uses these procedures primarily to enforce increased transparency, medium-term budgeting frameworks, and expenditure management processes among Member States.[30] Information about national fiscal rules and institutions, including monitoring mechanisms and multi-annual fiscal frameworks, must be reported annually to the EU institutions.[31] The Council has "recall[ed] the importance of domestic ownership, including the appropriate involvement of national Parliaments," but the main audience for these significant "transparency" obligations seems to be the Commission and the Council; the finance ministers and economic policy makers of the other Member States; and financial markets.

The notion of transparency does not on its face commit governments to restrain spending or deficits. However, as we show in Part II below, the need to establish credibility in the eyes of financial markets, donors, and investors has been a key driver of transparency initiatives. As one IMF staff member explained when promoting fiscal transparency to an audience consisting largely of representatives from developing countries:

> In fiscal policy perhaps nothing matters quite so much these days as what the financial markets think you are doing and how well you are doing it, and to add to the financial markets I think you increasingly have to take into account the fact that the donors like to know what it is that a country is doing and how well it is doing it.[32]

While prudent fiscal management has a commonsense appeal, what is less obvious on the face of the transparency debate are the constraints on taxation which, when combined with the spending constraints, have the ideological goal of restricting the overall size of government. Although the analogy between government and household budgeting is often made, there is a key difference: a government's overall budget constraint is not set by any objective or external standard. What a government can raise in resources is limited only by its capacity and desire to do so. The budget constraint is itself a set of political choices, capabilities, and distributional goals. In developed countries, there has been a trend towards reduction

30. Press Release, Council of the European Union (Oct. 9, 2007), *available at* http://ec.europa.eu/economy_finance/about/activities/sgp/council-october-2007_en.pdf [hereinafter EU Press Release].

31. *Id.* at 10.

32. Barry Potter, Address at the Second Conference on the International Budget Project: The IMF Transparency Code (Feb. 23, 1999), *available at* http://www.internationalbudget.org/conference/2nd/imf.htm.

of taxes on capital and on mobile labor since the beginning of the 1980s, although overall revenue collections have remained high. In developing countries, the trend is more complex: it is accepted that tax collections in these countries need to be increased so as to enable proper provision by government, but a combination of economic globalization (especially the mobility of capital) and domestic distributional politics puts great pressure on the ability of States to do so. We have written about the focus on fiscal deficits and the politics of tax reform elsewhere;[33] however, it remains an essential part of the neoliberal turn to which fiscal transparency norms can, in part, be traced.

B. Fiscal Transparency and Good Governance

The second major impetus for the new discourse on fiscal transparency came from changing ideas about governance that affected developing and developed countries in different ways. In the late 1990s, development theorists and agencies began to emphasize the need to support institutional reforms or "good governance" in developing countries, as well as to strengthen initiatives to reduce poverty and address the social side of development. These ideas took hold in the wake of widespread dissatisfaction with the neoliberal model, particularly the economic and political failure of structural adjustment programs in many developing countries. The U.N. Millennium Declaration of 2000 reflected these shifting attitudes and laid out specific targets for reducing the number of people living in extreme poverty and other measurable improvements in human welfare.[34] The U.N. Financing for Development process examined how resources can be made available to achieve these goals.[35] In 2001, a high-level panel chaired by Ernesto Zedillo offered a series of Recommenda-

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33. *See* Lisa Philipps, *Discursive Deficits: A Feminist Perspective on the Power of Technical Knowledge in Fiscal Law and Policy*, 11 CAN. J. L. & SOC. 141 (1996) [hereinafter Philipps, *Discursive Defecits*]; Lisa Philipps, *Taxing the Market Citizen: Fiscal Policy and Inequality in an Age of Privatization*, 63 LAW & CONTEMP. PROBS. 111 (2000); Miranda Stewart, *Global Trajectories of Tax Reform: The Discourse of Tax Reform in Developing and Transition Countries*, 44 HARV. INT'L L.J. 139 (2003) [hereinafter Stewart, *Global Trajectories*]; Miranda Stewart & Sunita Jogarajan, *The International Monetary Fund and Tax Reform*, 2 BRIT. TAX REV. 146 (2004).

34. United Nations Millennium Declaration, G.A. Res. 55/2, U.N. Doc. A/Res/55/2 (Sept. 18, 2000). Notably, the Declaration states that creating "an environment . . . conducive to development and to the elimination of poverty . . . depends on []good governance within each country . . . at the international level" as well as on "transparency in the financial, monetary and trading systems." *Id.* art. III(12)–(13).

35. *See generally* International Conference on Financing for Development, Mar. 18–25, 2002, *Monterrey Consensus on Financing for Development*, U.N. Doc A/CONF.198/11 (June 22, 2002), *available at* http://www.un.org/esa/ffd/monterrey/MonterreyConsensus.pdf.

tions ("Zedillo Report").[36] The panel emphasized the need for public investments in education, health, nutrition, and other basic social programs:

> Financing an adequate level of social public expenditure while limiting budget deficits calls for substantial tax revenues. Most countries of the developing world must undertake significant tax reforms if they are to raise the additional revenue that they need.[37]

The Zedillo Report further stated that developing countries themselves bear the primary responsibility for achieving growth and equitable development, in part by "creating the conditions that make it possible to secure the needed financial resources for investment."[38] These conditions include "[f]irst and foremost . . . good governance that commands the consent of the governed, and effective and impartial rule of law—including relentless combat of corruption . . . ."[39] Budget transparency initiatives can be seen as part of this good governance agenda aimed at securing resources for development. As we discuss in Part V below, a second element of "governance" reform in both developing and developed countries has been an increase in consultation on policy reform and its implementation, a trend that can been seen as both a logical consequence of increased transparency or information sharing and that has also developed as part of broader efforts to improve expenditure and tax policy outcomes. In sum, fiscal transparency laws are part of the shift to governance in the global context of fiscal reform for development.

36. U.N. High-Level Panel on Fin. for Dev., Report of the High-Level Panel on Fin. for Dev., Delivered to the General Assembly, U.N. Doc. A/55/1000 (2001), *available at* http://www.un.org/reports/financing/full_report.pdf [hereinafter Zedillo Report]. The Zedillo Report was followed by a major U.N. Conference on Financing for Development. *See* International Conference on Financing for Development, Monterrey, Mexico, Mar. 18–20, 2002, *Report of the International Conference on Financing for Development*, U.N. Doc A/CONF.198/11 (2002). The Follow-up International Conference on Financing for Development to Review the Implementation of the Monterrey Consensus was held in Doha, Qatar from November 29 to December 2, 2008. Follow-up International Conference on Financing for Development to Review the Implementation of the Monterrey Consensus, Doha, Qatar, Nov. 29−Dec. 2, *Doha Declaration on Financing for Development*, U.N. Doc. A/CONF.212/L.1/Rev.1 (Dec. 2, 2008).

37. Zedillo Report, *supra* note 36, at 5.

38. *Id.* at 4.

39. *Id.*

II. THE GLOBAL SPREAD OF FISCAL TRANSPARENCY NORMS

A. International Initiatives

This Part tracks the emergence and spread of budget transparency norms since the mid-1990s through the interaction of transnational "soft law" with more conventional legal forms at the country level. While international economic agencies have played a major role in this process, we find that they in turn have been influenced by government practices in certain developed countries, notably New Zealand. The normative underpinning of international agency codes is often obscured by the apparently neutral, procedural language of fiscal transparency. We also draw attention to the efforts of certain NGOs to reformulate budget transparency norms in order to advance an alternative fiscal politics in which the values of social equality and democratic legitimacy are more heavily weighted.

1. The IMF

In previous work, Stewart has documented the rising influence of international financial institutions and their affiliated experts over domestic tax reform agendas, especially, but not only, in developing countries.[40] A similar pattern of transfer from the international to the domestic level is clearly evident in the spread of fiscal transparency norms, and the IMF has taken the lead role in this process.

The IMF's work on fiscal transparency evolved directly out of its efforts to promote budget discipline as a cornerstone of worldwide economic policy. By 1996, however, the IMF had begun to stress that reforms to promote good governance, the rule of law, and public sector accountability were also needed in many countries to create conditions for the success of its economic policy prescriptions.[41] At this early stage

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40. Stewart, *Global Trajectories*, *supra* note 33; Miranda Stewart, *Tax Policy Transfer to Developing Countries: Politics, Institutions and Experts*, *in* GLOBAL DEBATES ABOUT TAXATION 182 (Holger Nehring & Florian Schui eds., 2007) [hereinafter Stewart, *Tax Policy Transfers*]; Stewart & Jogarajan, *supra* note 33. *See also* Allison Christians, *Hard Law, Soft Law, and International Taxation*, 25 WIS. INT'L L.J. 325, 331 (2007) (on the OECD).

41. *See* Press Release, Int'l Monetary Fund, Communiqué of the Interim Committee of the Board of Governors of the Internationall Monetary Fund, No. 96/49 (Sept. 29, 1996), *available at* http://www.imf.org/external/np/sec/pr/1996/pr9649.htm [hereinafter IMF Press Release 96/49]; Int'l Monetary Fund, *Good Governance: The IMF's Role* 3–4 (Aug. 1997), *available at* http://www.imf.org/external/pubs/ft/exrp/govern/govern.pdf [hereinafter *The IMF's Role*] (identifying issues of budget process and management as central to the IMF's mandate and expertise).

of the governance revolution, the IMF advocated fiscal transparency primarily as a means of shoring up fiscal discipline and improving a country's credibility with private investors. A critical 1996 declaration restated the IMF's longstanding view that countries should aim for "budget balance and strengthened fiscal discipline in a multi-year framework" and added the following:

> Continued fiscal imbalances and excessive public indebtedness, and the upward pressures they put on global real interest rates, are threats to financial stability and durable growth. *It is essential to enhance the transparency of fiscal policy* by persevering with efforts to reduce off-budget transactions and quasi-fiscal deficits.[42]

The link between transparency and fiscal restraint was further emphasized in an influential study paper by two senior members of the IMF Fiscal Affairs Department:

> Timely publication of a clearly presented budget document makes it easier for the market to evaluate the government's intentions and allows the market itself to impose a constructive discipline on the government. Transparency increases the political risk of unsustainable policies, whereas the lack thereof means that fiscal profligacy can go undetected longer than it otherwise would.[43]

Initially the IMF sought to encourage fiscal transparency by incorporating governance concerns into its existing programs of country surveillance, technical advice, and loan conditionality.[44] In carrying out these long-standing functions, IMF staff were to impress upon country authorities the "potential risk that poor governance could adversely affect market confidence and, in turn, reduce private capital in-flows and investment."[45] In 1997, the IMF moved to formalize its guidance on fiscal transparency in a detailed set of standards. This decision flowed directly from the Asian financial crisis and the sense of urgency it created about restoring market confidence.[46] At a meeting in October 1997, executive directors debated the merits of having staff prepare a "brief manual of

42. IMF Press Release 96/49, *supra* note 41 (emphasis added).
43. Kopits & Craig, *supra* note 27, at 2.
44. *The IMF's Role*, *supra* note 41, at 6–9.
45. *Id.* at 7.
46. This decision was the result of the Asian financial crisis and the sense of urgency it created about restoring market confidence. Murray Petrie, *The IMF Fiscal Transparency Code: A Potentially Powerful New Anti-Corruption Tool* 4 (paper presented at the 9th International Anti-Corruption Conference, Durban, Oct. 10–15, 1999) [hereinafter Petrie, *The IMF Fiscal Transparency Code*].

good practices for fiscal transparency."[47] While the report of this discussion indicates that some directors had reservations, the staff was instructed to proceed, and the IMF's first Code of Good Practices on Fiscal Transparency was approved in April 1998 ("Code").[48] Revised versions of the Code were published in 2001 and 2007, along with the extensive Manual on Fiscal Transparency ("Manual"), which provides detailed guidance to assist with "practical implementation."[49]

On publishing its first Code in 1998, the IMF stated the purposes of fiscal transparency more broadly than in earlier documents:

> The underlying rationale was that fiscal transparency could lead to better-informed public debate about the design and results of fiscal policy, make governments more accountable for the implementation of fiscal policy, and thereby promote good governance, strengthen credibility, and mobilize popular support for sound macroeconomic policies.[50]

The IMF's interest in promoting public debate must be read skeptically, we argue, in light of its fundamental policy orientation towards fiscal discipline. Its early discussions of transparency show that the driving purpose was not to facilitate more informed and inclusive political bargaining over budgetary decisions, but rather to help ensure that countries would stick to an IMF-approved set of fiscal policies, even in the face of domestic political protest.[51]

The resolution approving the Code noted that it "does not imply a legal obligation on members."[52] Nonetheless, the IMF has taken concerted

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47. IMF 1998 ANNUAL REPORT, *supra* note 27.

48. *Id.*; Press Release, Int'l Monetary Fund, Communiqué of the Interim Committee of the Board of Governors of the Internationall Monetary Fund, No. 98/14 (Apr. 16, 1998), *available at* http://www.imf.org/external/np/sec/pr/1998/pr9814.htm [hereinafter IMF Press Release 98/14].

49. Int'l Monetary Fund, Factsheet: How Does the IMF Encourage Greater Fiscal Transparency?, http://www.imf.org/external/np/exr/facts/fiscal.htm (last visited Apr. 8, 2009) [hereinafter IMF Factsheet]. *See also* 2007 IMF MANUAL, *supra* note 2; INT'L MONETARY FUND, FISCAL AFFAIRS DEP'T, GUIDE ON RESOURCE REVENUE TRANSPARENCY (2007), *available at* http://www.imf.org/external/np/pp/2007/eng/101907g.pdf.

50. IMF 1998 ANNUAL REPORT, *supra* note 27.

51. For example, in their leading paper on fiscal transparency, Kopits and Craig explained its role in quelling popular protest as follows:

> Although fiscal transparency cannot guarantee consensus, there have been episodes (including recent ones) where a failure to prepare the population, through adequate and candid explanation, for the removal of a critical subsidy or of a labor market regulation has led to major unrest and jeopardized the improved economic performance sought by those measures.

Kopits & Craig, *supra* note 27, at 2.

52. IMF Press Release 98/14, *supra* note 48.

steps to encourage compliance. As a result, the Code now exerts significant normative pressure on policy makers in many countries. The IMF's main implementation vehicle is the fiscal Report on the Observance of Standards and Codes ("fiscal ROSC"). This is a module on fiscal policy incorporated into the ROSC process which is applied generally by the IMF to evaluate country compliance with a range of norms and standard.[53] For example, in its 2001 fiscal ROSC on Brazil, the IMF commented favorably on the country's improved fiscal management and noted that "[t]he cornerstone of these achievements has been the enactment in May 2000 of the Fiscal Responsibility Law which sets out for all levels of government fiscal rules designed to ensure medium-term fiscal sustainability, and strict transparency requirements to underpin the effectiveness and credibility of such rules."[54] Formally, fiscal ROSCs are voluntary, as countries must request an assessment by the IMF, and they are published only by consent.[55] While many developed countries have undergone the process, participation has been especially strong among developing countries seeking better capital market access, in part because the IMF's published reports are used by credit-rating agencies and private analysts to gauge investment risk.[56] Moreover, the IMF indicated that it has sometimes incorporated the recommendations of fiscal ROSCs into loan conditionality for particular countries.[57] The decision to undergo or comply with the results of a fiscal ROSC cannot be seen as equally voluntary for all countries.

It is our view that, globally, the IMF Code is the dominant model and it has had pervasive influence via several channels. The norm-transmitting capacity of the Code has been magnified by the work of other transnational players in both the public and private sectors. This includes

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53. *See* 2007 IMF MANUAL, *supra* note 2, at 8–12.

54. Int'l Monetary Fund, Fiscal Affairs Dep't, *Brazil: Report on Observance of Standards and Codes (ROSC)—Fiscal Transparency Module* 1, IMF Country Report No. 01/217 (Dec. 2001).

55. By 2003, the IMF reported that "[fifty-four] fiscal ROSCs had been completed, of which [forty-eight] were published on the IMF website." INT'L MONETARY FUND, FISCAL AFFAIRS DEP'T, ASSESSING AND PROMOTING FISCAL TRANSPARENCY: A REPORT ON PROGRESS 4 (Mar. 5, 2003), *available at* http://imf.org/external/np/pdr/sac/2003/030503s2.pdf [hereinafter REPORT ON PROGRESS]. A more recent document indicates that "[a]s of March 2009, [eighty-eight] countries from all regions and levels of economic development had posted their fiscal transparency ROSCs on the IMF's Standards and Codes web page." IMF Factsheet, *supra* note 49.

56. REPORT ON PROGRESS, *supra* note 55, at 9, 17.

57. *Id.* at 12–13. One example is Argentina, where a new Fiscal Responsibility Law was enacted in 2004, as a direct response to IMF requirements for institutional reform. *See* Braun & Gadano, *supra* note 27, at 60–62.

the World Bank, which has sometimes collaborated with the IMF in completing fiscal ROSC reports and has relied on them in its own work, in particular in developing aid and loan expenditure accountability mechanisms.[58] The Code has also been promoted by the Financial Stability Forum ("FSF"), a group comprised of financial regulators from several developed countries, international financial institutions, and standard-setting bodies, including the IMF.[59] The FSF has urged "market practitioners to take further account, when making lending and investment decisions, of jurisdictions' observance of standards."[60] Private sector investment analysts do appear to use the Code in this manner, both by relying on IMF reports of country compliance and by applying the Code independently to evaluate fiscal transparency in countries for which no fiscal ROSC is available.[61] Furthermore, there is some evidence that the Code is influencing the way donor countries deliver foreign aid. For example, the United Kingdom's Department for International Development uses the Code along with other international standards to help it assess the risks of delivering aid directly through a government's central budget, as contrasted with aid tied to specific projects or administered by NGOs.[62] The prospect of securing less conditional forms of international

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58. *See* World Bank, Poverty Reduction & Econ. Mgmt. Network & Int'l Monetary Fund, Fiscal Affairs Dep't, *Bank/Fund Collaboration on Public Expenditure Issues* 20, Board Report No. 25763 (Feb. 14, 2003), *available at* http://www1.worldbank.org/publicsector/pe/BankFundPERCollaboration.pdf. World Bank analysts have also used the 2007 IMF CODE, *supra* note 2, as a benchmark for evaluating budget processes in developed and developing countries. *See, e.g.*, Zhicheng Li Swift, *Managing the Effects of Tax Expenditures on National Budgets* 26–27 (World Bank Pol'y Research, Working Paper No. 3927, 2006). Note also the endorsement by G7 Finance Ministers in 1999. *See generally* World Bank & IMF, *Bank/Fund Collaboration on Public Expenditure Issues* 20, IBRD Report No. 25763 (Feb. 14, 2003), *available at* http://www-wds.worldbank.org/external/default/WDSContentServer/WDSP/IB/2003/04/25/000094946_03041604014622/Rendered/PDF/multi0page.pdf.

59. *See* Financial Stability Forum, History, http://www.fsforum.org/about/history.htm (last visited Apr. 8, 2009). *See also* FIN. STABILITY FORUM, UPDATE ON THE IMPLEMENTATION OF THE FSF'S RECOMMENDATIONS: REPORT BY THE FSF CHAIRMAN TO THE G8 FINANCE MINISTERS (2008), *available at* http://www.fsforum.org/publications/r_0806.pdf.

60. Fin. Stability Forum, *Follow-Up Group on Incentives to Foster Implementation of Standards*, Sept. 6, 2001, http://www.fsforum.org/publications/r_0109a.htm.

61. Murray Petrie, *Promoting Fiscal Transparency: The Complementary Roles of the IMF, Financial Markets, and Civil Society* 6–14 (Int'l Monetary Fund, Working Paper No. 03/199, 2003), *available at* http://www.imf.org/external/pubs/ft/wp/2003/wp03199.pdf [hereinafter Petrie, *Promoting Fiscal Transparency*].

62. *See* DEP'T FOR INT'L DEV., MANAGING FIDUCIARY RISK WHEN PROVIDING DIRECT BUDGET SUPPORT 8−10 (2002), *available at* http://www.dfid.gov.uk/pubs/files/pfma-fiduciary risk.pdf. *See also* Norwegian Agency for Dev. Cooperation, *Coordination of Budget Support Programs: Lessons from the Joint Macro-Financial Aid Program to Mozambique* 5,

aid thus provides another impetus for developing countries to adopt IMF-defined fiscal transparency norms in their domestic law and practice.

2. The OECD

Following the IMF's lead, the OECD began work in 1999 on a set of Best Practices for Budget Transparency ("OECD Best Practices"), gleaned from the experience of member countries.[63] The active involvement of both the IMF and the OECD indicates the global sweep of fiscal transparency norms, encompassing developed and developing nations alike. As explained in Part I, like the IMF, the OECD's interest in this subject is firmly rooted in its concerns about the prudence and sustainability of fiscal policy among its members. Though many OECD countries reduced their large deficits during the 1990s, budget balances are clearly at risk in the current financial crisis as well as because of the longer term spending pressures associated with demographic aging, such as health care and pensions.[64] The OECD has predicted that the fiscal consequences of aging populations will be "severe" in virtually all its member countries.[65] From its perspective, the main purpose of transparency measures is to encourage spending restraint by revealing "the true cost of government activities."[66]

The OECD Best Practices notes that some countries have legislated fiscal rules while others have merely adopted policies or guidelines.[67] It strikes a more skeptical tone than the IMF about the value of law reform *per se*, observing that "enforcing fiscal frameworks is a political economy issue as well as a technical one."[68] The OECD explains that its description of best practices "are not meant to constitute a formal 'standard' for budget transparency."[69] The OECD is not a funding body and does not have the same types of leverage over its members as the IMF, in the sense of imposing conditions on financial assistance. Nor does the OECD formally report on country compliance with the OECD Best Practices. Nonetheless, one of the purposes of the document is clearly to encourage reform and convergence at the country level: "[t]he Best Practices are designed as a reference tool for Member and non-member coun-

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NORAD Report No. 2001/1 (2001), *available at* http://www.norad.no/items/1128/38/2574038865/0101coordination%20of%20budget%20support.pdf.

63. *OECD Best Practices*, *supra* note 1.
64. OECD, *Fiscal Sustainability*, *supra* note 27, at 117.
65. Joumard et al., *supra* note 22, at 117–18.
66. *Id.* at 127.
67. OECD Best Practices, *supra* note 1, at 122–23.
68. Joumard et al., *supra* note 22, at 130.
69. OECD Best Practices, *supra* note 1, at 7.

tries to use in order to increase the degree of budget transparency in their respective countries."[70]

Since 2003, the OECD has also engaged in a major research endeavour to collect detailed information about budget practices in member and selected non-member countries, through a questionnaire which covers many of the aspects of transparency addressed in OECD Best Practices.[71] The findings of this research are made public as a free electronic database which has been used by academics to compare and rank the fiscal transparency of different countries.[72] While it is difficult to measure the extent to which domestic policy makers, investment analysts, or other players are influenced by these rankings, their existence suggests that the OECD functions as another informal regulator of budgeting norms, though it plays a less direct role than the IMF.

3. NGOs

The concept of "transparency" has a venerable history among NGOs, particularly with respect to their work on corruption. Several nongovernmental actors are making efforts at the international level to encourage and assess budget transparency in different countries. Perhaps the most prominent is the IBP of the Centre on Budget and Policy Priorities, based in Washington, D.C. In a study on who uses the IMF Code, Petrie reported that civil society organizations generally found it inadequate for their purposes and thus have developed their own modified standards.[73] For example, in the late 1990s, the IBP worked with the IDASA to formulate an alternative budget transparency questionnaire for use in South Africa and several other African countries.[74] The authors of the IBP report offered a rationale for the study: "in the context of widespread poverty in the developing world, citizens and civil society organizations are

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70. *Id.*

71. ORG. FOR ECON. CO-OPERATION & DEV., OECD BUDGET PRACTICES AND PROCEDURES SURVEY, *available at* http://www.oecd.org/dataoecd/30/45/39466141.pdf (the most recent version of the survey). Interestingly, while the survey includes questions about any substantive fiscal rules applicable in the jurisdiction (such as spending caps or balanced budget rules), it does not ask whether a country has enacted fiscal transparency legislation. *Id.* at 14.

72. The database was most recently updated in 2007, and can be accessed at http://webnet4.oecd.org/budgeting/Budgeting.aspx. For rankings based on the database, see, for example, JAMES E. ALT ET. AL., FISCAL TRANSPARENCY AND FISCAL POLICY OUTCOMES IN OECD COUNTRIES (2003); Francisco Bastida & Bernardino Benito, *Central Government Budget Practices and Transparency: An International Comparison*, 85 PUB. ADMIN. 667, 680, 684–85 (2007).

73. Petrie, *Promoting Fiscal Transparency*, *supra* note 61, at 20.

74. FÖLSCHER ET AL., *supra* note 3, at 3.

increasingly focusing on the budget and its effects on the distribution of resources, leading them to demand more and better budget information."[75] Contrasting this explanation with the IMF and OECD emphasis on fiscal discipline and credibility demonstrates the range of different meanings and goals that can be attached to the concept of fiscal transparency. These different visions are also reflected in the specific criteria used to measure transparency at the country level, the subject of Part III below.

The IBP also helped to initiate a comparative study of budget transparency in five Latin American countries.[76] The study was designed and carried out by civil society groups and academics based in Latin America, and it employed both a survey of expert participants in the budget process and a separate study of the legal framework for budgeting in each country. This methodology was chosen in order to assess "whether the lack of transparency is due to legal gaps or a deficient application of budget legislation."[77] Since the release of these regional studies, in 2006 the IBP launched its more ambitious Open Budget Index ("IBP Index"), which examines budgeting practices in a large number of countries through a detailed questionnaire used by independent academic or civil society researchers to assess performance in each country.[78] The most recent Open Budget Index, from 2008, surveyed eighty countries. In its final report, the IBP asserts that eighty percent of these countries fail to provide enough information to their citizens to ensure accountability, while fifty percent of these countries provide such minimal information that they can hide unpopular, wasteful, or corrupt spending.[79]

It would be a mistake to treat NGO work on fiscal transparency as entirely separate and distinct from that of the international financial institutions. Certainly, the NGO focus on empowering local civil society

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75. *Id.* at 3.

76. *See Index of Five Latin American Countries*, *supra* note 3.

77. *Id.* at 1. The researchers found that while laws regulating the budget process existed in the region, they did not include mechanisms to promote citizen participation. *Id.*

78. Open Budget Initiative, Country Date Archives, http://www.openbudgetindex.org/countryData/?fa=archive&pubdate=10/18/06 (last visited Apr. 8, 2009). For this report and many resources on budget transparency projects worldwide, see Internationall Budget Partnershipship, http://www.internationalbudget.org (last visited Apr. 8, 2009). The survey results were unveiled on October 18, 2006. The concept of such an index clearly takes inspiration from Transparency International's work on measuring corruption worldwide. *See* Transparency Internationall: The Global Coalition Against Corruption, www.transparency.org (last visited Apr. 8, 2009).

79. INT'L BUDGET P'SHIP, OPEN BUDGETS TRANSFORM LIVES: THE OPEN BUDGET SURVEY 2008, at 3 (2008), *available at* http://openbudgetindex.org/files/FinalFullReportEnglish1.pdf [hereinafter OPEN BUDGET SURVEY 2008].

groups to engage in the budget process means they are less preoccupied than the IMF or OECD with issues of economic stability and growth. However, the IBP does not present itself as opposing the IMF's fiscal transparency campaign, but rather supplementing it with research and activism. The IBP is eager to point out that a consensus in favor of transparency crosses a range of interests:

> [T]he idea of promoting open budgets is one that can gather support from a wide range of actors, leading to a coalition not available on other issues. Business interests often favor open budgets because they provide a better understood context in which to invest. International organizations support them because they feel open budgets are essential to good governance. Civil society organizations favor open budgets reflecting their general support of more open and democratic societies. Governments find them hard to oppose.[80]

Thus, the IBP and IDASA have lauded the IMF Code as "an important advance in efforts to promote fiscal transparency," while also asserting that "it is limited, particularly when it is examined from the perspective of promoting participation in the budget decision-making process."[81] The IMF staff has participated in conferences of the IBP, and its Code has served as a starting point for IBP work. On the other side, there is some evidence that IMF personnel have begun to place some stock in the IBP's findings about transparency for particular countries and to incorporate them into its analyses.[82] This interweaving complicates the pattern of norm development at the transnational level, as it suggests a significant degree of collaboration among different policy networks or epistemic communities.

4. Aid Donors

Budget transparency and accountability also concern governments and institutions in their capacity as aid donors. As identified recently by the OECD, donors and the World Bank have put significant effort into strengthening and managing accountability for aid and project expenditure and much less into budgeting in general, or tax policy and administration in countries receiving aid.[83] Several avenues have been developed

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80. Transparency and Participation in the Budget Process, *supra* note 3.

81. FÖLSCHER ET AL., *supra* note 3, at 6 n.4.

82. *See, e.g.*, Taryn Parry, *The Role of Fiscal Transparency in Sustaining Growth and Stability in Latin America* 22 (Int'l Monetary Fund, Working Paper No. 07/220, 2007) (including data from the Open Budget Index).

83. ORG. FOR ECON. CO-OPERATION & DEV., GOVERNANCE, TAXATION AND ACCOUNTABILITY: ISSUES AND PRACTICES 27 (2008), *available at* http://www.oecd.org/dataoecd/52/35/40210055.pdf [hereinafter OECD, GOVERNANCE].

by country donors to strengthen and help manage public finances and fiscal policy in aid-recipient countries.

First, the process outlined in the Poverty Reduction Strategy Paper ("PRSP") associated with conditional lending and debt relief comprises the central means by which the IMF and World Bank seek to consult with developing States, the poor, and other stakeholders with respect to expenditures, reforms, and general policy. As of March 2009, more than sixty-six countries have completed PRSPs since 2000.[84] They are lengthy documents, running to several hundred pages. As stated by the IMF, the key goals of PRSPs are to "strengthen country ownership" and "enhance the poverty focus" of reform programs and to "provide for stronger collaboration" among the institutions, recipient countries, and other development lenders and donors.[85]

Second, the OECD, jointly with the Development Assistance Committee ("DAC"), the peak body for donor countries, have begun to monitor aid effectiveness, and in 2005 they established a program to monitor the use of harmonized standards to assess public financial management in aid-recipient countries; to provide training and share experiences; and to establish harmonized accounting standards for aid-recipient countries reporting on external assistance.[86]

This monitoring process builds on the Public Expenditure and Financial Accountability ("PEFA") program established in 2001, and is jointly financed by the European Commission, France, the IMF, Norway, Switzerland, the United Kingdom (through its Department for International Development), and the World Bank (using its Development Grant Facility), , the United Kingdom (through its Department for International Development)[87] PEFA's goal is to strengthen both "recipient and donor

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84. Int'l Monetary Fund, Poverty Reduction Strategy Papers, Mar. 9, 2009, http://www.imf.org/external/np/prsp/prsp.asp. Many countries have completed more than one PRSP. *Id.*

85. Int'l Monetary Fund, Indep. Evaluation Office, *Evaluation of the IMF's Role in Poverty Reduction Strategy Papers and the Poverty Reduction and Growth Facility* 14 (2004), *available at* http://www.imf.org/External/NP/ieo/2004/prspprgf/eng.index.htm.

86. Org. for Econ. Co-operation & Dev., *Paris Declaration on Aid Effectiveness: Ownership, Harmonization, Alignment, Results and Mutual Accountability* (Mar. 2, 2005), *available at* http://www.oecd.org/dataoecd/11/41/34428351.pdf [hereinafter *Paris Declaration*]. The Paris Declaration was an international agreement to which over one hundred ministers, heads of agencies, and other senior officials adhered and committed their countries and organizations in order to continue to increase efforts in harmonization, alignment, and managing aid. This resulted in a set of actions and indicators capable of being monitored.

87. Public Expenditure and Financial Accountability, About PEFA—PEFA Program, http://www.pefa.org/about_pefamn.php (last visited Apr. 27, 2009).

ability" in order to assess the condition of (presumably recipient) country public expenditure, and procurement and financial accountability systems, generally termed Public Financial Management ("PFM"), and to develop reforms and capacity building in this area.[88]

The PEFA framework replaces the previous Highly Indebted Poor Country framework for country financial assessment (so as to qualify countries for debt relief under that program) and is being used by the United Kingdom and some other States in their own donor assessments of countries.[89] PEFA claims strong support for its framework for assessing public financial management and suggests that the framework is likely to be sustainable into the future because of several factors, among others:

> (i) its wide support from international agencies (the members of the OECD DAC joint venture on PFM), (ii) its fast, global adoption, despite the decentralized (country based) decision-making on if and when to use the Framework, [and] (iii) the agreement to implement repeat assessments in many countries . . . .[90]

One concern that has been widely aired over the last decade about reforms implemented in donor and lender-dominated processes has been a lack of country "ownership" of the reform. Ten years ago, this was described in relation to conditionality-linked loan facilities of the IMF as follows:

> The one common theme that runs through perceptions of [the Enhanced Structural Adjustment Facility] . . . is a feeling of a loss of control over the policy content and the pace of implementation of reform . . . . [T]here is broad agreement that ownership is a necessary condition of successful policy reform.[91]

PEFA states that it aims for a significant level of "country ownership" of expenditure management policy and systems in order to reduce transaction costs for aid recipient and donor countries, and to increase donor harmonization (fragmentation of aid is described as a very significant

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88. Public Expenditure and Financial Accountability, About PEFA—PEFA Goals, http://www.pefa.org/about_pefamn.php (last visited Apr. 27, 2009).

89. ORG. FOR ECON. CO-OPERATION & DEV., BETTER AID: MANAGING DEVELOPMENT RESOURCES—THE USE OF COUNTRY SYSTEMS IN PUBLIC FINANCIAL MANAGEMENT 52–58 (2009).

90. Public Expenditure and Financial Accountability, Frequently Asked Questions, http://www.pefa.org/faqmn.php (last visited Apr. 8, 2009) [hereinafter PEFA FAQs].

91. INT'L MONETARY FUND, REPORT OF THE GROUP OF INDEPENDENT PERSONS APPOINTED TO CONDUCT AN EVALUATION OF CERTAIN ASPECTS OF THE ENHANCED STRUCTURAL ADJUSTMENT FACILITY (PART 2), at 20 (1998) (*prepared by* Kwesi Botchwey, Paul Collier, Jan Willem Gunning & Koichi Hamada), *available at* http://www.imf.org/external/pubs/ft/extev/esaf2.pdf.

complicating factor for recipient-country budget processes). While separate from the fiscal transparency and budget assessment processes, with a particular focus on expenditure and tracking of aid funds (and debt relief benefits), the PEFA framework has developed largely on account of increased attention to country ownership and the move to include aid funds in a government budget rather than off budget.[92]

Budget support requires donors to negotiate with a government about the overall budget expenditure process and administration through governmental mechanisms, in contrast to direct aid-to-project processes, which are administered and funded in communities by external agencies or nongovernment organizations. Most aid is provided directly on a project basis and hence is off budget. This presents real challenges for countries seeking to enhance budget transparency and accountability and also receiving large aid inflows, in particular, because these can be volatile and uncertain unless there is a mechanism for centrally tracking all aid disbursements. The World Bank has begun to take the view that a country's budget process is "the central institutional framework for exercising choices on where resources should be channeled and for holding governments accountable."[93] The European Commission and World Bank aim to provide thirty percent of aid through long-term budget support.[94]

Concerns associated with budget support as the mechanism for aid provision include fiduciary risk where financial management in a country is weak (especially, the risk that aid will be misappropriated), increased transaction costs for donors, and a strain on the capacity of the ministry of finance as the main coordinator of a variety of development priorities. However, the "emerging consensus among donors is that budget support is an approach better suited to countries with a good track record and . . . transparent budget management."[95]

The PEFA framework overlaps with the IMF fiscal ROSC process and with budget transparency norms. PEFA explains this as follows:

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92. BUDGET SUPPORT AS MORE EFFECTIVE AID? RECENT EXPERIENCES AND EMERGING LESSONS (Stefan Koeberle, Zoran Stavreski & Jan Walliser eds., 2006), *available at* http://www.wds.worldbank.org/external/default/WDSContentServer/IW3P/IB/2006/04/27/000090341_20060427100443/Rendered/PDF/359670Budget0Support01PUBLIC1.pdf.

93. *Id.* at 4.

94. *See id.* (providing a detailed discussion of recent experiences and issues).

95. *Id.* at 12. However, note that caution is required as the implementation of budget support can cause some perverse outcomes. *See* Philippa Venning, *Impact of Budget Support on Accountabilities at the Local Level in Indonesia*, 1 OECD J. ON BUDGETING 105 (2009).

> The mobilization and utilization of financial resources for the public is a most essential part of governance. Where transparency and accountability mechanisms are weak or lacking, poor people's needs are often marginalized and development outcomes suffer. Several PFM analytical tools can help to promote transparency through publication of their findings, including in a PFM Performance Report. However, monitoring is key to accountability . . . . The PEFA Framework can therefore provide an important part of a monitoring framework for governance.[96]

B. Country Initiatives

In this Section we shift the focus to the domestic level by charting the adoption of budget-related legislation in selected countries, seeking to uncover the historical process of norm creation and transfer.

1. Developed Countries: New Zealand, Australia, and the United Kingdom

The experience of these three countries is critical because it shows that ideas about fiscal transparency have migrated not only from the transnational to the domestic level, but also in the reverse direction. All three countries were ranked above average in a recent study of country compliance with OECD Best Practices, with New Zealand ranked "far and away" the best performing country.[97] As we shall see, this may be because the OECD Best Practices follow the New Zealand design. According to this study, Australia ranks high on integrity, control, and accountability, but less high on budget reports and specific disclosures, while the United Kingdom ranks high on disclosures and accountability, but very low on budget reports (a mark which brings its average down).[98] Both the United Kingdom and New Zealand also rank very high in the IBP Open Budget Survey 2008 (as does the United States); ironically, Australia is not included in that Index.[99]

As with monetary policy, New Zealand pioneered the design of budget transparency legislation with its Fiscal Responsibility Act 1994,[100] a move that predated all of the international fiscal transparency codes. This

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96. PEFA FAQs, *supra* note 90 (follow hyperlink to question 1.2).

97. Bastida & Benito, *supra* note 72, at 680, 684–85. We consider the results of this study (one of the few comparative studies made to date) to be interesting, but to have significant limitations, including that it is based on country self-reporting through the OECD questionnaire process; and that it does not examine actual practice but the legal and administrative procedures in place.

98. *Id.* at 684–85.

99. OPEN BUDGET SURVEY 2008, *supra* note 79, at 7.

100. Fiscal Responsibility Act 1994, 1994 S.N.Z. No. 18 (N.Z.).

Act was highly innovative in that it sought to tighten fiscal discipline not through hard fiscal caps, but through procedural rules that stressed transparency.[101] It caught the attention of fiscal policy analysts in the international agencies, and the New Zealand model quickly became a "benchmark" for defining fiscal transparency.[102]

Australia and the United Kingdom followed suit by enacting comparable statutes in 1998, the same year the IMF approved its first version of the Code.[103] All three governments eschewed strict numerical limits in favor of procedural rules that mandated disclosure of the government's fiscal policy agenda and actual results on an ongoing basis. The experience of these nations influenced the development and enforcement of fiscal transparency standards set by the IMF and OECD.

For example, Australia took an early leadership role by conducting a detailed analysis of its own compliance with the IMF Code shortly after its adoption in 1998. IMF staff participated as independent reviewers of the draft report. The stated purpose of the whole exercise was to "contribute to international financial reform" by "preparing a self-assessment report, providing a format and methodology that other countries may choose to follow."[104] Australia's Charter of Budget Honesty emphasizes the publication of fiscal strategies, outlook and performance reports, and a long-term intergenerational report.[105] Australia is said to have pioneered the medium term expenditure framework ("MTEF") using multiyear forward estimates as the starting point for considering governmental department bids for resources from the budget within the overall resource framework set by the government.[106] This requirement is not contained in detail in the Charter, although it does require fiscal objectives and forecasting on a rolling three-year time horizon—in substance, an MTEF.

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101. *See* Angela Barnes & Steve Leith, *Budget Management That Counts: Recent Approaches to Budget and Fiscal Management in New Zealand* 2 (N.Z. Treasury Dep't, Treasury Working Paper No. 01/24, 2001); Jon Janssen, *New Zealand's Fiscal Policy Framework: Experience and Evolution* 2 (N.Z. Treasury Dep't, Treasury Working Paper No. 01/25, 2001). *See also* GRAHAM C. SCOTT, GOVERNMENT REFORM IN NEW ZEALAND (1996); Marco Cangiano, *Accountability and Transparency in the Public Sector: The New Zealand Experience* (Int'l Monetary Fund, Working Paper No. 96/122, 1996).

102. *See* Kopits & Craig, *supra* note 27, at 37. The New Zealand legislation was highlighted as a novel approach in OECD, *Budgeting for the Future* 19–23 (OECD, Working Paper No. 95, 1997).

103. Charter of Budget Honesty Act, 1998, c. 22 (Austl.); Code for Fiscal Stability, 1998, c. 36, § 155 (Eng.).

104. COMMONWEALTH OF AUSTL., MAKING TRANSPARENCY TRANSPARENT: AN AUSTRALIAN ASSESSMENT at vi (1999), *available at* http://www.treasury.gov.au/documents/178/PDF/intro.pdf.

105. Charter of Budget Honesty Act, 1998.

106. Schick, *supra* note 11, at 18.

Overall, the budget is to be managed in accordance with "prudent" fiscal practice.[107]

The United Kingdom's Code for Fiscal Stability ("U.K. Code") was approved by the Parliament under Section 155(7) of the Finance Act 1998.[108] New Zealand's example and the IMF work on budget transparency both appear to have been important influences. However, perhaps most important was the goal of "signaling a commitment to sensible management of the public finances" by the new Labor government.[109] Chancellor Gordon Brown stated that the U.K. Code was intended to strengthen the openness, transparency, and "credibility" of fiscal policy.[110] The U.K. Code does not impose explicit fiscal caps, but operates together with two nonbinding, "conventional" budget principles outside the U.K. Code.[111] These principles are the "golden rule," which states that the current budget surplus must be at least zero, or rather, there should not be a deficit over an economic cycle, and the "sustainable investment" rule, which requires the net debt to be maintained below forty percent of GDP in an economic cycle.

The role of New Zealand especially suggests that fiscal transparency norms did not simply emerge from within the IMF, but were formed by a broader epistemic community that included policy makers from certain key developed countries. However, once a blueprint was codified at the international level, the IMF and OECD began using it to assess the budget institutions and practices of many other countries facing a wide range of different economic challenges. As Rodrik observes, the use of such blueprints may be beneficial in enabling an efficient process of reform, but also carries risks if it overshadows local political processes that ensure local ownership, and effective design and implementation of re-

107. Charter of Budget Honesty Act, 1998, § 5.

108. The EU Stability and Growth Pact was also being developed at this time. *See* Resolution of the European Council on the Stability and Growth Pact, 1997 O.J. (C 236). Although the United Kingdom did not join the euro currency area (and hence is not required to adhere to the strict budgetary deficit rules established under the Maastricht Treaty), as a member of the EU, it monitors its compliance with the European Pact. European Commission, Economic and Financial Affairs—United Kingdom, http://ec.europa.eu/economy_finance/eu_economic_situation/member_state8622_en.htm (last visited Apr. 19, 2009).

109. *See* Emmerson, Frayne & Love, *supra* note 10, at 6. The Labour Party under Tony Blair and Gordon Brown was elected in a landslide victory in 1997. *Blair's Britain—Blair's Team Tackles Britain*, BBCNEWS.COM, Dec. 26, 1997, http://news.bbc.co.uk/2/hi/special_report/for_christmas/_new_year/blairs_britain/39177.stm.

110. Code for Fiscal Stability, 1998, c. 36, § 155 (Eng.); Her Majesty's Treasury, *Chancellor Proposes Code for Fiscal Stability* (Nov. 25, 1997), http://www.hm-treasury.gov.uk/prebud_pbr97_presshmt2.htm.

111. 2007 IMF MANUAL, *supra* note 2, at 53.

forms.[112] In particular, according to Stevens, attempts to reform the public financial management systems of developing countries by simply transplanting advanced-country best practices have often failed. Too often, such reforms do not jibe with the informal culture and traditions that have helped to stabilize the host State, or they require too much support from external consultants to be sustained over the long-term.[113]

2. Developing and Emerging Countries: Nigeria, Pakistan, India, and South Africa

During the last decade, developing and emerging countries have also begun moving towards establishing or reforming budget laws and fiscal frameworks. In adopting these laws, some countries were influenced by the policy directions of the IMF, either through conditionality-linked borrowing or as part of the general surveillance process carried out by the IMF, including a fiscal ROSC. In other countries, in particular emerging economies and strong democracies like South Africa and India, a different path has been taken towards establishing fiscal transparency laws, with some different outcomes in both the content and impact of these laws.

(a) Pakistan and Nigeria: IMF-Linked Reforms

In 2000, the IMF lamented in a review of Pakistan's fiscal regime that "[t]he current legal framework does not make specific provision for reporting on performance or reporting to parliament or the public beyond the annual budget and annual accounts presentations."[114] It recommended that Pakistan consider "developing a Public Finance Act . . . giving explicit emphasis to performance and fiscal transparency."[115] Three years later, following a technical advice mission to Pakistan, the IMF reported that the country had made progress on transparency through several steps, including "preparation of a draft fiscal responsibility law."[116] Pa-

112. DANI RODRIK, ONE ECONOMICS, MANY RECIPES: GLOBALIZATION, INSTITUTIONS, AND ECONOMIC GROWTH (2007), at 164–65.

113. Stevens, *supra* note 9, at 1–4.

114. INT'L MONETARY FUND, FISCAL AFFAIRS DEP'T, REPORT ON OBSERVANCE OF STANDARDS AND CODES: PAKISTAN—FISCAL TRANSPARENCY, ¶ 13, (Nov. 28, 2000), *available at* http://www.imf.org/external/np/rosc/pak/fiscal.htm.

115. *Id.* ¶ 38.

116. REPORT ON PROGRESS, *supra* note 55, at 13. Additionally, there are other reports urging or praising the adoption of fiscal transparency legislation at the country level. *See, e.g.*, Int'l Monetary Fund, Fiscal Affairs Dep't, *United States: Report on the Observance of Standards and Codes—Fiscal Transparency*, ¶ 1, IMF Country Report No. 03/243 (Aug. 2003), *available at* http://www.imf.org/external/pubs/ft/scr/2003/cr03243.pdf.

kistan's Parliament subsequently enacted the Fiscal Responsibility and Debt Limitation Act 2005, which includes both substantive fiscal targets and transparency provisions requiring the government to make regular reports to the National Assembly.[117] While domestic politics undoubtedly also played a role in bringing about this law reform, the IMF's involvement through its fiscal ROSC process is clearly evident. In this sense, Pakistan's legislation can be viewed as a hard law manifestation of soft law promulgated at the transnational level.

There is no published IMF fiscal ROSC available for Nigeria. Transparency and corruption have been and remain enormous problems in this country, particularly in relation to oil extraction. Although Nigeria has managed to pay down its international creditors and does not borrow from the IMF, domestic tensions about oil projects remain high. However, in the last few years, there have been some developments relating to transparency, including the Fiscal Responsibility Act, 2007.[118] First introduced in 2004 by Finance Minister Ngolzi Okonjo-Iweala, this Act imposes only soft limits on deficits and debt.[119] Its main focus is to improve transparency, for example, by requiring the government to set explicit fiscal targets over a three-year time horizon, and then to file quarterly reports on its own performance in reaching these objectives.[120]

Although Nigeria is not publicly engaged with the IMF, its massive oil wealth has finally led to significant attention to the transparency of resource revenues. The Nigeria Extractive Industries Transparency Initiative report, prepared by an international auditor, was published in April 2006,[121] and Nigeria entered into a policy support instrument with the IMF in October 2005 (which ended in 2007, around the same time that the Fiscal Responsibility Bill received approval in the National Assem-

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117. Fiscal Responsibility and Debt Limitation Act, Gazette of Pakistan, No. VI, June 13, 2005, at 115.

118. *Nigeria: Yar'Adua Signs Fiscal Responsibility Bill into Law*, THIS DAY, Nov. 8, 2007, http://allafrica.com/stories/200711090303.html.

119. Fiscal Responsibility Act, § 12(1) (restricting annual deficits to no more than three percent of gross domestic product "or any sustainable percentage as may be determined by the National Assembly for each financial year"); *id.* § 41(1)(c) (requiring the government to ensure that public debt "is held at a sustainable level as prescribed from time to time by the National Assembly on the advice of the Minister").

120. *Id.* pt. II (Medium-Term Expenditure Framework); *id.* § 30.

121. This report follows the IMF Extractive Industries Transparency Initiative, a process also complemented by Transparency International's recently established civil society/NGO project. Transparency Int'l, *Promoting Revenue Transparency Project: Project Description and Relationship with EITI*, http://www.transparency.org/policy_research/surveys_indices/promoting_revenue_transparency/in_english/eiti (click "English" for PDF) (last visited Apr. 26, 2008).

bly). The policy support instrument is described by the IMF as a purely voluntary process in which a member country signs up for "more frequent Fund assessments" of its economic and financial policies.[122] It promotes a "close policy dialogue" between the IMF and the country, with the primary goal of "deliver[ing] clear signals on the strength of these policies."[123] The IMF explains:

> "Signaling" refers to the information that Fund activities can indirectly provide about countries' performances and prospects. Such information can be used to inform the decisions of outsiders. Outsiders can include *private creditors*, including banks and bondholders, who are interested in information on the repayment prospects of loans; *official donors and creditors*, both bilateral and multilateral, who may be interested in reassurance about the countries they are supporting; and the public at large.[124]

In its concluding review of the policy support instrument with Nigeria, the IMF highlighted the passage of the Fiscal Responsibility Bill as one of the structural reforms contributing to improved economic governance in the country.[125] Nigeria's engagement with the IMF suggests that its transparency initiatives are largely directed at outside investors, creditors, and donors. Even so, the Nigerian Fiscal Responsibility Bill has been praised by Human Rights Watch[126] and the Nigerian Budget Monitoring Group.[127] While the new law may represent an important symbolic victory for those advocating fiscal governance reforms within the country, it remains to be seen whether this will translate into greater fiscal openness and integrity.

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122. Int'l Monetary Fund, *Factsheet—The Policy Support Instrument*, Nov. 2008, http://www.imf.org/external/np/exr/facts/psi.htm.

123. *Id.*

124. *Id.*

125. Int'l Monetary Fund, *Nigeria: Fourth Review Under the Policy Support Instrument—Staff Report 29*, IMF Country Report No. 07/353 7 (2007), *available at* http://www.imf.org/external/pubs/cat/longres.cfm?sk=21414.0.

126. HUMAN RIGHTS WATCH, CHOP FINE: THE HUMAN RIGHTS IMPACT OF LOCAL GOVERNMENT CORRUPTION AND MISMANAGEMENT IN RIVERS STATE, NIGERIA 94–98 (2007), *available at* http://www.hrw.org/sites/default/files/reports/nigeria0107%5B1%5D.pdf.

127. Nigeria Budget Monitoring Project, *Fiscal Responsibility Bill: Rising Hopes in the Horizon*, Feb. 26, 2007, http://www.budgetmonitoringng.org/Spotlights/2007/02/26/News11618/ [hereinafter *Rising Hopes*]; Vincent Nwanma, *Fiscal Responsibility: Don't Spend Money Unless You Have It*, NIG. BUDGET MONITORING PROJECT, http://www.budgetmonitoringng.org/Spotlights/2007/12/13/News12271/ (last visited Apr. 8, 2009).

(b) India and South Africa: Activism and NGOs Driving Reform

India, which does not borrow from the IMF, is an example of a more homegrown fiscal transparency reform process. In 2003, the Indian federal Parliament passed the Fiscal Reform and Budget Management Act.[128] This Act provides a substantive medium-term three-year fiscal target and imposes on the central government reporting requirements for strategies and outcomes.[129] Section 6 states that the central government "shall take suitable measures to ensure greater transparency in its fiscal operations in the public interest and minimize secrecy."[130] According to the IBP, the push for greater budget openness in India started with grass roots civil society organizations tracking misuse of funds by local governments.[131] Yet here, too, the IMF promoted reform of budget practices. In its 2001 fiscal ROSC on India, the IMF commented that the country had "achieved a reasonably high level of fiscal transparency," but that "[e]nacting the Fiscal Responsibility and Budget Management Bill would be a major step forward given the emphasis it places on achieving a high standard of fiscal transparency."[132]

According to one recent study, South Africa ranks above average, and indeed, above the United Kingdom, in its compliance with OECD Best Practices on fiscal transparency.[133] In particular, South Africa has a high ranking with respect to integrity, control, and accountability and a reasonable ranking for budget reports and disclosures.[134] South Africa has a substantial and informative budget website for its National Treasury, including guides to the national budget in Afrikaans, English, Tswana, Xhosa, and Zulu.[135] The website also sets out the core goals of the Treasury:

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128. Fiscal Responsibility and Budget Management Act, No. 39 of 2003, Gazette of India (2003).

129. *Id.* § 3.

130. *Id.* § 6.

131. *See* International Budget Partnership, Access to Budget Information Empowers Citizens in India, http://openbudgetindex.org/files/IndiaStoryEnglish.pdf (last visited Apr. 8, 2009). India has an active NGO sector in this area. *See, e.g.*, Press Release, Ctr. for Budget & Governance Accountability, Civil Society People's Charter on Union Budget 2008–09: People's Budget Initiative (Nov. 16, 2007), *available at* http://www.cbgaindia.org/press_releases.php?id=7.

132. Int'l Monetary Fund, Statistics Dep't, *India: Report on the Observance of Standards and Codes*, ¶ 29, IMF Country Report No. 04/96 (Apr. 2004), *available at* http://www.imf.org/external/np/rosc/ind/fiscal.htm.

133. Bastida & Benito, *supra* note 72, at 680.

134. *Id.*

135. *See* National Treasury, Republic of South Africa, www.treasury.gov.za (last visited May 8, 2009).

> Supporting efficient and sustainable public financial management is fundamental to the promotion of economic development, good governance, social progress and a rising standard of living for all South Africans. The Constitution of the Republic (Chapter 13) mandates the National Treasury to ensure transparency, accountability and sound financial controls in the management of public finances.
>
> . . . Over the current medium-term expenditure framework period (2007–2009) the National Treasury will focus on sustaining growth and macroeconomic stability, while accelerating development and the creation of employment opportunities.[136]

The high level of fiscal transparency in South Africa seems to have been largely a response to NGO or civil society action during the late 1990s (after establishment of the new State in 1994). The Budget Information Service of the Institute for Democracy in South Africa and the IBP produced a report on transparency and participation in South Africa's budget process, which was released in October 1999, and revised in 2000.[137] Around the same time, South Africa followed Australia's example and successfully introduced a medium-term expenditure framework that remains part of its budgetary process today.[138] We suggest that the reasons for the relatively successful implementation of this constraint include its connection with the local activist push for fiscal transparency.[139] South Africa's engagement in the IMF fiscal ROSC process in 2001 was not the key influence on South African reform. South Africa now appears to have satisfied the IMF on its transparency score—such that the IMF's most recent country report, from 2007, does not once mention transparency as an issue or goal for South Africa.[140]

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136. National Treasury, Republic of South Africa, The Role of the National Treasury, http://www.finance.gov.za/nt/info.aspx (last visited Apr. 30, 2009).

137. FÖLSCHER ET AL., *supra* note 3, at 3. The South African report is said to have influenced research in other countries in Eastern Europe, Africa, and Latin America. *Id.* at 4.

138. *See Foreword*, *in* NAT'L TREASURY DEP'T, REPUBLIC OF S. AFR., MEDIUM TERM BUDGET POLICY STATEMENT (1997), *available at* http://www.treasury.gov.za/documents/mtbps/1997/all.pdf. *See also* NAT'L TREASURY DEP'T, REPUBLIC OF S. AFR., MEDIUM TERM BUDGET POLICY STATEMENT AND ADJUSTED ESTIMATES OF NATIONAL EXPENDITURE (2008), *available at* http://www.treasury.gov.za/documents/mtbps/2008/mtbps/MTBPS%20full.pdf.

139. Matthew Andrews, *Creating Space for Effective Political Engagement in Development*, *in* GOVERNANCE REFORM UNDER REAL-WORLD CONDITIONS: CITIZENS, STAKEHOLDERS, AND VOICE 95 (Sina Odugbemi & Thomas Jacobson eds., 2008).

140. Int'l Monetary Fund, *South Africa: 2007 Article IV Consultation*, IMF Country Report No. 07/274 (Aug. 2007), *available at* http://www.imf.org/external/pubs/ft/scr/2007/cr07274.pdf.

III. The Content of Fiscal Transparency Norms

Fiscal transparency is generally discussed as a neutral procedural norm that will produce better or more predictable fiscal policy. We argue that transparency standards have more normative content than their usual treatment suggests and may serve different constituencies and substantive policy ends depending on the types of disclosure and processes they require. Analysis of the IMF Code reveals a much larger "wish list" of desirable practices for governance, subsumed under the overall banner of fiscal transparency. While we will not set out exhaustively all of the elements of fiscal transparency as proposed by the various international codes and national laws and policies, it is useful to survey and discuss key elements of the IMF Code as the dominant model, as well as selected features of the OECD Best Practices.

A. Rule of Law and Structure of Government

The first section of the IMF Code (and accompanying Manual) emphasizes the "[r]oles and [r]esponsibilities" of government, in particular, establishing clear, public rules about the structure and fiscal powers and responsibilities of legislative, executive, and judicial branches of government; setting out the relationship between government and public corporations; and overseeing the relationship between government and private enterprise with respect to the public availability of contractual arrangements.[141] In addition, the Code requires governments to publish comprehensive, understandable budget, tax, and other public finance laws; set forth regulations and administrative procedures relating to the collection, commitment, and use of public funds; and provide the ability to appeal tax and nontax obligations, and an explicitly legal basis for the management of government assets and liabilities.[142]

The IMF appears, in this first section of the Code, to require member countries to establish a solid constitutional framework for government, together with property and contract rights, in a way that is recognizably "Western" in form. The Code steers clear of requiring "democracy," but it assumes a legislature and the separation of powers, including a legal basis for the power to tax; a legal basis for resource distribution and public-private contracting; a working judiciary and appeals system; and a clear legal definition of public property and public debt. The requirement for clear rules on taxation implicitly assumes private property (i.e., there must be something to tax). Thus, the "legal institutions" of property and contract are embedded in this part of the Code, and the necessity for a

141. 2007 IMF CODE, *supra* note 2, § 1.
142. *Id.* § 1.2.

clear demarcation of public and private realms inscribes the market into the very structure of the State.

This first section also makes clear that the IMF places considerable emphasis on the role of national laws in securing fiscal transparency. The Code states generally that "[t]he collection, commitment, and use of public funds should be governed by comprehensive budget, tax, and other public finance laws, regulations[,] and administrative procedures."[143] The Manual more clearly endorses the concept of fiscal transparency legislation or other legislated fiscal limits:

> These arrangements generally support fiscal transparency by providing a clear statement as to policy objectives and how these objectives will be achieved, including informing the public of fiscal risks. One function of these laws is to help build support for fiscal consolidation by strengthening the credibility of fiscal policies and by increasing accountability.[144]

Thus, the IMF evidences considerable faith in law as delivering the "governance" limb of development and in its use for the formalization of essentially political and economic processes.

A study by Isabelle Joumard and others for the OECD noted that some countries have legislated fiscal rules while others have merely adopted policies or guidelines.[145] The authors appear less persuaded than the IMF about the value of law reform per se in the absence of political will, observing that "enforcing fiscal frameworks is a political economy issue as well as a technical one."[146] Nonetheless, they identify how many countries have implemented fiscal transparency laws as a mechanism for improving fiscal discipline and policy outcomes, as seen in Part II.

B. Budget Process and Fiscal Objectives

The second key element of the IMF Code is a requirement for "open budget processes" that "follow an established timetable" and are "guided by well-defined macroeconomic and fiscal policy objectives."[147] In particular, the Code requires

- adequate time for a draft budget to be considered by the legislature;

143. 2007 IMF CODE, *supra* note 2, § 1.2.1.
144. 2007 IMF MANUAL, *supra* note 2, at 52.
145. Joumard et. al, *supra* note 22, at 120.
146. *Id.* at 130.
147. 2007 IMF CODE, *supra* note 2, § 2.1.

- a "realistic" budget presented in a medium-term framework and an assessment of "fiscal sustainability" setting out the main assumptions and sensitivity analysis (for estimated errors);
- a clear statement of any fiscal targets or rules;
- a description of major expenditure and revenue measures lined to policy objectives and with estimates of impact on the budget and the economy;
- clear mechanisms for coordination of budget and off-budget activities; and
- an effective accounting system for monitoring and tracking revenues, commitments, liabilities, and assets, including a timely midyear report and account auditing presented to the legislature and published within a year of the budget.[148]

These requirements for open and timely budget information are clearly essential for a legislature and for citizens to participate adequately in the budget process. Similarly, effective accounting of revenues and the setting out and costing of expenditure goals are crucial. Both of these elements support democratic participation in budgeting as well as donor or lender review of a government's fiscal position.

The concept of a "realistic" budget appears to relate primarily to the economic assumptions in the budget and assumptions about revenue projections and "targets" set out in multi-year development plans.[149] Revenue forecasting[150] is notoriously difficult even for developed countries, except for the rule of thumb that a good starting point for predicting revenues in a given year is the revenues achieved in the prior year. Treasuries of developed countries, including that of the United Kingdom, have been criticized for under-estimating tax revenues, in particular corporate tax revenues.[151] Developing countries may be too optimistic about revenue estimates, in particular where they are striving to increase "tax effort." Both of these tendencies may be based on politics as well as statistics.

Both the IMF and the OECD emphasize that the creation of formal procedures takes a substantial period of time. In addition to preparing the advance provision of draft budgets and policies (several months before the year commences), a government must plan a medium-term framework beyond the fiscal year and manage "sustainably" over the long-

148. *Id.* pt. II.
149. 2007 IMF MANUAL, *supra* note 2, at 37–38.
150. *Id.* at 49.
151. *See, e.g.*, Emmerson, Frayne & Love, *supra* note 10.

term—usually a time well beyond a normal democratic electoral cycle.[152] In particular, the MTEF (or the similar notion of a medium-term budget framework) has been most often proposed as an external "blueprint" for reform, and the IMF contends that it is essential for fiscal transparency.[153]

However, even the IMF acknowledges how difficult establishing a plausible and sustained MTEF can be. The IMF Manual points to successful implementation in Australia, Brazil, Chile, and the United Kingdom. Nonetheless, the IMF underlines the necessity for "stringent conditions"; "robust revenue forecasts"; "rigorous" connections between target expenditures and the expected economic prospects over time; and "clearly defined and fully costed policy proposals." It emphasizes that a medium-term framework is "most likely to be effective in the context of a real, stable, transparent, and well-publicized commitment to fiscal control."[154] These conditions are very challenging for developing countries with poor systems, under-staffing, and low government commitment.[155]

It is also interesting to note the mechanisms for coordinating "on-budget" and "off-budget" items. Clearly, if we see the budget as a central element of democratic governance, expenditures should be largely "on-budget." However, it is often the case that various items are "off-budget," such as pension entitlements and special purpose funds. Furthermore, as discussed above, most aid for developing countries is currently delivered off-budget. It is laudable that the IMF calls for "a strong interface between the government's national planning or development framework (e.g. Poverty Reduction Strategy Paper) and the medium-term budget."[156] If aid flows are also accounted for in this overall framework, it may improve management and coordination of aid and other revenues and spending. However, on the whole, the IMF Code as it is currently drafted cannot address the issue of accountability of aid flows; these issues are outside the scope of its fiscal transparency framework.

C. Public Budget Documentation

The third key element of the IMF Code is a requirement for timely publication of all budget documentation, especially of fiscal information.

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152. 2007 IMF CODE, *supra* note 2, § 2.1.2; 2007 IMF MANUAL, *supra* note 2, at 78.

153. 2007 IMF MANUAL, *supra* note 2, at 40–41.

154. *Id.*

155. A very recent IMF working paper acknowledges this and other difficulties in budget reform. Richard Allen, *The Challenge of Reforming Budgetary Institutions in Developing Countries* (Int'l Monetary Fund, Working Paper No.09/96, 2009).

156. *Id.* at 39.

Again, this is to be a "legal obligation" upon a government. In particular, the IMF looks for the following:

- the release of information in advance and the publication of outcomes for at least the two preceding years and forecasts for at least the two following years;
- tax expenditure statements and explanation of quasi-fiscal activity and other fiscal risks;
- reporting fiscal data on a gross basis, including separate identification of receipts from all revenue sources such as taxes, resource-related activities, foreign aid, information about expenditures and debt, other significant liabilities (e.g., pensions), and natural resource assets;
- reporting subnational government budgets and public corporation positions;
- a periodic report on long-term public finances;
- wide distribution of a "clear and simple summary guide" at the time of the annual budget;
- reporting overall balance (fiscal deficit or surplus) and gross debt of government for the period; and
- reporting on an annual basis results linked to objectives of major budget programs.[157]

Few would disagree that publicizing such information benefits a wide range of social interests. Indeed, the IBP argues that many governments could significantly improve fiscal transparency simply by making available to the public the budget information they already collect for donors or for internal government purposes.[158] However, some controversy surrounds the requirement to report on long-term finances, because of the virtual impossibility of making accurate cost or revenue predictions over a long horizon, which creates a risk that such reports will do more to mislead than to inform. Neil Buchanan, for instance, has argued that long-term forecasting, also known as "generational" accounting, tends to raise false fears that social programs are unaffordable over the long-term or will be excessively burdensome to future generations.[159] To this we would add that requiring such a report goes beyond simple disclosure. It also directs fiscal policy makers to gather, analyze, and consider particu-

157. 2007 IMF CODE, *supra* note 2, pt. III.
158. OPEN BUDGET SURVEY 2008, *supra* note 79.
159. *See* Neil H. Buchanan, *Social Security, Generational Justice and Long-Term Deficits*, 58 TAX L. REV. 275, 312 (2005).

lar kinds of information focused on the longer term, and tends to overemphasize the values of fiscal prudence and discipline. These values are further reinforced by the need to disclose aggregate budget balance and debt. In contrast, it is striking that neither the IMF Code nor the OECD Best Practices call for disclosure of any specific information about the distributive impact of the annual budget or fiscal policy for the *current* population. The content of tax expenditure reports, for example, is either left to governments to determine or weighted toward the types of information that will expose any risk of fiscal imbalance.

D. Integrity of Data and Bureaucracy

The fourth element of the IMF Code encompasses a number of different strands that concern the integrity of data and bureaucracy. The IMF calls for measures to secure the quality of fiscal data.[160] These include forecasts, indication of the cash or accrual accounting basis, and the application of "generally accepted accounting standards" for the public sector in a manner that is internally consistent and reconciled with other data sources.[161] The Code also proposes internal and external auditing of government activities and finances. These data and accounting criteria draw heavily on the establishment and dissemination of global accounting standards for both public and private bodies—integrating the "fiscal transparency" norm-development process into a wider network.

The IMF also calls for clear ethical standards for public servants and publication of their conditions of employment. And concerning procurement, it demands purchase and sale of public assets and major transactions; independence of the revenue authority from political direction; protection of taxpayer rights; and regular reporting to the public by the revenue authority.[162] Here, the IMF Code overlaps with the very considerable work that international institutions responding to corruption have undertaken in the last decade.

The reference to an independent revenue authority has a long history in the IMF and its reform recommendations for developing countries. The OECD has recently noted that the establishment of autonomous revenue authorities has been a "high-profile innovation, and a particular focus for donor support," and about thirty such authorities have now been established in developing countries, mostly in Africa and South America.[163] However, as the OECD has also observed, experience in successfully

160. 2007 IMF CODE, *supra* note 2, at 3.
161. *Id.*
162. *Id.* at 4.
163. OECD, GOVERNANCE, *supra* note 83, at 28.

establishing an "autonomous" agency independent of political interference has been mixed and "early gains have been hard to sustain."[164] As "tax collection cannot be entirely divorced from making tax and budget policy," reporting lines to the executive government must be carefully established.[165]

Even more recently, a new emphasis on taxpayer rights, as opposed to merely strengthening the revenue authority, is welcome, as this can help establish a sounder political basis for participation in taxing and spending.[166] This seems to be one way in which the IMF has (indirectly) acknowledged the need for active engagement and protection of taxpayers, albeit it proposes this in the quite limited context of engagement with the revenue authority, rather than the budget process more broadly.

In this Part, we have reviewed the main features of the IMF model and have pointed out that it does far more to promote values of fiscal prudence, discipline, and integrity than to support other possible goals of transparency, such as equity or democratic oversight. No one could seriously protest that prudence, discipline, and integrity are unimportant—they are clearly imperative to all citizens, including those concerned with improving the fairness and democratic oversight of budgets. This is reflected in the fact that independent watchdogs such as the IBP and IDASA have incorporated many of the IMF's budget transparency requirements. However, as discussed in the next Part, these groups have supplemented the IMF standards with their own criteria related to social equality and democracy.

IV. FISCAL TRANSPARENCY AND DISTRIBUTIVE JUSTICE

Distributive politics are at the heart of fiscal policy because they will often make or break the viability of a reform. For this pragmatic reason, if no other, the omission of distributive analysis from the dominant model of fiscal transparency is problematic. We also consider it to be troublesome, though, for the establishment of fairness in principle.

As already noted, there is no requirement in the IMF Code or OECD Best Practices for governments to report on how fiscal policy decisions impact different income groups or segments of the population. However, in the most recent version of the Manual that accompanies the IMF

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164. *Id.* South Africa, as in so many other ways, is an exception.
165. *Id.*
166. Florens Luoga, *Taxpayers Rights in the Context of Democratic Governance: Tanzania*, 33 INST. OF DEV. STUD. BULL. 50 (2002).

Code, the IMF does briefly acknowledge that fiscal discipline may involve political tradeoffs that ideally should be disclosed:

> Reforms aimed at reducing fiscal deficits and improving macro stability, or at enhancing efficiency, may affect different income and social groups differently, and may hurt or benefit vulnerable and low-income groups more than others. It is important for transparency that some assessment of these impacts be included in the budget documentation . . . . Poverty and Social Impact Analysis refers to the analysis of the distributional impact of policies and policy reforms on the welfare of different groups, with a specific emphasis on the poor and vulnerable . . . . Good practice would require that budget documentation include at least a simple analysis of the differential impacts of new policies and measures.[167]

The addition of this commentary may reflect the IMF's sensitivity to criticisms of its structural adjustment programs and the need to acknowledge the turn in development discourse often found in its own policy advice. However, it is important to note that the Manual is 124 pages long (plus glossary and references), and these passages only briefly interrupt an otherwise unrelenting focus on fiscal discipline and integrity.[168] Nor do they impose more than a minimal obligation to include some basic analysis of distributional impact. Most importantly, these recommendations are not reflected in the Code itself. The reason may have to do with concerns that this type of information will increase the likelihood of political resistance to tough decisions about spending restraint or taxation, challenging the ability of governments to deliver on their promises of fiscal prudence. As Heald discusses, one view is that "'too much' transparency produces 'over-exposure,' leading to losses in effectiveness through high levels of transaction costs and excessive politicization."[169]

Unsurprisingly, NGOs involved with budget transparency have placed social equity issues higher on the agenda. In developing the IBP Index, the IBP states that IMF standards "do not go far enough to ensure that budgeting is responsive and accountable to citizens."[170] To redress this,

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167. 2007 IMF MANUAL, *supra* note 2, at 44. The Manual goes on to briefly describe various methods that can be used to carry out a Poverty and Social Impact Analysis. *Id.* at 45.

168. *See generally id.*

169. David Heald, *Fiscal Transparency: Concepts, Measurement and U.K. Practice*, 81 PUB. ADMIN. 723, 727 (2003). Similarly, Tanzi argues that "[t]rying to eliminate corruption altogether would be too costly, both in terms of resources and in other ways." Vito Tanzi, *Corruption Around the World*, 45 INT'L MONETARY FUND STAFF PAPERS 559, 586 (1998).

170. IBP INDEX, *supra* note 3, at 3.

the IBP's survey questionnaire includes the following questions, to be answered on a transparency scale of one to five:

> 55. Does the executive's budget or any supporting budget documentation present information on policies (both proposals and existing commitments) in at least the budget year that are intended to benefit directly the country's most impoverished populations? . . .
>
> . . . .
>
> 57. Does the executive make available to the public an analysis of the distribution of the tax burden? . . .
>
> . . . .
>
> 65. Are citizens able in practice to obtain non-financial information related to expenditures (for example, number of beneficiaries, number of persons employed by the program, etc.) for individual programs in a format that is more highly disaggregated than that which appears in the executive's budget proposal if they request it from a ministry or agency? . . .
>
> . . . .
>
> 109. Does the year-end report explain the difference between the enacted level of funds intended to benefit directly the country's most impoverished populations and the actual outcome? . . .[171]

In addition, the IBP asks numerous questions about availability of information to citizens and recommends that the right to obtain not only budget documents but also detailed information about particular program expenditures at the local level be established by legislation.[172]

An earlier 2001 study of budget transparency in Latin American countries also highlighted the connection of transparency to social equity, stating that "knowledge and analysis of the budget should be sufficient to make it possible for the external observers to verify whether the distribution of . . . resources and their application reflect social preferences and comply with the criteria of equality and justice."[173] Notably, however, this survey instrument did not include direct questions about the availability of distributive information related to budget policies. Instead, these

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171. INT'L BUDGET P'SHIP, OPEN BUDGET QUESTIONNAIRE: NEW ZEALAND (Sept. 28, 2007), *available at* http://openbudgetindex.org/files/IBPQuestionnaire2008NewZealand.pdf. The survey questionnaires with country responses are available online at http://www.openbudgetindex.org/countryData/ (last visited Apr. 30, 2009).

172. *See, e.g.*, INT'L BUDGET P'SHIP, KEY FINDINGS AND RECOMMENDATIONS (2008), *available at* http://openbudgetindex.org/files/KeyFindingsEnglish.pdf.

173. *Index of Five Latin American Countries*, *supra* note 3, at 12. This study was facilitated in part by the IBP, but conducted independently by the Latin American partners.

issues were addressed indirectly through numerous questions about citizen access to and influence over the budget process.[174] This approach has remained consistent in two follow-up studies, the most recent of which adopts a more politically neutral definition of transparency, but also states that "[a]pplied budget analysis . . . makes it possible to evaluate who wins and who loses with the distribution of public resources."[175]

In South Africa, the collaborative 1999 study by the IBP and IDASA concluded, among its many findings, that "analysis of tax incidence is lacking"[176] in South Africa's budget documentation. The report recommended that detailed information on spending allocations be provided to Parliament earlier in the budget process and cited the lack of consistent and detailed data as a barrier to oversight of budgets by civil society.[177] It also described the limited but growing role of civil society groups in meeting with parliamentary committees to discuss issues such as the priorities of low-income people and women, as well as sectionalized social welfare.[178]

Like the IMF and OECD, these NGOs have attempted to articulate global standards of fiscal transparency that can be applied to evaluate country practice and create pressure for reform. The NGOs have taken some modest steps to add a distributive lens to the assessment of fiscal transparency, while also confirming the importance of reliable information regarding the government's fiscal prudence and integrity. It must be acknowledged that analysis of distributional incidence of taxes and spending may be difficult, especially for countries with a low analytical capacity in government.[179] However, such difficulties also arise with revenue estimating, forecasting, and the establishment of credible medium-

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174. *See generally id.*

175. CENTRO DE ANÁLISIS E INVESTIGACIÓN, LATIN AMERICAN INDEX OF BUDGET TRANSPARENCY 2005: A COMPARISON OF 8 COUNTRIES, at 7 (2005), *available at* http://www.fundar.org.mx/indice2005/docs/Regional%20Transparency%20Report%202005.pdf [hereinafter BUDGET TRANSPARENCY 2005]; LATIN AMERICAN INDEX OF BUDGET TRANSPARENCY 2003: A COMPARISON OF 10 COUNTRIES, at 5 (2003), *available at* http://www.internationalbudget.org/themes/BudTrans/English.pdf [hereinafter BUDGET TRANSPARENCY 2003].

176. FÖLSCHER ET AL., *supra* note 3, at 21.

177. *Id.* at 46, 49–51.

178. *Id.* at 49–51. Note that this project led to a further study of budget transparency in several African countries. *See generally* INST. FOR DEMOCRACY & ACCOUNTABILITY IN S. AFR., BUDGET TRANSPARENCY AND PARTICIPATION: FIVE AFRICAN CASE STUDIES (Dec. 17, 2003), *available at* http://www.idasa.org.za/index.asp?page=output_details.asp%3FRID%3D511%26oplang%3Den%26TID%3D8%260TID%3D6.

179. Richard M. Bird & Eric M. Zolt, *Redistribution via Taxation: The Limited Role of the Personal Income Tax in Developing Countries*, 52 UCLA L. REV. 1627, 1639–44 (2005).

term budget frameworks, which are nonetheless explicitly included in the IMF Code.

Budget transparency legislation at the country level has tended to track the IMF and OECD approaches—it generally makes no explicit reference to social justice indicators. For example, the Australian Charter requires an assessment of distributional impact not for *current* generations, but for *future* ones alone. One exception is the U.K. Code for Fiscal Stability, which includes fairness as one of the principles that must govern fiscal policy. It defines "fairness" as follows: "[t]he principle of fairness means that, so far as reasonably practical, the Government shall seek to operate fiscal policy in a way that takes into account the financial effects on future generations, as well as its distributional impact on the current population."[180] The mandate to consider future generations relates back to the issue of discipline over current social spending. However, the reference to distributional impact on the current population at least creates an opening for scrutiny of the distributive impact of budgets. This potential is not realized in practice, because none of the requisite public reports under the Code must include a distributional analysis. According to a 2004 report, the U.K. Treasury has, on some occasions, provided information about the impact of its proposals on different income groups.[181] The report recommends making this mandatory:

> There is no reason why the Code . . . should not contain an explicit requirement that, where significant and possible, the distributional impact on the current population of new measures should be made publicly available. Similarly estimates of the impact on marginal deduction rates across the whole population should also be provided . . . . It is also desirable that indicative information be provided as early as possible in the consultation process rather than simply being provided when all of the details of the policy have been finalized.[182]

The obvious problem with giving governments discretion to publish such information selectively is that they will tend to do so only when it is politically convenient. Even if distributive analyses were required for all

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180. Code for Fiscal Stability, 1998, c. 36, § 2(7) (Eng.). The other principles governing fiscal policy are transparency, stability, responsibility, and efficiency. *See id.* c. 36, § 155. For example, "equity" features prominently among the principles governing fiscal policy in Ontario. *See* Fiscal Transparency and Accountability Act, 2004 S.O., ch. 27 (Can.). *See also* Mary Condon & Lisa Philipps, *Transnational Market Governance and Economic Citizenship: New Frontiers for Feminist Legal Theory*, 28 T. JEFFERSON L. REV. 105, 140–46 (2005) (discussing the U.K. and Ontario, Canada, legislation as well as the IMF's efforts to have countries adopt its Code).

181. Emmerson, Frayne & Love, *supra* note 10, at 29.

182. *Id.*

new policies, though, there is concern about how to ensure a degree of rigor and objectivity in the way such data is presented. This points to the need for effective oversight of the executive by legislative and civil society actors, which we discuss in the next Part.

In Pakistan, the transparency provisions of the Fiscal Responsibility and Debt Limitation Act of 2005 are based on the IMF Code and do not require disclosure of any distributional data.[183] However, equity issues are addressed in a different way. The statute's deficit and debt reduction targets are subject to an exception for "social and poverty alleviation related expenditures," which are not to fall below 4.5% of GDP in any given year.[184] The term "social and poverty related expenditure" is defined to include, *inter alia*, health, education, and "such other expenditures as may be specified in the National Poverty Reduction Strategy Paper from time to time."[185] The government must report on its compliance with these objectives in an annual fiscal policy statement; some account must be given as to the amount of budgetary spending that qualifies as "social and poverty related."[186] The IBP reported in 2008 that Pakistan's budget did include information "highlighting the impact of key policies intended to alleviate poverty, but some details are excluded."[187] However, the IBP report indicates that the Pakistani government does not publicize any analysis of the distribution of the tax burden.[188]

Tax expenditures are one aspect of fiscal policy that cries out for more open distributive analysis. The IMF Code recommends that tax expenditures be reported in the budget documents, but does not prescribe exactly what information should be reported.[189] It is common, particularly for

183. ESTANDARDS FORUM, BEST PRACTICES REPORT: PAKISTAN 3 (2008), *available at* http://www.estandardsforum.org/servlet/PrintPDFReport?country_id=136&bpr=on (indicating that Pakistan merely expressed intent to adopt full disclosure practices, but the practice has yet to be implemented).

184. Pakistan Fiscal Responsibility and Debt Limitation Act, Gazette of Pakistan, No. VI, June 13, 2005, § 3(3)(c). This provision also states that education- and health-related expenditures should double as a percentage of GDP over ten years. *Id.* Section 9 of the Act protects social and poverty alleviation spending from any cuts that must be made to meet deficit and debt targets. *Id.* § 9(b).

185. *Id.* § 2(l).

186. *See id.* §§ 4, 6.

187. INT'L BUDGET P'SHIP, OPEN BUDGET QUESTIONNAIRE: PAKISTAN 42 (2008), *available at* http://openbudgetindex.org/files/IBPQuestionnaire2008Pakistan.pdf.

188. *Id.* at 43. In contrast to Pakistan, the U.K. government fully discloses "policies intended to alleviate poverty" and a "detailed analysis of the distribution of the tax burden." *See* INT'L BUDGET P'SHIP, OPEN BUDGET QUESTIONNAIRE: UNITED KINGDOM 44–45 (2007), *available at* http://openbudgetindex.org/files/IBPQuestionnaire2008UK.pdf.

189. 2007 IMF CODE, *supra* note 2, § 3.1.3. Since its establishment by Stanley Surrey in the United States during the 1960s, the concept of tax expenditures, which compares

developed countries, to provide some kind of report that compares tax expenditures to a defined, baseline, "normal" income or consumption tax. This is required, for example, in the Australian Charter.[190] However, the reports are frequently not well integrated into the budget process, include inadequate estimates of lost revenue, and contain little or no evidence about the distributive impact of particular tax concessions.[191] This weakens their usefulness in improving transparency.

Tax expenditure reporting could be strengthened significantly in developed and developing countries to illuminate the benefits received by different social groups and firms. India began releasing tax expenditure reports with its 2006–2007 budget, and in 2008–2009, it included a distributive analysis of corporate tax expenditures showing that the smallest firms were receiving the least benefits from these concessions.[192] The Nigerian Fiscal Responsibility Law 2007, Section 11(3)(c)(iii), calls for an "aggregate tax expenditure projection" on a rolling three-year time horizon.[193] Section 29(1) states that "[a]ny proposed tax expenditure shall be accompanied by an evaluation of its budgetary and financial implications in the year it becomes effective and in the three subsequent financial years," and in the event of unplanned revenue losses, such expenditure requires offsetting measures "such as tax rate raises and expansion of the

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the income tax law with a "benchmark" income tax said to be an ideal income tax system, has had a primarily political purpose, to draw legislators' attention to the many concessions, exemptions, and other incentives in the U.S. tax code and to the implicit "cost to revenue," or revenue foregone, as a result of these concessions. For all of the flaws that can be identified with respect to the tax expenditure concept, this is still its most valuable function, and it is thus best understood as a strategic intervention into the budget process.

190. Charter of Budget Honesty Act, 1998, pt. 5, div. 1, cl. 12(1)(d) (Austl.). We do not propose here to enter the debate about how to define the baseline for identifying and measuring tax expenditures, but instead, see tax expenditure reporting as an additional and useful tool for analyzing and debating the distributional burdens and benefits of fiscal policy.

191. HANA POLACKOVA BRIXI, CHRISTIAN VALENDUC & ZHICHENG LI SWIFT, TAX EXPENDITURES: SHEDDING LIGHT ON GOVERNMENT SPENDING THROUGH THE TAX SYSTEM—LESSONS FROM DEVELOPED AND TRANSITION ECONOMIES (2003); Mark Burton, *Making the Australian Tax Expenditures Statement an Effective Policy Instrument—From Fiscal Record to Transparent Report*, 8 J. OF AUSTRALIAN TAX'N 1 (2005).

192. *See* GOV'T OF INDIA, MINISTRY OF FIN., UNION BUDGET RECEIPTS BUDGET 2008–2009: REVENUE FOREGONE UNDER THE CENTRAL TAX SYSTEM: FINANCIAL YEARS 2006–07 AND 2007–08, at Annex 12, 45 (2008), *available at* http://indiabudget.nic.in/ub200809/rec/annex12.pdf; GOV'T OF INDIA, MINISTRY OF FIN., UNION BUDGET 2006–2007: TAX EXPENDITURE UNDER THE CENTRAL TAX SYSTEM: FINANCIAL YEAR 2004–2005, at Annex 12, 45 (2006), *available at* http://indiabudget.nic.in/ub2006-07/rec/annex12.pdf.

193. Fiscal Responsibility Act, Gazette of the Federal Republic of Nigeria, No. 126, Dec. 31, 2007, § 11(3)(c)(iii). *See also Rising Hopes*, *supra* note 127.

tax base."[194] This type of initiative could help build support for base-broadening reforms in developing countries, which have been identified as crucial for increasing the resources available for antipoverty and other types of development spending.

The strategy of using fiscal transparency and tax expenditure reporting to build domestic political support for base-broadening tax reforms could have some advantages over other strategies that focus on reducing tax competition through a more international coordination of tax policy. Many international tax scholars have criticized developing countries' use of investment tax incentives, pointing out their negative effects on corporate tax revenue and on the efficiency and fairness of tax systems.[195] The persistence of this form of tax competition has led some scholars to recommend changes in the way developed countries tax business income earned abroad by their resident multinationals. They have advocated eliminating any benefits from the host countries' tax incentives, thereby freeing these countries from pressure to engage in self-destructive tax competition.[196] Others have argued just the opposite, that developed countries should engage in more tax sparing to preserve the value of these incentives, on the basis that this may help developing countries attract much-needed investment and accord them greater autonomy over domestic tax policy.[197] Promoting more transparency at the country level with respect to the cost and distributive impact of tax expenditures could help to resolve this impasse by enabling a country's own citizens to challenge incentives that shift the burden of taxation onto local firms and individuals without achieving any clear benefits. Similarly, especially in developed countries, tax expenditures are a significant way for governments to deliver government spending programs.[198] Requiring govern-

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194. Fiscal Responsibility Act § 29(1).

195. *See, e.g.*, Michael Keen & Alejandro Simone, *Tax Policy in Developing Countries: Some Lessons from the 1990s and Some Challenges Ahead*, *in* HELPING COUNTRIES DEVELOP: THE ROLE OF FISCAL POLICY 302 (Sanjeev Gupta, Benedict J. Clements & Gabriela Inchauste eds., 2004).

196. *See, e.g.*, Reuvan S. Avi-Yonah, *The OECD Harmful Tax Competition Report: A Retrospective After a Decade*, 34 BROOK. J. INT'L L. 783 (2009).

197. *See, e.g.*, Yoram Margalioth, *Tax Competition, Foreign Direct Investments and Growth: Using the Tax System to Promote Developing Countries*, 23 VA. TAX. REV. 161, 192–94 (2003). The traditional U.S. view against tax sparing was also questioned by Karen R. Brown, Book Review, *Harmful Tax Competition: The OECD View*, 32 GEO. WASH. J. INT'L L. & ECON. 311 (1999).

198. Burton, *supra* note 191. *See also* U.S. GOV'T ACCOUNTABILITY OFFICE, GAO NO. 05-690, TAX EXPENDITURES REPRESENT A SUBSTANTIAL FEDERAL COMMITMENT AND NEED TO BE REEXAMINED 19–42 (2005); Zhicheng Li Swift, *Managing the Effects on National Budgets* (World Bank, Working Paper No. 3927, 2006).

ments to publicize with the budget an analysis of these effects would radically increase the overall transparency of fiscal policy.

The gender budgeting initiatives undertaken in several countries, including India and South Africa, provide yet another angle on distributive transparency.[199] The Platform of Action adopted at the 1995 U.N. Fourth World Conference on Women, in Beijing, called on governments to "facilitate, at appropriate levels, more open and transparent budget processes"[200] and mandated "the integration of a gender perspective in budgetary decisions on policies and programs."[201] In response, the United Nations and other international agencies organized to support many local gender budgeting projects at both the civil society and governmental level.[202] The basic starting point for these projects is the fact that even though fiscal policy often purports to be gender neutral on its face, its impact is seldom gender neutral because of the different economic status and roles of men and women. A variety of methods are used to reveal and analyze the differential impacts of taxes and spending on women and men, in terms of both the distribution of costs and benefits, and behavioral effects (for example, marginal choices between paid and unpaid labor, or the effectiveness of business incentives). In addition, many initiatives focus on increasing women's participation in budget processes as well as the capacity of civil society organizations to critically analyze budget documents from a gender perspective. Advocates of gender budgeting often use the language of transparency in describing its value. In

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199. *See generally* DEBBIE BUDLENDER & GUY HEWITT, GENDER BUDGETS MAKE MORE CENTS: COUNTRY STUDIES AND GOOD PRACTICE (2003); U.N. DEV. FUND FOR WOMEN, GENDER BUDGET INITIATIVES: STRATEGIES, CONCEPTS AND EXPERIENCE 113 (2001), *available at* http://www.bridge.ids.ac.uk/gender_budgets_cd/Budgets%20CD%20subsection%204.1/4.1c%20Gender%20budget%20initiatives%20UNIFEM%20link%20for%204.4f.pdf; Vibhuti Patel, Gender Budgeting in India, Paper presented at National Workshop on Gender Budgeting—An Effective Tool for Achieving Women's Empowerment (Apr. 15, 2007), *available at* http://www.gender-budgets.org/content/blogcategory/84/156/.

200. Fourth World Conference on Women, Sept. 4–15, 1995, *Report of the Fourth World Conference on Women*, ¶ 165(i), U.N. Doc. A/CONF.177/20/Rev.1 (1996) [hereinafter *Report of the Fourth World Conference on Women*].

201. *Id.* ¶ 345.

202. *See* Lisa Philipps, *Gender Budgets and Tax Policy-Making: Contrasting Canadian and Australian Experiences*, 24 LAW IN CONTEXT 143 (2006). *See also Report of the Fourth World Conference on Women*, *supra* note 200, ¶¶ 165(i), 345 (reporting that governments pledged to "[f]acilitate, at appropriate levels, more open and transparent budget processes" and emphasizing the need for "the integration of a gender perspective in budgetary decisions on policies and programs"); Janet Stotsky, *Gender Budgeting* (Int'l Monetary Fund, Working Paper No. 06/232, Oct. 2006), *available at* http://www.imf.org/external/pubs/ft/wp/2006/wp06232.pdf.

particular, the U.N. Financing for Development Conference has recently emphasized the importance of including a gender lens in the analysis of fiscal policy.[203] This is in stark contrast with the standards of transparency articulated by the IMF and OECD, which do not mention gender impact as a relevant fact to be reported by governments. With the exception of the IBP/IDASA report, gender also does not receive any explicit mention in the NGO-led budget transparency exercises.

V. FISCAL TRANSPARENCY AND DEMOCRATIC EMPOWERMENT

Our genealogy of fiscal transparency indicates that the interventions of the IMF and OECD are directed mostly at promoting fiscal discipline and capital market efficiency. The institutional codes and best practices pay little attention to the democratic accountability aspects of transparency in budgeting, an area of government policy making that, as we have demonstrated elsewhere, is already prone to ignore citizens in favor of economic expertise and markets.[204] While the IMF and OECD pay some lip service to citizen accountability, a detailed examination of the IMF Code and OECD Best Practices reveals a democratic deficit in relation to both the expected audience for fiscal transparency information and the overall understanding of the purpose and processes of budgeting. If the budget is, as the OECD suggests, the most important policy document of a government, the question of who receives information and is empowered to participate is crucial for the legitimacy, fairness, and sustainability of budget decisions.

The IMF Code itself does not state who the expected audience is for fiscal information. The accompanying Manual notes that transparency involves openness to "the public" about "the structure and functions of government, fiscal policy intentions, public sector accounts, and fiscal projections."[205] The "public," as explained by the Manual, incorporates four distinct audiences. First are governments themselves (past, current, and future), which should utilize budget analysis to improve economic decision making.[206] Second are "citizens" and the goal of fiscal transparency here is to "giv[e] them the information they need to hold their government accountable for its policy choices."[207] The third audience is "international capital markets," and the last is the IMF itself, in its role in

203. *Doha Declaration on Financing for Development*, *supra* note 36, at 3–6.

204. *See generally* Condon & Philipps, *supra* note 180; Philipps, *Discursive Deficits*, *supra* note 33; Stewart, *Global Trajectories*, *supra* note 33; Stewart & Jogarajan, *supra* note 33.

205. 2007 IMF MANUAL, *supra* note 2, at 6.

206. *Id.* at 1.

207. *Id.*

the economic "surveillance" of member countries "to assess economic vulnerabilities."[208] The explicit recognition of citizens in the IMF Code is a significant change from the first edition, released in 1998, which emphasized "surveillance of economic policies by country authorities, financial markets, and international institutions."[209] Indeed, according to a note in the 2001 edition of the Manual, "there is an issue as to the language(s) in which information should be made available," and this note even suggested that "it is unclear whether countries should routinely publish fiscal information, and economic information more generally, in a commonly-used language."[210] This note recognized, though, that "for countries seeking access to international capital markets, there is likely to be some benefit from translating key documents and reports for release simultaneously with national language versions."[211]

The OECD Best Practices also addresses the role of citizens, in particular, by requiring publication of reports and active promotion of citizens' and NGOs' understanding of the budget process.[212] Both the IMF Code and OECD Best Practices find that the most important way to achieve accountability to citizens is, unsurprisingly, through legislative review of an executive budget.[213] As explained in Part III, Section A, for such accountability to have any content, this approach implicitly requires a democratic legislature.

While the IBP and other organizations involved in budget assessment consider accountability to the legislature important, they have a different vision of democratic control over fiscal processes. The IBP Open Budget Initiative is explicitly oriented towards empowering relatively disadvantaged constituencies to engage with budgetary policy, though it is also concerned with exposing fiscal corruption or unrealistic and imprudent budgeting. NGO researchers in Latin America frame the issue as follows: "[p]articipation by the citizenry throughout the budget process is indispensable, not only to strengthen the democracy of a country, but also because it represents an effective way to ensure that the population's

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208. *Id*. at 1–2.

209. Int'l Monetary Fund, *Code of Good Practices on Fiscal Transparency—Declaration of Principles* (1998), *reprinted in* Int'l Monetary Fund, *Communiqué of the Interim Committee of the Board of Governors of the International Monetary Fund* (Apr. 16, 1998), *available at* http://www.imf.org/external/np/cm/1998/041698A.HTM.

210. INT'L MONETARY FUND, MANUAL ON FISCAL TRANSPARENCY pt. II, para. 57 n.49 (2001), *available at* http://www.imf.org/external/np/fad/trans/manual/manual.pdf.

211. *See id.*

212. *OECD Best Practices*, *supra* note 1, at 8, 14.

213. 2007 IMF CODE, *supra* note 2, §§ 2.1.1, 4.3.2; *OECD Best Practices*, *supra* note 1, at 14.

most pressing needs are covered within the government's budget."[214] In the index these researchers prepared, citizen participation received the lowest score of all its variables.[215]

Although fiscal transparency laws and codes acknowledge the role of the legislature in constraining the executive from undisciplined spending and taxation, other rules seek to constrain the legislature by institutionalizing stronger executive control over many budget decisions.[216] The common factor in these apparently contradictory checks and balances is not accountability as such, but fiscal discipline to establish credibility for the market.[217]

If the discussion is refocused towards the fundamental purpose of a budget, namely, to establish politically legitimate and sustainable distributional decisions for a country, the meaning and uses of fiscal transparency may be reexamined. Fiscal transparency norms have the potential to expand the political space for budget decision making, allowing citizens to participate in more than just elections for legislative representatives in a given electoral cycle. Effective fiscal transparency norms could operate to connect fiscal policy makers with existing networks of governmental departments, businesses, civil society, and local communities in order to more effectively design, assess, and implement fiscal decisions. Transparency norms and frameworks should seek to increase the knowledge of ordinary citizens and "civil society" about fiscal policy decisions and their impact on the distribution of benefits and burdens throughout society.

The use of fiscal transparency norms to increase participation in budgeting fits with a global trend to encourage public participation in policy making. As a broad principle, the United Nations has stated that "widespread participation in decision-making processes" is important in enabling "the creation of the critical mass of support needed to change institutions."[218] The second half of the 1990s saw a massive enhancement of

214. BUDGET TRANSPARENCY 2005, *supra* note 175, at 16.

215. *Index of Five Latin American Countries*, *supra* note 3, at 2.

216. *See, e.g.*, Alesina & Perotti, *supra* note 27; 2007 IMF MANUAL, *supra* note 2, at 21–22.

217. Mario Marcel & Marcelo Tokman, *Building a Consensus for Fiscal Reform: The Chilean Case*, 2(3) OECD J. ON BUDGETING 2002, at 35, 37. This recent and insightful article about fiscal reform in Chile emphasizes the combined macroeconomic, managerial, and political role of budgets and the need, in the longer term, to establish a political consensus through increasing and strengthening the contributions of the Congress, in addition to a strong government leader and a strict fiscal rule. *Id.* at 37.

218. U.N., WORLD ECONOMIC AND SOCIAL SURVEY 2000: TRENDS AND POLICIES IN THE WORLD ECONOMY 211 (2000), *available at* http://www.un.org/esa/policy/wess/WESS%20since%201948/world%20economic%20and%20social%20survey%202000.pdf.

consultation on expenditure policies in PRSPs associated with conditional loans from the IMF, the World Bank, and aid donors. This has been called a "paradigm shift" for development policy.[219] A concept of "participatory development" has become the norm, at least as a matter of rhetoric, in the broader development discourse, whether carried out by multilateral development agencies or NGOs.[220] Using Bolivia, Burkina Faso, Cambodia, Tanzania, and Vietnam as case studies, a recent evaluation of PRSPs and their interaction with budget formation concluded that PRSPs have enhanced public education about government policies and expenditures and, to some extent, have increased citizen participation in budget processes.[221]

Despite this new emphasis on participation, some critics have suggested that citizen participation in economic and fiscal policymaking is not well-embedded in existing political structures, such as parliaments.[222] A recent study criticizes the PRSP process as being insufficiently linked to budget and government fiscal agencies.[223] It observes that the Ministry of Finance is not always given a lead role in the PRSP process, which is often established in a separate ministry.[224] This is likely to lead to a failure of the Ministry of Finance to "own" the PRSP process. Such a "weak link between the PRSP and the budgets" is identified as a crucial problem in many countries; the solution seems to be to establish an MTEF, but doing so successfully, as outlined above, is very challenging.[225] Problems also arise in ensuring that local governments participate in both PRSP formulation and budget decisions at a national level, although PRSPs are supposed to be driven by local-community consultation, and tax systems are increasingly decentralized. Furthermore, it is rare for consultation in a PRSP process to involve a discussion of taxation policy

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219. *See* Fantu Cheru, *Building and Supporting PRSPs in Africa: What Has Worked Well So Far? What Needs Changing?*, 27 THIRD WORLD Q. 355, 364 (2006). Regarding Australia, see Mark Burton, *Is Participatory Tax Transparency in Australia Achievable?*, 43 TAX NOTES INT'L 333 (2006) [hereinafter Burton, *Participatory Tax Transparency*].

220. *See, e.g.*, DEEPA NARAYAN & LYRA SRINIVASAN, WORLD BANK, PARTICIPATORY DEVELOPMENT TOOL KIT: MATERIALS TO FACILITATE COMMUNITY EMPOWERMENT (1994); Maia Green, *Participatory Development and the Appropriation of Agency in Southern Tanzania*, 20 CRITIQUE OF ANTHROPOLOGY 67–89 (2000).

221. Rosa Alonso et al., *PRSPs and Budgets: A Synthesis of Five Case Studies*, *in* BUDGET SUPPORT AS MORE EFFECTIVE AID? RECENT EXPERIENCES AND EMERGING LESSONS, *supra* note 92, at 155, 159.

222. *See* Condon & Philipps, *supra* note 180, at 128; Kevin M. Morrison & Mathew M. Singer, *Inequality and Deliberative Development: Revisiting Bolivia's Experience with the PRSP*, 25 DEV. POL'Y REV. 721 (2007).

223. Stevens, *supra* note 9, at 8–9.

224. *Id.*

225. *See* Cheru, *supra* note 219, at 362.

(as opposed to spending). Attention needs to be paid to identifying "mechanisms of accountability" that could incorporate the poor into the tax reform debate and "enhance their ability to articulate their interests and advance a progressive system of public finance, both in taxation and expenditures."[226] The disconnect between participation in the PRSP process and the budget process is an indication of the inadequacy of fiscal transparency norms, which have tended to focus heavily on prudence and discipline, rather than the legitimacy of budgetary policy.

Consultation mechanisms have also become popular in many countries as a means of securing political support for tax reform.[227] The IMF Code calls for adequate consultation in reform,[228] but surprisingly, the OECD Best Practices does not. In developed countries, consultation about technical or detailed policy elements of tax reform is frequently carried out with the private sector. The advantages of such consultation may include provision of an external expert eye to identify issues, uncertainties, or problems with the law, and to provide examples and information about taxpayer practices, accounting, and other compliance issues. The expert may also ensure professional or business support for tax legislation and its effective implementation, which is likely to be politically important. As Gordon and Thuronyi have noted, less attention has been paid to the process of designing and drafting tax legislation in developing countries.[229]

Consultation on aspects of policy, or the way a tax law or policy is implemented or administered, is usually carried out with business groups and professional tax advisors, rather than with a broad spectrum of taxpayers. However, consultation targeted to particular business sectors or taxpayers may collapse into a "thin" politics of taxation, which, as described by Moore and Rakner, is essentially special interest groups nego-

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226. *See* RICARDO SABATES & AARON SCHNEIDER, INST. OF DEV. STUD. AT THE UNIV. OF ESSEX, TAXATION, ACCOUNTABILITY AND THE POOR 5 (2003), *available at* http://www2.ids.ac.uk/gdr/cfs/pdfs/Tax%20account%20poor-final%20report.pdf. *See also* Alonso et al., *supra* note 221, at 162.

227. *See* CEDRIC SANDFORD, SUCCESSFUL TAX REFORM: LESSONS FROM AN ANALYSIS OF TAX REFORM IN SIX COUNTRIES (1993); Thomas E. McDonnell, *Toward Getting It Right: Reflections on 50 Years of the Tax Legislative Process in Canada*, 43 CAN. TAX. J. 1131, 1133 (1995). Miranda Stewart, *Consultation in Business Tax Reform: Towards an Effective Tax Policy Network*, *in* EXECUTING THE INCOME TAX 249 (Graeme Cooper ed., 2008) [hereinafter Stewart, *Consultation in Business Tax Reform*] (discussing the "tax policy network" with respect to taxation of the corporate sector in Australia).

228. 2007 IMF CODE, *supra* note 2, § 1.2.3.

229. *See* Richard K. Gordon & Victor Thuronyi, *Tax Legislative Process*, *in* TAX LAW DESIGN AND DRAFTING 1, 2 (Victor Thuronyi ed., 2000).

tiating behind closed doors.[230] The "tax policy network" identified by Stewart with respect to taxation of the corporate sector in Australia is not open to broader citizen engagement, although it appears to have contributed to some successful business tax reforms.[231] Ideally, a fiscal transparency law would build institutional procedures and mechanisms that would help ensure that consultation in policy formation is public to the greatest extent possible and that would enable a wide spectrum of taxpayers an opportunity to engage in the process.

A lack of consultation on tax reform often seems to go hand in hand with a failure to respect taxpayer rights and procedural or appellate processes concerning taxation, particularly in developing countries.[232] In this context, the IMF Code's incorporation of a requirement to ensure taxpayer rights and due process is likely to increase taxpayers' capacity to engage in tax reform processes, though this capacity is somewhat indirect. Business and taxpayer associations may not exist or may be poorly educated or resourced. There is also a need for "skilling up" both parliamentarians and the wider population in all countries, so as to enable them to participate in consultation about tax reforms that will affect them and the broader public interest.[233] Gordon and Thuronyi have also identified inadequate coordination between the legislative branch and tax policy makers in the treasury or executive branch. They argue that it is important to both educate and consult with members of parliament, perhaps via a parliamentary committee, and with parliamentary staff.[234] Formal interest groups and business associations may be weak or subject to cooption, thus creating an inadequate demand for broad consultation and hiding the influence of smaller groups.[235]

The claim in support of consultation in budget policy is that it enhances information sharing, accountability, institutional knowledge, and public understanding, which in turn strengthen the quality and legitimacy of the budget.[236] Often, however, there is an assumed dichotomy between

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230. Moore & Rakner, *supra* note 5, at 1. *See also* Avi Nov, *The 'Bidding War' to Attract Foreign Direct Investment: The Need for a Global Solution*, 25 VA. TAX. REV. 835, 847 (2006) (discussing foreign direct investment as an example of the dominant dynamic that corrupts tax policy in the developing world).

231. Stewart, *Consultation in Business Tax Reform*, *supra* note 227.

232. *See, e.g.*, Luoga, *supra* note 166 (referring to more than twelve studies of the Tanzanian tax system since 1990, none of which addressed the need for consultation or the legal framework for taxation).

233. *See* Burton, *Participatory Tax Transparency*, *supra* note 219, at 335.

234. *See* Gordon & Thuronyi, *supra* note 229, at 8.

235. Lise Rakner, *The Politics of Revenue Mobilization: Explaining Continuity in Namibian Tax Policies*, 28 F. FOR DEV. STUD. 125, 135 (2001).

236. *See* 2007 IMF MANUAL, *supra* note 2, at 5–6, 27.

content and *process* in fiscal policy reform. That is, it is assumed that consultation will not affect the *content of reforms* (which can be determined by reference to abstract or "ideal" technical policy choices), but will simply enable the refining of a policy and assure more effective implementation of that policy. This assumption is consistent with what has been termed the "technical idea" approach to a development intervention, an approach used across the broad field of development and according to which "effective political engagement is evidenced by receptivity to the technical idea and support of its implementation."[237] However, the serious implementation of process-oriented reforms is likely to lead to significant compromises in the ultimate content of tax and spending proposals. The discourse of transparency reflects an underlying tension between the drive for "best practice" policy and fiscal discipline, on the one hand, and the need to achieve a legitimate fiscal bargain among citizens, on the other.[238]

There is a striking contrast between the OECD's approach to fiscal transparency, which only marginally considers participation, and the considerable attention the OECD has paid in recent years to public participation in Member States' policy making more generally.[239] In a recent, substantial document on participatory policy making, the OECD identifies three different types of relationships, based on information, consultation, and active participation, respectively: "a one-way relationship in which government produces and delivers *information* for use by citizens"; "a two-way relationship in which citizens *provide feedback* to government" on a defined issue; and "a relation based on *partnership* with government, in which citizens actively engage in defining the process and content of policy-making."[240] It seems safe to say that most

237. Andrews, *supra* note 139.

238. *See, e.g.*, Stewart, *Tax Policy Transfers*, *supra* note 40.

239. *See* ORG. FOR ECON. CO-OPERATION & DEV., CITIZENS AS PARTNERS: INFORMATION, CONSULTATION AND PUBLIC PARTICIPATION IN POLICY-MAKING (2001) [hereinafter CITIZENS AS PARTNERS]; ORG. FOR ECON. CO-OPERATION & DEV., EVALUATING PUBLIC PARTICIPATION IN POLICY MAKING (2005).

240. CITIZENS AS PARTNERS, *supra* note 239, at 23 (emphasis added). Some commentators have called for increased and more widespread participation in tax policy making. *See* Mark Burton, *Democratic Tax Administration*, *in* FURTHER GLOBAL CHALLENGES IN TAX ADMINISTRATION (Margaret McKerchar & Michael Walpole eds., 2006); Burton, *Participatory Tax Transparency*, *supra* note 219. In contrast to the call for widespread "citizen" participation, Stewart has found that enhanced consultation in business tax policy making in Australia has certainly strengthened a "shared ownership" of the tax system between business and government, but within a closed and tightly held "network" of interdependence that does not incorporate citizens or civil society more broadly. Stewart, *Consultation in Business Tax Reform*, *supra* note 227.

efforts at engaging citizens in tax reform initiatives or budget processes do not rise to the third level of active participation, and many involve only the provision of *information* to those who already have the skills to understand and utilize it.

An alternative view of a successful development intervention by international experts or institutions is targeted towards local "ownership" and warns against the wholesale implementation of external technical ideas or blueprints without adequate local consideration. This view suggested by Andrews, involves the creation of "space in which the developing entity can identify, define, and solve its own problems."[241] The dominant fiscal transparency norms are not aimed at creating "space" for political negotiation or engagement concerning the budget.

The IBP and other fiscal policy NGOs form part of an emergent civil society network within States and in the international arena that aims to fill this democratic deficit, but currently operates with limited communication and coherence among the different participants. The importance of civil society or independent critique of budget policy has been noted in a variety of contexts, including tax expenditures and gender budgeting. Without external monitoring and pressure, governments are unlikely to engage in meaningful disclosure or self-criticism of their policies. However, also well-known are the challenges of developing a civil society network that is both socially diverse and well-informed about fiscal policy. The international codes fail not only to prioritize information or processes that would serve economically marginalized groups in the wider civil society, but also to foster critical analysis by those interested in problems of poverty and inequality.

Our call for "political space" and for increased citizen participation in fiscal policy (and other policy aimed at development) is grounded in a notion of "deliberative democracy."[242] Philip Pettit has argued that deliberative democracy should combine two dimensions: first, representative "contestatory institutions," and second, institutions that remove some decisions from the immediately political domain, but are designed to

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241. Andrews, *supra* note 139, at 95.

242. Although it has a longer history in democratic theory, the theory around deliberative democracy is being made simultaneously with various experiments in participation and consultation taking place with respect to development and policy. *See, e.g.*, Joshua Cohen, *Deliberation and Democratic Legitimacy*, *in* THE GOOD POLITY: NORMATIVE ANALYSIS OF THE STATE 17 (Alan P. Hamlin & Phillip Petit eds., 2002); James D. Fearon, *Deliberation as Discussion*, *in* DELIBERATIVE DEMOCRACY 44, 44–45 (Jon Elster ed., 1998). In the development context, it has been termed "deliberative development." *See, e.g.*, Morrison & Singer, *supra* note 222.

empower participation.[243] Relevant to our discussion of budget transparency, "contestatory institutions" ensure that "the people" are "individually enabled to act as editors of the laws and policies that the representatives author—and author in their collective name."[244] On the other hand, the "depoliticizing" institutions "reduce" the "contestatory burden," including constitutional constraints and consultative procedures.[245]

At their best, fiscal transparency laws and other laws relating to budgeting would empower "contestation"—participation in fiscal decision making—by informing and enabling citizens, while at the same time providing adequate constraints and procedures to achieve "realistic" outcomes.[246] These constraints could include the use of an MTEF, and requirements to assess the achievement of development goals and to weigh distributive impact on both current and future generations. The Nigerian Fiscal Responsibility Act of 2007 includes a number of provisions that gesture in this direction, though their impact on the ground is yet to be determined. For example, the Act creates a Fiscal Responsibility Commission charged with implementing the statute and empowered to demand relevant information from any person.[247] The Commission has ten members, with one appointed to represent organized labor, and another to represent "[c]ivil [s]ociety engaged in causes relating to probity, transparency[,] and good governance."[248] The law also provides for timely and wide publication of its many reports, including via the Internet.[249] Most interestingly, it gives standing to ordinary citizens to seek prerogative orders or other remedies in the Federal High Court to enforce the law.[250]

We call on the international financial institutions ("IFIs") to turn their attention to fostering "contestatory" processes and networks both locally and internationally. What best practices could be identified at the country level for involving and providing resources to civil society? Could transparency be broadened by promoting more effective parliamentary over-

243. Pettit, *supra* note 6, at 52–65.

244. *Id.* at 61.

245. *Id.* at 62–63.

246. *See* James E. Alt & David Dreyer Lassen, *Transparency, Political Polarization, and Political Budget Cycles in OECD Countries*, 50 AM. J. OF POL. SCI. 530, 531 (2006) (conducting a rigorous inquiry into the relationship between electoral politics and fiscal transparency).

247. Fiscal Responsibility Act, Gazette of the Federal Republic of Nigeria, No. 126, Dec. 31, 2007, pt. 1.

248. *Id.* § 5(1)(b).

249. *Id.* §§ 30(2), 44(5), 48(1).

250. *Id.* § 51.

sight of fiscal policy impacts, including the wider use of committees and local community consultations?

VI. FORMALISATION, META-INSTITUTIONS, AND GLOBAL NORMS

This Article has sought to analyze and critique budget transparency laws through the lens of social justice and democratic values. In this final Part, we discuss the role of law in the network of codes, standards, and regulators dealing with fiscal transparency and operating at both an international and national level. We also explore the import of fiscal transparency for the broader project of "ruling the world." Our analysis suggests that the international institutions, and even NGOs, put considerable faith in law as a vehicle for mandating transparency and accountability. However, scholars of law and development have expressed skepticism about the role of law in development and the ability of law reform to enhance or influence development.[251]

The IMF Code and OECD Best Practices are prime examples of the increasing role of "soft law" in transnational economic governance. Soft law can be defined as standards or norms developed by quasi-public international institutions, with a view to influencing policy development and practice at the state level so as to convince markets of sound economic policy-making.[252] They are just one element of a broader network of standards and codes at the international level aimed at establishing "good governance" norms so as to achieve "macroeconomic stability and high-quality growth."[253] Even the "hardest" set of global rules, the Maastricht fiscal rules for the euro area, operates in practice predominantly as a set of procedural and reporting requirements.[254]

The IMF Code and OECD Best Practices also seek to embed and legitimate other global norms or standards with respect to government fiscal, monetary, and investment policies. The IMF Manual notes that the Code is "one of [twelve] standards that have been recognized by the international community" (and endorsed by the IMF and the World Bank) in various guises.[255] The Code is also supported by private sector investors as one of twelve key international standards deserving of priority implementation by governments.[256] The OECD Best Practices forms an ele-

251. Davis & Trebilcock, *supra* note 7.

252. *See* Christians, *supra* note 40; Schick, *supra* note 11 (discussing "hard rules" for fiscal restraint).

253. 2001 IMF MANUAL, *supra* note 2, at 1.

254. EU Press Release, *supra* note 30.

255. *Id.* at 1.

256. *See* Financial Stability Forum, 12 Key Standards for Sound Financial Systems, http://www.fsforum.org/cos/key_standards.htm (last visited Apr. 8, 2009).

ment of its overall Policy Framework for Investment. In addition to proposing ten policy "domains" that have the most impact on investment, and setting out questions or issues for governments to consider in each domain, the Framework seeks "to define the respective responsibilities of government, business and other stakeholders and to pinpoint where international co-operation can most effectively redress weaknesses in the investment environment."[257] Transparency in policy development and implementation is one of three core principles that underlie the Framework, together with "policy coherence" and regular evaluation of policies' impact.[258]

The expansion of efforts in monitoring aid and government expenditures is a part of the World Bank's efforts to monitor and implement "governance" reforms worldwide. These efforts are epitomized by the World Bank's Governance Indicators, which seeks to measure governance quality across six dimensions and 212 countries and territories.[259] Most of these dimensions could incorporate fiscal transparency, but it has not always been the subject of attention.[260] The Indicators draw on a range of institutional, governmental, nongovernmental, and academic sources for components of data, and these have recently begun to include monitoring of fiscal transparency.[261]

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257. ORG. FOR ECON. CO-OPERATION & DEV., POLICY FRAMEWORK FOR INVESTMENT 11 (2006), *available at* http://www.oecd.org/dataoecd/1/31/36671400.pdf. One question that arises is to what extent nongovernment actors, in particular transnational corporations (but also, increasingly, charities, NGOs, and the international institutions themselves), are also called upon to be "transparent." It is arguable that transnational corporations face much lower expectations of transparency despite their very significant impact on the economy and society, although it must be noted that transparency norms are also being urged on the corporate sector by the OECD and, of course, by national regulators.

258. *Id.*

259. Daniel Kaufmann et al., *Governance Matters VII: Aggregate and Individual Governance Indicators 1996–2007*, at 1 (World Bank Pol'y Res. Working Paper No. 4654, 2008), *available at* http://info.worldbank.org/governance/wgi/pdf/GovernanceMattersVII.pdf.

260. The "dimensions of governance" assessed by the Worldwide Governance Indicators are "Voice and Accountability," "Political Stability and Absence of Violence/Terrorism," "Government Effectiveness," "Regulatory Quality," "Rule of Law," and "Control of Corruption." World Bank, Governance and Anti-Corruption: Worldwide Governance Indicators 1996–2008 Interactive, http://info.worldbank.org/governance/wgi/index.asp (last visited Mar. 28, 2009).

261. For example, one data source for the Worldwide Governance Indicators is the Institutional Profiles Database, a project of the French Government examining eighty-five developed and developing countries. Commenced in 2006, this project includes an examination of the transparency of fiscal and tax policy, tax evasion, and regulatory quality. *See* Kaufmann et al., *supra* note 259, at 59, tbl.A21. The Indicators also draw on the IBP Index. *Id.* at 63, tbl.A25.

Together with a host of international regulators or observers led by the IFIs, these standards and codes create an international web of metaregulation (of States by States and nonstate actors) that has the primary goal of ensuring that governments are more fully subjected to the discipline of well-informed markets. As illustrated in this Article, this range of international standards can infiltrate local policy making in a variety of ways, including country surveillance by the IMF, creation of an OECD database then used by academic researchers to rank country performance, and incentives for developing countries to participate as a way of demonstrating good governance.

In particular countries, substantive fiscal transparency norms may be embedded in a legislative framework—that is, may assume a formal legal character—but they are more often built into "soft" procedural rules or codes that governments will adhere to because of political, rather than legal, constraints. Australia, New Zealand, and the United Kingdom have each chosen not to legislate hard fiscal targets or rules. Instead, they apply transparency requirements to impose fiscal discipline. Many of these requirements, such as medium-term frameworks, are not legislated, although all three countries legislate reporting, auditing, and institutional independence requirements.[262] By contrast, many developing countries have attempted to combine hard legal restrictions for deficits with a range of legal and nonlegal transparency obligations. Mike Stevens reminds us that it is important to look at the history of budgeting laws and processes in a country when analyzing and seeking to "modernize" the budgeting frameworks of many developing countries along the lines proposed by the IMF and OECD.[263] Some countries, like India and South Africa, provide a much more diverse set of reports and information than is required in their legal systems, largely in response to legislators' concerns and an active, vocal civil society and NGO sector. The effectiveness and content of fiscal transparency norms are both largely shaped by domestic politics and pre-existing institutions, not by formal laws.

In practice, country transparency laws and norms, even if strictly nonbinding, may have the effect of binding future governments in all but the most extreme circumstances: "in practice it is also the case that given that the [United Kingdom] now has a code in place it might be very difficult for a future government to remove or substantially loosen the code without significant loss to its economic credibility."[264] A future government may only succeed in removing a fiscal code in a time of crisis. The

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262. 2007 IMF MANUAL, *supra* note 2, at 80.
263. Stevens, *supra* note 9, at 11.
264. Emmerson, Frayne & Love, *supra* note 10, at 39.

global financial crisis of 2008, in which governments have been required to spend unprecedented levels of public funds to support banks, mortgage institutions, and credit markets, as well to stimulate countries out of recession, may have given governments some flexibility to operate with significant fiscal deficits for a period of time. Whether governments generate adequate authority to raise taxes if required is yet to be seen.

Are global transparency norms, which seem to be the goal of the IMF and the OECD, desirable or useful, or are policies designed in one context simply being transplanted elsewhere without adequate attention to local visions of development? Would local development or experimentation—or grassroots action—be better? Rodrik argues that institutions are central to development, but the most successful institutions tend to be local and embedded.[265] We argue here that international transparency norms have positive potential but that more attention must be paid to local (or national) distributional and democratic implications of fiscal transparency. We have observed that the dominant institutional approaches to fiscal transparency tend to call for comprehensive and timely disclosure of certain kinds of "relevant" fiscal information, so that *external* parties, including lenders, institutions and markets, can assess the "performance" or "effectiveness" of government. Budget transparency norms with only this goal may ensure accountability of a government to lenders and donors, but a different sort of information and analysis is called for to ensure the "effectiveness" of government performance and accountability to local constituencies in a particular country. Regarding the "law and development" debate more generally, Kennedy has suggested that formalization itself may be of greater benefit to outsiders than to locals.[266] Discretionary or unformalized taxing and spending powers may operate predictably for local people, but not for external investors. There is, of course, a danger of relativism: discretionary powers are very likely to be applied for the benefit of only some local participants, in a way that discriminates against the less powerful and less well resourced in a national economy, such as a rural underclass, urban factory workers at the mercy of footloose industries, or women. Nonetheless, as noted by Kennedy, it is important to acknowledge squarely the politics embedded in apparently neutral standards and procedural norms.[267]

A related question is whether the transfer of such global transparency norms across borders challenges national control over economic policy. Fiscal policies are classically the domain of national governments, a core

265. *See* RODRIK, *supra* note 112.
266. Kennedy, *supra* note 7, at 22.
267. *Id.*

element of the sovereign State. In particular (but not only) for developing countries, however, tax and spending policies are increasingly formulated at a global level, utilizing expertise in international and regional institutions. In the era of globalization, the "fiscal compact" must be understood as traversing national boundaries. It concerns both the relationship between a national government (or other levels of government) and citizens in that country, and the relationship of the government and these citizens with other countries and organizations in the international sphere. In this broad sense, the "fiscal compact" encompasses all elements of a government budget, including taxes, spending, aid, debt, and the political and institutional arrangements necessary to sustain equitable development through the budget.

Recently, various commentators have begun to envisage what global governance might look like.[268] Tax scholars have envisaged various means of collecting and distributing tax revenues at the global level, either through the establishment of an international tax organization that would enable significantly enhanced cooperation and sharing among countries, or even through an international tax.[269] As discussed with respect to tax expenditures, above, international coordination is argued by many to be essential to stop harmful tax competition with respect to corporate tax incentives. International tax policy literature has debated the problem of how to increase multilateral coordination in a manner consistent with international equity.[270] As outlined above, there has also been a significant increase in cooperation regarding the delivery of aid and the implementation of lending—on one level, this is the "transfer" element of a nascent global tax system.

Increased fiscal transparency at a country level is likely to enhance a country's domestic political and social fiscal compact, which is negotiated at national, provincial, and local levels of government. At present, fiscal transparency rules and norms tend to enhance accountability of national governments, especially those of developing countries, to external lenders and donors rather than to the domestic polity. We argue that national budgets remain the centerpiece for establishing a sustainable

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268. RODRIK, *supra* note 112, at 211–12 (putting forth an idealistic vision of global fiscal federalism).

269. Avi-Yonah, *supra* note 196; Jinyan Li, *Global Profit Split: An Evolutionary Approach to International Income Allocation*, 50 CANADIAN TAX J. 823, 844 (2002); Vito Tanzi, *The Impact of Globalization on Taxation*, 52 BULL. FOR INT'L FISCAL DOCUMENTATION 338, 338–43 (1998).

270. *See* Reuven S. Avi-Yonah, *Globalization, Tax Competition, and the Fiscal Crisis of the Welfare State*, 113 HARV. L. REV. 1573, 1648–51 (2000); Diane Ring, *International Tax Relations: Theory and Implications*, 60 TAX L. REV. 83, 89 (2007).

fiscal compact for development. New developments in international aid that link it to the budget process seek, however imperfectly, to integrate the global and national dimensions of the fiscal compact by engaging international agencies, donors, and recipients in budget policy making. This is promising because the budget process provides a space for contesting the distributive and other consequences of taxing and spending. One difficult question, though, is how a country's budget process can handle so many different policy goals and stakeholders in an effective manner.

In conclusion, we find that global norms of fiscal transparency have been developed through a complex interaction of international and domestic processes, public and private actors, and soft and hard legal forms. While there is an obvious pattern of norm transfer from international agencies to the domestic level, the reverse has also occurred. Certain developed countries have been especially influential in defining what constitutes best practice, and this points to a concern about the implications of simply transplanting these norms around the world without adequate attention to local priorities and stages of development. Furthermore, the distinction between soft and hard law is often blurry. Informal norms may have de facto enforcement mechanisms having to do with market credibility and access to loans, thus giving them some characteristics of hard law for developing countries. Conversely, domestic fiscal transparency legislation may take the form of hard law, but its power may be primarily symbolic and contingent on the strength of domestic institutions, making it similar to soft law.

Global fiscal transparency norms may be an important pillar in a global fiscal framework that links citizens, local and national governments, and international institutions. This pillar could comprise a first step in meta-regulation of a global fiscal federation.[271] It may also be combined with a move in many sectors, but pushed primarily by NGOs, towards establishing increased transparency and accountability in the international financial institutions and other agencies with respect to their policy prescriptions and funding choices.[272] The IMF and other organizations are increasingly engaging directly with civil society as well as with governments.[273] On one level, this engagement is aimed at improving the processes and outcomes of these agencies' activities; for example, a fair-

271. RODRIK, *supra* note 112, at 114, 148.

272. *See* MICHAEL BARNETT & MARTHA FINNEMORE, RULES FOR THE WORLD: INTERNATIONAL ORGANIZATIONS IN GLOBAL POLITICS 48–51 (2004).

273. *See, e.g.*, INT'L MONETARY FUND, GUIDE FOR STAFF RELATIONS WITH CIVIL SOCIETY ORGANIZATIONS (2003), *available at* http://www.sarpn.org.za/documents/d0002110/IMF_Civil-society_Oct2003.pdf.

ly widespread consultation took place with respect to the revision of the 2007 IMF Code. On another level, this engagement is aimed at increasing the legitimacy of the IFIs themselves in the face of public opposition to organizational policies. As Ben Thirkill-White explains, however, this involves agencies such as the IMF in an inevitably political process and therefore sits uneasily with their current technocratic function of managing global stability.[274]

This Article calls for carefully balancing these goals with the promotion of a meaningful and inclusive fiscal politics at the domestic level. Budgeting remains primarily an activity of nation states. A particular fiscal bargain between growth- and equity-promoting policies needs domestic support in order to gain traction. Our study draws attention to the equal importance of domestic budget processes and institutions in generating the political support needed for fiscal reforms, including any new forms of transnational cooperation.

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274. Ben Thirkill-White, *The International Monetary Fund and Civil Society*, 9 NEW POL. ECON. 251 (2004).

GLOBAL FINANCIAL STANDARD SETTING, THE G10 COMMITTEES, AND INTERNATIONAL ECONOMIC LAW

Kern Alexander[*]

INTRODUCTION

The global financial and credit crisis of 2007–2009 has highlighted the important role of the G10 committees in setting international standards for the regulation of bank capital adequacy, payment systems, and related issues pertaining to global financial stability. The main three G10 committees—consisting of the Basel Committee on Banking Supervision ("Basel Committee" or "BCBS"), the Committee on Payment and Settlement Systems ("CPSS"), and the Committee on the Global Financial System—are the most influential international financial standard-setting bodies and exercise either direct or indirect influence over the development of banking and payment system law and regulation for all developed countries and most developing countries. Specifically, the Basel Committee has produced a number of important international agreements that regulate the amount of capital that banks must set aside against their risk-based assets, and the allocation of jurisdictional responsibility for bank regulators in overseeing the international operations of banks. Its activities have usually been kept away from the fanfare of high politics, but its recent efforts to amend the 1988 Basel Capital Accord by adopting the Basel II Capital Agreement ("Basel II") and to extend its application to all countries where international banks operate have attracted significant critical comment and brought its work under close scrutiny by leading policymakers and regulators. The CPSS has created important agreements setting forth principles and recommendations for the regulation of bank payment systems and for the regulation of clearing and settlement of securities trading, and recommendations regarding counterparties. The Committee on Global Financial Systems, though it has not yet adopted regulatory principles or recommendations, has produced a number of influential reports that have influenced the debate on

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the credit crisis and have analyzed other issues that affect financial stability.

This Article considers the role of these Committees in influencing the development of international financial law norms that govern domestic law standards, and rules of banking and financial regulation. This Article also examines how the Committees' decision making influences international norms of banking regulation and constitutes an alternative form of international lawmaking. In particular, it will focus on the decision making of the Basel Committee and address how its decision-making process led to the adoption of Basel II and how Basel II has put the global financial system at serious risk. Finally, this Article suggests that the voluntary, nonlegally binding decision-making process of these Committees has important international public policy implications because of the influence they exert on the development of national banking law and regulation, and on the stability of financial markets.

I. SOURCES OF INTERNATIONAL ECONOMIC LAW AND FINANCIAL REGULATION

International economic law has become important for economic policymakers who seek to design legal rules by which to manage the growth of global economic interdependence.[1] In 1965, Vellas defined the foundations of international economic law as "dynamic and evolutionary," in contrast to the traditional sources of "general public international law," which he found to be more primitive because they are limited to elementary relationships, such as the concept of state sovereignty; these relationships have made filling in the gaps in international legal rules and principles extremely difficult.[2] Vellas further noted that international economic law is characterized by the specific qualities that constitute a supranational legal order, an empirical and nonformalistic order, one of pragmatism, realism, flexibility, and mobility.[3]

More recently, Lowenfeld suggested that international economic law should be considered all "rules . . . [that] have been developed against the

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1. *See* PETER MALANCZUK, AKEHURST'S MODERN INTRODUCTION TO INTERNATIONAL LAW, 222 & nn.2, 4–5 (7th rev. ed. 1997) (with further references).

2. The U.S. Restatement (Third) of Foreign Relations defines international economic law as "all the international law and international agreements governing economic transactions that cross state boundaries or that otherwise have implications for more than one state, such as those involving the movement of goods, funds, persons, intangibles, technology, vessels or aircraft." RESTATEMENT (THIRD) OF FOREIGN RELATIONS OF THE UNITED STATES pt. 8, intro (1987).

3. PIERRE VELLAS, DROIT INTERNATIONAL ECONOMIQUE ET SOCIAL [INTERNATIONAL ECONOMIC AND SOCIAL LAW] 21–34 (1965) (Fr.).

backdrop of the theory of international trade, and . . . the question—sometimes explicit, at other times tacit—how far deviations from the theory should be allowed."[4] A broader doctrine of international economic law includes the role of money, exchange rates, and the balance of payments, in addition to related areas concerning international finance. According to this view, international economic law covers many specialized areas such as trade in the World Trade Organization ("WTO") agreements, and finance and monetary policy under the Bretton Woods Agreements, as well as the work of the Organisation for Economic Cooperation and Development ("OECD"), the U.N. Commission on International Trade Law, and the Bank for International Settlements ("BIS"). Also, international economic law is usually governed by bilateral and multilateral agreements rather than custom or general principles of law.[5]

International financial law has been defined as covering both the private law relationships of banking and financial services and the public international law of currency and foreign exchange arrangements.[6] The inclusion of international financial law in the broader regime of international economic law, as well as the emergence of the specialized field of international monetary law, can be attributed to the works of the late Sir Joseph Gold.[7] Indeed, according to Gold, the purpose of international monetary law is to form "a complex of relationships among countries on matters . . . that are governed by rules and understandings that are more extensive than international monetary law as a branch of public international law."[8]

Global economic law has also been interpreted as a self-replicating process in which legal norms arise from nonstate actors, such as associations of private market participants and multinational corporations that operate on a transnational basis. Teubner and others, building on Eh-

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4. ANDREAS F. LOWENFELD, INTERNATIONAL ECONOMIC LAW 8 (2003).

5. *Cf.* MALANCZUK, *supra* note 1, at 223.

6. *See* ROSA M. LASTRA, LEGAL FOUNDATIONS OF INTERNATIONAL MONETARY STABILITY 18–20 (2006). *See also* Stephen Zamora & Sir Joseph Gold, *Development of International Monetary Law*, *in* FESTSCHRIFT IN HONOR OF SIR JOSEPH GOLD 439 & n.2 (Werner F. Ebke & Joseph J. Norton eds., 1990) (providing further references) (discussing international financial law as "encompassing both private and public international law, the private law of international banking relationships, national regulation of financial transactions, and the public international law of money, including the rules of the IMF").

7. Sir Joseph was the IMF's General Counsel from 1960 to 1979, and was the drafter of the First and Second Amendments to the IMF Articles of Agreement. *See* Kenneth W. Dam, *Introduction*, *in* FESTSCHRIFT IN HONOR OF SIR JOSEPH GOLD, *supra* note 6, at 17–19; Zamora, *supra* note 6, at 440.

8. Zamora, *supra* note 6, at 446. Gold argued that the IMF administered a legal regime. *Id.*

rlich's "Bukowina," argue that a modern *lex mercatoria* has emerged outside public law sources and relatively insulated from state institutions to constitute a new "trans-national law of economic transactions."[9] A theory of legal pluralism can explain this global nonstate law governing commercial and economic transactions that has arisen from diverse social systems and is subject to "a highly asymmetric process of legal self-reproduction."[10] For example, the model contracts for cross-border investments, such as project finance or financial services between wholesale counterparties, are often governed by terms that do not have a necessary link to a national legal system. Moreover, accountants and lawyers have agreed to use transnational rule-making processes to govern multinational insolvencies. Similarly, the internal legal regimes of multinational corporations are often devised independently of any one country's corporate law and apply *sui generis* to particular areas of corporate activity. This has also been recognised in the area of labour relations, where multinational firms adopt agreements to govern employee relations with transnational labor unions that are outside the laws of any state legal system.

The generation of international economic norms has also been analyzed through various institutional perspectives. For instance, Slaughter describes the current global order as a world of "disaggregated" States rather than the traditional realist notion of unitary States.[11] These disaggregated states interact with each other not only through foreign ministries, but also through regulatory, judicial, substate, and legislative bodies.[12] She views this "network" system as a novel development in response to globalization. Networks involve mainly government officials who create links across national borders and between national and supranational institutions. These networks perform a variety of functions, including the facilitation of information collection and sharing, technical assistance, and coordination of cross-border enforcement. The scope of these networks can be bilateral, plurilateral, regional, or global, and they interact with a wide range of international organizations, nongovernmental organizations, and civil society movements.[13] Upon closer analysis, however, the novelty of the "network" theory is undermined by the fact that economic, financial, and commercial diplomacy has been conducted through interstate networks since the early nineteenth century and, there-

9. Gunther Teubner, *"Global Bukowina": Legal Pluralism in the World Society*, *in* GLOBAL LAW WITHOUT A STATE 3, 3 (Gunther Teubner ed., 1997).

10. *Id*. at 11.

11. ANN-MARIE SLAUGHTER, NEW WORLD ORDER 5 (2004).

12. *Id*.

13. *Id*. at 5–6.

fore, is not a new form of international cooperation.[14] Nevertheless, as Howse observes, the theory of networks helps to "keep in perspective the role of international law and international institutions in contrast to other mechanisms and tools of governance."[15]

II. GLOBALIZATION AND INTERNATIONAL STANDARD SETTING

State borders no longer contain and define economic activity.[16] While sovereign nation states regulate domestic markets, advances in transportation and communication links, which require transnational management and international regulation, facilitate cross-border trade in goods, services, capital, and labor. The growth of financial markets, cross-border capital flows, and financial transactions has led States to create multilateral institutions and international standard-setting bodies to attempt to regulate the cross-border activities of transnational corporations and other firms, and to control and minimize the cross-border externalities produced by certain types of economic and financial risk taking.[17] It is recognized that the influence of these multilateral institutions and standard-setting bodies has grown immensely and that many States have responded by building parallel structures to counterbalance their influence.[18] This has raised several questions: how state decision-making and standard-setting practices should be regulated in these multilateral institutions; what type of legal competency States should exercise when engaged in standard setting; and what the optimal allocation of competency is between international and state-level actors.

Although nation states remain the principal actors in public international law, it is widely accepted today that legal personality can extend to international organizations and, in certain circumstances, to other nonstate actors, such as individuals and juridical or corporate persons.[19] Sov-

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14. Extensive networks of economic, financial, and central bank policymakers were involved in the negotiations leading up to the London Conference in 1932 on currency and trade arrangements, as well as in the creation of the Bretton Woods institutions in 1944, and the General Agreement on Tariffs and Trade in 1947.

15. Robert Howse, Book Review, 101 AM. J. INT'L L. 231, 232 (2007).

16. JOHN EATWELL & LANCE TAYLOR, GLOBAL FINANCE AT RISK ch. 1 (1999).

17. For a discussion of the negative externality of systemic risk in financial systems and its cross-border dimension, see KERN ALEXANDER, RAHUL DHUMALE & JOHN EATWELL, GLOBAL GOVERNANCE OF FINANCIAL SYSTEMS: THE INTERNATIONAL REGULATION OF SYSTEMIC RISK 23–25 (2006).

18. *See* ALVIN LEROY BENNETT, INTERNATIONAL ORGANIZATIONS: PRINCIPLES AND ISSUES 265 (1996). *See also* Ngaire Woods, *The Political Economy of Globalization*, *in* THE POLITICAL ECONOMY OF GLOBALIZATION 1, 4–5 (Ngaire Woods ed., 2000).

19. IGNAZ SEIDL-HOHENVELDERN, INTERNATIONAL ECONOMIC LAW 13 (2nd rev. ed. 1992).

ereign States also continue to be the main actors in economic policy and regulation, usually in both formal international economic organizations, such as the International Monetary Fund ("IMF") and the WTO, and international financial standard-setting bodies, such as the G10 committees, which include the Basel Committee. In these international institutions, States typically establish the initial terms of reference and decide on membership for States, interstate organizations, and nonstate actors, as well as approve the financing and general operational oversight of these international bodies and organizations. States, though, are finding it increasingly difficult to regulate and manage cross-border trading activities and financial transactions, given the new modes of production, distribution, and consumption, and the rising interconnectedness of governments, societies, and private actors in the world economy. Indeed the forces of globalization are changing the structure of the world economy and are posing major regulatory challenges for States.[20]

As a response to the growing cross-border flow of goods, services, ideas, and people, States have sought to enhance their management and surveillance of cross-border economic activities by coordinating their economic and financial policies with other States through international organizations and multilateral institutions. States have also facilitated the rise and transformation of domestic corporations and firms into multinational enterprises, thus creating new and influential entities at the international level. For international financial markets, the process of globalization has been no different. Expansion, diversification, and international coordination of banking activities and operations have been transformed with the increase of "global competition among bank and non-bank financial intermediaries" and have resulted in the rise of global financial service companies and the consolidation and conglomeration of the banking and financial services industry.[21]

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20. *See, e.g.*, Jost Delbrück, *Structural Changes in the International System and Its Legal Order: International Law in the Era of Globalization*, *in* 11 SCHWEIZERISCHE ZEITSCHRIFT FÜR INTERNATIONALES UND EUROPÄISCHES RECHT 1, 16 (2001) (Switz.) (defining globalization "as the process or the processes of denationalization/deterritorialization of politics, markets, and laws or, more specifically, process of denationalization/deterritorialization of clusters of political, economic and social transactions involving national and international actors, public and private, leading to a global interconnectedness of these actors in time and space including individuals").

21. *See* Joseph J. Norton, *The Multidimensions of the Convergence Processes Regarding the Prudential Supervision of International Banking Activities: The Impact of the Basel Supervisors Committee's Efforts Upon, Within and Without the European Community*, *in* FESTSCHRIFT IN HONOR OF SIR JOSEPH GOLD, *supra* note 6, at 249.

III. INTERNATIONAL STANDARD SETTING AND THE G10 COMMITTEES

In contrast to international economic organizations such as the WTO,[22] or BIS,[23] international standard-setting bodies are not entities with separate legal personality created by States, but rather informal associations of state representatives and/or professionals that meet to address specific problems or to identify issues of concern. In international finance, the globalization of financial services has necessitated that regulators develop cooperative relations to facilitate their oversight and regulation of banking and financial services. Beginning in 1962, the central banks of the ten leading industrialized nations, as well as the Swiss National Bank, began to meet regularly at the BIS and other venues to coordinate central bank policy and to organize lending to each other through the General Arrangements to Borrow.[24] These ten countries plus the Swiss National Bank became known as the Group of Ten or G10.[25] Goodhart has described the relationship of the G10 with one of its standard-setting committees—the Basel Committee—as one of delegated authority to engage in regulatory standard setting:

> Having established a standing committee of specialists in this field, the G-10 Governors would find it difficult to reject a proposal from them, especially on a technical matter. The relationships between the G-10 Governors and the BCBS emerge from the analysis of what the BCBS actually did and were quite complex. The G-10 Governors set priorities for work, and frequently required papers to be revised and reconsidered. But at the same time they often gave the BCBS considerable

22. The WTO was created by the Uruguay Round of Multilateral Trade Negotiations which adopted the WTO Agreements. *See* Marrakesh Agreement Establishing the World Trade Organization pmbl., Apr. 15, 1994, 1867 U.N.T.S. 154, 33 I.L.M. 1144.

23. The BIS is an international organization created under the Hague Agreements of 1930 and the Constituent Charter of the Bank for International Settlements of 1930. It was established in the context of the Young Plan, which dealt with the reparation payments imposed on Germany by the Treaty of Versailles following the First World War. *See* JAMES C. BAKER, THE BANK FOR INTERNATIONAL SETTLEMENTS: EVOLUTION AND EVALUATION 34 (2002). The BIS served as the payment agent for the European Payments Union, which facilitated the restoration of currency convertibility for the western European countries following the Second World War. For more on the European Payment Union, see DANIEL GROS & NIELS THYGESEN, EUROPEAN MONETARY INTEGRATION 4–8 (1998).

24. For a discussion of the General Arrangements to Borrow, see Kern Alexander, *The Fund's Role in Sovereign Liquidity Crises*, *in* 5 CURRENT DEVELOPMENTS IN MONETARY AND FINANCIAL LAW 131, 140–46.

25. The G10 central banks today consist of the central governors of eleven countries—Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Sweden, Swiss National Bank, United Kingdom, and United States—as well as the European Central Bank.

> freedom to decide its own agenda, and frequently rubber-stamped the papers emerging; basically the Governors did not have the time or the desire for textual criticism. They had a general oversight role; the detail was to be hammered out in the BCBS.[26]

The G10 established several committees whose secretariats were based at the BIS. The first of these committees was the Eurocurrency Standing Committee. Founded in 1962, it was formed to monitor and assess the operations of the then newly established Euro-currency markets. This Committee later became the Committee on the Global Financial System in 1971. It now deals with broader issues of systemic risk and financial stability. The best-known Committee, the Basel Committee on Banking Regulation and Supervisory Practices, was established in 1974, and today is known as the Basel Committee on Banking Supervision. Finally, the Committee on Payment and Settlement Systems was formed in 1990 to negotiate and set standards to support the continued functioning of payment and settlement systems.[27]

These Committees have examined many important economic policy and financial regulatory issues, as well as elaborated and promulgated best practices in supervision and regulation, the functioning of payment, settlement systems, and the overall operation of financial markets. The Committees are usually chaired by senior officials of member central banks and are composed of experts from central banks, regulatory authorities, and finance ministries. In the case of the BCBS, members also include noncentral bank supervisory authorities and other regulatory and economic policy experts. Members of the Committees have voting power and decision-making authority, while non-G10 country representatives are often consulted for their views on a variety of regulatory and economic issues. Frequently, special initiatives are undertaken to share experience with, and invite the opinions of, those not directly involved in the work of the Committees. In promoting cooperation in their respective areas, the Committees determine their own agenda and, within their mandate, operate independently from their host organization, the BIS,

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26. CHARLES A.E. GOODHART, A HISTORY OF THE BASEL COMMITTEE ON BANKING SUPERVISION (forthcoming 2009) (manuscript at ch. 14, on file with author).

27. The CPSS adopted the *Core Principles of Systemically Important Payment Systems*, CPSS Publications, No. 43 (Jan 2001). *See also* CPSS, *Recommendations for Securities Settlement Systems*, CPSS Publications, No. 46 (Nov. 2001). Three other secretariats for international financial standard setting bodies operate out of the BIS: the Financial Stability Board ("FSB") (originally established as the Financial Stability Forum in 1999), the International Association of Deposit Insurers ("IADI"), and the International Association of Insurance Supervisors ("IAIS").

which only provides its good offices for meetings as well as administrative and research support.

Significantly, these Committees have resolved not to adopt legally binding international standards in a public international law sense, but rather to influence domestic regulatory law, practices and standards by adopting what has become known as "international soft law." Indeed, Giovanoli, examining some of the issues in the international soft law debate as it relates to financial regulation and markets, has observed that

> [f]rom the institutional point of view, the new international financial system involves a great number and variety of institutions, entities and bodies which are directly or indirectly concerned with setting international financial standards. In other words, the new system is decentralized, although some institutions, in particular the IMF, have a prominent position as a result of their strong institutional basis and broad membership. The legal status of the multitude of entities involved varies significantly. The [international financial institutions] are fully-fledged international organizations, while the 'Gs' (G–7, G–10 or G–20) are *de facto* groupings created at the initiative of the governments of a number of states and meeting at different levels. There also are sector-specific international groupings of supervisors and regulators, central bank experts' committees and other groupings such as the FSF. However, what all these bodies have in common is the fact that, as a whole, they have no competence with regard to law-making or rule-making at either the national or international level.[28]

The Basel Committee has been the most important G10 committee with respect to its impact on developing legally nonbinding international financial standards. In December 1974, the Basel Committee was formed by the G10 central bankers to respond to a financial crisis that had arisen from the collapse of the German bank Herstatt, which had led to signifi-

28. Mario Giovanoli, *A New Architecture for the Global Financial Market: Legal Aspects of International Financial Standard Setting*, *in* INTERNATIONAL MONETARY LAW: ISSUES FOR THE NEW MILLENNIUM 3, 11 (Mario Giovanoli ed., 2000). The FSF was established by the G7 in 1999 in response to the Asian financial crisis, partly to coordinate the work of the multifarious bodies already established, including the BCBS and the various departments of the OECD. *See* Financial Stability Forum, History, http://www.financialstabilityboard.org/about/history.htm (last visited June 3, 2009). The FSF Compendium of Standards with a summary and classification of the most significant rules, best practices, principles, and guidelines of international financial regulation. They are categorized based on twelve key standards, which are broken into three categories: macroeconomic policy and data transparency; institutional and market infrastructure; and financial regulation and supervision. *See* Financial Stability Forum, Compendium of Standards, 12 Key Standards for Sound Financial Systems, http://www.financialstabilityboard.org/cos/key_standards.htm (last visited June 3, 2009). *See* LASTRA, *supra* note 4, at 459–60.

cant problems with foreign exchange and settlement risk between U.S. and European banks. In the same year, the U.S. Franklin National Bank became insolvent and posed a risk to counterparty banks because of its miscalculations of foreign exchange risk in the wholesale loan market. Both of these crises exposed substantial gaps in the ability of central bankers and national regulators to control and manage a crisis with cross-border effects. The Basel Committee adopted a Concordat, in February 1975, that established principles of information exchange and coordination for the oversight of the cross-border operations of banking institutions.[29] The 1975 Concordat was amended in 1983, in response to the collapse and insolvency of the Italian bank Banco Ambrosiano.[30] The 1983 Revised Concordat contained the principle of consolidated supervision; this principle provides that home country regulators shall have responsibility for ensuring that the transnational operations of their home country banks are sound regarding credit risk exposure, quality of assets, and the capital adequacy of the banking group's global operations.[31]

Later, following the Latin American sovereign debt crisis of the early 1980s, and the resulting near collapse of several major U.S. banks because of their excessive lending to emerging market sovereigns, the Basel Committee adopted the 1988 Capital Accord, which established a minimum eight percent capital adequacy requirement on internationally active banks within G10 country jurisdictions.[32] The Capital Accord was originally calculated based on a bank's credit risk exposure, but was later

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29. *See* GEORGE A. WALKER, INTERNATIONAL BANKING REGULATION: LAW, POLICY AND PRACTICE 87 (2001).

30. The 1983 Revised Concordat was entitled "Principles for the Supervision of Banks' Foreign Establishments."

31. *See* ALEXANDER, *supra* note 17, at 47–48.

32. The 1988 Capital Accord's original purpose was to prevent the erosion of bank capital ratios resulting from aggressive competition for market share by the leading banks during the 1980s. The Accord also hoped to harmonize the different levels and approaches to capital among the G10 countries. In adopting the 1988 Accord, banking regulators wanted to establish an international minimum standard that would create a level playing field for banks operating in the G10 countries, and banking regulators wanted capital requirements to reflect accurately the true risks facing banks in a deregulated and internationally competitive market. The 1988 Capital Accord required banks actively engaged in international transactions to hold capital equal to at least eight per cent of their risk-weighted assets. This capital adequacy standard was intended to prevent banks from increasing their exposure to credit risk by imprudently incurring greater leverage. The Accord was entitled "International Convergence of Capital Measurement and Capital Standards," and it applied, according to the principle of home-country control, to banks based in G10 countries with international operations. Basle Comm. on Banking, *International Convergence of Capital Measurement and Capital Standards*, July 1988, http://www.bis.org/publ/bcbs04a.pdf?noframes=1.

amended in 1996 to include a bank's market risk exposure (i.e., trading book exposure), thereby extending the eight percent capital adequacy requirement to a bank's trading book activities.[33] Between 1999 and 2004, the Committee engaged in a lengthy and radical revision of the Accord known as "Basel II." The revision was concluded in 2004, and the Committee published a final text of the revised Capital Accord in June 2004.

Basel II aims to make regulatory capital more sensitive to the risks that banks face in the marketplace. In doing so, it allows banks, under most conditions, to hold less regulatory capital for their credit, market, and operational risk exposures. The global credit crisis, however, revealed that banks are also exposed to significant liquidity risks, especially in their off-balance sheet exposures. Basel II regulatory capital requirements fail to address the liquidity risks to which banks are exposed and also do not require banks to hold adequate capital for the systemic risk that their lending and risk-taking creates.[34] These issues are now under review by the Basel Committee in light of the credit crisis. Having committed themselves to implementing Basel II into their domestic legal systems, the G10 countries have begun to do so or have already completed the implementation process.[35]

A. Decision Making and Implementation

The Basel Committee's decision making operates on a consensus basis. Although the Committee's decision making has traditionally been secretive and substantially relied on personal contacts, it has become more formalized in recent years because of the considerable attention given to the deliberations over Basel II.[36] As discussed above, the Com-

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33. This was known as the "Market Risk Amendment 1996." *See* ALEXANDER, *supra* note 17, at 38–39.

34. *See* KERN ALEXANDER ET AL., FINANCIAL SUPERVISION AND CRISIS MANAGEMENT IN THE EU 2–7 IP/A/ECON/ST/2007-26 (Dec. 2007) (Commissioned Report by the EU Parliament Committee on Economic and Monetary Affairs), *available at* http://www.europarl.europa.eu/activities/committees/studies/download.do?file=19191#search=%20Financial%20supervision [hereinafter FINANCIAL SUPERVISION].

35. In Europe, the European Community adopted Basel II as EC law in 2006, when the Council of Ministers and the EU Parliament approved the Capital Requirements Directive, which is contained in Council Directives 2006/48/EC, 2006 O.J. (L 177) and 2006/49/EC, 2006 O.J. (L 177).

36. For instance, during the Basel II negotiations, the Committee put a number of issues for consultation on its website where it then engaged in a public dialogue through the publication of its quantitative impact studies, which, on a hypothetical basis, measured the impact of Basel II using the reports of a number of banks in both G10 and non-G10 countries.

mittee's decisions are *legally nonbinding* in a traditional public international law sense and place a great deal of emphasis on decentralized implementation and informal monitoring of member compliance.[37] The Committee has sought to extend its informal network with banking regulators outside the G10 through various consultation groups.[38] It has conducted seminars and consultations with banking regulators from over one hundred countries as part of the deliberations over adopting the Basel II agreement. Most recently, in response to criticism over Basel II and to the lack of accountability and legitimacy in its decision-making structure, the Committee expanded its membership from thirteen to twenty countries in March 2009.[39]

Although some have viewed the informality of the Committee's decision-making process as effective for developing international banking regulatory standards,[40] others have considered it a constraint on effective implementation.[41] As Goodhart has observed, "The way that the BCBS, under its various Chairmen, interpreted this constraint was that all proposals for forward transmission to the G-10 Governors, and thence to the

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37. Indeed, the Basel Committee states the following on the BIS website:

> The Committee does not possess any formal supranational supervisory authority, and its conclusions do not, and were never intended to, have legal force. Rather, it formulates broad supervisory standards and guidelines and recommends statements of best practice in the expectation that individual authorities will take steps to implement them through detailed arrangements—statutory or otherwise—which are best suited to their own national systems. In this way, the Committee encourages convergence towards common approaches and common standards without attempting detailed harmonisation of member countries' supervisory techniques.

Basel Comm. on Banking Supervision, *History of the Basel Committee and Its Membership* 1 (Jan. 2007), http://www.bis.org/bcbs/history.pdf.

38. The Core Principles Liaison Group remains the most important forum for dialogue between the Committee and systemically-relevant non-G10 countries. Moreover, the BIS established the Financial Stability Institute to conduct outreach to non-G10 banking regulators by holding seminars and conferences on implementing international banking and financial standards.

39. *See* Bank for Int'l Settlements, *Expansion of Membership Announced by the Basel Committee* (Mar. 13, 2009), http://www.bis.org/press/p090313.htm (announcing that the Basel Committee decided on March 10–11, 2009, to expand its membership from thirteen to twenty countries by adding Australia, Brazil, China, India, South Korea, Mexico, and Russia). The BCBS's expanded membership, however, does not apply to the membership of the G10 central bank governors, which remains the same with twelve developed countries plus the European Central Bank.

40. Patricia Jackson, Bank of Eng., Lecture at the Judge Institute of Management, University of Cambridge (Mar. 15, 2002).

41. *See* GOODHART, *supra* note 23.

wider community of regulators/supervisors around the world, had to be accepted consensually by all country members of the Committee."[42] As a consensus of all Committee members was required to adopt any standards or agreement, each country had a veto. According to Goodhart, however, this was in practice "somewhat less of a constraint than it might seem at first sight."[43] The smaller countries, for example, Benelux, Canada, Italy, Sweden, and Switzerland, were reluctant to object to proposals by the United States and United Kingdom and rarely took a minority position, "except on a matter of extreme national importance, an example of [which is] . . . banking secrecy for Switzerland."[44] Despite Japan's substantial economic and financial influence, Goodhart notes that Japanese representatives on the Committee "usually remained quiet and withdrawn . . . partly due to their rapid turn-over of personnel, so they had little opportunity to build up expertise."[45]

Monitoring noncompliance has generally been a decentralized task that is the responsibility of Member States themselves, not international organizations, such as the BIS, or other international bodies.[46] Nonetheless, the Committee monitors and reviews the Basel framework with a view to achieving greater uniformity in its implementation and convergence in substantive standards. Moreover, the Committee claims that the legitimacy of the international standards it adopts derives from a communiqué issued by the G7 Heads of State in 1998 that encouraged emerging economies to adopt "strong prudential standards" and "effective supervisory structures."[47] To ensure that its standards are adopted, the Committee expects the IMF and World Bank to play a surveillance role in overseeing Member State adherence through its various conditionality programs. In addition, because most G10 countries are members of the European Union, they are required by EU law to implement the Capital Accord into domestic law.[48] In fact, the only G10 countries not required by local law to implement the Capital Accord are Canada, Japan, and the United States.[49] This extended application of the Basel Committee's standards to

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42. *Id.*
43. *Id.*
44. *Id*.
45. *Id*.
46. *See* JOSEPH NORTON, DEVISING INTERNATIONAL STANDARDS OF BANKING SUPERVISION (1995).
47. *Id.*
48. *See* Council Directive 2006/48/EC, 2006 O.J. (L 177); Council Directive 2006/49/EC, 2006 O.J. (L 177).
49. In fact, a major obstacle in negotiations over Basel II had been the initial reluctance of the U.S. Congress and the refusal of some U.S. bank regulators to apply Basel II to most U.S. banks. The Federal Reserve, which has been an important supporter of Basel

non-G10 countries has raised questions regarding the accountability of its decision-making structure and its suitability for application in developing and emerging market economies.[50]

As an international legal matter, the Basel Capital Accord and its amended version, Basel II, are not legally binding in any way for G10 countries or other countries that adhere to it. The Capital Accord has been analyzed and classified as a form of "soft" law.[51] On an institutional level, the BCBS has no authority to take a decision of its own and has no formal legal mandate. It merely serves as a forum for discussion amongst central bankers and bank supervisors. It voluntarily adopts common regulatory standards and suggested financial policies, but leaves it to the discretion of national authorities to implement them into their national systems.[52]

The work of the Basel Committee does generate international standards of financial regulation, but these standards are not intended to have legally binding effect under public international law. Basel Committee standards only become legally effective when national authorities adopt

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II and has the authority to apply it to U.S. financial holding companies, has begun applying it to the largest of such companies, while all other U.S. credit institutions will follow a different implementation schedule that will result in Basel II being fully adopted by U.S. banks between 2013 and 2015. *See* Risk-based Capital Guidelines; Capital Adequacy Guidelines; Capital Maintenance; Domestic Capital Modifications, Advanced Notice of Proposed Rule-Making, 12 C.F.R. pt. 3 (Oct 6, 2005).

50. ALEXANDER, *supra* note 17, at 135–37.

51. *See id.* ch. 3 (discussing international soft law). *See also* Giovanoli, *supra* note 28, at 11–12.

52. Walker observes that

> [i]nternational standards have become of particular importance in recent years due to the need to develop some common or, at least, minimum level of rules and regulations in various core areas of modern financial and economic practice. In light of the difficulties that naturally arise in attempting to agree [to] any formal treaty, convention or similar formal prescriptive solution at the international level, a more informal consensus based approach has to be attempted, at least[] during the early stages until some basic common agreement (and supporting sense of self-interest and commitment) may be achieved. This will certainly be the case in many such sensitive and complex areas as international bank and financial market control. A standards based approach also has the obvious advantage of flexibility and informality although this necessarily means that it suffers from the associated operational limitations of weak adoption and compliance. The key issues that then arise with international standards are not with regard to legal classification and formal enforcement but with national adoption and implementation[,] and implementation review.

GEORGE ALEXANDER WALKER, LAW, POLICY AND PRACTICE, at xxiii (2000).

them into domestic law and regulation. Although there is a tendency to attribute international legal significance to the international standards generated by the various committees that meet at the BIS, the overwhelming opinion of experts and policymakers clearly holds that the international standards adopted by these committees are not legally binding in any sense. They are, however, important international norms that influence and shape state behavior and are an effective form of legally nonbinding international soft law that has significant public policy relevance in the global financial governance debate.

The Basel Committee's capital adequacy standards and rules on consolidated supervision were intended to apply only to credit institutions based in G10 countries that had cross-border operations. But this changed in 1998 during the Asian financial crisis when, at the urging of the G7 finance ministers and the world's largest financial institutions, which were lobbying for more market sensitive capital standards, the Basel Committee stated its intent to amend the Capital Accord and to begin working on Basel II with a view to making it applicable to all countries where banks operate on a cross-border basis. Many non-G10 countries have incorporated the Basel standards into their regulatory frameworks for a variety of reasons, including strengthening the soundness of their commercial banks, raising their credit rating in international financial markets, and achieving a universally recognized international standard. The IMF and World Bank have also required many countries to demonstrate adherence or a realistic effort to implement the Basel Accord in order to qualify for financial assistance as part of IMF Financial Sector Assessment Programs and World Bank Financial Sector Adjustment Programs. Moreover, as a condition for obtaining a bank license, all G10 countries require foreign banks to demonstrate that their home country regulators have adopted the Capital Accord and other international agreements. International reputation and market signals are also important in creating incentives for non-G10 countries to adopt the Capital Accord. Many non-G10 countries (including developing countries) have found it necessary to require their banks to adopt similar capital adequacy standards in order to attract foreign investment as well as to stand on equal footing with international banks in global financial markets.

B. The CPSS and the Committee on the Global Financial System

The other G10 committees that serve as international financial standard setting bodies—the CPSS and the Committee on Global Financial System—have adopted standards, principles, codes, guidelines, frameworks, and reports that have had a significant impact on the development of domestic public law standards, national regulations, and supervisory practices. The CPSS consists of the G10 central bank officials who examine issues of payment system regulation as well as clearing and settlement of securities and foreign exchange transactions. The Committee undertakes specific studies in the field of payment and settlement systems at its own discretion or at the request of the G10 Governors. It has published several important sets of principles and recommendations in the areas of payment system regulation and clearing and settlement of securities.[53] The Committee operates through a network of working groups. To address concerns that it is merely an exclusive committee of G10 central bankers, the Committee has in recent years developed relationships with other central banks, particularly those of emerging market economies, so that its work can have more influence with, and be influenced by, central banks outside the G10. The CPSS has also published a number of reports that have influenced the regulation of payment infrastructure and settlement systems.[54] As with the Basel Committee, the principles and recommendations issued by the CPSS are not legally binding, as regulators seek to agree on standards that different jurisdictions can flexibly implement into their regulatory regimes. Although these international standards are without legal effect, they provide an important set of international norms that influence regulatory and supervisory practices and the standards for controls and oversight of financial infrastructure.

Similarly, the Committee on Global Financial Systems monitors developments in global financial markets for the G10 central bank Governors. The G10 Governors have provided a mandate to the Committee to identify and assess potential sources of stress in global financial markets.[55] The Committee engages in research to identify issues and threats to systemic stability in global financial markets, examine the structural underpinnings of financial markets, and promote improvements to the functioning and stability of these markets. Representatives of the G10 monitor on a quarterly basis the discussions and reports issued by the

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53. The CPSS's publication of the Core Principles for Systemically Important Payment Systems, the CPSS/IOSCO Recommendations for Securities Settlement Systems, and the CPSS/IOSCO Recommendations for Central Counterparties has contributed to the set of standards, codes, and best practices that are deemed essential for strengthening the international financial system. Committee on Payment and Settlement Systems, CPSS Publications, http://www.bis.org/cpss/index.htm (last visited Apr. 26, 2009).

54. The Committee has published various reports examining large-value funds transfer systems, securities settlement systems, settlement mechanisms for foreign exchange transactions, clearing arrangements for exchange-traded derivatives, and retail payment instruments, including electronic money. Its "Red Book" on payment systems provides extensive information on the most important systems in the CPSS countries.

55. Bank for Int'l Settlements, *Committee on the Global Financial System: Mandate*, Feb. 8, 1999, http://www.bis.org/cgfs/mandate.htm.

Committee; they also work with the Committee to identify long-term research projects involving working groups, which consist of central bank and regulatory staff, and the drafting of various reports.

Other international supervisory bodies have also played a key role in developing international standards and rules for the regulation of financial markets. The International Association of Deposit Insurers meets at the BIS and discusses and adopts international principles and standards that govern deposit insurance regulation. In the area of money laundering and terrorist financing, the OECD's Financial Action Task Force ("FATF") has attained a high profile role in setting international standards (so-called recommendations) of disclosure and transparency for the regulation of banks, financial service providers, and other businesses in order to combat the global problem of financial crime.[56] The FATF and the Basel Committee have each played a much more prominent role in their respective international regulatory standard-setting functions as compared to the International Organization of Securities Commissions ("IOSCO") and the IAIS. In recent years, however, IOSCO and the IAIS have attracted much more policy attention since their standards and recommendations have been recognized by the IMF and World Bank as international benchmarks against which IMF and World Bank member countries are assessed for compliance in their financial sector assessment programs.

As discussed above, these international standard-setting bodies have been characterized as "networks" of international technical experts. But, it is submitted that their role is much larger than narrow technical experts, as they influence the development of broader economic policy and their negotiations and standard setting is more accurately characterized as a form of financial diplomacy. Although they are at the "coal face" of technical and regulatory standard setting, the goal of these regulatory technicians in international bodies is to devise broader international standards that govern the operations of financial markets and the many financial firms—banks, securities and insurance companies—in those markets with an important impact on the broader macroeconomy. These national regulators and supervisors—mainly from developed countries—use international standard-setting bodies to influence not only technical areas of regulation, but also broader areas of financial development. This

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56. Other important international standard setting bodies include the International Accounting Standards Board and the International Federation of Accountants, which are composed of non-state representatives that include professional accountants and academics who devise international accounting standards for the accounting industry. Similarly, the International Auditing and Assurance Standards Board sets standards for international financial reporting.

is especially the case with the creation of the G20 and the enhanced financial policy role of the FSB and the broader policy agenda for the Basel Committee with respect to the Core Principles of Banking Supervision. The G20, the FSB, and the G10 committees are all playing high profile roles in economic and financial policymaking and in influencing the development of international financial regulation.

In this vein, the Joint Forum on Financial Conglomerates ("Joint Forum") and the FSB[57] have both been characterized as intergovernmental standard-setting bodies. They are composed of regulators and supervisors from the G10 and G20 countries and some large emerging market countries, and of representatives from other G10 standard-setting bodies. Established in 1996 under the aegis of the BCBS, IAIS, and IOSCO,[58] the Joint Forum issues legally nonbinding documents and principles. In contrast to its constituent international bodies, the Joint Forum has established a set of principles designed to assist regulated entities in determining the minimum steps they should take when considering outsourcing activities. These include creating a coherent policy and specific management plan for programs as well as deciding the types of issues that should be considered in contracts. The principles also contain some broad standards to help supervisors.[59] It develops its principles in conjunction with IOSCO, which produced the Objectives and Principles of Securities Regulation in 1998.[60] The Joint Forum's principles are in its own words "high-level and cross-sectoral, designed to provide a minimum benchmark" for all financial institutions.[61] In contrast to the IOSCO principles, the Joint Forum minimum benchmarks are complementary and designed specifically for securities firms.

57. The FSB, formerly the Financial Stability Forum, was "re-established" at the G20 Summit in London in April 2009. *See* G20, *Declaration on Strengthening the Financial System—London* 1 (Apr. 2, 2009). The FSB will play a higher-profile role than its predecessor, the FSF, in monitoring global financial stability. Specifically, it will establish a supervisory college to monitor each of the largest international financial services firms. It will monitor a firm's financial and operational structure, and any contingency funding arrangements, and will act as a clearing house for information sharing and contingency planning for the benefit of its member countries. *Id*.

58. ALEXANDER, *supra* note 17, at 50.

59. *Id.*

60. INT'L ORG. OF SEC. COMM'NS, OBJECTIVES AND PRINCIPLES OF SECURITIES REGULATION (1998), *available at* http://www.iosco.org/library/pubdocs/pdf/IOSCOPD82.pdf.

61. Bank for Int'l Settlements, *Joint Forum Provides Outsourcing Guidance to the Financial Sector* (Aug. 2, 2004) http://www.bis.org/press/p040802.htm.

The FSB consists of the twenty countries that compose the G20.[62] It coordinates activities relating to issues common to the banking, securities, and insurance sectors. As the common body of three international financial bodies, the BCBS, the IAIS, and IOSCO, the FSB sets soft law in the form of guidance, and issues reports producing principles of prudential regulation, international cooperation between supervisors, executive compensation in financial firms, accounting standards, tax havens, and non-cooperative jurisdictions. It also collaborates with the IMF in conducting early warning exercises.

These international bodies lack the requisite attributes of an international organization, namely, they are not subject to international law, and do not have international personality, the capacity to conclude treaties, or international legal immunities. It is precisely because of these nonlegal attributes that these international standard-setting bodies—composed of state representatives and international organizations—have been praised for having a more flexible decision-making structure with a powerful normative component that significantly influences the development of national economic law and regulatory practices. Indeed, the type of international financial standard setting engaged in by the Basel Committee has been praised as an alternative form of international lawmaking without the burden of cumbersome treaty formation rules and the imprecise—and often politically impractical—requirements for the formation of customary international law. The international financial standard-setting bodies have been praised for being more effective in adopting economically beneficial regulatory norms and standards for most countries, while exercising far more influence over state economic and regulatory practice than the influence exerted by many formal international and regional economic organizations.[63] The worldwide credit crisis, however, has called the efficacy of this flexible and unstructured international decision-making process into question.

IV. THE BASEL COMMITTEE AND THE WORLDWIDE CREDIT CRISIS

Although the flexible and secretive manner in which the Basel Committee and the other G10 committees have conducted their deliberations and standard setting has generally been considered a strength in the effectiveness of their governance structures and decision-making processes,[64]

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62. The G20 countries are the same countries that are members of the Basel Committee. *See supra* note 39 and accompanying text.

63. *See* ALEXANDER, *supra* note 17, at 136–39.

64. The unstructured and secretive deliberations process has been praised because it allows regulators to respond quickly to rapidly changing developments in financial markets. *See* Jackson, *supra* note 38.

it has also had the unfortunate result of exposing them to special interest group pressure from major banks and international finance associations.[65] Most of the major international banks and their advocates used the more flexible institutional structure of the Basel Committee with its opaque decision-making processes to lobby regulators and central bankers to adopt more market-sensitive regulatory capital requirements. This led to weaker capital adequacy measurement processes for banks, which resulted in lower bank capital levels that did not cover the social costs (or negative externalities) of bank lending and overall risk-taking.[66] Moreover, Basel II did not address the serious liquidity risks which banks were exposed to through securitization and other forms of credit risk transfer. The combination of the banks' exposure to liquidity risk in securitization markets and to higher levels of credit risk and market risk, because the Basel II models permitted banks to hold far lower levels of regulatory capital than what was socially optimal, created serious systemic risk to the global financial system and contributed significantly to the causes of the global credit and financial market crisis of 2007–2009.[67] Essentially, Basel II permitted regulators to approve more market-risk sensitive capital models, which led to lower levels of regulatory capital and created an incentive for banks to increase their leverage levels in the structured finance and securitization markets.[68]

The failure of the Basel Committee and other international financial standard-setting bodies to anticipate the virulent risks created in the financial system over the last ten years has resulted in tremendous criticism of the bodies and the G10 committees for their failure to oversee adequately the international standard-setting process. The Basel Committee's failure to adopt regulatory capital standards that would require banks to manage their balance sheets in a more socially compatible manner resulted in high levels of leverage in the global financial system that contributed significantly to the causes of the worst financial crisis since the Great Depression of the 1930s. In other words, the lack of transparency and accountability in the Committee's decision-making structure, and the bankers' excessive influence on the regulators who were members of the Committee, resulted in the leading G10 countries adopting

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65. For example, the Institute for International Finance in Washington D.C.

66. Indeed, a major impetus for Basel II was the lobbying of major multinational banks and their trade associations, which wanted the eight-percent capital adequacy standard of the 1988 Capital Accord lowered significantly to reflect more approximately the economic capital levels that bank risk models suggested they hold to protect the investment capital of bank shareholders.

67. FINANCIAL SUPERVISION, *supra* note 34, at 2–7.

68. *Id*.

weak bank capital standards, thereby bringing about the world economy's fall into a serious economic recession.

CONCLUSION

The legal implications of the international financial standards produced by these bodies have raised important questions regarding the definition, relevance, and development of international economic law. The growing importance of the international financial standards, such as the Basel Capital Accord, and their acceptance by most countries for their domestic regulatory systems have demonstrated the importance of international financial soft law in influencing state practice. It has also shown that States in the financial regulatory arena have a certain disregard for using traditional public international law to govern state practice and the operations of global financial markets.

The current enthusiasm for international financial soft law standards has two disquieting implications. First, many governments not actively involved in the Basel standard-setting process are suffering an involuntary loss of sovereignty, as they have not been involved in the negotiation and design of the international standards. This loss is at odds with the general presumption in international law that governments are sovereign unless they decide to cede their sovereignty. Moreover, the growing obligation for States to adopt the Basel standards without representation in the standard-setting process calls into question the accountability and legitimacy of the Basel Committee. Perhaps, the G10's effective monopoly on decision making should be ended by allowing other countries that are also representative of the global financial system to have a seat at the table.

Second, as a matter of economic policy, if those designing the standards maintain the fiction that they are voluntary when in fact they are not, the content of the standards is likely to be suboptimal for economic growth and financial development, as is demonstrated with the recent financial crisis. Future research should elaborate what role international economic law should play in enhancing the institutional structure of decision making in order to achieve financial stability and development objectives. Moreover, the catastrophic financial crisis that has plagued Western financial markets from 2007 to the present raises important issues regarding the governance structure of the G10 committees and in particular the standard-setting competence of the Basel Committee, whose regulatory standards have completely failed in protecting the global financial system and in providing an efficacious, prudential regulatory model for future financial development.

THE HARDENING OF SOFT LAW IN SECURITIES REGULATION

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INTRODUCTION

Securities law has long existed at the intersections of private and public law, and also state and federal law. Currently, securities law, like the capital markets, is becoming international. This Article will address how international securities regulation relies upon soft law, but frequently becomes hard law.

Soft law is nonbinding standards and principles of conduct. It may emanate from international organizations such as the Organisation for Economic Co-operation and Development ("OECD"), where state members agree to resolutions or recommendations. Or it may be the result of international organizations such as the International Organization of Securities Commissions ("IOSCO"), where individual regulators espouse principles and best practices. A large part of the soft law of securities regulation is standard setting by self-regulatory organizations ("SROs") such as the International Accounting Standards Board ("IASB"), which formulates accounting principles for use by companies.

Hard law, on the other hand, is statutes, regulations, and treaties and is binding. Soft law sometimes can harden law when it is incorporated into statutes, regulations, and even treaties. For example, after establishing norms through soft law, the OECD concluded a treaty combating bribery that States adopted and ratified. Congress may implement standards set by private bodies in a statute. Frequently, statutes in the securities field are passed in response to financial crises and, to some extent, incorporate pre-existing soft law into statutory language. Soft law may be codified through regulation. For example, the Securities and Exchange Commission ("SEC") has adopted rules codifying best practices established by IOSCO. Alternatively, self-regulatory law can become subject to government oversight and consequently become binding.

In the United States, securities regulation is primarily found in the federal securities laws enacted from 1933 to 1940 and their subsequent amendments, as well as in the implementing regulations of the SEC. Some securities regulation also comes from state corporate and securities laws. Much of federal securities regulation is based upon SRO standards, and today, securities industry SROs are subject to extensive SEC oversight. In other countries, a similar trajectory—from SRO standard setting to regulation by government securities commissions—has been followed. In the European Union, although there are numerous securities regulation directives, there is not an EU securities commission. Nevertheless, the Committee of European Securities Regulators ("CESR") coordinates regulation by the various EU Member States, each of which has a securities regulatory commission.

Numerous international bodies are involved in the development of securities standards. IOSCO, for instance, is an international body composed of securities regulators from all over the world, which formulates standards for securities regulation. Its members pledge to implement these standards in their home countries to the extent they are able to do so, but IOSCO standards do not have the force of either international or national law. Other bodies that work on establishing regulatory standards in the securities field include the OECD, the World Bank and similar regional banks, and the World Federation of Stock Exchanges. But any standard setting by such bodies is soft law, although it may influence national legislatures or even lead to treaties.

One issue that this Article will address is why so much standard setting in the field of securities regulation is accomplished through soft law. We believe this occurs because of the need for speed, flexibility, and expertise in dealing with fast-breaking developments in capital markets. Since SRO standards and other soft law are based on a consensus by participants in the markets, soft law is frequently more informed and more effective than statutory law, although it may eventually be translated into statutes or rules for enforcement purposes. The soft law of securities regulation also can become hard law when it is recognized as custom and usage in the securities industry; this is the content of many SRO standards. National legislatures are often leery of interfering with financial markets and may be even more divided than players in those markets as to how to address problems that threaten the markets or investors. International regulatory bodies find it even more difficult to agree on appropriate regulation for the securities markets, in part because national market centers and firms compete with one another. Treaties take much too long to become law to rectify most problems that arise in capital markets.

Despite the advantages of soft securities regulatory law, its use has some drawbacks. Not all concerned parties necessarily have input into its formulation. To some extent, this deficit can be addressed through appropriate consultative processes by standard-setting organizations. In terms of U.S. constitutional law, the widespread use of soft law in the regulation of global capital markets seems to contradict the treaty-making powers of Congress and the President. Indeed, the SEC, an independent regulatory agency, negotiates and utilizes memoranda of understanding ("MOUs"), which are treaty-like agreements, but are soft law. Even though MOUs and other forms of soft law may survive constitutional scrutiny, they still raise some serious questions concerning checks and balances, accountability, and transparency.

The plethora of regulators and organizations engaged in the production of both hard and soft law in the securities field can lead to a race to the bottom in standard setting, and to the under-enforcement of the established regulations. While some academics argue that regulatory competition is salutary, the authors are skeptical that such competition in the international realm produces sufficiently robust legal standards. Until relatively recently, the U.S. economy and capital markets were so much stronger than any other national economy that the SEC could impose rigorous standards upon the issuers and investment bankers of other nations. In a world where there is no economic hegemony by any one country, it is necessary for all of the major players in the global capital markets to agree upon the regulation of these markets. The development of standards through soft law is probably the only realistic method of doing so.

Part I of this Article will discuss the use of soft law in securities regulation, and why soft law works in this field. It will also introduce some international soft-law generators. Part II will set forth four examples of the use and hardening of soft law in the international realm, specifically, the establishment of international financial reporting standards ("IFRS") by the IASB; the development of MOUs by securities regulators; the negotiation of an anti-bribery treaty in the OECD; and the development of standards regulating credit rating agencies ("CRAs"). Part III will discuss some of the costs and benefits of the widespread use of soft law to regulate capital markets.

I. THE USE OF SOFT LAW FOR SECURITIES REGULATION

A. A Short History of Soft Law in Securities Regulation

Before there were any state or federal securities laws, securities regulation was a matter of contract between stock exchanges and other SROs and their members and listed companies. The New York Stock Exchange ("NYSE") was organized in 1792 by brokers to govern securities trading in the wake of a scandal in the government bond market after the Revolutionary War.[1] In addition to establishing fixed commission rates[2] and

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1. *See* RON CHERNOW, ALEXANDER HAMILTON 383–84 (2004).

2. The fixing of commission rates was the keystone of SRO regulation, not only for the NYSE, but later for the National Association of Securities Dealers, Inc. ("NASD"), which was formed in 1936, in a restructuring of a trade group previously known as the Investment Bankers Association of America. *See* Donna Nagy, *Playing Peekaboo with Constitutional Law: The PCAOB and Its Public/Private Status*, 80 NOTRE DAME L. REV. 975, 1023–24 (2005). Members of the NASD, and later, the Nasdaq Stock Market ("Nasdaq") did not trade on an agency basis and charge commissions, but did trade as dealers with members at preferential prices. *See* Roger D. Blanc, *Intermarket Competition and*

setting standards of conduct for the trading of securities, the NYSE also regulated the corporate governance of large public corporations by contractual agreements so that the exchange could advertise that its listed issuers were "blue chip" companies. Prior to the twentieth century, such listing agreements were individually negotiated with companies and were flexible and subject to *ad hoc* enforcement.[3]

As early as 1869, the Stock List Committee of the NYSE evaluated the qualitative character of listed companies regarding business, management, capitalization structure, financials, and accounting policies to determine whether a company should be listed.[4] It was not until the early twentieth century that listing criteria became more standardized and included such investor protections as requirements that listed companies have an annual shareholders' meeting and distribute financial information to shareholders.[5]

After the 1929 stock market crash the first federal securities laws were passed. The Securities Act of 1933 ("Securities Act")[6] covers initial distributions of securities and requires that securities issuances be registered with the SEC prior to sale unless an appropriate exemption from registration was available.[7] The Securities Exchange Act of 1934 ("Exchange Act")[8] covers postdistribution trading of securities and gives the SEC oversight of stock exchanges and trading markets, including listed companies, as well as securities industry intermediaries. Many matters previously dealt with in NYSE listing agreements, such as quarterly and annual financial reporting, the holding of annual meetings, and the need for independent audits, became matters of federal law.[9] Nevertheless, stock exchanges continued to formulate and enforce listing standards, and in 1996 Congress pre-empted blue sky securities laws.[10] Then, in

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Monopoly Power in the U.S. Stock Markets, 1 BROOK. J. CORP. & COM. L. 273, 278 (2007). *See also* United States v. Nat'l Ass'n of Sec. Dealers, Inc., 422 U.S. 694 (1975).

3. Douglas C. Michael, *Untenable Status of Corporate Governance Listing Standards Under the Securities Exchange Act*, 47 BUS. LAW. 1461, 1465–66 (1992).

4. *See* CHARLES A. DICE & WILFRED J. EITEMAN, THE STOCK MARKET 111–16 (2d ed. 1941).

5. *See Special Study on Market Structure, Listing Standards and Corporate Governance*, 57 BUS. LAW. 1487, 1498–99 (2002) [hereinafter *Special Study on Listing Standards*]. At about this same time, the states began to pass securities regulation statutes designed to assure that public offerings of securities were based on fair, just, and equitable capital structures. *Id. See also* Hall v. Geiger-Jones Co., 242 U.S. 539 (1917).

6. Securities Act of 1933, 15 U.S.C. § 77a et seq. (1933).

7. 15 U.S.C. § 77e.

8. Securities Exchange Act of 1934, 15 U.S.C. § 78a et seq. (1934).

9. *Special Study on Listing Standards*, *supra* note 5, at 1500.

10. 15 U.S.C. § 77r (1996). *See also* Pinnacle Commc'ns Int'l, Inc. v. Am. Family Mortgage Corp., 417 F. Supp.2d 1073 (D. Minn. 2006).

response to the Enron and WorldCom debacles and the bursting of the stock market technology bubble, the Sarbanes-Oxley Act of 2002[11] authorized the SEC to oversee SROs.[12]

SRO ratemaking had a somewhat different history. The fixed minimum commission rate for NYSE and other stock exchange trades was undermined by market practices and the growth of institutional investors in the 1970s. The NYSE, however, resisted the unfixing of commission rates, while the Supreme Court held that antitrust laws did not apply to the system of fixed commission rates because direct and active SEC supervision negated antitrust liability.[13] Then, both Congress and the SEC provided that fixed commission rates be abolished.[14] Under a threat similar to Congressional legislation, the SROs also moved from the one-eighth securities trading convention to decimal pricing.[15]

Both the NYSE and NASD engaged in regulation of their members with respect to the protection of customers, and disciplined members for unfair or improper conduct. Prior to 1975, any SEC oversight of SRO rulemaking and disciplinary activities was loose and informal. In the Securities Act Amendments of 1975, the SEC was given the power to initiate, as well as to approve, SRO rulemaking, and the SEC's role in SRO enforcement and discipline was expanded.[16] The Exchange Act now provides that new SRO rules and rule changes must be filed with the SEC and approved by the SEC before they can become effective.[17]

At one time, SROs denied their members certain fundamental rights. For example, persons under investigation were not entitled to bring

11. Pub. L. No. 107-204, 116 Stat. 745 (2002) (codified in scattered sections of 11, 15, 18, 28, and 29 U.S.C.).

12. This included changing SRO listing rules to meet certain corporate governance standards as to board and committee structures. Sarbanes-Oxley, § 301, 15 U.S.C. § 78j-1 (2002).

13. Gordon v. New York Stock Exch., 422 U.S. 659 (1975).

14. Securities Acts Amendments of 1975, Pub. L. No. 94-29, 89 Stat. 97 (1975); Exchange Act, § 6(e), 15 U.S.C. § 78f(e) (1934). Exchange Act Rule 19b-3 prohibited fixed commissions, but was rescinded in 1988. Rescission of Rules, Exchange Act Release No. 26,180, 53 Fed. Reg. 41,205 (Oct. 20, 1988). The Nasdaq market did not have fixed commissions, but had a similar type of rate making in the one-eighth securities trading convention, a structure found by the SEC to be anticompetitive in 1996. *See* Report Pursuant to Section 21(a) Regarding the NASD and Nasdaq Market, Exchange Act Release No. 37,542, 1996 WL 452691 (Aug. 8, 1996).

15. *See* PLI, THE SEC SPEAKS IN 1999, Corp. L. & Prac. Handbook B-1105, at 115–19 (1999).

16. Exchange Act §§ 11A, 19(c).

17. *Id.* § 19(b).

counsel to investigative hearings.[18] Since 1975, however, the SEC's oversight of SROs has assured that all members of SROs would be treated fairly in connection with investigations and disciplinary proceedings. SROs must provide a "fair procedure," which includes bringing specific charges, notifying a person subject to discipline, giving him or her an opportunity to defend against such charges, and keeping a record. Further, in order to impose a sanction, there needs to be a statement setting forth the act or practice in which the member engaged or omitted, the provision(s) of the regulation(s) violated, and the sanction and reason for its imposition.[19] Sanctioned individuals have a right to appeal a decision to the SRO board or other committee.[20] A further appeal to the SEC also is provided.[21] In most respects, all of these due process rights are similar to the rights granted to persons subject to SEC disciplinary proceedings.[22]

Whether or not securities industry SROs have become—or should be considered—government agencies for various purposes,[23] the soft law of SROs, which began as private contract law between SROs and their listed companies and members, has been transformed into hard law and is legally binding upon public corporations and SRO members as a matter of federal securities regulation. Indeed, in some instances, SRO rules have been held to preempt state law.[24] This hardening was a gradual

18. *See* Villani v. New York Stock Exch., 348 F. Supp. 1185 (S.D.N.Y. 1972), *aff'd* Sloan v. NYSE, 489 F.2d 1 (2d Cir. 1973).

19. 15 U.S.C. §§ 78f(b)(7), 78o-3(h)(1) (2000).

20. In the case of the NASD, this committee has been the National Adjudicatory Council. *See* National Adjudicatory Council, FINRA Regulatory Enforcement (NAC), http://www.finra.org/Industry/Enforcement/Adjudication/NAC/index.htm (last visited Feb. 17, 2009).

21. Exchange Act § 19(e)(2).

22. *See* SEC Rules of Practice, 17 C.F.R. pt. 201 (2009). Prior to 1975, these procedural rights were afforded to persons subject to NASD discipline, but not stock exchange discipline. *See* S. DOC. NO. 13, at 145 (1973). As pointed out by the Senate Committee on Banking, Housing and Urban Affairs when the 1975 Act Amendments were drafted, since the SROs "exercise government power . . . by imposing a disciplinary sanction, broadly defined, on a member or person affiliated with a member . . . [they] must be required to conform their activities to fundamental standards of due process." S. REP. NO. 94-75, at 24–25 (1975). The Committee also noted that SROs can adversely affect the interests of particular persons by denying membership to an applicant or requiring members to cease doing business in specified ways. *Id.*

23. *See* Roberta S. Karmel, *Should Securities Industry Self-Regulatory Organizations Be Considered Government Agencies?*, 14 STAN. J.L. BUS. & FIN. (forthcoming 2009), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1128329.

24. *See* NASD Dispute Resolution, Inc. v. Judicial Council, 488 F.3d 1065 (9th Cir. 2007); Credit Suisse First Boston Corp. v. Grunwald, 400 F.3d 1119 (9th Cir. 2005).

process, brought about by the Congressional and SEC view that SROs should not be private clubs, looking out for the interests of their members, but public bodies, looking out for the interests of investors.

From time to time, self-regulation has been seriously questioned due to stock market abuses that were not prevented,[25] but SROs have continued to exist and formulate new standards of conduct under SEC oversight. These soft law standards come under the rubric of "just and equitable principles of trade."[26] The theory justifying self-regulation is that it is more flexible than government regulation and is based on a superior knowledge of industry practices and capabilities. Further, it can promote ethical as well as legal standards.[27] These arguments also apply to the production of soft law in international financial regulation. But as can be seen from the experience of SRO regulation, soft law frequently hardens into statutes and government regulations, particularly when soft law is used for anticompetitive purposes or has been ineffective in preventing securities fraud. Despite some failings, soft law works well for securities regulation. Not surprisingly it has continued to work well as securities law has become international.

B. Why Soft Law Works for International Securities Regulation

The long history of national soft law securities regulation has continued in the international sphere out of necessity. Neither treaty law nor customary international law can provide the speed, flexibility, and expertise that international securities regulation requires. The treaty process is not easy. Typically treaties take years to conclude.[28] Thereafter, they

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25. *See, e.g.*, H.R. DOC. NO. 88-95, pt. 4, at 502 (1963); Report Pursuant to Section 21(a) Regarding the NASD and Nasdaq Market, Exchange Act Release No. 37,542, 1996 WL 452691 (Aug. 8, 1996).

26. *See, e.g.*, Order Approving Rule Change by National Association of Securities Dealers, Inc. Relating to Limit Order Protection, Exchange Act Release No. 35,751, 1995 WL 316674 (May 26, 1995) (discussing the "Manning decision" and approving amendments to the NASD's rule based on this case, which prohibits market makers from trading ahead of customer limit orders because the practice "is inconsistent with just and equitable principles of trade").

27. *See* S. DOC. NO. 13, at 149 (1973).

28. *See, e.g.*, Jason C. Nelson, *The Contemporary Seabed Mining Regime: A Critical Analysis of the Mining Regulations Promulgated by the International Seabed Authority*, 16 COLO. J. INT'L ENVTL. L. & POL'Y 27, 30–34 (2005) (detailing the history of the United Nations Convention on the Law of the Sea from 1958 through 1994); S. Jacob Scherr & R. Juge Gregg, *Johannesburg and Beyond: The 2002 World Summit on Sustainable Development and the Rise of Partnerships*, 18 GEO. INT'L ENVTL. L. REV. 425, 432–33 (2006) (discussing treaty-making stages of the Stockholm Convention on Persistent Organic Pollutants); David Weissbrodt & Muria Kruger, *Norms on the Responsibilities of Transnational Corporations and Other Business Enterprises with Regard to Human*

need to be ratified by a number of countries in order to enter into force.[29] Ratification can be a long and complicated process in many countries and often may not occur.[30] For example, the United Nations Commission on International Trade Law ("UNCITRAL") has been very successful in developing a number of treaties that have broad support such as the United Nations Convention on the Carriage of Goods by Sea (1978),[31] the United Nations Convention on Contracts for the International Sale of Goods (1980),[32] and the Convention on the Recognition and Enforcement of Foreign Arbitral Awards (1958) ("New York Convention").[33]

Rights, 97 AM. J. INT'L L. 901, 914 (2003) (discussing development of the U.N. Draft Declaration on the Rights of Indigenous Peoples and the Universal Declaration of Human Rights, both spanning over a decade).

29. Vienna Convention on the Law of Treaties art. 24(2), May 23, 1969, 1155 U.N.T.S. 331 (stating that "a treaty enters into force as soon as consent to be bound by the treaty has been established for all the negotiating States"); *id.* art. 2(b) (defining "ratification" as "the international act so named whereby a State establishes . . . its consent to be bound").

30. RESTATEMENT (THIRD) OF FOREIGN RELATIONS LAW OF THE UNITED STATES § 303 cmt. d (1987) (stating that the president may only ratify a treaty after the Senate gives its consent and ratification must be subject to any conditions imposed by the Senate); *id.* § 312 cmt. j (stating that a treaty may not enter into force in the United States unless it is also in force internationally and even if the treaty is in force, "it will not be given effect as law of the United States" if it is inconsistent with the U.S. Constitution).

31. U.N. Comm'n on Int'l Trade Law [UNCITRAL], *Status of Conventions and Model Laws*, at 2, ¶ 4(c), A/CN.9/626 (May 25, 2007) [hereinafter *Status of Conventions and Model Laws*]. UNCITRAL's Working Group III handled topics related to "international legislation on shipping" and held eight sessions between 1970 and 1975. Working Group III, http://www.uncitral.org/uncitral/en/commission/working_groups/3Shipping.html (last visited Feb. 12, 2009). Following these sessions, a diplomatic conference adopted the Convention on Carriage of Goods by Sea on March 31, 1978, but the treaty did not enter into force until November 1, 1992. United Nations Convention on the Carriage of Goods by Sea, http://www.uncitral.org/uncitral/en/uncitral_texts/transport_goods/Hamburg_rules.html (last visited Feb. 12, 2009).

32. *Status of Conventions and Model Laws*, *supra* note 31, at 2, ¶ 4(d). UNCITRAL's Working Group II held nine sessions between 1968 and 1978 to develop the Convention on Contracts for the International Sale of Goods ("CISG"). Working Group II, http://www.uncitral.org/uncitral/en/commission/working_groups/2Sale_of_Good.html (last visited Feb. 12, 2009). The CISG was adopted on April 11, 1980, by a diplomatic conference, but did not enter into force until January 1, 1988. United Nations Convention on Contracts for the International Sale of Goods, http://www.uncitral.org/uncitral/en/uncitral_texts/sale_goods/1980CISG.html (last visited Feb. 12, 2009).

33. *Status of Conventions and Model Laws*, *supra* note 31, at 2, ¶ 4(j). *See also* Noah Rubins, *The Enforcement and Annulment of International Arbitration Awards in Indonesia*, 20 AM. U. INT'L L. REV. 359, 360 (2005) (noting that the New York Convention is "one of the most widely-ratified treaties in the world"). There was a draft New York Convention by early 1955, and the comment period lasted until 1958. Convention on the Recognition and Enforcement of Foreign Arbitral Awards: Travaux Préparatoires, http://www.

The first two of these agreements took over twenty years to negotiate and enter into force, while the New York Convention took a mere four years to establish. Other efforts have resulted in treaties that failed to enter into force or gain widespread acceptance: the United Nations Convention on International Bills of Exchange and International Promissory Notes (1988), which has five States parties but requires ten for entry into force;[34] and the United Nations Convention on the Liability of Operators of Transport Terminals in International Trade (1991), which has four signatories and requires five for entry into force.[35] Thus, developing rules through formal international agreements is by no means swift or sure.

Even when formal international agreements are reached, their place in domestic law is uncertain. In dualist countries, the international legal effect is separate and distinct from the national legal effect.[36] In the United States, for example, unless the treaty is "self-executing" it lacks domestic force until it is codified in domestic legislation.[37] Whether a treaty is self-executing in the United States is not always clear. Recently, the U.S. Supreme Court, for example, found that the Vienna Convention on Consular Notification was not a self-executing treaty because the treaty text itself lacked a clear indication of such status.[38] Thus, the treaty lacked force to override an inconsistent federal statute.[39] Other dualist

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uncitral.org/uncitral/en/uncitral_texts/arbitration/NYConvention_travaux.html (last visited Feb. 12, 2009). The New York Convention was completed and adopted on June 10, 1958, by diplomatic conference, and entered into force on June 7, 1959. Convention on the Recognition and Enforcement of Foreign Arbitral Awards, http://www.uncitral.org/uncitral/en/uncitral_texts/arbitration/NYConvention.html (last visited Feb. 12, 2009).

34. *Status of Conventions and Model Laws*, *supra* note 31, at 2, ¶ 4(e).

35. *Id.* at 2, ¶ 4(f). *See also* Claire R. Kelly, *Legitimacy and Law-Making Alliances*, 29 MICH. J. INT'L L. 605 (2008) (discussing successes and failures of UNCITRAL's treaties).

36. IAN BROWNLIE, PRINCIPLES OF PUBLIC INTERNATIONAL LAW 32–33 (4th ed. 1990) ("[In dualist countries i]nternational law is a law between sovereign states: municipal law applies within a state and regulates the relations of its citizens with each other and with the executive."); John H. Jackson, *Status of Treaties in Domestic Legal Systems: A Policy Analysis*, 86 AM. J. INT'L L. 310, 314 (1992) [hereinafter Jackson, *Status of Treaties*] ("[I]nternational treaties are part of a separate legal system from that of the domestic law . . . .").

37. Foster v. Neilson, 27 U.S. (1 Pet.) 253, 314 (1829).

38. In *Medellin v. Texas*, the Supreme Court held that the language of the Vienna Convention on Consular Notification does not indicate by "explicit textual expression" that the treaty is self-executing. 128 S. Ct. 1346, 1361–62 (2008).

39. *See id.* at 1361 ("The Executive Branch has unfailingly adhered to its view that the relevant treaties do not create domestically enforceable federal law."). The ratification history of the Convention on Consular Notification also does not suggest that either the Senate or the president intended that the Convention and any resultant International Court of Justice judgments would be immediately enforceable in U.S. domestic courts. *Id.* at

countries do not even recognize the possibility of a self-executing treaty and always require implementing legislation.[40]

Customary international law develops in a different but equally arduous fashion. Customary international laws are norms that most States follow out of a sense of obligation.[41] They are not really custom; they are binding law.[42] But parties can disagree as to whether a practice has risen to the level of customary international law.[43] Identifying and tracking state practice on a particular issue takes time.[44] Moreover, the requirement that States follow the norm out of a sense of obligation creates an interpretive ambiguity that can lead to disputes over what is customary international law.[45] Not surprisingly, it takes time for norms to evolve to the point where most would agree that States follow the norms out of a

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1360. Further, the relief sought by Medellin was not supported by "the postratification understanding" of any other Convention signatories. *Id.* at 1363.

40. Jackson, *Status of Treaties*, *supra* note 36, at 315 (discussing that dualist States require "act[s] of transformation" before treaty norms can be incorporated into domestic law). *See also, e.g.*, Carl Baudenbacher, *Judicialization: Can the European Model Be Exported to Other Parts of the World?*, 39 TEX. INT'L L.J. 381, 391 (2004) (stating that, as a dualist country, Norway had to implement the Convention establishing the European Court of Human Rights into its domestic law to give the court legal effect); David Dyzenhaus, *The Rule of (Administrative) Law in International Law*, 68 LAW & CONTEMP. PROBS. 127, 141–42 (2005) (noting that the dualist legal system of Canada requires parliamentary approval); Michael H. Lee, *Revolution, Evolution, Devolution: Confusion? The Erosion of the "Supremacy of Parliament" and the Expanding Powers of the Courts in the United Kingdom*, 23 SUFFOLK TRANSNAT'L L. REV. 465, 466 (2000) (stating that treaties do not become part of domestic law in the United Kingdom unless the provisions are passed in an act of parliament).

41. MARK E. VILLIGER, CUSTOMARY INTERNATIONAL LAW AND TREATIES: A MANUAL ON THE THEORY AND PRACTICE OF INTERRELATION OF SOURCES 53–54 (2d ed. 1997) (describing a pattern by which practices are "hardened" and become "generally regarded as obligatory"). *See also* North Sea Continental Shelf (F.R.G. v. Den.; F.R.G. v. Neth.), 1969 I.C.J. 4, 44 (Feb. 20) ("Not only must the acts concerned amount to a settled practice, [but] . . . [t]he States concerned must . . . [also] feel that they are conforming to what amounts to a legal obligation."); SIR HERSCH LAUTERPACHT, THE DEVELOPMENT OF INTERNATIONAL LAW BY THE INTERNATIONAL COURT 379 (1958) (discussing that international customary law primarily consists of a "psychological conception" that a practice should be followed out of obligation).

42. *See* LAUTERPACHT, *supra* note 41, at 377 (noting that legally binding rules are manifestations of the general and gradual acceptance of international customs).

43. Andrew T. Guzman, *Saving Customary International Law*, 27 MICH. J. INT'L L. 115, 142–43 (2005) (discussing the doctrine of "persistent objectors").

44. *See id.* at 126–27.

45. *See id.* at 124–25 (noting the circularity of the subjective *opinio juris* requirement and the resultant vagueness regarding when a practice is customary).

sense of obligation.[46] Some never agree.[47] For example, the United States and Switzerland often disagree over the U.S. desires to prosecute insider trading and to seek information in connection with an alleged crime in the United States, where revealing that information would violate Swiss bank secrecy laws.[48] The Swiss norms value bank secrecy, while the U.S. norms criminalize insider trading and support the production of evidence in connection with criminal activity.[49]

Unlike treaty or customary international law, soft law is nonbinding law that can form in a variety of relatively timely ways. It may be developed through resolutions, practices, aspirational agreements, and the promulgation of norms in various forms that guide behavior.[50] Although soft law is not customary international law—norms that most States follow out of a sense of obligation—it can evolve into customary international law and thus into hard law.[51] International soft law may also evolve from self-regulatory bodies, such as the IASB, and voluntary international standard-setting bodies, such as IOSCO. Paradoxically, soft law, while nonbinding, may also be found in treaties, which do bind. The parts of treaty law that are soft law (and thus nonbinding) are so because they are imprecise or lack an obligatory command.[52] A treaty provision

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46. H.W.A. THIRLWAY, INTERNATIONAL CUSTOMARY LAW AND CODIFICATION 1–2 (1972) (stating that the development of customary international law is a "majestic" process).

47. *E.g.*, Melynda J. Price, *Balancing Lives: Individual Accountability and the Death Penalty as Punishment for Genocide (Lessons from Rwanda)*, 21 EMORY INT'L L. REV. 563, 566 & n.13 (2007) (discussing that there are varying viewpoints on the use of the death penalty); A. Mark Weisburd, *Customary International Law and Torture: The Case of India*, 2 CHI. J. INT'L L. 81 (2001) (discussing differing opinions on torture).

48. *See, e.g.*, *Europe, U.S. Battle Swiss Bank Secrecy*, BUS. WK., May 21, 2008, http://www.businessweek.com/globalbiz/content/may2008/gb20080521_571069.htm.

49. *See infra* notes 153–57 and accompanying text.

50. *See* Kenneth W. Abbott & Duncan Snidal, *Hard and Soft Law in International Governance*, 54 INT'L. ORG. 421, 421–23 (2000) [hereinafter Abbott & Snidal, *Hard and Soft Law*] (noting that most international law is soft and its form varies greatly depending on the purpose of the law).

51. Catherine Tinker, *Responsibility for Biological Diversity Conservation Under International Law*, 28 VAND. J. TRANSNAT'L L. 777, 804 (1995) (stating that while soft law may not be binding, it "indicates[s] the direction in which the international community is interested in moving and how far states are willing to go"). *See also* Pierre-Marie Dupuy, *Soft Law and the International Law of the Environment*, 12 MICH. J. INT'L L. 420, 428–29 (1991) (stating that soft law identifies future goals rather than current legal duties, but noting that parties often ascribe much importance to soft law instruments and negotiate them as they would treaty provisions).

52. *See, e.g.*, North American Agreement on Environmental Cooperation, U.S.-Can.-Mex., Sept. 8–14, 1993, 32 I.L.M. 1480 (1993); North American Agreement on Labor Cooperation, U.S.-Can.-Mex., Sept. 8–14, 1993, 32 I.L.M. 1499 (1993). Abbott and

may speak in aspirational terms. For example, the Organization of American States ("OAS") in its Inter-American Convention Against Corruption asks States parties to agree "to consider the applicability of measures within their own institutional system[]."[53] Even though such aspirations are contained within a treaty, they are nonetheless "soft law." Soft law, unlike customary international law or treaty law (hard law), does not purport to bind States.

To understand the close relationship among these different sources of norms, it is helpful to compare hard and soft law more generally. Professors Abbott and Snidal explain hard and soft law through a legalization optic. Legalization refers to the degree of precision, obligation, and delegation contained in any rule or norm.[54] Rules or norms with high degrees of each of these characteristics reflect hard law; those instances where States have bound themselves to precise rules that can be adjudicated by a body having the authority to pass on the rules.[55] Rules or norms that lack precision, obligation, and/or delegation are soft law.[56] Thus, soft law may be "soft" because, although it is contained in a treaty and therefore has a high degree of obligation, it is not precise or lacks an interpretive forum.[57] Alternatively, soft law may be precise in terms of its requirements, by establishing technical standards in a fair degree of detail, for example, but States may not commit to those standards as binding (even though they may use them consistently).[58]

Snidal reference these side agreements as instances where States used "hortatory or imprecise provisions to deal with the difficult issues, allowing them to proceed with the rest of the bargain." Abbott & Snidal, *Hard and Soft Law*, *supra* note 50, at 445. See also the Vienna Convention for the Protection of the Ozone Layer, Mar. 22, 1985, 1513 U.N.T.S. 324, as discussed in Kenneth W. Abbott et al., *The Concept of Legalization*, 54 INT'L ORG. 401, 407 (2000). As the authors explain, the agreement "imposed binding treaty obligations, but most of its substantive commitments were expressed in general, even hortatory language and were not connected to an institutional framework with independent authority." *Id.*

53. Organization of American States, Inter-American Convention Against Corruption art. III, Mar. 29, 1996, 35 I.L.M. 724 [hereinafter IACAC].

54. *See* Abbott & Snidal, *Hard and Soft Law*, *supra* note 50, at 421–24 (discussing legalization along the continuum from hard law to soft law).

55. *Id.* at 421–22.

56. *Id.* at 422.

57. *Id.* at 441–43 (stating that precision and delegation can be reduced or even unattainable in response to concerns regarding uncertainty, and referencing the Vienna Ozone Convention as legally binding yet imprecise and arms control agreements as "precise and binding[,] but limit[ing] delegation to forums that promote political bargaining").

58. *Id.* at 442 (noting the advantages of hortatory rules utilizing precision to limit obligations and maintain flexibility).

The difficulty of developing international law through the treaty process or customary international law reveals the comparative advantage of soft law. Soft law often evolves over time with less of a commitment than treaty law. For example, the IOSCO nonfinancial disclosure standards took a decade to develop.[59] The SEC adopted the substance of the IOSCO standards when it codified them through the regulatory process.[60] Additionally, self-regulatory organizations that develop soft law build upon expertise and fashion norms through consensus. As a result, soft law norms face less resistance and thus may be better able to secure compliance.

Soft law's ability to secure compliance, despite its nonbinding status, enhances its appeal internationally. International rules developed through treaty, customary international law, or soft law may go unheeded. Despite *pacta sunt servanda*, the principle that agreements are to be obeyed,[61] all international law sources generally face a compliance challenge. Treaties typically do not provide remedies for their breach and even where they do, parties usually retain the option to withdraw from the treaty altogether.[62] Customary international law and soft law also lack explicit compliance mechanisms.[63] Some claim that international law is

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59. *See* About IOSCO, http://www.iosco.org/about/index.cfm?section=history (last visited Mar. 26, 2009) (detailing IOSCO's formation in 1983 and ultimate adoption of the disclosure standards in 1998).

60. *See infra* note 122 and accompanying text.

61. Vienna Convention on the Law of Treaties, *supra* note 29, art. 26 ("Every treaty in force is binding upon the parties to it and must be performed by them in good faith."). *See also* Norwegian Loans (Fr. v. Nor.), 1957 I.C.J. 9, 53 (July 6) (separate opinion of Judge Lauterpacht) (stating that the obligation to act in good faith is "a general principle of law, [and] is also part of international law"); Vienna Convention on the Law of Treaties, *supra* note 29, art. 31(1) (stating that all treaties "shall be interpreted in good faith"); *id.* pmbl. ("[n]oting that the principle[] of . . . good faith and the *pacta sunt servanda* rule are universally recognized").

62. Vienna Convention on the Law of Treaties, *supra* note 29, art. 54 (stating that a party may withdraw from a treaty as provided in the treaty's provisions or following consultations with other signatories); *id.* art. 56 (stating that a party may withdraw from a treaty where its provisions do not indicate the right to withdrawal if the right was either intended or implied).

63. *See* George Norman & Joel P. Trachtman, *The Customary International Law Game*, 99 AM. J. INT'L L. 541, 544 (2005) (discussing whether States comply with customary international law out of a "sense of legal obligation," or *opinio juris*); *id.* at 572 (noting that in order for customary international law to maintain its dynamism and to evolve, it necessarily must not require total compliance). *See also* Charles K. Whitehead, *What's Your Sign?—International Norms, Signals, and Compliance*, 27 MICH. J. INT'L L. 695, 715–18 (2006) (discussing that compliance with soft law is a matter of relational theory rather than enforcement based).

not law at all because there is no means of enforcement.[64] This claim overemphasizes coercion as a compliance tool.[65] In international law, compliance can stem not only from coercion but also from self-interest[66] and/or from the sense that the law ought to be obeyed, i.e., the "legitimacy pull." Some have argued that a State's commitment to honor an international agreement exists whether that commitment comes in the form of treaty law or soft law.[67] In fact, soft law may be followed more consistently than a rule adopted by treaty or acknowledged as customary international law. Even when soft law rules eventually harden, there is often a great deal of regulatory discretion regarding enforcement. Thus, hard law rules are not necessarily more likely to be enforced simply because they are "hard law." Rather, compliance stems from self-interest and legitimacy.

In sum, treaties are not easy to conclude, their effect in domestic law often awaits domestic legislation, and compliance stems less from the written agreement and more from the compliance benefits or the recognition that the rules contained in those treaties are legitimate. So too with customary international law. Although its creation takes a different path than treaty law, it is still a cumbersome, complicated, and time-consuming process. It is also fraught with ambiguities and disagreement. While soft law is certainly not free from ambiguities, its less threatening nature allows it to develop more swiftly. At the same time, it may be able to guide conduct as effectively as treaty or customary international law. It, too, must look to tangible benefits and legitimacy to secure compliance. Soft law, however, has its own problems. Examining the international organizations that create soft law, as well as how soft law develops and hardens, will help illustrate these problems.

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64. *E.g.*, John R. Bolton, *Is There Really "Law" in International Affairs?*, 10 TRANSNAT'L L. & CONTEMP. PROBS. 1, 7 (2000) (discussing that international law is not law because "there are certainly no agreed-upon enforcement, execution, or compliance mechanisms").

65. H. L. A. HART, THE CONCEPT OF LAW 217–18 (2d ed. 1994) (stating that identifying binding obligations with the threat of punishment distorts the concepts of duty and obligation in international law).

66. *See* IAN HURD, AFTER ANARCHY: LEGITIMACY AND POWER IN THE UNITED NATIONS SECURITY COUNCIL 37–38 (2007) [hereinafter HURD, AFTER ANARCHY] (noting that self-interest as a means of compliance is preferable to coercion because the latter necessarily "leaves the coerced worse off than before").

67. JAN KLABBERS, THE CONCEPT OF TREATY IN INTERNATIONAL LAW 165–217 (1996) (arguing that soft law is no less binding than hard law by detailing various cases in which the World Court held that parties were legally bound to agreements or commitments regardless of their form).

C. Important Soft Law Organizations

There are a number of soft law norm generators in the securities field. It is helpful to understand how some of them are structured.

1. IOSCO

IOSCO is an "international association of securities regulators"[68] with tremendous influence on the development of international norms for the regulation of securities.[69] The IOSCO membership[70] has agreed

> to cooperate together to promote high standards of regulation in order to maintain just, efficient and sound markets; to exchange information on their respective experiences in order to promote the development of domestic markets; to unite [their] efforts to establish standards and an effective surveillance of international securities transactions; and to provide mutual assistance to promote the integrity of the markets by a

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68. INT'L ORG. OF SEC. COMM'NS, 2007 ANNUAL REPORT 34 (2007), *available at* http://www.iosco.org/annual_reports/annual_report_2007/pdf/annual_report_2007.pdf [hereinafter IOSCO, ANNUAL REPORT].

69. Aaron Unterman, *Exporting Risk: Global Implications of the Securitization of U.S. Housing Debt*, 4 HASTINGS BUS. L.J. 77, 117 (2008) (citing Harold S. Bloomenthal & Samuel Wolff, *International Organizations and Processes: International Organization of Securities Commissions—Background*, 10 INT'L CAP. MARKETS & SEC. REG. 1:73 (2006). Originally founded as the "Inter-American Conference of Securities Commissions" in 1974, it became IOSCO in 1983 when its membership expanded beyond North and South American securities regulators. About IOSCO, *supra* note 59.

70. IOSCO's membership is broken down into three categories: "ordinary" members (who possess a single vote); "associate" members (who do not possess voting power and may not become members of the Executive Committee, though they are eligible to become members of the Presidents Committee); and "affiliate" members (who possess no vote and cannot become members of either the Executive Committee or the Presidents Committee). There are currently 109 ordinary members, eleven associate members, and seventy-one affiliate members. *See* IOSCO Membership Lists, http://www.iosco.org/lists/index.cfm?section=general (last visited Feb. 16, 2009) (follow "Ordinary," "Associate," and "Affiliate" hyperlinks for individual lists). Ordinary membership is available to securities commissions and similar government bodies, and in the event that a given jurisdiction does have a regulatory government body, a self-regulatory body (e.g., a stock exchange) may become eligible. IOSCO, ANNUAL REPORT, *supra* note 68, at 37. Ordinary members include the SEC, the United Kingdom's Financial Services Authority ("FSA"), and Hong Kong's Securities and Futures Commission. IOSCO Membership Lists, *supra*. Associate membership is available to public regulatory bodies of countries that are already ordinary members: the Commodity Futures Trading Commissions ("CFTC") is a notable example. Affiliate membership is available to SROs and international bodies with "an appropriate interest in securities regulation," IOSCO, ANNUAL REPORT, *supra* note 68, at 37, including the London Stock Exchange, the New York Stock Exchange, and the International Monetary Fund ("IMF"). IOSCO Membership Lists, *supra*.

> rigorous application of the standards and by effective enforcement against offenses.[71]

The resulting dialogue established at IOSCO has led to a set of principles and best practices for securities regulation.[72] For example, IOSCO's Objectives and Principles of Securities Regulation[73] ("OPSR") sets forth thirty principles of securities regulation based upon three objectives: (1) the protection of investors; (2) ensuring that markets are fair, efficient, and transparent; and (3) the reduction of systemic risk.[74] The principles promulgated by IOSCO are nonbinding on its members, though members undertake "to use their best endeavors within their jurisdiction to ensure adherence" to the organization's principles.[75] The nonbinding nature of IOSCO's resolutions is reflective of the organization's predilection towards flexibility.[76]

IOSCO is set apart from many other international regulatory organizations insofar as it has become formalized enough to justify a general secretariat, even though it merits "no place on the landscape of the international legal system."[77] The General Secretariat, based in Madrid, Spain, organizes IOSCO's business (including the collection of dues and planning of annual conferences)[78] and handles all requests for information from members and nonmembers.[79] IOSCO has a number of committees,[80] but the Technical Committee is responsible for developing finan-

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71. IOSCO, ANNUAL REPORT, *supra* note 68, at 3.

72. ANNE-MARIE SLAUGHTER, A NEW WORLD ORDER 53–54 (2004).

73. The OPSR was originally adopted in 1998 and amended in May 2003. Int'l Org. of Sec. Comm'ns [IOSCO], *Objectives and Principles of Securities Regulation* (2003), *available at* http://www.iosco.org/library/pubdocs/pdf/IOSCOPD154.pdf.

74. *Id*. at i.

75. *Id*. at 3.

76. The essence of this flexibility is captured in the OPSR's declaration that "there is often no single correct approach to a regulatory issue" and, therefore, local developments and history must be taken into account in order for members to implement the organization's principles domestically. *Id*.

77. SLAUGHTER, *supra* note 72, at 38.

78. IOSCO, ANNUAL REPORT, *supra* note 68, at 37.

79. David Zaring, *Informal Procedure, Hard and Soft, in International Administration*, 5 CHI. J. INT'L L. 547, 563 (2005). While IOSCO's administration is lodged with the General Secretariat, its regulatory standards are created through its committees. Cheryl Nichols, *The Importance of Selective Federal Preemption in the U.S. Securities Regulatory Framework: A Lesson from Canada, Our Neighbor to the North*, 10 CHAP. L. REV. 391, 406 (2006).

80. There are ten IOSCO committees. IOSCO, ANNUAL REPORT, *supra* note 68, at 35. The Presidents' Committee is composed of the presidents of regular and associate member agencies, meets annually, and "has all the powers necessary or convenient to achieve the purpose of IOSCO." *Id*. at 34. The Executive Committee is composed of nineteen

cial regulatory standards and recommendations of best practices, and has therefore garnered the majority of IOSCO's press.[81] It has been characterized by one commentator as the place where "most of the important work is done."[82] Its meetings are closed to the public and its work is divided into five subject areas, each deliberated upon by a working group: (1) multinational disclosure and accounting, (2) regulation of secondary markets, (3) regulation of market intermediaries, (4) enforcement and the exchange of information, and (5) investment management.[83] After reviewing the issues in each of these defined areas, the recommendations of these working groups are forwarded to the Presidents and Executive Committees, where they are ultimately promulgated.[84]

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members, meets periodically, is "subject to the By-Laws of IOSCO, [and] takes all decisions and undertakes all actions necessary or convenient to achieve the objectives of IOSCO." *Id.* Membership of the Executive Committee is comprised of "the Chairmen of the Technical and Emerging Markets Committees, the Chairmen of each Regional Committee, one ordinary member elected by each Regional Committee from among the ordinary members elected by the Presidents Committee, and nine ordinary members elected by the Presidents Committee." *Id*. The Executive Committee consists of two highly specialized working committees: the Technical Committee and the Emerging Markets Committee. IOSCO Working Committees, http://www.iosco.org/about/index.cfm?section=workingcmts (last visited Mar. 18, 2009). The Technical Committee is composed of financial regulators from the world's most developed markets, and its stated objective is "to review major regulatory issues related to international securities and futures transactions and to coordinate practical responses to these concerns." *Id.* Membership currently includes representatives from the SEC, the CFTC, and the FSA. *Id*. (follow "Executive Committee" hyperlink). The Emerging Markets Committee was established to promote efficiency in the world's emerging securities and futures markets through the establishment of standards and principles. *Id*. The SRO Consultative Committee ("SROCC") is comprised of self-regulatory organizations that are affiliate members, and its primary function is to provide information regarding SRO rules and regulations to individuals contemplating investment in the global securities market. Nichols, *supra* note 79, at 407. The SROCC also interacts with the Technical Committee in order to provide information about domestic markets to aid in the drafting of regulatory initiatives. *See* IOSCO, ANNUAL REPORT, *supra* note 68.

81. Zaring, *supra* note 79, at 564.

82. SLAUGHTER, *supra* note 72, at 227.

83. IOSCO, ANNUAL REPORT, *supra* note 68.

84. Marc I. Steinberg & Lee E. Michaels, *Disclosure in Global Securities Offerings: Analysis of Jurisdictional Approaches, Commonality and Reciprocity*, 20 MICH. J. INT'L. L. 207, 240 (1999).

2. IASB

The IASB is "an independent, privately-funded accounting standard setter based in London, [United Kingdom]."[85] It was created to meet the increasing demand for international accounting rules.[86] Its goal is "to provide the world's integrating capital markets with a common language for financial reporting"[87] through the creation of a universal, understandable, and enforceable set of accounting standards.[88]

The oversight of the IASB, which includes the appointment of its members and fundraising, is handled by the twenty-two trustees of the International Accounting Standards Committee Foundation ("IASC").[89] In the interest of ensuring that the makeup of the board of trustees reflects the diversity of the world's capital markets, six trustees must be appointed from North America, Europe, and the Asia/Oceania region, respectively, and the remaining four trustees can come from anywhere so long as the "overall geographical balance" is maintained.[90]

The IASB is comprised of fourteen members, twelve on a full-time basis and two on a part-time basis, and unlike the IASC trustees, membership is not based upon geographical criteria.[91] The most important quali-

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85. About the IASB, http://www.iasb.org/About+Us/About+the+IASB/About+the+IASB.htm (last visited Mar. 18, 2009). The IASB is the standard-setting body of IASC Foundation. Int'l Accounting Standards Comm. [IASC], *IASC Foundation Constitution* 14, *available at* http://www.iasb.org/NR/rdonlyres/1904AEEE-3554-49C6-BD96-A4611A6964BE/0/IASCFoundationConstitution2.pdf [hereinafter IASC, *Constitution*]. The IASB exists under the umbrella of its parent entity, the IASC, a not-for-profit corporation incorporated in the State of Delaware. About the IASB, *supra*. The IASC was formed in 1973 through an agreement among nine national accounting bodies: Australia, Canada, France, Germany, Japan, Mexico, Holland, the United Kingdom, and the United States. Mark J. Hanson, *Becoming One: The SEC Should Join the World in Adopting the International Financial Reporting Standards*, 28 LOY. L.A. INT'L & COMP. L. REV. 521, 524 (2006). The IASC was criticized for being a part-time accounting principle setter whose structure would hinder its ability to promulgate fair and efficient global accounting standards, so it overhauled its infrastructure, creating the IASB and delegating most of the technical rulemaking power to it. *Id*. at 524–25.

86. Walter Mattli & Tim Buthe, *Global Private Governance: Lessons from a National Model of Setting Standards in Accounting*, 68 LAW & CONTEMP. PROBS. 225, 228 (2005).

87. INT'L ACCOUNTING STANDARDS BD., IASB AND THE IASC FOUNDATION: WHO WE ARE AND WHAT WE DO 1 (2008), *available at* http://www.iasb.org/NR/rdonlyres/0A5A767C-E7DE-49E5-8B12-499F62F8870C/0/WhoWeAre_Final12508.pdf.

88. International Accounting Standards Board—About Us, http://www.iasb.org/About+Us/International+Accounting+Standards+Board+-+About+Us.htm (last visited Mar. 14, 2009).

89. IASC, *Constitution*, *supra* note 85, at 19.

90. *Id*.

91. *Id*. at 18.

fications for membership are that individuals shall have the professional and practical experience to ensure that the membership is comprised of "the best available combination of technical expertise and diversity of international business and market experience in order to contribute to the development of high quality, global accounting standards."[92] Each member possesses a single vote, and nine votes are required for the promulgation of any standard.[93]

The IASB is solely responsible for drafting and promulgating International Accounting Standards ("IAS"), most notably IFRS. However, the IASB consults with two other bodies, the Standards Advisory Council ("SAC") and the International Financial Reporting Interpretations Committee ("IFRIC"), and reports to the IASC. The SAC is responsible for providing comments and advice on the development of IASB projects, and IFRIC is charged with reviewing any potential accounting concerns that arise from IASB projects, though any interpretation that it proffers is subject to the approval of the IASB.[94] The IASB's meetings are open to the public (as well as publicly available on its website).[95] It also solicits public comments on its standards.[96]

The IASB is also given the authority by the IASC to "have full discretion in developing and pursuing the technical agenda of the IASB and over project assignments on technical matters: in organising the conduct of its work, the IASB may outsource detailed research or other work to

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92. *Id*. Current board members include Professor Mary E. Barth from the Stanford University Graduate School of Business, Stephen Cooper from the UBS Investment Bank in London, and Tatsumi Yamada, a former Partner of ChuoAoyama Audit Corporation (PricewaterhouseCoopers) in Japan. *See* About IASB: Board Members, http://www.iasb.org/About+Us/About+the+IASB/IASB+members.htm (last visited Feb. 15, 2009).

93. DOUGLAS R. CARMICHAEL, RAY WHITTINGTON & LYNFORD GRAHAM, ACCOUNTANTS' HANDBOOK 907 (11th ed. 2007).

94. Mattli & Buthe, *supra* note 86, at 251.

95. INT'L ACCOUNTING STANDARDS BD., DUE PROCESS HANDBOOK ¶ 68 (2006), *available at* http://www.iasb.org/NR/rdonlyres/7D97095E-96FD-4F1F-B7F2-366527CB4FA7/0/DueProcessHandbook.pdf [hereinafter IASB, DUE PROCESS HANDBOOK]. Information on IASB meetings can be found at IASB Meetings, http://www.iasb.org/Meetings/Meetings+Page.htm (last visited Feb. 16, 2009).

96. IASB, DUE PROCESS HANDBOOK, *supra* note 95, ¶¶ 94–98 (discussing public comments on published proposals and exposure drafts, and duration of comment periods); *id.* ¶¶ 103–06 (discussing IASB's usage of public hearings, round-table discussions, and the possibility that IASB will send representatives to meetings initiated by the public to address concerns about the organization's agenda). For documents currently open to public comment, see International Accounting Standards Board—Open to Comment, http://www.iasb.org/Open+to+Comment/International+Accounting+Standards+Board+-+Open+to+Comment.htm (last visited Feb. 16, 2009).

national standard setters or other organizations."[97] One notable example of this is the fact that IFRS were originally a recommendation of IOSCO.[98]

Due to the fact that the IASB derives its funding from private sector firms, some commentators have argued that the international accounting standards that it promulgates are rife with potential conflicts of interest.[99] Since the IASB's funding and budgetary concerns are handled by the IASC, it may be argued that the IASB's members are insulated from the influence of the donors.[100]

3. OECD

The OECD, an international organization with its general secretariat headquartered in Paris, France, "provides a forum where governments can compare and exchange policy experiences, identify good practices and promote decisions and recommendations" with respect to "the economic, social and governance challenges that can accompany [globalization]."[101] As others have pointed out, it is a forum for national regulators to tackle common problems.[102] The OECD develops guidelines and models of best practices, and sometimes formal agreements.[103]

The thirty market democracies that comprise the OECD's current membership are represented by ambassadors, and unlike many international organizations, membership is contingent upon approval by the Council of members following the "accession process."[104] The OECD is

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97. IASC, *Constitution*, *supra* note 85, at 20.

98. *See* Hanson, *supra* note 85, at 526. IOSCO released an "International Equity Offers" report in 1989, which "called for a single worldwide securities disclosure document that would use internationally accepted accounting standards." *Id.*

99. Caroline Bradley, *Private International Law-Making for the Financial Markets*, 29 FORDHAM INT'L L.J. 127, 178 (2005) (quoting Charlie McCreevy, European Comm'r for Internal Mkt. & Servs., Governance and Accountability in Fin. Servs., Speech at the Economic and Monetary Affairs Committee of European Parliament, Brussels (Feb. 2, 2005)) ("The standard setters are currently sponsored by voluntary contributions from contributors ranging from central banks to listed companies, which raises potential issues of conflict of interest.").

100. Nevertheless, some commentators have admonished that the case of the FASB and Sarbanes-Oxley in the United States provides a strong argument that "alternative sources of funding are required to guarantee effective independence." Mattli & Buthe, *supra* note 86, at 254.

101. ORG. FOR ECON. CO-OPERATION & DEV., OECD ANNUAL REPORT 2008, at 10, *available at* http://www.oecd.org/dataoecd/39/19/40556222.pdf.

102. SLAUGHTER, *supra* note 72, at 17.

103. *See id*.

104. OECD, Members and Partners, http://www.oecd.org/pages/0,3417,en_36734052_36761800_1_1_1_1_1,00.html (last visited Jan. 25, 2009). The "accession process" in-

funded by contributions from its member countries, which are based upon a percentage of the member's economy.[105]

The OECD largely functions through its General Secretariat, specialized committees, and the Council.[106] There are approximately 200 specialized committees, working groups, and expert groups, all of which are comprised of representatives from member countries that discuss, exchange information, and evaluate the progress of policy areas ranging from economics to employment and education.[107] The Council is where "decision-making power is vested."[108] "It is made up of one representative per member country, plus a representative from the European Commission."[109] Council meetings involve discussion of key issues and lead to the delegation of work projects to the General Secretariat.[110] The OECD has described the manner in which it functions as "consist[ing] of a highly effective process that begins with data collection and analysis and moves on to collective discussion of policy, then decision-making and implementation."[111]

None of these organizations develop soft law in the same way; thus, it is helpful to consider some concrete examples of how soft law develops and how it subsequently hardens. Although a variety of international organizations, primarily SROs, trade associations, and international banks, develop soft securities regulation, IOSCO, the IASB, and the OECD are the bodies focused upon in this Article.[112]

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volves a review by the Council where the applicant must show "attachment to the basic values shared by all OECD members: an open market economy, democratic pluralism and respect for human rights." The applicant must also "state its position vis-à-vis the OECD 'legal instruments' (meaning the Decisions, Recommendations and Declarations adopted within the framework of the Organisation)." OECD, Becoming a Member of the OECD: The Accession Process, http://www.oecd.org/document/11/0,3343,en_2649_34489_1958091_1_1_1_1,00.html (last visited Mar. 18, 2009).

105. ORG. FOR ECON. CO-OPERATION & DEV., THE OECD 12 (2008), *available at* http://www.oecd.org/dataoecd/15/33/34011915.pdf ("The largest contributor is the United States, which provides approximately 25% of the budget, followed by Japan.").

106. *Id.* at 11. The general secretariat is comprised of 2,500 staff members ("includ[ing] about 700 economists, lawyers, scientists and other professionals"), and its primary function is to perform research and analysis requested by its member countries. *Id.* at 12.

107. *Id.* at 11.

108. *Id.*

109. *Id.*

110. *Id.*

111. *Id.* at 13.

112. CESR is composed of representatives from the securities regulatory agencies of the EU and functions as a coordinating and advisory group under the European Commission. CESR's determinations are soft law, but CESR is influential in formulating a Euro-

II. STORIES ABOUT THE HARDENING OF SOFT LAW

A. IFRS[113]

The U.S. federal securities laws establish mandatory disclosure of the business and financial affairs of all companies that make public offerings of securities in the United States or that have 500 shareholders and $10 million in assets and trade in the U.S. securities markets. Public offering documents must include audited financial statements prepared according to U.S. generally accepted accounting principles ("GAAP"), and publicly traded companies must file annual and periodic reports that include audited annual financial statements prepared according to U.S. GAAP.[114] Although it has been argued for some time that international accounting standards would better serve the needs of investors in the global capital markets,[115] the SEC has been slow to accept any non-U.S. GAAP financial statements for SEC filings. But in response to pressures from the European Union and foreign issuers, the SEC is currently in the process of shifting its requirements from U.S. GAAP to IFRS. Although accounting standards are promulgated by private sector bodies, they become hard law when regulators require their inclusion in financial statements given to investors.

The most important part of an SEC registration statement is the prospectus circulated to investors. Information required in a prospectus is specified in § 7 of the Securities Act.[116] Under § 19(a) of the Securities

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pean position with regard to securities regulation in the EU. CESR has played an important role in the convergence of accounting standards between the United States and the EU and may be utilized in development of international standards for credit rating agencies. *See* CESR in Short, http://www.cesr-eu.org/index.php?page=cesrinshort&mac=0&id= (last visited Mar. 26, 2009). *See also supra* note 138 and accompanying text.

113. A more comprehensive analysis of this topic, arguing that the EU was instrumental in moving the SEC to recognizing IFRS, can be found at Roberta S. Karmel, *The EU Challenge to the SEC*, 31 FORDHAM J. INT'L L. 1692 (2008).

114. 15 U.S.C. § 78m (2008).

115. *See* Edward F. Greene, *Beyond Borders: Time to Tear Down the Barriers to Global Investing*, 48 HARV. INT'L L.J. 85 (2007); Roberta S. Karmel & Mary S. Head, *Barriers to Foreign Issuer Entry into U.S. Markets*, 24 LAW & POL'Y INT'L BUS. 1207 (1993); Ethiopis Tafara & Robert J. Peterson, *A Blueprint for Cross-Border Access to U.S. Investors: A New International Framework*, 48 HARV. INT'L L.J. 31 (2007); Edward F. Greene, *Beyond Borders Part II: A New Approach to the Regulation of Global Securities Offerings* (2007), http://www.sechistorical.org/collection/papers/2000/2007_0501_GreeneBeyondT.pdf; Edward F. Greene & Linda C. Quinn, *Building on the International Convergence of the Global Markets: A Model for Securities Law Reform*, 1372 PLI/CORP 561 (Nov. 15, 2001, revised Aug. 2002).

116. 15 U.S.C. § 77g.

Act, the SEC may adopt rules and regulations and define terms.[117] Pursuant to this authority, the SEC has adopted forms for the registration of securities offerings, regulations specifying the narrative contents of such forms, and the accounting statements required to be included in SEC filings.[118] The SEC's rulemaking power is very broad and gives the SEC authority to formulate accounting principles, but the SEC has delegated this authority to the accounting profession, specifically the Financial Accounting Standards Board ("FASB"), by recognizing its standards as "authoritative" for filed documents.[119] In Sarbanes-Oxley, Congress set forth requirements as to board composition, funding, and other matters for a body that would promulgate accounting standards that the SEC could recognize as "authoritative."[120] Such a body is required to be from the private sector, rather than a government body. The IASB is such a private sector body, although, as will be explained below, its governance was changed at the insistence of the SEC so that the SEC could eventually recognize its standards as "authoritative."

The SEC generally requires foreign (that is, non-U.S.) issuers that publicly raise capital in the United States or list their shares on a U.S. securities exchange to comply with the registration requirements of the Securities Act and the Exchange Act, unless appropriate exemptions from registration are available. Although the SEC's approach to foreign issuer disclosure is essentially a national treatment approach, the SEC has designed special registration forms for foreign issuers that relax some of the rigors of the registration process.[121] In October 1999, the SEC amended the foreign issuer disclosure forms to substantially replace the nonfinancial disclosure requirements with disclosure standards endorsed by IOSCO.[122] The development of these international disclosure stan-

117. *Id.* § 77s(a).

118. Form S-1 is the general form of registration statement; Form S-3 is a form for seasoned issuers. Regulation S-K, specifying the contents of such forms, is set forth at 17 C.F.R. §§ 229.101 *et seq.* Regulation S-X, specifying the contents of accounting statements, is set forth at 17 C.F.R. §§ 210.2-01 *et seq.*

119. Accounting Series Release No. 150, 1973 WL 149263 (Dec. 20, 1973), updated in Commission Statement of Policy Reaffirming the Status of FASB as a Designated Private-Sector Standard Setter, Securities Act Release No. 8221 (Apr. 25, 2003). The SEC has specified the contents of financial statements and other information for Securities Act registration statements, and Exchange Act filings in Regulation S-K and Regulation S-X.

120. Securities Act § 19(b)(1), 15 U.S.C. § 77s(b)(1).

121. Form 20-F is the core document authorized by the SEC for use by foreign issuers. 17 C.F.R. § 249.220f. Forms F-1 and F-3 are registration forms for foreign private issuers. 17 C.F.R. §§ 239.31, 239.33.

122. *See* International Disclosure Standards, Securities Act Release No. 7745, 64 Fed. Reg. 53,900, 53,903 (Oct. 5, 1999).

dards by IOSCO was an important step in the convergence of U.S. and EU narrative and financial disclosure standards, and influenced Asian and other countries to move toward international accounting standards.

In adopting IOSCO's disclosure standards for foreign private issuers, the SEC significantly changed the form, although not the content, of previous disclosure standards.[123] At that time, the SEC did not change its accounting disclosure regulations for foreign private issuers, which were still required to reconcile their financial statements to U.S. GAAP. The SEC nevertheless issued a Concept Release requesting comments to determine under what conditions it would accept financial statements of foreign private issuers prepared using international accounting standards.[124]

Previously, in 1988, the SEC "explicitly supported the establishment of . . . international accounting standards . . . to reduce regulatory impediments [] result[ing] from disparate national accounting standards," but continued to reject a mutual recognition approach.[125] But at this time, the SEC decided not to adopt a process-oriented approach to IASB standards, recognizing them as "authoritative" and therefore comparable to U.S. GAAP standards promulgated by the FASB. However, after a decade of considering IASB standards, the SEC's 2000 Concept Release was part of an assessment process possibly leading to the SEC's acceptance of IFRS. IOSCO, as well as the SEC and others, were working on financial disclosure harmonization, and by May 2000, IOSCO had assessed all thirty core standards in the IASB work program and recommended to its members that multinational issuers use the core standards, supplemented by reconciliation, and such disclosure interpretation as might be necessary.[126]

At this time, the SEC was not concerned about particular IFRS standards, with a few exceptions, but it questioned whether these standards could be rigorously interpreted and applied.[127] In particular, the SEC criticized the structure and financing of the IASB and took a heavy hand in restructuring it. A new constitution was adopted in May 2000 that estab-

123. *See id.* at 53,908.

124. International Accounting Standards Concept Release, Securities Act Release No. 7801, 65 Fed. Reg. 8896 (Feb. 23, 2000) [hereinafter IAS Concept Release].

125. Conrad W. Hewitt, Chief Accountant, & John W. White, Director, Division of Corporation Finance, Testimony Concerning Globally Accepted Accounting Standards, Before the Subcomm. on Securities, Insurance and Investment of the Sen. Comm. on Banking, Housing, and Urban Affairs (Oct. 24, 2007), *available at* www.sec.gov/news/testimony/2007/ts102407cwh-jww.htm.

126. *See* Press Release, Int'l Org. of Sec. Comm'ns, IASC Standards (May 17, 2000), *available at* http://www.iosco.org/news/pdf/IOSCONEWS26.pdf.

127. *See* IAS Concept Release, *supra* note 124, at 8901–02.

lished this body as an independent organization with two main bodies, the Trustees and the Board, as well as a Standing Interpretations Committee and a Standards Advisory Council.[128] The Trustees appoint the Board Members, exercise oversight, and fundraise, whereas the Board has sole responsibility for setting accounting standards. The Chairman of the Nominating Committee established for the purpose of selecting the initial Trustees for the restructured IASB was then-SEC Chairman Arthur Levitt, Jr. The Chairman selected to head the new body of Trustees was Paul A. Volker, Former Chairman of the U.S. Federal Reserve Board.[129]

It appeared that, despite SEC staff reservations about IFRS, momentum for mutual recognition of accounting standards based on convergence, if not harmonization, was moving along.[130] But the spirit of cooperation that had been established between the SEC and the IASB was unfortunately dampened by the stock market collapse of 2000–2001 and the enactment of the Sarbanes-Oxley Act. The provisions of Sarbanes-Oxley dealing with the structure of audit committees and the registration and regulation of auditors by the newly created Public Company Accounting Oversight Board ("PCAOB") were met with strenuous objections abroad because they were applicable to foreign issuers and their auditors. Relations between U.S. and foreign regulators soured to some extent, and the SEC became too preoccupied with implementing various mandates in Sarbanes-Oxley, and structuring necessary accommodations for foreign auditors and audit committees, to focus on mutual recognition in financial disclosure.[131]

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128. *See* Acceptance from Foreign Private Issuers of Financial Statements Prepared in Accordance with International Financial Reporting Standards Without Reconciliation to U.S. GAAP, Securities Act Release No. 8818, 72 Fed. Reg. 37,962, 37,964. (July 11, 2007) [hereinafter Acceptance of IFRS Proposing Release].

129. *IASC Trustees Announce New Standard-Setting Board to Reach Goal of Global Accounting Standards*, BUS. WIRE, Jan. 25, 2001.

130. Donald T. Nicolaisen, *A Securities Regulator Looks at Convergence*, 25 NW. J. INT'L L. & BUS. 661 (2005).

131. The Sarbanes-Oxley Act created the PCAOB and directed public accounting firms that participate in audits of SEC reporting companies to register with the PCAOB and become subject to PCAOB audit rules and inspection. Sarbanes-Oxley, §§ 102–04, 15 U.S.C. § 7212 (2004). These provisions applied on their face to foreign auditors, a situation that created conflict between the SEC and foreign regulators. In order to ameliorate these problems, the PCAOB stated its intention to cooperate with non-U.S. regulators in accomplishing the goals of the statute without subjecting non-U.S. public accounting firms to unnecessary burdens or conflicting requirements. *See* Final Rules Relating to the Oversight of Non-U.S. Public Accounting Firms, PCAOB Release No. 2004–005, at 2–3 (June 9, 2004), www.pcaobus.org/Rules/Docket_013/2004-06-09_Release_2004-005.pdf.

The European Union then seized the initiative with respect to international accounting standards, undermining those European issuers that had been considering reporting in U.S. GAAP rather than their home country GAAP, by mandating that all listed companies report in IFRS and threatening to make U.S. EU-listed companies also report in IFRS. Moreover, Asian and other issuers also began looking at IFRS, rather than U.S. GAAP, as an alternative to reporting in their national GAAPs for offerings in the international capital markets.[132] As the markets in Europe and Asia strengthened, relative to the U.S. markets, New York was no longer the only place where multinational corporations could raise capital, and the SEC was no longer a regulator that could force its regulations on foreign issuers.

In April 2005, the Chief Accountant of the SEC set forth a "roadmap" for eliminating the need for non-U.S. companies to reconcile to U.S. GAAP financial statements prepared according to IFRS.[133] This roadmap was explicitly affirmed by successive SEC chairmen in meetings with EU Internal Market Commissioner Charlie McCreevy.[134]

On July 2, 2007, the SEC issued a release proposing to accept from foreign private issuers financial statements prepared in accordance with IFRS.[135] In that release, the SEC pointed out that almost 100 countries, including the twenty-seven EU Member States, were using IFRS, with more countries considering adopting IFRS.[136] The SEC made two arguments in favor of allowing foreign issuers to report in IFRS, which were a somewhat remarkable turnabout from its prior resistance to a foreign GAAP. First, the SEC asserted that it had long advocated reducing the disparity between U.S. accounting and disclosure regulations and those of other countries as a means to facilitate cross-border capital formation. Second, the SEC asserted that an international accounting standard may be adequate for investor protection even if it is not the same as the U.S. standard.[137] Therefore, based on increasing convergence between U.S. GAAP and IFRS, and cooperation among the SEC, IOSCO, and CESR,

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132. Sir David Tweedie & Thomas R. Seidenstein, *Setting a Global Standard: The Case for Accounting Convergence*, 25 NW. J. INT'L L. & BUS. 589, 593 (2005).

133. Nicolaisen, *supra* note 130.

134. *See* Press Release, SEC, No. 2006-17, Accounting Standards: SEC Chairman Cox and EU Commissioner McCreevy Affirm Commitment to Elimination of the Need for Reconciliation Requirements (Feb. 8, 2006), *available at* www.sec.gov/news/press/2006-17.htm; Press Release, SEC, No. 2005-62, Chairman Donaldson Meets with EU Internal Market Commissioner McCreevy (Apr. 21, 2005), *available at* www.sec.gov/news/press/2005-62.htm.

135. Acceptance of IFRS Proposing Release, *supra* note 128.

136. *Id.* at 37,965.

137. *Id.* at 37,965–66.

the SEC proposed amendments to its rules that would allow a foreign private issuer to file financial statements without reconciliation to U.S. GAAP, if those financial statements are in full compliance with the English language version of IFRS as published by the IASB.[138] The SEC also then issued a Concept Release proposing possible reporting in IFRS by U.S. corporations.[139] The SEC adopted final rules permitting foreign issuers to report in IFRS, substantially as proposed, based primarily on the progress of the IASB and the FASB toward convergence, their expressed intention to work toward further convergence in the future, and a finding that IFRS are high-quality standards.[140]

The interplay and negotiations among the SEC, IOSCO, the EU, CESR, and the IASB leading to the SEC's acceptance of IFRS were arduous and complex. As a practical matter, this is not a result that could have been accomplished by treaty. Further, whether IFRS is soft or hard law is debatable, but once it becomes the accounting standard for SEC filings, adherence to IFRS is legally binding for public companies regulated by the SEC. Moreover, it already is legally required for EU confirmations.

B. MOUs

Although growth of the global capital markets has proceeded rapidly, and linkages between various markets have become quite efficient, the harmonization of regulation, surveillance, and enforcement has progressed at a much slower pace. As was stated in a congressional report in 1989, and continues to be true, there is "no global regulatory structure to

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138. *Id.* at 37,970.

139. Concept Release on Allowing U.S. Issuers to Prepare Financial Statements in Accordance with International Financial Reporting Standards, Securities Act Release No. 8831, 72 Fed. Reg. 45,600 (Aug. 14, 2007), corrected 72 Fed. Reg. 53,509 (Sept. 19, 2007). This development is related to the European Union's program for accepting U.S. GAAP financial statements by U.S. companies listed on European exchanges. Such companies can continue to report in U.S. GAAP because the United States has permitted EU companies to use IFRS in SEC filings and also has made a public commitment to converge U.S. GAAP with IFRS. *See* Commission Regulation (EC) 1569/2007, Establishing a Mechanism for the Determination of Equivalence of Accounting Standards Applied by Third Country Issuers of Securities Pursuant to Directives 2003/71/EC and 2004/109/EC of the European Parliament and of the Council, 2007 O.J. (L 340/66). The SEC has subsequently issued a roadmap for a switch to IFRS by U.S. companies. Roadmap for the Potential Use of Financial Statements Prepared in Accordance with International Accounting Standards by U.S. Issuers, Exchange Act Release No. 58,960, 73 Fed. Reg. 226 (Nov. 21, 2008).

140. Acceptance from Foreign Private Issuers of Financial Statements Prepared in Accordance with International Financial Reporting Standards Without Reconciliation to U.S. GAAP, Securities Act Release No. 8879, 73 Fed. Reg. 986 (Jan. 4, 2008).

oversee the markets and coordinate harmonization of laws and regulations to ensure efficiency and honesty. Therefore, securities regulators in each nation must work with their foreign counterparts to seek coordinated international solutions to assure fairer as well as more efficient market operations across borders."[141] One consequence of the dramatic increase in foreign participation in U.S. securities markets is the increased opportunity for transnational securities fraud.

The SEC has been particularly concerned about insider trading, market manipulation, and financial fraud where information and evidence relating to suspicious conduct is located beyond the agency's jurisdictional reach. Many foreign countries have secrecy or blocking statutes that prohibit the disclosure of information. Bank secrecy laws provide (criminal) sanctions against banks that breach client confidentiality.[142] Blocking laws prevent evidence gathering under U.S. law in foreign jurisdictions. A blocking statute forbids the communication of information except as provided by treaty or international agreement.[143] It would generally apply to domestic courts and prevent such courts from forwarding information to another jurisdiction. Therefore, even if a subpoena can be served on a foreign bank, the bank is prohibited by secrecy or blocking statutes from giving the SEC any information pursuant to its national law.

For example, in *SEC v. Tome*, there was substantial insider trading in the common stock and options of St. Joe Minerals shortly before a tender offer by Seagram.[144] The day before the tender offer was announced, accounts at *Banca Della Swizzera Italiana* ("BSI") purchased 3000 shares and options for over 100,000 shares. Showing a strong probability of insider trading, the SEC obtained a temporary restraining order and a freeze order on profits in BSI's account at Irving Trust. The SEC did not know the identity of BSI's customers and did not identify them in the complaint. BSI refused to disclose their identity because of Swiss bank secrecy laws. The SEC obtained a discovery order on the basis that it would be a "travesty of justice" for foreign companies to "invade American markets, violate American laws . . . , withdraw profits, and resist ac-

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141. H.R. REP. NO. 101-240, at 3 (1989), *as reprinted in* 1990 U.S.C.C.A.N. 3888.

142. *See, e.g.*, United States v. First National Bank of Chicago, 699 F.2d 341 (7th Cir. 1983). *See also* Ralph C. Ferrara & Triplett Mackintosh, *Legal Representation in the International Securities Market: Representing a Party or Witness in an SEC or SRO Proceeding*, 14 DEL. J. CORP. L. 893, 912–13 (1989).

143. *See* Societe Nationale Industrielle Aeros-Patiale v. U.S. Dist. Court for the S. Dist. of Iowa, 482 U.S. 522, 526 n.6 (1987); ANDREAS F. LOWENFELD, INTERNATIONAL LITIGATION AND ARBITRATION 773–75 (2d ed. 2002); Ferrara & Mackintosh, *supra* note 142, at 910, 915–16.

144. 638 F. Supp. 596 (S.D.N.Y. 1986), *aff'd* 833 F.2d 1086 (2d Cir. 1987).

countability."[145] BSI's client turned out to be an Italian national operating a firm in Switzerland, and the SEC was able to permanently enjoin him and order disgorgement of over $4 million in profits.[146] In this case, the SEC was able to crack Swiss bank secrecy laws, but it was able to do so only because it froze the profits of illegal activity so soon after trading on inside information.

International agreements for the production of evidence can be used to obtain evidence abroad, even from banks in countries that have secrecy or blocking statutes, but the pursuit of evidence under these agreements is painfully slow and makes it difficult for the SEC or other securities commissions to proceed. The first U.S. Mutual Legal Assistance Treaty entered into force with Switzerland in 1977.[147] The United States then entered into treaties to provide mutual assistance in criminal matters with many other countries.[148] The SEC was able to make use of the Swiss treaty in the *Santa Fe* case.[149]

After the entry of a preliminary injunction in 1981, the SEC sought to learn the identities of certain account holders who had directed purchases of Santa Fe stock and options through Swiss banks just prior to the announcement of a merger, making a profit of $6.2 million.[150] The Swiss banks refused to respond to the SEC request. In March 1982, the SEC submitted a request for assistance under the Swiss Treaty with the United States.[151] In May 1984, the request was finally granted, and in February 1986, the SEC was successful in obtaining disgorgement of $7.8 million,[152] but this took over three years, and if the SEC had not frozen the funds from the insider trading transactions, the profits from this illegal activity would probably have been long dissipated. As this case demonstrates, although the SEC can use mutual assistance treaties for the production of information, the coverage of the agreements is limited, and the

145. SEC v. Banca Della Svizzera Italiana, 92 F.R.D. 111, 119 (S.D.N.Y. 1981).

146. Sec. Exch. Comm'n v. Tome, Litigation Release No. 11,120, 1986 SEC LEXIS 2348, at *1–2 (June 9, 1986).

147. Treaty Between the United States of America and the Swiss Confederation on Mutual Assistance in Criminal Matters, U.S.-Switz., May 25, 1977, 20 U.S.T. 2019.

148. JORDAN J. PAUST ET AL., INTERNATIONAL LAW AND LITIGATION IN THE U.S. 732 (2d ed. 2005).

149. SEC v. Certain Unknown Purchasers, 81 Civ. 6553 (WCC), 1983 WL 1343 (S.D.N.Y. 1983).

150. SEC v. Certain Unknown Purchasers, Litigation Release No. 11,012, 1986 WL 70986, at *1 (Feb. 26, 1986).

151. *Id.* at *2.

152. In addition to the $6.2 million in profits made by the "unknown purchasers," a Santa Fe director and his business associate also traded on the stock in violation of insider trading laws, realizing profits in excess of $3.5 million. *Id.* at *1–2.

procedures that must be followed are cumbersome and entail lengthy negotiations. Further, generally there must be dual criminality. Until 1988, insider trading was not criminal in Switzerland, and the absence of dual criminality hampered SEC investigations.[153]

The SEC set out to solve its problems in obtaining evidence of illegal behavior from foreign regulators by negotiating MOUs. MOUs are statements of cooperative intent, not legally binding obligations.[154] They do not override domestic law or preclude other avenues for obtaining evidence abroad.[155] The first MOU that the SEC negotiated was with Switzerland in 1982.[156] Since insider trading was not then illegal, the MOU stated that the parties would rely on a private agreement between the SEC and the Swiss Bankers Association until the Swiss legislature criminalized insider trading.[157] The MOU between the SEC and Switzerland was followed by numerous negotiated MOUs between the SEC and foreign regulators. MOUs formalize methods of requesting and providing information between like-minded regulators. The Swiss MOU was limited, however, in that it allowed private parties to challenge SEC requests and restricted the SEC's use of information provided. In the next few years, the SEC negotiated MOUs with the U.K. Department of Trade and Industry, the Japanese Ministry of Finance, and the Brazilian Securities Commission.[158] Also, in 1989, the SEC created the Office of International Affairs, reporting directly to the Chairman, specifically to negotiate MOUs.[159]

Seeking a more global solution to the problems of gathering evidence in foreign countries, the SEC sought and received assistance from IOSCO. In November 1986, an IOSCO resolution called on all securities authorities, to the extent permitted by law, to provide assistance on a re-

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153. *See* Daniel L. Goelzer, Anne Sullivan & Robert Mills, *Securities Regulation in the International Marketplace: Bilateral and Multilateral Agreements*, 9 MICH. Y.B. INT'L STUD. 53, 83–84 (1988).

154. *See* DOUGLAS M. JOHNSTON, CONSENT AND COMMITMENT IN THE WORLD COMMUNITY: THE CLASSIFICATION AND ANALYSIS OF INTERNATIONAL INSTRUMENTS 38 (1997).

155. MARC I. STEINBERG, INTERNATIONAL SECURITIES LAW: A CONTEMPORARY AND COMPARATIVE ANALYSIS 205 (1999).

156. *See id.* at 218.

157. *Id.* The mechanism for such cooperation was that a private group of Swiss bankers required their customers to waive Swiss bank secrecy as a condition to conducting U.S. securities transactions. Goelzer et al., *supra* note 153, at 87. *See also* Jonathan R. Macey, *Regulatory Globalization as a Response to Regulatory Competition*, 52 EMORY L.J. 1353, 1368 (2003) (noting that the Swiss eventually criminalized insider trading in 1988).

158. H.R. REP. NO. 101-240, at 7 (1989), *as reprinted in* 1990 U.S.C.C.A.N. 3888.

159. *Office of International Affairs Established*, SEC NEWS DIG., Dec. 19, 1989, at 1.

ciprocal basis for obtaining information relating to market oversight and protection of markets against fraud.[160] When questions arose as to the SEC's authority to collect evidence for foreign regulators, Congress passed the International Securities Enforcement Cooperation Act of 1990[161] to confirm the SEC's authority to enter into MOUs and to gather evidence for foreign regulators. In addition, the statute created a confidentiality exception from the Freedom of Information Act for evidence that the SEC obtains from foreign regulators.[162]

In 2002, IOSCO created a Multilateral Memorandum of Understanding ("MMOU") for enforcement cooperation among securities regulators. The SEC was an initial signatory to the agreement, and by December 2007, there were forty-three securities and derivatives regulators that were signatories.[163] Before the IOSCO MMOU came into existence, the SEC had signed bilateral information-sharing MOUs with the securities authorities of twenty different countries, and in 2007, the SEC made 556 requests to foreign regulators for assistance and responded to 454 requests.[164] Yet, the IOSCO MMOU is neither a treaty nor an international agreement, and it specifically states that its provisions "are not intended to create legally binding obligations or supersede domestic laws."[165]

The globalization of the securities markets has created the need for the sharing of information and cooperation among securities regulators beyond the sharing of evidence in a particular enforcement investigation. Demutualization of securities exchanges and their search for cross-border merger partners have raised questions about how these new multinational markets should be regulated.[166] In 2007, the SEC approved the combina-

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160. Michael D. Mann & William P. Barry, *Developments in the Internationalization of Securities Enforcement*, 39 INT'L LAW. 667, 673 n.23 (2005).

161. International Securities Enforcement Cooperation Act of 1990, Pub. L. 101-550, 104 Stat. 2714 (1990).

162. 15 U.S.C. § 78x(d) (1934).

163. List of Signatories to the IOSCO MMOU, http://www.iosco.org/library/index.cfm?section=mou_siglist (last visited Mar. 14, 2009). *See* Office of International Affairs Outline, *in* The SEC Speaks in 2008, at 1181, 1200–01 (PLI Corp. L. & Practice Course, Handbook Series No. 13966, 2008) [hereinafter SEC Speaks in 2008].

164. SEC Speaks in 2008, *supra* note 163, at 1201–02.

165. Multilateral Memorandum of Understanding Concerning Consultation and Cooperation and the Exchange of Information, IOSCO, May 2002, ¶ 6(a), *available at* http://www.sec.gov/about/offices/oia/oia_bilateral/iosco.pdf. Indeed, adherence to MOU protocols cannot override U.S. constitutional protections of persons under government investigation. *See* Elliott M. Beard, *A Critical Analysis of the Effects of* Collelo v. SEC *on International Securities Law Enforcement Agreements*, 7 DUKE J. COMP. & INT'L L. 271 (1996).

166. *See* Amir N. Licht, *Stock Exchange Mobility, Unilateral Recognition, and the Privatization of Securities Regulation*, 41 VA. J. INT'L L. 583 (2001).

tion of the NYSE Group, Inc., the publicly traded parent of the New York Stock Exchange, and Euronext N.V., a Netherlands company that owns five European stock exchanges. The SEC then entered into an MOU with the College of Euronext Regulators, a consortium of five European national authorities, that provides a framework for coordination, consultation, cooperation, and exchange of information in connection with the oversight of NYSE Euronext and its markets.[167] Yet, the absence of a global securities regulator, conflicting securities regulation on market structure by the SEC and the European Union,[168] and political and economic tensions between the United States and the European Union make the future of such voluntary regulatory cooperation uncertain.[169]

MOUs, like IFRS, are soft law responses to the regulatory challenges of the global securities markets. Neither the SEC, nor any other securities regulator, has the economic or political clout to impose its standards on the rest of the world. However, financial intermediaries and capital markets are no longer national, and if they can no longer be regulated by a single national regulator, they will not be effectively regulated unless securities authorities cooperate and agree upon common standards. The need for regulators to remain relevant and to exercise authority over fast-moving global markets and the players in those markets has driven them to cooperative, soft law solutions to the challenges posed by multinational issuers, investors, and traders. Whether these soft law solutions will stand up in times of economic crisis and market stress remains to be seen.

National hard law solutions may well conflict because of differing corporate finance systems, and the only international body with a worldwide constituency in the general securities regulatory field is IOSCO, which is a voluntary organization. IOSCO, and more specialized bodies like the IASB, can discuss problems in the capital markets and possible solutions to those problems, and often obtain a consensus for international securities law standards, but IOSCO has no authority to compel any member commission to implement or enforce such standards. Whether IOSCO standards are even international law could probably be debated, but they are the best international law norms that exist in this field.

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167. SEC Speaks in 2008, *supra* note 163, at 1194–95.

168. *See* Roberta S. Karmel, *The Once and Future New York Stock Exchange: The Regulation of Global Exchanges*, 1 BROOK J. CORP. FIN. & COM. L. 355, 367–79 (2007).

169. *See* Sara M. Saylor, Note, *Are Securities Regulators Prepared for a Truly Transnational Exchange?*, 33 BROOK. J. INT'L L. 685 (2008).

C. Anti-bribery

Over a period of thirty years, international anti-bribery norms evolved from national hard law, to soft law, to international treaty law in the form of the 1997 Convention on Combating Bribery of Foreign Officials in International Business Transactions ("OECD Anti-Bribery Convention" or "Convention"). This evolution was prodded by the United States, which saw combating bribery of foreign officials by its own business people (and those from other nations) in its normative and rationalistic interests. The strategic use of soft law instruments as well as diplomatic and public pressure made the commitment to a hard law instrument politically attainable.

In 1977, the United States enacted the Foreign Corrupt Practices Act ("FCPA")[170] in response to evidence of widespread illegal payments to government officials by large U.S. companies.[171] Some of these scandals not only were morally repugnant, but also implicated U.S. foreign policy interests because foreign governments were threatened by the news that their officials had been bribed by U.S. businesses.[172] In response, the United States enacted the FCPA, which criminalized the bribing of any foreign official by any U.S. issuers or domestic concerns.[173]

Initially, the United States believed that other countries would follow suit and enact similar legislation.[174] That did not happen. Instead, U.S. companies faced a disadvantage trying to do business overseas and competing with companies whose national laws did not govern bribery of

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170. 15 U.S.C.A. §§ 78m, 78dd-1 & 2, 78ff (2008).

171. Following the Watergate scandal, U.S. government investigations revealed that U.S. businesses had used foreign ties to launder illegal financial contributions to President Nixon's campaign, prompting the SEC to launch parallel investigations into other corporate practices. The SEC uncovered similar corrupt actions, most notably Lockheed's bribery of Japanese, Dutch, and Italian officials. During the course of the SEC investigations, over $300 million in bribes to foreign public officials was uncovered, with almost half of the 400 U.S. companies involved ranking in the Fortune 500. Peter W. Schroth, *The United States and the International Bribery Conventions*, 50 AM. J. COMP. L. SUPP. 593, 593–96 (2002). The moral upheaval that resulted in the United States created a genuine political issue to which legislators responded by enacting the FCPA. *Id.* at 596–97.

172. S. REP. NO. 114, at 3–4 (1977), *as reprinted in* 1977 U.S.C.C.A.N. 4098, 4101–02.

173. 15 U.S.C.A. §§ 78dd-1(a)(1)(B), 78dd-2(a)(1)(B). Following the completion of the OECD Anti-Bribery Convention, a provision was added to the FCPA in 1998, which made it unlawful for "any person other than an issuer . . . or a domestic concern" to bribe a foreign official. *Id.* § 78dd-3.

174. Kenneth W. Abbott & Duncan Snidal, *Values and Interests: International Legalization in the Fight Against Corruption*, 31 J. LEGAL STUD. S141, S162 (2002) [hereinafter Abbott & Snidal, *Values and Interests*].

foreign officials.[175] Some of these countries viewed bribery as part of a developing country's economy and saw no moral or economic reason to stop it.[176] Indeed, even the World Bank failed to condemn corruption.[177]

At first, efforts to develop soft law principles condemning corruption failed to produce meaningful commitments. In tracking the development of the OECD Anti-Bribery Convention, Professors Abbott and Snidal note the efforts of many international organizations, including "the [U.N.], the development banks, the [IMF], the [OAS], the Council of Europe, the European Union . . . and of course the OECD . . . [, which] adopted anticorruption policies, though their enthusiasm and effectiveness varied widely."[178] For example, the OAS first unanimously resolved in 1975 "to cooperate in the exchange of information" and to "prepare[] a draft code of conduct,"[179] and asked that members "clarify their national laws" accordingly.[180] There was, however, no provision detailing any means by which to enforce the statements made in the resolution.[181] The OAS then ceased to address the problem again until the 1994 Summit of the Americas, where it called for multilateral efforts to combat corruption.[182]

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175. Alejandro Posadas, *Combating Corruption Under International Law*, 10 DUKE J. COMP. & INT'L L. 345, 364–65 (2000) (stating that although the U.S.-led investigations revealed widespread bribery abroad, no other countries addressed the problem); *id.* at 359 (noting that since enacting the FCPA, Congress has amended it twice in an "effort to strengthen the global competitiveness of American businesses").

176. Christopher F. Corr & Judd Lawler, *Damned If You Do, Damned If You Don't?: The OECD Convention and the Globalization of Anti-Bribery Measures*, 32 VAND. J. TRANSNAT'L L. 1249, 1253 (discussing that in developing countries bribery was seen as a "necessary evil"); Daniel K. Tarullo, *The Limits of Institutional Design: Implementing the OECD Anti-Bribery Convention*, 44 VA. J. INT'L L. 665, 673–74 (2004) (noting that many countries did not see corruption and bribery as immoral or "bad," but rather as necessary to economic and political progress in developing countries).

177. Posadas, *supra* note 175, at 399–400 (discussing that the World Bank and International Monetary Fund only began taking steps towards combating corruption in the latter half of the 1990s).

178. Abbott & Snidal, *Values and Interests*, *supra* note 174, at S159–60.

179. Organization of American States [OAS], Resolution on the Behavior of Transnational Enterprises, ¶¶ 1–2, OAS Doc. OEA/Ser. G, CP/RES. 154 (167/75) (July 10, 1975).

180. OAS, Resolution on the Behavior of Transnational Enterprises, *supra* note 179, ¶ II.

181. *See* OAS, Resolution on the Behavior of Transnational Enterprises, *supra* note 179. The resolution declared that the Permanent Council should consult experts and devise "appropriate procedures" in developing a code of conduct, but that any resulting information would only be "placed on the agenda . . . for consideration." *Id.* ¶¶ 2–3.

182. Summit of the Americas, Declaration of Principles and Plan of Action, Dec. 11, 1995, 34 I.L.M. 808, 811 (1995).

Other organizations dabbled in anticorruption norms in the 1970s as well. In 1977, the International Chamber of Commerce's Commission on Ethical Practices promulgated a set of recommendations for governments and rules of conduct for corporations and their employees.[183] The recommendations urged countries to negotiate a multilateral treaty and to implement their own domestic legislation.[184] The Rules of Conduct to Combat Extortion and Bribery provided a self-regulatory framework for corporations to adopt if they so chose.[185] Also in the 1970s, the U.N. acted through Resolution 3514 in condemning bribery and urging governments to legislate accordingly.[186] These efforts lacked follow-up.

Finally, in 1993, the OECD, at the behest of the United States, tackled the problem of bribery.[187] In some ways the OECD was a perfect soft law venue.[188] It provided a forum for policy discussion and persuasion.[189] As a club organization with a limited number of members, it was conducive to consensus.[190] It established a Working Group on Bribery in Interna-

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183. Int'l Chamber of Commerce [ICC], *Extortion and Bribery in Business Transactions*, Nov. 29, 1977, Publ'n No. 315, *reprinted in* 17 I.L.M. 417, 418–21 (1978).

184. ICC, *Extortion and Bribery in Business Transactions*, *supra* note 183, at 418.

185. *Id.* at 419.

186. G.A. Res. 3514 (XXX), ¶¶ 1–5, U.N. Doc. A/10467 (Dec. 15, 1975). Even after the U.N. issued this resolution and bribery scandals in Japan and Iran emerged, U.S. efforts to garner consensus on a mandatory international corporate code of conduct were met with "deafening silence." Seymour Rubin, *International Aspects of the Control of Illicit Payments*, 9 SYRACUSE J. INT'L L. & COM. 315, 318–20 (1982). These attempts were apparently doomed from the start as previously the United States had "firmly insisted that the codes of conduct [for other aspects of transnational corporations] be voluntary," and this inconsistent stance seemed to block further U.N. cooperation. *Id.* at 321.

187. Schroth, *supra* note 171, at 610–11 (discussing that Congress had pressed for action within the OECD, but that it was not vigorously pursued until 1993, after which the OECD ultimately issued a Recommendation against bribery in 1994).

188. Abbott and Snidal track the OECD efforts to illustrate the interplay of rationalist and constructivists accounts of international norm development. Abbott & Snidal, *Values and Interests*, *supra* note 174, at S143–44.

189. *See* THE OECD, *supra* note 105, at 7 (describing the advantages of the OECD forum in discussing issues and persuading other actors to change their policies).

190. Robert O. Keohane & Joseph S. Nye, Jr., *Between Centralization and Fragmentation: The Club Model of Multilateral Cooperation and Problems of Democratic Legitimacy*, Kennedy School of Government Working Paper Series, RWP01-004 at 4, (2001) *available at* http://ksgnotes1.harvard.edu/Research/wpaper.nsf/rwp/RWP01-004/$File/rwp01_004_nye_rev1.pdf (discussing that the club model fosters "close working relationships" between negotiators within an issue-area and reports only a finished product, thus eliminating interference from outsiders and domestic politics). *See also* Reuven S. Avi-Yonah, *National Regulation of Multinational Enterprises: An Essay on Comity, Extraterritoriality, and Harmonization*, 42 COLUM. J. TRANSNAT'L L. 5, 32 (2003) ("The OECD is the preferred forum for coordinating action when extraterritoriality with reciprocity is the preferred approach."); Barbara Crutchfield George, Kathleen A. Lacey & Jutta Birmele,

tional Business Transactions, which included member nations as well as members of civil society, including Transparency International, other international organizations such as the World Bank, and prosecutors from the United States and Europe.[191] In accordance with the Council's statement condemning bribery, the Working Group issued a recommendation that member countries also abolish the tax deductibility of bribes.[192] As Abbott and Snidal discuss, these instruments were intended to be soft law instruments that would work towards moving public opinion to pressure governments to attack the problem more forcefully.[193] Over time, attitudes concerning the effect of bribery on developing nations changed, partly due to public opinion and partly in response to U.S. pressure.[194] Between 1993 and 1997, the OECD used soft law instruments to move its members towards a firm commitment against bribery in international business transactions.[195]

The 1998 OECD Convention: An Impetus for Worldwide Changes in Attitudes Towards Corruption in Business Transactions, 37 AM. BUS. L.J. 485, 487 (2000) (identifying the OECD as "the club").

191. Org. for Econ. Co-operation and Dev. [OECD], *Recommendation on Bribery in International Business Transactions*, ¶ VIII, OECD Doc. C(94)75/FINAL (May 27, 1994) (instructing the Committee on International Investment and Multinational Enterprises to create the Working Group); Abbott & Snidal, *Values and Interests*, *supra* note 174, at S166–67 (discussing the various "value activists" that were included in the OECD's Working Group); OECD, Working Group on Bribery in International Business Transactions, http://www.oecd.org/document/5/0,3343,en_2649_34855_35430021_1_1_1_1,00.html (last visited June 18, 2008) (describing the establishment and mandate of the Working Group).

192. OECD, *Recommendation on the Tax Deductibility of Bribes to Foreign Public Officials*, OECD Doc. C(96)27/FINAL (Apr. 17, 1996).

193. In pursuing its anticorruption agenda in the OECD, the U.S. State Department relied on the emerging public interest in combating corruption in Europe and the bad press generated by European scandals. Abbott & Snidal, *Values and Interests*, *supra* note 174, at S164–65.

194. *See* Tarullo, *supra* note 176, at 678–80 (discussing U.S. attempts to persuade other governments to alter their policies on bribery and to address public concern with domestic scandals and their effects on democratization).

195. Kenneth W. Abbott, *Rule-Making in the WTO: Lesson from the Case of Bribery and Corruption*, 4 J. INT'L ECON. L. 275, 289–90 (2001). At the same time, other soft law efforts to combat corruption proceeded. The OAS efforts picked up again. In a 1992 General Assembly Resolution, the OAS declared that corruption had a negative effect on development, and in 1996 it adopted an anticorruption agreement, the Inter-American Convention Against Corruption ("IACAC"). *See* OAS, *Corrupt International Trade Practices*, OAS Doc. AG/RES. 1159(XXII–092) (May 22, 1992), *available at* http://www.oas.org/juridico/english/ga-res97/eres1159.htm; IACAC, *supra* note 53. The IACAC lacked monitoring and compliance mechanisms and instructed States to "consider" certain preventative measures and to take steps to establish transnational bribery and illicit enrichment as offenses under each country's national law. IACAC, *supra* note 53, art. III

The end game for anti-bribery efforts was a hard law convention—soft law was the means to the end. Admittedly, U.S. negotiators thought that obtaining a hard law instrument was not a realistic short-term goal.[196] But, an international hard law commitment was needed to combat the prisoner's dilemma faced by nations.[197] If any one nation prohibited bribery of foreign officials by its business people, it lost out to a greater extent than if it allowed bribery to continue.[198] Forcing all nations to prohibit bribery maximized gains for all.[199] Initially, negotiators focused on persuasion, and their partners in civil society, namely Transparency International, championed the effectiveness of public opinion as a soft law tool to pressure governments and move them towards the hard law commitment.[200]

The process took time and prodding. The OECD first recognized bribery as a problem in its Guidelines for Multinational Enterprises ("Guidelines") as part of the Declarations and Decisions on International Investment and Multinational Enterprises in 1976.[201] But until U.S. pres-

("States Parties agree to consider the applicability of measures within their own institutional systems"); *id.* art. VIII (discussing transnational bribery); *id.* art. IX (discussing illicit enrichment). Thus, while the IACAC was a treaty, its proscriptions fell short of hard law. *See* Mark E. Baker, *Tightening the Toothless Vise: Codes of Conduct and the American Multinational Enterprise*, 20 WIS. INT'L L.J. 89, 128–29 (2001) (noting that the IACAC's potential effectiveness is undermined by its loose terms). After recognizing the necessity of a compliance monitoring system, the OAS General Assembly passed a resolution in 2001 adopting a follow-up mechanism to the IACAC. OAS, *Mechanism for Follow-up of Implementation of the Inter-American Convention Against Corruption*, OAS Doc. AG/RES. 1784 (XXXI-O/01) (June 5, 2001), *available at* http://www.oas.org/juridico/english/ga01/agres1784.htm.

196. Posadas, *supra* note 175, at 376–77 (stating that although the State Department at first wanted to pursue a binding agreement, it later realized that insistence upon hard law could prove counterproductive).

197. *See* Tarullo, *supra* note 176, at 675 (stating that the United States in particular sought a binding agreement that would enforce anti-bribery laws and impose sanctions in order to equalize the playing field and induce cooperation between U.S. and foreign corporations).

198. *Id.* at 670 (discussing the positive outcomes for companies permitted to bribe officials in obtaining contracts, while nonbribers receive no payoff at all); *id.* at 674–75 (identifying the advantage created by the FCPA for non-U.S. corporations once their U.S. counterparts had become committed cooperators).

199. *Id.* at 694 (stating that so long as the nature of the commitment offered assurances that made compliance more attractive than noncompliance, countries would benefit from mutual enforcement).

200. Abbott & Snidal, *Values and Interests*, *supra* note 174, at S165 (noting Transparency International's strong belief in "normative persuasion").

201. *See* OECD Declarations and Decisions on International Investment and Multinational Enterprises, http://www.oecd.org/document/24/0,3343,en_2649_34889_1875736_1_1_1_1,00.html (last visited Feb. 16, 2009). The most recent revisions of the Guidelines

sure in the 1990s, anti-bribery efforts—even soft law efforts—were at a standstill.[202] A 1994 recommendation of the OECD Council referenced the Guidelines and instructed the corresponding committee to form the Working Group on Bribery in International Business Transactions.[203] It also recommended both domestic legislation and international cooperation (through existing agreements and the formation of new ones) to prohibit bribery.[204] In 1996, the OECD issued another recommendation that further encouraged member countries to eliminate tax deductibility in connection with bribery of foreign public officials.[205] At the same time, the United States was applying pressure amongst its allies and capitalizing on public attitudes towards corruption.[206] The OECD issued a final recommendation regarding bribery on May 23, 1997 ("Final Recommendation").[207] The Final Recommendation included a list of "Agreed Common Elements" and opened the negotiations for the eventual Anti-Bribery Convention.[208] Ambitiously, the Final Recommendation discussed criminalization, tax deductibility, public procurement, international cooperation, arrangements for a monitoring system, cooperation with non-OECD members, and cooperation with intergovernmental organizations ("IGOs") and nongovernmental organizations ("NGOs").[209] These efforts to change the values of the public and governments bore fruit. By 1997, attitudes concerning the appropriateness of bribery and its effect on international business had changed significantly.[210]

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occurred in 2000, and contain a section on Combating Bribery, which instructs multinational enterprises not to "directly or indirectly" offer bribes and, likewise, that bribes should not be solicited from them. ORG. FOR ECON. CO-OPERATION & DEV., GUIDELINES FOR MULTINATIONAL ENTERPRISES 24–25, *available at* http://www.oecd.org/dataoecd/56/36/1922428.pdf.

202. *See supra* note 186, and accompanying text.

203. OECD, *Recommendation on Bribery in International Business Transactions*, *supra* note 191, ¶ VIII.

204. *Id.* ¶ IV.

205. OECD, *Recommendation on the Tax Deductibility of Bribes to Foreign Public Officials*, *supra* note 192.

206. *See supra* notes 187–95 and accompanying text.

207. OECD, *Revised Recommendation C(97)123/Final on Combating Bribery in International Business Transactions*, OECD Doc. C(97)123/FINAL (May 23, 1997) [hereinafter OECD, *Revised Recommendation*].

208. *Id.* annex ("Agreed Common Elements of Criminal Legislation and Related Action"). The Council stated that the ultimate Anti-Bribery Convention was to be completed by the end of the year, and that it should ideally enter into force one year after that. *Id.* ¶ III.

209. *Id.* ¶¶ III–XIII.

210. Posadas, *supra* note 175, at 380. NGOs also began to get involved in the process, and Transparency International was an integral part of the negotiations that led to the

After accepting several soft law instruments, OECD members found it easier to accept (or more difficult to resist) a hard law instrument.[211] The Final Recommendation moved the members to the point where they had agreed to a list of common elements for anti-bribery legislation.[212] Once these elements had been agreed upon, the task of negotiating a hard law treaty became much easier.[213] The OECD Anti-Bribery Convention was the result.[214] It is a legally binding hard law instrument that incorporates the common elements of bribery and requires signatories to implement domestic legislation consistent with the Convention.[215] While it does not mandate a particular format for that legislation, it does provide for a monitoring system of peer review to ensure that legislation exists and that it is enforced.[216]

Although negotiators reached their hard law goal, the OECD Anti-Bribery Convention still faces criticisms. It only addresses bribery and not other forms of corruption.[217] And individual States still define bribery

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OECD Recommendations and Convention. Corr & Lawler, *supra* note 176, at 1299–303. The group also currently assists OECD countries in implementing, enforcing, and monitoring compliance with the OECD Anti-Bribery Convention, as well as other similar conventions. Transparency International: Projects and Conventions, http://www.transparency.org/global_priorities/international_conventions/projects_conventions (last visited Jan. 25, 2009).

211. The European countries submitted their own draft of the proposed Convention, which was rejected. Specifically, the United States suspected that the push for a legally binding document was an "obstructionist tactic." Abbott and Snidal note, however, that once these European countries were "on record" as supporting hard law, it became more difficult for them to back out of negotiations. Abbott & Snidal, *Values and Interests*, *supra* note 174, at S167–68.

212. The common elements included definitions, sanctions, and enforcement provisions. Emphasis was placed on international cooperation. Specifically, members were supposed to make efforts to eliminate the delaying effects of dual criminality constraints and to facilitate information sharing between governments. OECD, *Revised Recommendation*, *supra* note 207, annex.

213. Abbott & Snidal, *Values and Interests*, *supra* note 174, at S168.

214. There are now thirty-seven signatories. *See* OECD Anti-Bribery Convention: Entry into Force of the Convention, http://www.oecd.org/document/12/0,3343,en_2649_34859_2057484_1_1_1_1,00.html (last visited Jan. 25, 2009).

215. OECD Convention on Combating Bribery of Foreign Public Officials in International Business Transactions pmbl., Dec. 18, 1997, 37 I.L.M. 1 (1998), *available at* http://www.olis.oecd.org/olis/1997doc.nsf/LinkTo/NT00000B7E/$FILE/04E81240.PDF [hereinafter Anti-Bribery Convention] (referencing the agreed common elements as set forth in the OECD's Final Recommendation of 1997); *id.* arts. 1–3 (requiring Parties to establish bribery as a criminal offense, to establish liability for bribery of foreign public officials, and to make the offence punishable within their respective domestic legal systems).

216. Anti-Bribery Convention, *supra* note 216, art. 12.

217. *Id.* pmbl. *See also* Peter J. Henning, *Public Corruption: A Comparative Analysis of International Corruption Conventions and United States Law*, 18 ARIZ. J. INT'L &

pursuant to their own national laws.[218] Broader provisions targeting payments to political candidates are noticeably absent,[219] and commentators have noted that despite the monitoring provisions, the Convention still has serious enforcement problems.[220]

What is remarkable about the OECD Anti-Bribery Convention, though, is that it exists at all, especially in light of the fact the U.S. FCPA lessened any incentive for other governments to agree to such a convention. As Daniel Tarullo has discussed, basic game theory illustrates that once the United States enacted the FCPA, it became a winning proposition for other countries to resist any anti-bribery legislation.[221] The prospect of having countries commit to international hard law mandating such legislation seemed dim.[222] Soft law brightened those possibilities. As Professors Abbott and Snidal have explained in their work, soft law allowed normative influences to transform rationalist ones.[223] In other words, while it may not have been in most countries' rationalistic interests to commit to anti-bribery legislation, soft law persuaded them to

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COMP. L. 793, 862–63 (2003) (discussing that the Convention focuses on bribery as "the primary harm from corruption").

218. Anti-Bribery Convention, *supra* note 216, cmt. 3. While the Anti-Bribery Convention may "promote" uniformity, the Commentaries following the official text state that the goal of the Convention is "to assure a functional equivalence among the measures taken by the Parties . . . without requiring uniformity or changes in fundamental principles of a Party's legal system." *Id.* cmt. 2.

219. The FCPA's prohibition on bribery includes conveying anything of value to "any foreign political party or official thereof or any candidate for foreign political office." 15 U.S.C. §§ 78dd-1(a)(2), 78dd-2(a)(2) (2008). The Anti-Bribery Convention leaves this language out of its definition of "foreign public officials." Anti-Bribery Convention, *supra* note 216, art. 1. Additionally, the Commentaries indicate that although "there is a commonly shared concern and intent to address this phenomenon through further work," it is not covered by the Convention. *Id.* cmt. 10.

220. Tarullo, *supra* note 176, at 682–83 (noting the difficulties in enforcing the Convention's requirements through the mechanism of peer review). The primary difficulty in relying on individual members, rather than an overseeing body, is that bribery tends to be the sort of offense that is not readily reported to government officials. Thus, there is no guarantee that these offenses will be investigated and prosecuted. *Id.* Furthermore, "the path of the domestic law enforcement system" is troublesome because many of the members' legal systems are insufficiently organized to allow for investigations overseas, which causes indifference towards ensuring compliance. *Id.* at 688. Taken together, these issues create an "insufficiency of the 'compliance pull'" and States feel less obligated to ensure compliance with the Convention. *Id.* at 687.

221. *Id.* at 672–74.

222. *Id.* at 674.

223. Abbott & Snidal, *Values and Interests*, *supra* note 174, at S143–44, S163 (discussing that the use of soft law as a vehicle to the OECD Anti-Bribery Convention highlights the effectiveness of the value tactics utilized by the United States to influence interest-based concerns).

change their interests.[224] The calculus that followed allowed for a hard law commitment.

Although soft law was a tool in changing that calculus, it was not the only tool. It is clear that the OECD's employment of soft law came at the behest of the United States and that the United States was able to exercise its moral and diplomatic influence to spur soft law development beyond the fits and starts that occurred in the 1970s. The persistent use of soft law made the transformation politically attainable.

D. Credit Rating Agencies

Intense focus on the role and appropriate regulation of CRAs has been ongoing in the United States and abroad since at least the collapse of Enron. Until four days before Enron declared bankruptcy, major CRAs continued to rate its debt as "investment grade."[225] Similarly, WorldCom was rated investment grade three months before filing for bankruptcy, and Global Crossing was rated investment grade in March 2002 and defaulted on loans in July 2002.[226] Such failures to downgrade the debt of failing companies have not been limited to U.S. issuers.[227] Further, the rating agencies did not anticipate the 1997–1998 Asian debt crisis, which adversely impacted sovereign debt issues.[228] More recently, criticism of the conduct and competence of CRAs has focused on the huge number of rating agencies' write downs of previously highly rated residential mortgage-backed securities ("RMBS") and collateralized debt obligations ("CDOs") in the context of the subprime mortgage crisis.[229]

CRAs analyze and evaluate the creditworthiness of corporate and sovereign issuers of debt securities. While CRA ratings are often thought to represent a judgment on the worthiness of an investment because of the use of the term "investment grade" to refer to highly rated securities, the opinions of CRAs relate solely to the likelihood that a particular debt

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224. *Id.* at S164–68 (discussing European incentives to support bribery, the value transformation that occurred during the OECD negotiations, and the relatively smooth evolution from the "soft law" Recommendations to the Anti-Bribery Convention).

225. Claire A. Hill, *Regulating the Rating Agencies*, 82 WASH. U. L.Q. 43 (2004).

226. Statement of Egan Jones on Credit Rating Agencies, Nov. 15, 2002 Hearing on Credit Rating Agencies, www.sec.gov/news/extra/credrate/eganjones2.htm (last visited Mar. 18, 2009).

227. *See* U.N. Conference on Trade & Dev. [UNCTAD], Credit Rating Agencies and Their Potential Impact on Developing Countries, UNCTAD Discussion Paper 18, at 2, UNCTAD/OSG/DP/2008/1 (Jan. 2008) (*prepared by* Marwan Elkhoury) [hereinafter UNCTAD Elkhoury Discussion Paper].

228. *Id.*

229. *See* Proposed Rules for Nationally Recognized Statistical Rating Organizations, Exchange Act Release No. 57,967, 73 Fed. Reg. 36,212, at 36,216–18 (June 25, 2008).

security will perform according to its terms. A high credit rating does not purport to be an opinion that the debt instrument is a good investment.[230] Nevertheless, as a surrogate for the riskiness of investments held by regulated entities, specific references to credit ratings in the rules of the SEC and Basel II have given such ratings significance and credibility as a measure of the creditworthiness of issuers.[231] In 1975, the SEC adopted the term "nationally recognized statistical rating organization" ("NRSRO") to determine capital charges for broker-dealers for purposes of the SEC's capital adequacy or net capital rule.[232] Marketplace and regulatory reliance on credit ratings then gradually increased, and the concept of an NRSRO became embedded in a wide range of U.S. regulations of financial institutions, as well as state, federal, and foreign laws relating to creditworthiness.[233] The failure of the CRAs to promptly adjust ratings or forecast the demise of issuers that went bankrupt when the stock market technology bubble burst then led to scrutiny of their performance and the lack of government regulation.

The SEC never passed a rule defining NRSROs, but rather, recognized agencies as such through a no-action letter process. The SEC staff considered a number of factors, the most important of which was that the agency was "nationally recognized" for ratings reliability.[234] This opaque process and the highly concentrated number of NRSROs led to criticism of the SEC's procedures, and in 1997 the SEC proposed codifying its NRSRO criteria and giving rejected organizations a right to appeal denial of the designation.[235] This proposal was not acted upon, however.

Government regulation of CRAs in the United States was controversial and remains so. Some believe that the NRSRO designation is a barrier to competition in the credit rating business.[236] Others have argued that the

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230. INT'L ORG. OF SEC. COMM'NS, TECHNICAL COMM., THE ROLE OF CREDIT RATING AGENCIES IN STRUCTURED FINANCE MARKETS, at n.8 (Mar. 2008) [hereinafter IOSCO, CRA REPORT].

231. *See* UNCTAD Elkhoury Discussion Paper, *supra* note 227, at 1; SEC. & EXCH. COMM'N, REPORT ON THE ROLE AND FUNCTION OF CREDIT RATING AGENCIES IN THE OPERATION OF THE SECURITIES MARKETS 5 (Jan. 2003), *available at* http://www.sec.gov/news/studies/credratingreport0103.pdf [hereinafter SARBANES-OXLEY REPORT].

232. SARBANES-OXLEY REPORT, *supra* note 231, at 6.

233. *Id.* at 7–8.

234. Hill, *supra* note 225, at 55. Other factors taken into consideration were organizational structure; size and experience of staff; the agency's independence from the company it rates; and internal procedures to prevent misuse of inside information. *Id.* at 55–56.

235. Capital Requirements for Brokers or Dealers Under the Securities Exchange Act of 1934, Exchange Act Release No. 39,457, 66 SEC Docket 254 (Dec. 17, 1997).

236. *E.g.*, Steven L. Schwarcz, *Private Ordering of Public Markets: The Rating Agency Paradox*, 2002 U. ILL. L. REV. 1, 20 (2002) (noting that the NRSRO designation blocks competition among rating agencies because it limits the number of agencies).

SEC lacks authority to substantively regulate CRAs[237] and that such authority would be inappropriate because the activities of CRAs are journalistic and protected by the First Amendment.[238] Yet, shortcomings by CRAs raised questions as to whether their lack of regulation and the SEC's process for designating NRSROs were appropriate. Accordingly, the Sarbanes-Oxley Act mandated that the SEC study the role and function of CRAs and submit a report to Congress.[239] This study was required to cover the following areas: the role of CRAs in evaluating issuers; the importance of that role to investors and the markets; impediments to accurate appraisals of the financial resources and risks of securities issuers; barriers to entry to the CRA business; measures to improve dissemination of CRA appraisals; and conflicts of interest in rating operations. The SEC issued this required report, but did not draw any firm conclusions concerning how, if at all, CRAs should be regulated. Instead, the SEC stated that it intended to issue a Concept Release covering the following issues: mandating disclosure by NRSROs about the ratings process and other matters; conflicts of interest; anticompetitive or unfair practices; reducing barriers to entry; and ongoing SEC oversight of CRAs.[240] This Concept Release was duly issued in June 2003.[241]

In the meantime, the Technical Committee of IOSCO formed a task force to study issues relating to CRAs and released a report in September 2003 describing the role of CRAs in the global capital markets.[242] This task force was chaired by a commissioner of the U.S. SEC and included representatives from Australia, Brazil, France, Germany, Hong Kong, Italy, Japan, Ontario, Canada, Portugal, Spain, and the United Kingdom.[243] At the same time, IOSCO published a set of principles that regulators, CRAs, and other market participants could follow to improve the integrity of the ratings process and help ensure that investors are pro-

237. As will be explained, some authority was given to the SEC in the Credit Rating Agency Reform Act of 1996, Pub. L. No. 109-291 (2006).

238. Concept Release: Rating Agencies and the Use of Credit Ratings Under the Federal Securities Law, Exchange Act Release No. 47,972, 68 Fed. Reg. 113, at 4 (June 12, 2003) [hereinafter Rating Agencies Concept Release].

239. The report was to be filed not less than 180 days after the passage of the Act. Sarbanes-Oxley § 702, 15 U.S.C. § 78j-1 (2002).

240. SARBANES-OXLEY REPORT, *supra* note 231, at 43–45.

241. Rating Agencies Concept Release, *supra* note 238.

242. INT'L ORG. OF SEC. COMM'NS, TECHNICAL COMM, REPORT ON THE ACTIVITIES OF CREDIT RATING AGENCIES (Sept. 2003), *available at* www.iosco.org/library/pubdocs/pdf/IOSCOPD153.pdf.

243. *Id.* at 1 n.3. The three largest international CRAs—Moody's, S & P, and Fitch—are all U.S. companies. *Id.* at 8.

vided with timely, high-quality ratings.[244] These principles were fairly general and related to the quality and integrity of the ratings process, independence and conflicts of interest, transparency and the timeliness of ratings disclosure, and the use of confidential information.

Responding to suggestions that these principles were insufficient to deal with the problems posed by CRAs, particularly in light of the use of credit ratings in Basel II, IOSCO continued to analyze how CRAs should be regulated. In September 2003, IOSCO issued a report on the activities of CRAs, and a Code of Conduct Fundamentals for CRAs.[245] The Code of Conduct Fundamentals was much more specific than the earlier published principles, and especially focused on the quality of the ratings process, including updating of opinions, conflicts of interest, employee and analyst independence, and transparency. In response, the two largest CRAs, Moody's and Standard and Poor's, published their own Code of Professional Conduct in the second half of 2005.[246]

With IOSCO having paved the way for regulation of CRAs, Congress passed the Credit Rating Agency Reform Act ("CRA Reform Act") in 2006, which established a system of registration and regulation of NRSROs and instructed the SEC to formulate implementing rules.[247] The CRA Reform Act effected three changes in the SEC's regulation of NRSROs. First, it added definitions of "credit rating," "credit rating agency," "nationally recognized statistical rating organization," and "person associated" with an NRSRO.[248] Second, it replaced the SEC's no-action letter procedure for recognizing NRSROs with a registration procedure, and also imposed substantive requirements on NRSROs with respect to misuse of nonpublic information, conflicts of interest, and anticompetitive or abusive conduct.[249] Third, it amended the Exchange Act to include NRSROs among the types of entities subject to SEC recordkeeping and reporting requirements.[250]

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244. IOSCO Statement of Principles Regarding the Activities of Credit Rating Agencies (Sept. 2003), *available at* www.iosco.org/library/pubdocs/pdf/IOSCOPD151.pdf.

245. IOSCO, CRA REPORT, *supra* note 230; ANNEX A, CODE OF CONDUCT FUNDAMENTALS FOR CREDIT RATING AGENCIES (Dec. 2004, revised Feb. 2008), *available at* http://www.iosco.org/library/pubdocs/pdf/IOSCOPD263.pdf.

246. UNCTAD Elkhoury Discussion Paper, *supra* note 227, at 12

247. Credit Rating Agency Reform Act of 2006, Pub. L. No. 109-291, 120 Stat. 1327 (2006) (implementing SEC rules issued in June 2007).

248. Exchange Act § 3(a)(61)–(63).

249. Credit Rating Agency Reform Act of 2006 § 4 (codified at Securities Exchange Act of 1934 § 15G, 15 U.S.C.A. § 78o-7 (2009)).

250. *Id.* § 5 (codified at Securities Exchange Act of 1934 § 17(a)(1), 15 U.S.C.A. § 78q(a)(1)).

In June 2007, the SEC passed rules implementing the CRA Reform Act. These rules set forth basic registration requirements for NRSROs and obligations to update registration forms.[251] Further rules subject NRSROs to recordkeeping and annual financial reporting rules,[252] and require NRSROs to establish procedures to prevent the misuse of confidential information and to manage conflicts of interest.[253] Finally, NRSROs are prohibited from certain anticompetitive or abusive practices relating to tying the issuance or level of a credit rating to an issuer's purchase of services or products in addition to the credit rating.[254]

IOSCO continued to work on the problems posed by CRAs and in March 2008, issued a Consultation Report on the role of CRAs in structured finance markets, as well as a new Code of Professional Conduct.[255] This new code did not recommend any sweeping overhaul, and Charles McCreevy, the European financial commissioner, called it "toothless" and has been pushing for EU regulation of CRAs. It is unclear what form any such EU regulation would take, but it could involve registration of CRAs with CESR, or the creation of a European rating agency to break the dominance of the big U.S. firms.[256] On December 3, 2009 the SEC adopted new rules aimed at the conflicts of interest at CRAs. These amendments impose additional disclosure requirements on CRAs with respect to verification of structured finance assets; assessments of the quality of structures finance transaction originators; and surveillance. Also, these amendments would add prohibited conflicts to NRSRO rules.[257] Although these rules were welcomed by some, others criticized the rules as not going far enough.[258] EU regulators are also continuing to propose new regulations for CRAs.[259] These rules will regulate conflicts of interests, disclosures, internal policies, and business practices of CRAs, and as stated by SEC Chairman Christopher Cox, reflect the input

251. Exchange Act Rule 17g-1, 17 C.F. R. § 240.17g-1 (2007).
252. Exchange Act Rules 17g-2, g-3, 17 C.F.R. §§ 17g-2, g-3 (2007).
253. Exchange Act Rules 17g-4, g-5, 17 C.F.R. §§ 240.17g-4, g-5 (2007).
254. Exchange Act Rule 17g-6, 17 C.F.R. § 17g-6 (2007).
255. IOSCO CONSULTATION REPORT, THE ROLE OF CREDIT RATING AGENCIES IN STRUCTURED FINANCE MARKETS (2008), *available at* http://www.iosco.org/library/pubdocs/pdf/IOSCOPD270.pdf.
256. *See* Tony Barber, *EU Turns Up Heat on Rating Agencies,* FIN. TIMES, July 8, 2008, at 3; Gillian Tett, *Unease as Regulators Call for More Control over Ratings System,* FIN. TIMES, June 25, 2008, at 25.
257. *See* SEC Press Release Dec. 3, 2008, SEC Approves Measures to Strengthen Oversight of Credit Rating Agencies, www.sec.gov/news/press/2008/2008-284.htm. (To date, the SEC rules have not been posted on the SEC web site or in the Federal Register.)
258. *See S.E.C. Issues Rules on Conflicts in Credit Rating*, N.Y. TIMES, Dec. 3, 2008.
259. *Id.*

of a number of international regulatory organizations, including the Financial Stability Forum and IOSCO.[260] Further, the SEC conducted a sweeping investigation of CRAs. Its findings have now been made public, and it is likely that the SEC will now move forward with enforcement actions.[261]

While it remains to be seen how the SEC or the European Union, or other governmental bodies, will proceed to further regulate CRAs, the move from soft law to hard law in this area is interesting because, unlike the other stories in this Part of the Article, progress was very quick. Confronted with opposition to government regulation of CRAs, the SEC turned to IOSCO to formulate a soft law standard of conduct. But the bursting of the technology bubble, and the subprime meltdown and credit freeze in the global markets allowed government officials to blame CRAs (among others) for these economic debacles and to swiftly pass U.S. legislation giving the SEC statutory authority to exercise oversight of CRAs, and the SEC has proceeded to pass implementing regulations. Quite possibly, the European Union will now move to similarly regulate CRAs, although EU regulations could conflict with U.S. regulations, and

260. Christopher Cox, Chairman, SEC, Statement at Open Meeting on Rules for Credit Rating Agencies (June 11, 2008), *available at* www.sec.gov/news/speech/2008/spch061108cc.htm. The SEC's first proposed rulemaking package addressed the imposition of additional requirements on NRSROs to better assure integrity in their credit rating procedures, and to separate the rating of structured financial products from the rating of other securities. Proposed Rules for Nationally Recognized Statistical Rating Organizations, Exchange Act Release No. 57,967, 73 Fed. Reg. 36,212 (June 25, 2008) (to be codified at 17 C.F.R. pts. 240, 249b). The SEC then issued three simultaneous proposals designed to reduce the reliance of regulated entities on CRA ratings. References to Ratings of NRSROs, 73 Fed. Reg. 40,088 (proposed July 11, 2008) (to be codified at 17 C.F.R. pts. 240, 242, 249); References to Ratings of NRSROs, 73 Fed. Reg. 40,124 (proposed July 11, 2008) (to be codified at 17 C.F.R. pts 270, 275); Security Ratings, 73 Fed. Reg. 40,106 (proposed July 11, 2008) (to be codified at 17 C.F.R pts. 229–30, 239, 240). Recently, the SEC issued rule amendments aimed at the integrity of NRSRO ratings methods and procedures. Amendments to Rules for Nationally Recognized Statistical Rating Organizations, Exchange Act Release No. 59,342, 74 Fed. Reg. 6456 (Feb. 9, 2009). On the same day, the SEC supplemented this release by proposing rules to address conflicts of interest pertaining to subscriber-paid ratings, and requirements for disclosures concerning the history of credit ratings. Re-proposed Rules for Nationally Recognized Statistical Rating Organizations, Exchange Act Release No. 59,343, 74 Fed. Reg. 6485 (Feb. 9, 2009).

261. Joanne Chung & Michael Mackenzie, *SEC Sees Conflicts of Interest at Rating Agencies*, FIN. TIMES, July 8, 2008, at 1. Following investigations, the SEC made public its report on credit rating agencies in July 2008. SEC. EXCH. COMM'N, SUMMARY REPORT OF ISSUES IDENTIFIED IN THE COMMISSION STAFF'S EXAMINATIONS OF SELECT CREDIT RATING AGENCIES 1 (2008), *available at* http://www.sec.gov/news/studies/2008/craexamination070808.pdf.

then throw this problem back to IOSCO or some other international body to harmonize new regulations.

III. SOFT LAW CONSEQUENCES

Soft law has advantages and may be necessary for securities regulation, but it also raises some concerns. First, there is the problem of soft law's legitimacy, which is important because of both normative and instrumental concerns. Second, in the United States, the creation of international soft law and its subsequent hardening arguably occurs outside of the constitutional framework for international agreements. We are not overly troubled by what we consider largely academic arguments concerning soft law's constitutionality, given that most soft law instruments are not treaties as contemplated by the Constitution, and given the power that exists and is exercised in the administrative state by agencies. But we are concerned with the fundamental issues of accountability, checks against abuses, and transparency that these arguments raise. Still, one cannot lose sight of the valuable alternative to regulatory competition that soft law offers, namely cooperation. Multiple regulatory venues foster regulatory competition and the race to the bottom. Commentators disagree over whether such a pattern is detrimental,[262] but for those who think it is, soft law serves as a valuable framework in the absence of an economic hegemon that might persuade or pressure others to avoid the race to the bottom.

A. The Legitimacy Problem

States, and the people in them, should reasonably be able to expect that the laws they live under were legitimately established. At first blush, the legitimacy of soft law seems a nonissue. After all, since soft law is non-

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262. *Compare* Roberta Romano, *The Need for Competition in International Securities Regulation*, 2 THEORETICAL INQ. L. 387, 393–96 (2001) [hereinafter Romano, *Need for Competition*] (arguing that regulatory competition is a race to the top because it maximizes benefits and corrects policy errors), *and* Ralph K. Winter, *On "Protecting the Ordinary Investor*,*"* 63 WASH. L. REV. 881, 901–02 (1988) (favoring competition because it maximizes market efficiency), *with* William L. Cary, *Federalism and Corporate Law: Reflections upon Delaware*, 83 YALE L.J 663, 663–68 (1974) (discussing "the deterioration of corporation standards" and noting that the "race" for corporate charters is "not one of diligence but of laxity"), *and* Daniel J.H. Greenwood, *Democracy and Delaware: The Mysterious Race to the Bottom/Top*, 23 YALE L. & POL'Y REV. 381, 385 (2005) (noting that deregulation in favor of competition is problematic because it empowers management while harming shareholders, thus creating a race to the bottom).

binding,[263] a State could simply not adopt or follow it. Since nothing compels a State to follow soft law, one may not care whether the norms embodied in that soft law are legitimate. But States *do* follow soft law.[264] States sometimes follow soft law until the point where it hardens.[265] Thus, if we care about the idea that laws should possess some basis for compelling behavior, even if the compulsion to follow that norm evolves slowly over time, then soft law's legitimacy matters.

In addition to normative considerations, legitimacy matters because it affects compliance.[266] International rules generally secure compliance in one (or a combination) of three ways: coercion, self-interest, or legitimacy.[267] Although coercion may initially seem like the most powerful tool, it is not—especially in the international setting.[268] Going to war to enforce a rule is an extraordinary step.[269] More likely, States will follow rules not because of coercion, but because they will benefit by doing so and/or they believe that they should follow the rule because the rule is legitimate.[270] Thus, a rule's legitimacy causes a compliance pull;[271] States are drawn to comply in part because they perceive the rule as legitimate.

Legitimacy is also important because it mitigates some of the uncertainties created by soft law. While it can be a valuable tool for policymakers, some soft law can leave us without real rules that actually im-

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263. Dinah Shelton, *Law, Non-Law and the Problem of 'Soft Law,' in* COMMITMENT AND COMPLIANCE: THE ROLE OF NON-BINDING NORMS IN THE INTERNATIONAL LEGAL SYSTEM 1, 1 (Dinah Shelton ed., 2000).

264. *See, e.g.*, JOSÉ E. ALVAREZ, INTERNATIONAL ORGANIZATIONS AS LAW-MAKERS 237 (2006) (discussing the World Bank Guidelines).

265. Christine Chinkin, *Normative Development in the International Legal System*, *in* COMMITMENT AND COMPLIANCE, *supra* note 263, at 21, 32 (discussing that repetition and compliance may indicate the hardening of soft law into customary international law, but also noting that the level of compliance required for the transformation is uncertain).

266. Ian Hurd, *Legitimacy and Authority in International Politics*, 53 INT'L ORG. 379, 387 (1999).

267. HURD, AFTER ANARCHY, *supra* note 66, at 35.

268. HART, *supra* note 65, at 82 (discussing that coercion is a logical starting point when examining compliance with the law, but that it does not fully explore the concept of obligation). *See also id.* at 217–18 (discussing that coercion undermines the importance of obligation in the international sphere).

269. *Id.* at 219.

270. *See* HURD, AFTER ANARCHY, *supra* note 66, at 37–38 (noting that self-interest and legitimacy as means of compliance are preferable to coercion because the latter necessarily "leaves the coerced worse off than before").

271. THOMAS M. FRANCK, THE POWER OF LEGITIMACY AMONG NATIONS 24–26 (1990).

plement the policies that are needed.[272] As José Alvarez points out: "[w]hen everything—from 'guidelines' to commitments made in loan agreements—can be regarded as legally significant, even if not equally legally binding, there is understandable fear that law and lawyers will lose their value to the policymaker, that if everything is 'law,' nothing, in the end, will be."[273] Identifying soft law's legitimacy is thus important, as it not only enhances compliance, but also distinguishes it as law in the first place.

Legitimacy can be assessed by means that can be roughly placed in two categories, input and output legitimacy. Input legitimacy focuses on what goes into the development of norms, while output legitimacy focuses on the usefulness of the end product.[274] One form of input legitimacy is where States consent to be bound to a treaty, for example. Many would agree that the rules contained in the treaty are legitimate.[275] Where democratic States consent to treaties pursuant to nationally accepted procedures, such treaties would appear to be supported by the consent of the State as well as its voting citizenry.[276] Input legitimacy may also be claimed where an international organization allows for the participation of those affected by its rules, i.e., representative legitimacy.[277] Another

272. C. M. Chinkin, *The Challenge of Soft Law: Development and Change in International Law*, 38 INT'L & COMP. L.Q. 850, 856–57 (1989) [hereinafter Chinkin, *Challenge of Soft Law*] (noting the purposeful use of soft law to shift state practices and thus alter the status of legal principles). *See id.* at 859 (stating that before soft law can transform into hard law, "it must be possible to both determine breach and the legal outcome of any claim of breach").

273. ALVAREZ, *supra* note 264, at 627.

274. Keohane & Nye, *supra* note 190, at 12–16.

275. *See* ALVAREZ, *supra* note 264, at 391 (discussing that treaty negotiations derive legitimacy from their processes because of the expectation that the resultant treaty's rules will be applicable to all States involved and noting that even nonparties may be persuaded to follow the codified norms).

276. Daniel C. Esty, *Good Governance at the Supranational Scale: Globalizing Administrative Law*, 115 YALE L.J. 1490, 1515–16 (2006) (discussing democratic legitimacy). *See also* Keohane & Nye, *supra* note 190, at 12–13 (noting that publics can easily judge whether to accept a product of international negotiations if their respective governments have operated in a transparent manner consistent with the states' political systems). States also consent to work within international organizations. However, when these organizations create rules, the process of consent is further removed from the people affected by these rules and a democratic deficit is sometimes claimed. *Id.* at 21. The rules that emanate from these organizations are seen as lacking input legitimacy. *See* Esty, *supra* note 276, at 1502–03 (stating that international organizations suffer from "serious legitimacy issues" because the decision-making process is so far removed from the public).

277. *See* Keohane & Nye, *supra* note 190, at 14.

form of input legitimacy stems from process.[278] Rules may be considered legitimate because they are the product of good procedures (and are therefore more likely to be both effective and more representative).[279]

Alternatively, legitimacy may be claimed by virtue of the fact that the rules are effective—they do what they are supposed to do.[280] Assessing the effectiveness of rules is a form of output legitimacy.[281] People perceive the rules as legitimate because they are good rules; they work. Naturally, this assessment requires an assumption about what is a good rule or what works.[282] Ultimately, as Ian Hurd explains, legitimacy is a matter of perception.[283] Something is legitimate because one party believes that it is legitimate. It is a subjective understanding that is based upon a claim.[284] That claim—the claim to legitimacy—can be assessed objectively using representation, process, or effectiveness.[285]

Assessing the legitimacy of soft law poses some unique challenges. First, since it is typically not treaty law, the claim to legitimacy based upon consent is not available. Moreover, claims of representativeness may be difficult to sustain as well. While organizations representing States may generate soft law, these organizations may suffer from the democratic deficit charge.[286] For example, state agencies comprise IOSCO, but as others have argued, the United States dominates the Technical Committee, which sets the fundamental standards.[287] Input

278. Esty, *supra* note 276, at 1521.

279. *Id.* at 1519–20 (discussing systemic legitimacy).

280. Robert O. Keohane, *Decisiveness and Accountability as Part of a Principled Response to Nonstate Threats*, 20 ETHICS & INT'L AFF. 219, 219 (2006). *See also* Esty, *supra* note 276, at 1517 (noting that results-based legitimacy primarily concerns good outcomes).

281. Keohane & Nye, *supra* note 190, at 15–16 (discussing output legitimacy in terms of effectiveness).

282. Kelly, *supra* note 35, at 619.

283. HURD, AFTER ANARCHY, *supra* note 66, at 7. *See also* Ian Hurd, *Legitimacy, Power and the Symbolic Life of the UN Security Council*, 8 GLOBAL GOVERNANCE 35, 38 (2002).

284. HURD, AFTER ANARCHY, *supra* note 66, at 7.

285. Kelly, *supra* note 35, at 608 (identifying input and output criteria for assessing legitimacy).

286. *See supra* note 276 and accompanying text. *See also* ALVAREZ, *supra* note 264, at 630–31 (stating that rules and standards promulgated by international organizations "lack the legitimation of national law produced through democratic processes").

287. The Technical Committee is currently comprised of fifteen member organizations, two of which—the SEC and the CFTC—are U.S. organizations. IOSCO Committee Lists, http://www.iosco.org/lists/display_committees.cfm?cmtid=3 (last visited Feb. 5, 2009). *Cf.* Beth A. Simmons, *The International Politics of Harmonization: The Case of Capital Market Regulation*, 55 INT'L ORG. 589, 594–95 (2001) (discussing the dominance of the United States and the United Kingdom in international equity markets and high-

legitimacy in the form of process can likewise be problematic because soft law often gels behind closed doors or in a club organization.[288] Some organizations have responded to this concern. IOSCO has procedures to promote transparency and public participation.[289] Nevertheless, the Executive and Technical Committee Meetings are still closed to the public.[290]

The claim to effectiveness as a basis of output legitimacy seems most appealing, but it is difficult to assess. First, one must assume that the "good" outcome is in fact a good outcome.[291] A second concern is that effectiveness for one set of participants may not be the same for another.

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lighting that regulatory standards promulgated to ensure "best practices" generally stem from the practices of one or both of these countries). *See also* Bradley, *supra* note 99, at 137 (noting that IOSCO tends "to be dominated by members from northern, economically developed States").

288. Janet Koven Levit, *A Bottom-Up Approach to International Lawmaking: The Tale of Three Trade Finance Instruments*, 30 YALE J. INT'L L. 125, 131 (2005) (describing club organizations as secretive and stating that their industry-specific rules nonetheless tend to mature into law); Zaring, *supra* note 79, at 562 & n.64 (noting that IOSCO has been characterized as a club organization).

289. Zaring, *supra* note 79, at 563–65 (describing IOSCO's efforts to comply with requests for information, to provide information to the public through its website, to allow SROs to contribute to the rulemaking process, and to maintain comment periods). For example, the Technical Committee's report of its work program was made public in 2007 for the purpose of soliciting comments and suggestions from stakeholders. IOSCO, *An Overview of the Work of the IOSCO Technical Committee*, at 2–4 (July 2008), *available at* http://www.iosco.org/library/pubdocs/pdf/IOSCOPD278.pdf. In response, IOSCO received comments from seventeen different organizations. IOSCO, *Comments Received in Relation to the Consultation Report on "An Overview of the Work of the IOSCO Technical Committee,"* at 2 (June 2007), *available at* http://www.iosco.org/library/pubdocs/pdf/IOSCOPD251.pdf.

290. *See* Conference Programme—IOSCO 2008, http://www.iosco2008.org/spip.php?rubrique26 (last visited Feb. 5, 2009) (detailing the schedule for IOSCO's 2008 Conference and dividing sessions according to those open only to IOSCO members and those open to the general public). Likewise, IASB is an expert-driven standard-setting organization. About the IASB, *supra* note 85. Amid criticisms that its standards were not fully legitimate because of its dependence on private funding, the organization "focused on increasing the transparency of its standards-making processes." Bradley, *supra* note 99, at 177–78. Following public consultations in 2004 and 2005, IASB issued a "Due Process Handbook," which describes in detail its procedures for standard setting, transparency, and accountability. IASB, DUE PROCESS HANDBOOK, *supra* note 95, ¶¶ 4–17. Nonetheless, the organization remains "an independent group of experts." *Id.* ¶ 5.

291. Daniel Bodansky, *The Legitimacy of International Governance: A Coming Challenge for International Environmental Law?*, 93 AM. J. INT'L L. 596, 620 (1999) (discussing outcome-based legitimacy in terms of expertise and noting that by preferring that experts formulate rules and standards in a given area, the public relies on the assumption that "expert" value and policy judgments will in fact produce the "best" results).

Whether the OECD Anti-Bribery Convention ultimately works well might be a different question for Canada than for Nigeria. A large, wealthy country may find some rules effective, while a weaker country might not. Third, effectiveness can be disputed, and it sometimes takes a great deal of time to determine whether a standard is effective.[292] Some gaps only appear over time. The NRSROs were effective for years before the recent crisis.[293]

Soft law securities regulation thus raises some legitimacy problems. The basis of its legitimacy seems most solidly rooted in its claim to effectiveness, a claim that is sometimes hard to substantiate. Still, it seems worthwhile to consider ways in which the legitimacy of soft law securities regulation can be improved from an input perspective. Good procedures are helpful to promote debate and develop better rules.[294] However, procedures can impede progress and increase costs.[295] Similarly, input legitimacy claims would benefit from greater transparency and participation by those affected by the resulting rules, even if national regulators will exercise a fair degree of discretion implementing those rules. But again, participation slows things down and one would need to consider the possibility of capture and distortion in the rulemaking process.[296]

B. Constitutional Queries

International soft law securities regulation poses some constitutional queries, which are in large part academic, but nonetheless prompt questions concerning procedure, accountability, and transparency. First, in the United States, international agreements are constitutionally enacted as Article II treaties, congressional-executive agreements, or executive

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292. Kelly, *supra* note 35, at 621–22 (discussing the shortcomings of effectiveness as a determinant of legitimacy).

293. *See* Unterman, *supra* note 69, at 122–25 (stating that the recent "monumental failings are indicative of the poor health of the ratings industry" and that conflicts of interest within the industry further emerge as the rating agencies extend their services without regulation).

294. Michael S. Barr & Geoffrey P. Miller, *Global Administrative Law: The View from Basel*, 17 EUR. J. INT'L L. 15, 26–29 (2006) (discussing how mechanisms for participation encourage debate and allow for greater accountability).

295. Richard B. Stewart, *U.S. Administrative Law: A Model for Global Administrative Law?*, 68 LAW & CONTEMP. PROBS. 63, 81 (2005) (noting that when taken to extremes, procedure can thwart confidentiality and hinder both the formation and implementation of agreements).

296. *Id.* at 87 (noting the limitations on extensive participation in the international regulatory realm).

agreements.[297] Each of these methods has a constitutional foundation that reflects the role of the executive and legislative branches.[298] The regulation of securities through the development of international soft law arguably operates outside of this framework. Second, we are somewhat concerned about what seems to be the delegation of standard-setting power to international bodies where those standards are then codified into U.S. law. We do not suggest that these arguments be given much merit, as we think it is largely a theoretical exercise, and we believe that international soft law securities regulations, on balance, are a good thing.[299] Moreover, we feel that these delegations may be necessary in order to achieve regulatory cooperation and that they are not inconsistent with the level of delegations currently permitted under U.S. constitutional analysis. Nevertheless, reflecting upon these theoretical constitutional concerns prompts us to consider the principles underlying our constitutional structures, i.e., procedures for checks and balances, transparency, and accountability,[300] and how those principles should be applied to international soft law development.

In the United States, treaties are "agreement[s] between two or more states or international organizations that [are] intended to be legally binding and [are] governed by international law"[301] and may be negotiated in

297. RESTATEMENT (THIRD) OF FOREIGN RELATIONS LAW OF THE UNITED STATES § 303 & cmt. a (1987). Comment a also includes executive agreements for which the president derives authority from a treaty.

298. The text of the Constitution grants the president the authority to enter into treaties on behalf of the United States. U.S. CONST. art. II, § 2, cl. 2. Although Article II confers authority on the Senate to approve treaties, Article I grants both Houses the ability to regulate foreign commerce; thus, Congress is within its powers in authorizing the president to negotiate and conclude congressional-executive agreements. *E.g.*, Made in the U.S.A. Found. v. United States, 242 F.3d 1300, 1313 (11th Cir. 2001) (referencing this power with specific regards to the North American Free Trade Agreement). Similarly, the Constitution does not grant specific authority to the president to enter into executive agreements. The power to do so, however, is traditionally found in "the presidential responsibility of representing the country in foreign affairs, the authority to receive ambassadors, the role of the commander-in-chief of the military, and the obligation to 'take care that the laws be faithfully executed.'" Robert J. Spitzer, *The President, Congress, and the Fulcrum of Foreign Policy*, *in* THE CONSTITUTION AND THE CONDUCT OF AMERICAN FOREIGN POLICY 95 (David Gray Adler & Larry N. George eds., 1996).

299. *See supra* Part II.B.

300. *See* THE FEDERALIST NO. 9, at 72–73 (Alexander Hamilton) (Clinton Rossiter ed., 1961) (stating that checks and balances and electoral representation are powerful principles by which republican government is enhanced); THE FEDERALIST NO. 10 (James Madison), *id.* at 81–83 (noting that finding the optimal ratio of elected representatives to constituents is essential to ensuring that public interest is accurately represented).

301. RESTATEMENT (THIRD) OF FOREIGN RELATIONS LAW OF THE UNITED STATES § 301(1) (1987).

a variety of constitutionally acceptable ways. First, Article II of the U.S. Constitution provides that the President shall have the power to negotiate treaties with the "advice and consent" of the Senate.[302] While this treaty power may be well-known, it is certainly not the most frequently exercised.[303] Rather, most international agreements are not really treaties as contemplated by Article II of the U.S. Constitution; they are executive agreements or congressional-executive agreements.[304] These are international agreements where the President acts pursuant to either his inherent or statutory powers.[305] International soft law, however, evolves, and sometimes hardens, outside of these frameworks.

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302. U.S. CONST. art. II, § 2, cl. 2 ("[The President] shall have Power, by and with the Advice and Consent of the Senate, to make Treaties, provided two thirds of the Senators present concur.").

303. *See* Stefan A. Riesenfeld & Frederick M. Abbott, *The Scope of U.S. Senate Control over the Conclusion and Operation of Treaties*, 67 CHI.-KENT L. REV. 571, 636–37 (1991) (discussing the rise to prominence of executive and congressional-executive agreements over treaties).

304. Laurence H. Tribe, *Taking Text and Structure Seriously: Reflections on Free-Form Method in Constitutional Interpretation*, 108 HARV. L. REV. 1221, 1231 (1995). *See also* Peter J. Spiro, *Treaties, Executive Agreements, and Constitutional Method*, 79 TEX. L. REV. 961, 1002 (2001) (referencing the predominant use of congressional-executive agreements for international trade purposes).

305. Jeff Nemerofsky, *Litvinov Lives?: U.S. Investors May Be Playing Russian Roulette*, 8 MICH. ST. U.-DCL J. INT'L L. 487, 492–93 (1999). The president may enter into executive agreements pursuant to his or her independent constitutional powers. RESTATEMENT (THIRD) OF FOREIGN RELATIONS LAW OF THE UNITED STATES § 303(4) & cmt. a. Because they do not require independent approval, executive agreements are quicker and easier to conclude. Congressional-executive agreements, however, are treaty-like in both substance and magnitude and are thus preferred, if not required, over executive agreements in cases concerning "material long-term agreements." MICHAEL D. RAMSEY, THE CONSTITUTION'S TEXT IN FOREIGN AFFAIRS 197–98 (2007). In congressional-executive agreements, the president has been pre-approved by Congress to commit the United States to subsequently enact legislation. John H. Jackson, *The Great 1994 Sovereignty Debate: United States Acceptance and Implementation of the Uruguay Round Results*, 36 COLUM. J. TRANSNAT'L L. 157, 168 (1997) [hereinafter Jackson, *Sovereignty Debate*]. Thus, for example, both the General Agreement on Tariffs and Trade and the Agreement Establishing the World Trade Organization are congressional-executive agreements. Spiro, *supra* note 304, at 962, 983 (noting the establishment of WTO specifically, and the Uruguay Round generally). The process involved in these agreements is sometimes referred to as a "fast track" or "statutory" approval for what would otherwise be considered a treaty. Jackson, *Sovereignty Debate*, *supra* note 305, at 168 & n.21. Understandably, it would have been impossible for the United States to negotiate complicated tariff and trade liberalization commitments with over 100 nations unless those nations were assured that the agreement would not falter in the typical treaty ratification process under Article II. *See* John K. Setear, *The President's Rational Choice of a Treaty's Preratification Pathway: Article II, Congressional-Executive Agreement, or Executive Agreement?*, 31 J. LEGAL STUD. S5, S27 (2002) (discussing that for trade agreements

Initially, even though soft law develops outside of the treaty system, it does not seem troubling because it is not binding. The Case-Zabloki Act requires the Secretary of State to compile and publish "United States Treaties and Other International Agreements" for each year.[306] The regulations under the Act set forth the criteria for identifying treaties and international agreements, namely that they (1) identify the parties as States, agencies, or IGOs, and their intent to be bound by international law;[307] (2) be of political or financial significance, or pertain to technical cooperation or assistance;[308] (3) be specific and contain "objective criteria for determining enforceability";[309] and (4) must at least be bilateral.[310] Soft law is not "treaty law" because it does not purport to bind either by intent or by its terms, nor does it contain explicit provisions for enforceability.[311]

Soft law sometimes hardens into binding treaty law. That hardening may occur, as in the OECD Anti-Bribery Convention, after soft law moves normative positions far enough that States are willing to make a hard law commitment in a form of agreement already recognized as constitutionally acceptable. But other times, soft law hardens through regulatory codification. One recent example of regulatory codification involves CRAs. Since the collapse of Enron there has been increased focus on the appropriate regulations of CRAs.[312] While national regulators have stu-

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the president usually chooses the congressional-executive route to "signal [that] reliable and rapid implementation is paramount"). *See also id.* at S6 (discussing various Article II treaties previously submitted to the Senate for approval, but which have "languish[ed] without definitive floor action"). Concerns that executive agreements and congressional-executive agreements are outside constitutional bounds have been laid to rest by the Supreme Court. Generally speaking, the judiciary has upheld such agreements and has left the distinction of whether an agreement is a treaty within the meaning of Article II up to the legislative and executive branches as a political matter. *See, e.g.*, Am. Ins. Ass'n v. Garamendi, 539 U.S. 396, 414–15 (2003).

306. 1 U.S.C. § 112a(a) (2006).

307. 22 C.F.R. § 181.2(a)(1) (2008). It is noteworthy that unless otherwise specified, such agreements are presumed to be governed by international law. However, if either U.S. or foreign law is specified as solely governing, the agreement is not considered "international."

308. *Id.* § 181.2(a)(2). "Minor or trivial undertakings, even if couched in legal language and form, are not considered international agreements." *Id.*

309. *Id.* § 181.2(a)(3). Yet again, however, vagueness of terms will not of itself preclude an agreement from being a legally binding international agreement. The most important determination will be that of the parties' intent.

310. *Id.* § 181.2(a)(4).

311. *See supra* note 263 (defining soft law as nonbinding); and *supra* note 52 (noting that soft law can be contained in treaty law).

312. Hill, *supra* note 225, at 43–44 (stating that "the impetus for regulatory change [was] the Enron debacle"). *See also* Unterman, *supra* note 69, at 108–09 (noting the need

died the problem, so have international bodies such as IOSCO and the Financial Stability Forum. IOSCO's Consultation Report of 2008 and new Code of Professional Conduct represent soft law.[313] However, the SEC's current regulatory initiatives for CRAs that incorporate some IOSCO and Financial Stability Forum input are solidifying international soft law into hard law. Another example concerns IFRS. The SEC currently has out for comment proposed rules and a roadmap that would require U.S. companies to state their financials in accordance with IFRS, again transforming international soft law into domestic hard law. Also, the SEC amended its foreign issuer disclosure forms to replace the nonfinancial disclosure forms with ones substantively endorsed by IOSCO.[314]

Where soft law hardens via regulatory action, the practical effect seems indistinguishable from hard law codified after the conclusion of a treaty. In the United States, agency regulations, if enacted pursuant to delegated authority and not arbitrary and capricious, are the law,[315] just as a statute implementing a treaty is the law. In the case where the SEC uses substantive norms developed by IOSCO, assuming that the SEC acted within its regulatory mandate (and pursuant to proper procedure), the only remaining question would be whether the substantive standard was arbitrary and capricious.[316] One could envision a situation where the SEC's case for nonarbitrariness was bolstered by the fact that the standard had been developed by an international organization.[317] The result is hard law.

Admittedly, one can argue that soft law is of no constitutional concern until a constitutionally acceptable codification occurs. Thus, for example, despite the soft law evolution of the OECD Anti-Bribery Convention, the

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for additional resources to oversee the international market in light of the SEC's inability to both discover and prevent abuses in the U.S. domestic market, including the WorldCom and Enron collapses).

313. *See supra* note 255 and accompanying text.

314. International Disclosure Standards, Securities Act Release No. 7745, 64 Fed. Reg. 53,900, 53,903 (Oct. 5, 1999) (stating that the SEC amended Form 20-F to include "ten new items that track the wording of the IOSCO disclosure standards").

315. Chevron, U.S.A., Inc. v. Natural Res. Def. Council, Inc., 467 U.S. 837, 843–44 (1984) (stating that where Congress had delegated authority to an agency to fill gaps in legislation, that agency's "regulations are given controlling weight unless they are arbitrary, capricious, or manifestly contrary to the statute") (citations omitted).

316. Motor Vehicle Mfrs. Ass'n. v. State Farm Mut. Auto. Ins. Co., 463 U.S. 29, 42–45 (1983) (accepting petitioner's construction of the arbitrary and capricious standard and agreeing that if an agency is within its mandate, the Court may not set the agency's rules and standards aside unless they are not rationally linked to relevant data).

317. Bradley, *supra* note 99, at 138 (noting that international standards may receive the benefit of the doubt when domestic regulators consider implementing them).

final binding instrument was an Article II treaty that was signed by the President and ratified by the Senate.[318] Up to that point, the negotiations at the OECD did not have any constitutional significance. Even codification through the regulatory process seems unobjectionable as long as the agency has the authority to enact the regulations and the choice of the internationally set standard is not arbitrary and capricious.

But sometimes soft law operates like hard law prior to any codification. For example, as discussed above, MOUs are not legally binding instruments.[319] They are negotiated between the SEC and foreign regulators.[320] Despite their nonbinding status, however, these agreements are followed.[321] As previously noted, in 2007, the SEC made 556 requests to foreign regulators for assistance and information under MOUs and responded to 454 requests.[322] Likewise, in 2005, IOSCO required that all of its members sign or commit to signing its MMOU by 2010.[323] This "nonbinding" agreement is now virtually mandatory.

Theoretically, if MOUs were considered treaties, they would fail to satisfy our constitutional framework. They are negotiated and agreed to by an independent agency, the SEC.[324] They cannot be characterized as executive agreements, as it would be very difficult to argue that the matters they concern fall under inherent presidential powers;[325] nor are they congressional-executive agreements.[326] Assuming *arguendo* that one could view the SEC as negotiating on behalf of the executive, there is no *ex ante* congressional authorization to do so. Subsequent congressional au-

318. Convention on Combating Bribery of Foreign Public Officials in International Business Transactions, Dec. 17, 1997, S. Treaty Doc. No. 105-43 (1998), *reprinted in* Hein's No. KAV 5210.

319. JOHNSTON, *supra* note 154, at 37 (discussing that MOUs are accorded "less-than-treaty status" because of their informality and nonbinding form).

320. STEINBERG, *supra* note 155, at 205.

321. *See supra* notes 157–58, 164 and accompanying text (discussing SEC requests to foreign regulators under MOUs).

322. SEC Speaks in 2008, *supra* note 163, at 1201–02.

323. *See* Jane Diplock, AO, Chairman, Executive Comm. of IOSCO & Sec. Comm'n, N.Z., Speech—ASIC Summer School: Is Regulation Keeping up with or Fettering Cross-Border Developments (Feb. 17, 2006), *available at* http://www.seccom.govt.nz/speeches/2006/jds170206.shtml.

324. *See* text accompanying *supra* notes 154–56, 158 (discussing the first MOU signed by the SEC and Switzerland in 1982, and the Office of International Affairs).

325. *See supra* note 302 (discussing the derivation of authority by the executive to enter into international agreements).

326. *See supra* note 298, 304–05 and accompanying text (citing the ability of Congress to delegate its powers to the executive for the purposes of concluding international agreements).

thorization that speaks to only one class of MOUs[327] does not validate the process in all instances.

Nevertheless, we believe that these instruments are not binding and a treaty powers analysis does not foreclose international soft law securities regulation. It may be formalistic to say that these agreements are not binding until they are binding, but given the myriad of ways in which soft law forms and hardens over time, a line must be drawn at some point. That point, in our view, should be where States formally commit to bind themselves, even if in practice States may routinely comply with obligations prior to such time.

A more challenging constitutional concern, in our view, is the nondelegation question. The nondelegation doctrine prevents the abdication of lawmaking power by Congress.[328] Congress must give an agency an intelligible principle in order to fulfill its legislative mandate.[329] The SEC's negotiation of MOUs seems dangerously close to agency lawmaking without an intelligible principle and without sufficient safeguards.[330]

327. In 1989, Congress amended the Exchange Act by adding § 21(a)(2), which gave the SEC the authority to cooperate with requests for information from foreign regulators and allowed the SEC discretion in deciding whether to supply the information. The SEC is to consider two factors when deciding to provide assistance: reciprocity and the U.S. public interest. Specifically, the first consideration is "whether . . . the requesting authority has agreed to provide reciprocal assistance." Insider Trading and Securities Fraud Enforcement Act of 1988, Pub. L. No. 100-704, sec. 6(b), § 21(a), 102 Stat. 4677, 4681–82 (codified as amended at 15 U.S.C.A. § 78u(a)(2) (2008)). Then in 1990, Congress amended the Exchange Act again to include a section stating that the SEC "shall not be compelled to disclose records obtained from a foreign securities authority if . . . the Commission obtains such records pursuant to . . . a memorandum of understanding." International Securities Enforcement Cooperation Act of 1990, Pub. L. No. 101-550, sec. 201–02, § 24(d), 104 Stat. 2713, 2714–15 (codified as amended at 15 U.S.C.A. § 78x(d) (2008)). These amendments, however, merely recognized the SEC's information-sharing MOUs—they did not grant the agency further authority to conclude future MOUs.

328. Cass Sunstein, *Nondelegation Canons*, 67 U. CHI. L. REV. 315, 315 (2000) (stating that traditionally the purpose of the nondelegation doctrine was "to ensure that law is made by the national legislature rather than by the executive").

329. Whitman v. Am. Trucking Ass'ns, Inc., 531 U.S. 457, 472 (2001) (stating that since the Constitution vests lawmaking powers in Congress, the delegation of congressional authority must be specific and provide an "intelligible principle" (quoting J. W. Hampton, Jr., & Co. v. United States, 276 U.S. 394, 409 (1928)). *See also* Sunstein, *supra* note 328, at 318 (identifying the "intelligible principle" requirement).

330. While the SEC's mandate is "to enforce . . . securities laws, to promote stability in the markets and, most importantly, to protect investors," Congress did not specifically authorize the SEC to enter into information-sharing MOUs with foreign regulators. The Investor's Advocate: How the SEC Protects Investors, Maintains Market Integrity, and Facilitates Capital Formation, http://www.sec.gov/about/whatwedo.shtml (last visited Feb. 14, 2009) (noting the purpose behind the SEC's formation). *See also supra* note 161–62 and accompanying text (discussing congressional amendments to the Exchange

While the nondelegation doctrine gives us pause, ultimately we feel that the practical benefits of international soft law instruments weigh in favor of a generous view of delegation, consistent with that of the Supreme Court with respect to domestic lawmaking.[331]

The constitutional status of MOUs and other international soft law instruments that may harden at some later date is (and in our opinion should remain) a theoretical question. These soft law instruments are expedient, flexible, and very useful. The time and burdens of negotiating either an Article II treaty or a congressional-executive agreement would impede effective and timely standard setting.[332] The delegation question, although somewhat troubling, occurs in the domestic setting as well. But the constitutional inquiry should cause us to at least consider the values that support our constitutional system: procedures for checks and balances, accountability, and transparency. While soft law may escape constitutional objections, it should be supported by the foundational values akin to those underlying our constitutional system, i.e., division of powers, accountability, and transparency.[333]

The division of powers provides checks and balances against the abuse of power.[334] The process by which the United States enters into binding

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Act that recognize, but do not specifically authorize, the SEC's MOUs). Nonetheless, the SEC claims the authority to enter into such agreements based on its duty to enforce securities laws because MOUs are mechanisms that facilitate "enforcement-related information sharing." Office of International Affairs: International Enforcement Cooperation, http://www.sec.gov/about/offices/oia/oia_crossborder.htm#mechanisms (last visited Feb. 14, 2009).

331. *Whitman*, 531 U.S. at 472.

332. *See supra* notes 301, 305, 307–10 and accompanying text (discussing the processes of concluding Article II treaties and congressional-executive agreements).

333. *See* THE FEDERALIST NO. 9 (Alexander Hamilton), *supra* note 300, at 72–73 (discussing that although they were "wholly new discoveries" at the time, republican principles of power distribution, checks and balances, and representation would help to perfect the Framers' choice of government); THE FEDERALIST NO. 10 (James Madison), *id.* at 81–83 (noting that the proper ratio of representatives to constituents results in greater accountability and transparency).

334. *See* THE FEDERALIST NO. 47 (James Madison), *id.* at 301 (responding to charges that the Constitution violated the "political maxim" that the three governmental branches must be entirely "separate and distinct"). Madison discussed the necessity of the separation of powers amongst governmental branches, but noted that the branches must be somewhat intermingled if they are to prevent the usurpation and abuse of power. *Id.* at 302–04 (citing the New Hampshire constitution in declaring that the branches should be entirely independent of each other only to the extent that it "is consistent with the chain of connection that binds the whole fabric of the constitution in one indissoluble bond of unity and amity"). *See also* THE FEDERALIST NO. 48 (James Madison), *id.* at 308 (discussing that this "blending" of the branches affords each a check on the other two, and thus

international agreements envisions a role for both the legislative and the executive branches (save for those issues solely within the executive's power).[335] Some soft law instruments, such as MOUs or IASB accounting standards, may endanger this balance. When soft law hardens into international obligations, it would seem fair to question whether the manner in which it evolved had sufficient protections against the abuse of power.

The lack of input from both the executive and legislative branches raises problems of accountability. Where internationally set standards fall short or fail, a question arises as to who can be held accountable.[336] Arguably, if the IASB standards or MOUs fail, then blame can lay with the SEC the same way it would if any standard or rule set by the SEC failed. However, the SEC may not be called to task for such failures; blame may be levied at the international system instead.[337] There may be a backlash against international cooperation, and that backlash may occur in multiple jurisdictions.[338] Additionally, the SEC could seek greater au-

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maintains the maxim of free government in a way that complete separation could never achieve).

335. U.S. CONST. art. II, § 2, cl. 2 (granting power to the president to make treaties with the Senate's advice and consent); RESTATEMENT (THIRD) OF FOREIGN RELATIONS LAW OF THE UNITED STATES § 303 (1987) (listing four ways by which the United States may enter into binding international agreements, the first three of which require Senate or congressional approval on some level, and the final being pursuant to the executive's sole authority).

336. *See* Chris Kentouris, *Harmonizing Accounting Standards No Easy Task—Uniformity Could Promote Cross-Border Investment, But When?*, SEC. INDUS. NEWS, June 30, 2008 (discussing support for an overseeing body to monitor the IASB and facilitate cooperation among regulators and standard setters); Floyd Norris, *S.E.C. Says Foreign Companies Do Not Have to Adjust to U.S. Accounting*, N.Y. TIMES, Nov. 16, 2007, at C8 (discussing concerns that there is no international equivalent of the SEC to ensure consistent enforcement of international standards and also noting that European officials are skeptical of the IASB because it is not currently politically accountable). *Cf.* David Reilly & Kara Scannell, *Global Accounting Efforts Gain a Step—SEC Drops Requirement on Foreign Companies, but Other Challenges Loom*, WALL ST. J., Nov. 16, 2007, at A4 (noting that the IASB could be "buffered from political interference").

337. *See, e.g.*, Joseph J. Norton, *A Perceived Trend in Modern International Financial Regulation: Increasing Reliance on a Public-Private Partnership*, 37 INT'L LAW. 43, 59 (2003) (stating that in a globalized financial regulatory scheme, the onus is ultimately on the private international institutions to oversee implementation and enforcement of rules and standards and that failures by these institutions can lead to industry crises). *Cf.* Rachel Brewster, *The Domestic Origins of International Agreements*, 44 VA. J. INT'L L. 501, 537–38 (2004) (discussing motivations for international agreements generally, but noting that by delegating rulemaking authority to an international body, the executive "can shift much of the blame for unpopular policies").

338. *See, e.g.*, Stephen Labaton, *Accounting Plan Would Allow Use of Foreign Rules*, N.Y. TIMES, July 5, 2008, at A1 (mistaking the SEC's proposal to allow U.S. companies

thority from Congress, claiming that the failure stemmed from the lack of authority to regulate as it would like.[339]

Perhaps the most difficult problem is the lack of transparency that is endemic to international standard setting. The development of international soft law and its hardening are particularly susceptible to nontransparency.[340] Experts that develop standards, rules, or guidelines that become soft law sometimes do so without the participation or even knowledge of the wider public.[341] The OECD is a club organization that has a limited number of members from the wealthiest nations.[342] Yet its anti-bribery work targeted activities that occurred throughout the developing world. IOSCO is a club of securities regulators.[343] But it is dominated by Amer-

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to shift to international accounting standards and to promote international enforcement cooperation as part of a deregulation agenda meant to soften the stricter securities laws in place following the Enron collapse, primarily because the international standards are "weaker" than those of the United States). *But see* Jeffrey H. Birnbaum, *Push for New Accounting Standards Gains Speed*, WASH. POST, July 8, 2008, at D01 (noting that by allowing U.S. companies to use international accounting standards, it would "ease global business dealings and help corporations raise capital around the world," but discussing that critics see the move as a means to weaken post-Enron rules).

339. In its 2003 report on CRAs, the SEC discussed a number of problems inherent to the industry and indicated that participants in the CRA hearings had suggested that the SEC "consider more substantive regulation of rating agencies . . . and engage in more active ongoing oversight of them." SARBANES-OXLEY REPORT, *supra* note 231, at 25. The report concluded by stating that the SEC would investigate whether ongoing oversight was necessary and if so, would subsequently ask Congress for the legislative authority to monitor the rating agencies. *Id.* at 45. Responding to the SEC report and calls for CRA oversight, Congress passed the Credit Rating Agency Reform Act in 2006, and the SEC promulgated implementing rules in 2007. *See supra* notes 247 and accompanying text. *See also* Roberta Karmel, *Realizing the Dream of William O. Douglas: The Securities and Exchange Commission Takes Charge of Corporate Governance*, 30 DEL. J. CORP. L. 79, 80–81 (2005) (discussing that the SEC exploited corporate failures to entice Congress to grant the agency regulatory power over corporate governance, which it finally did with the Sarbanes-Oxley Act of 2002).

340. Brewster, *supra* note 337, at 539 (noting that international rulemaking occurs with less transparency than the domestic process).

341. *E.g.*, Mattli & Buthe, *supra* note 86, at 254 (noting that because IASB is a private standard setter, it relies on technical expertise and suggestions from large accounting firms); *supra* notes 289–90 (discussing that even with IOSCO's increased availability of information, the organization still does not provide a mechanism whereby the public can actively participate in rulemaking). *See also* Brewster, *supra* note 337, at 539 (discussing the inaccessibility of international organizations to the general public and noting that the compromises achieved in these rulemaking fora are usually only possible because of "[t]he promise that all deals will be kept behind closed doors").

342. The OECD has been characterized as a "rich countries' club" because of its limited membership. SLAUGHTER, *supra* note 72, at 144; Avi-Yonah, *supra* note 190, at 32.

343. Zaring, *supra* note 79, at 562 & n.64.

ican regulators.[344] Even when soft law emerges from the international agreement process that surrounds MOUs, it can be the result of compromise that is hidden from the public view.[345] In fact, MOUs are often used because of the parties' concerns regarding confidentiality.[346] Sometimes, private actors who are unaccustomed to acting in the public view are involved. The FASB and the IASB standards are established by an industry, not a legislator or regulator. The rating agencies established criteria that were, in effect, adopted by the SEC by virtue of its recognition of NRSROs.[347] Private actors are not necessarily accustomed to acting in a transparent manner and may need to adopt specific procedures to become transparent.[348] Admittedly, private actors influence the national legislative process as well. Legislation evolves through the efforts of private parties, industry, or even regulators who lobby the legislative branch to adopt laws.[349]

International soft law is also less transparent because it usually takes the form of standards rather than rules. International standards usually

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344. *See supra* note 287 and accompanying text.

345. Chinkin, *Challenge of Soft Law*, *supra* note 272, at 861 (stating that "[t]he use of a soft law form is often a compromise"); Kal Raustiala, *Form and Substance in International Agreements*, 99 AM. J. INT'L L. 581, 597 (2005) (discussing soft law agreements as "pacts" and noting that they are more confidential than other international agreements and that use of them "lessens the likelihood that Congress—and domestic interest groups—will be aware of an agreement or able to capitalize politically on criticism of it").

346. JOHNSTON, *supra* note 154, at 37–38 (noting the desirability of MOUs where confidentiality is a concern). MOUs are ideal for this purpose because so few are published. ANTHONY AUST, MODERN TREATY LAW AND PRACTICE 43 (2007). Additionally, in the United States, all binding international agreements must be reported to Congress, regardless of their secretive subject matter. Case-Zablocki Act, 1 U.S.C.A. § 112b(a) (2008). But if MOUs are carefully constructed so as not to create binding rights and obligations, they do not have to be reported to Congress or the State Department. *See* 22 C.F.R. § 181.2(a) (1981) (stating that all criteria must be met for a document to be construed as an international agreement within the purview of the Case-Zablocki Act).

347. SARBANES-OXLEY REPORT, *supra* note 231, at 6–9 (describing the function and recognition process for NRSROs).

348. Mattli & Buthe, *supra* note 86, at 261 (discussing that while private bodies are advantageous to international regulation, they provide less transparency and accountability than public regulatory bodies). *See also id.* at 258 (noting that following the Enron collapse, institutions including the IASB were pressured to adopt more transparent procedures and provide greater public access to their rulemaking processes); IASB, DUE PROCESS HANDBOOK, *supra* note 95 (detailing IASB's new due process standards in response to criticisms concerning accountability and transparency).

349. International standard setting may involve foreign parties or regulators whose presence may raise additional sovereignty concerns. However, international regulatory cooperation will necessarily involve some diminution of sovereignty.

grant a fair amount of discretion to national regulators. Discretion is, by definition, nontransparent. In IOSCO, national regulators develop standards that grant those same national regulators a great deal of discretion in implementation.[350] The fact that discretion is endorsed by an international organization (made up of those same regulators) seems troubling.

A lack of transparency is particularly worrisome because transparency guards against two problems that are of particular concern internationally: capture and conflicts of interest.[351] Both capture and conflicts of interests are problems in the domestic arena, however, as regulatory cooperation proliferates, the incentives for capture, the danger of conflicts, and the harm that can come from either are magnified.[352] The incentives for capture and conflicts are not increased in the international sphere, but the dangers posed by them are magnified in this globalized world. The systemic and global effects of a regulatory failure are palpable. The recent credit rating crisis serves as an example.[353] Moreover, the collateral damage from securities law failures now reaches the public even if it did not before. Pensioners, municipalities, and entities that invest in the market, from universities to charitable funds, all rely upon a well-functioning securities system.[354] Thus, although the international soft law deficiencies may mirror those found domestically, their potential impact seems greater, and care should be taken to address them.

C. Regulatory Competition v. Regulatory Cooperation

Soft law may offer an alternative to regulatory competition by facilitating regulatory cooperation. The absence of a single international securities law regulator creates the potential for a classic regulatory race to the

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350. IOSCO, *Objectives and Principles of Securities Regulation*, *supra* note 73, at 3 (stating that IOSCO members are to "use their best endeavors within their jurisdiction to ensure adherence to [the] principles" and noting that however each regulator implements the principles, they should take "the entire domestic context" into account).

351. Stewart, *supra* note 295, at 83 (stating that transparency allows the public to see the facts underlying decision making, which opens the process to scrutiny and can "alleviate information asymmetries, and check the influence of narrow interest groups").

352. *See supra* notes 294–96.

353. Unterman, *supra* note 69, at 122–24 (discussing the failures and conflicts of interest of the rating agencies and noting that these failures resonate globally because of the tremendous power CRAs have in both domestic and international markets).

354. *See, e.g.*, Arthur Levitt, Jr., Opinion, *Standards Deviation*, WALL ST. J., Mar. 9, 2007, at A15, ¶ 1 (stating that "[t]he potential for crisis in municipal finance arguably is worse than that in corporate America"); Reilly & Scannell, *supra* note 336, at A4 (noting that large institutional investors such as Calpers are concerned about the possibility of international accounting standards because inconsistent application of such standards would affect the credibility of financial disclosures).

bottom. Race to the bottom theorists assume that regulatory competition and the lack of a single mandatory framework will encourage managers to incorporate in jurisdictions that have the least demanding regulatory structure.[355] Others propose that regulatory competition can be beneficial.[356] The authors believe that without the leadership of an economic hegemon to insist upon some fundamental minimum standards, it is likely that international securities regulation will remain weak and reactive.

The availability of multiple regulatory jurisdictions leads to harmful regulatory competition. Without binding standards, States are free to adopt whatever standards they feel are best. States wishing to make themselves more attractive business centers will opt for standards that are more favorable to those businesses.[357]

Others disagree. Race to the top theorists contend that regulatory competition will promote efficiency and that efficiency ultimately benefits investors.[358] A variety of regulatory frameworks provides managers with options to respond to investor preferences.[359] As preferences are revealed and management responds in order to produce efficiencies, jurisdictions will then realign their laws.[360] Thus, a level of harmonization will emerge, but not as a result of a paternalistic single regulator.[361] Race to

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355. *See* Lucian Arye Bebchuk & Allen Ferrell, *On Takeover Law and Regulatory Competition*, 57 BUS. LAW. 1047, 1047 (2002) (discussing state competition in takeover law in particular and noting that this competition tends to favor and even entrench management while harming shareholder interests).

356. *E.g.*, Robert A. Prentice, *Regulatory Competition in Securities Law: A Dream (That Should Be) Deferred*, 66 OHIO ST. L.J. 1155, 1156 (2005) (discussing the race to the top and efficiency); Romano, *Need for Competition*, *supra* note 262, at 393–96 (discussing that competition aids management in choosing the jurisdiction with optimal regulations and can compensate for policy differences).

357. Shelley Thompson, *The Globalization of Securities Markets: Effects on Investor Protection*, 41 INT'L LAW. 1121, 1123 (2007) ("Permitting companies to list on global exchanges, while simultaneously allowing them to choose the most favorable and least onerous national regulatory scheme, will result in global competition among regulators. And where the very purpose of regulation is to protect the public where competition does not, competition between regulators will likely lead to less protection for the public.").

358. Prentice, *supra* note 356, at 1156 (noting that race to the top proponents argue that state competition creates maximally efficient corporate law).

359. Romano, *Need for Competition*, *supra* note 262, at 393–96 (discussing that competition tends to reveal investors' preferences and allows for different jurisdictions to both find the "optimal mix" of management and shareholder benefits).

360. Roberta Romano, *Empowering Investors: A Market Approach to Securities Regulation*, 107 YALE L.J. 2359, 2385, 2394 [hereinafter Romano, *Empowering Investors*] (stating that if investors prefer the mandatory disclosure rules promulgated by the SEC, then those same rules would still emerge as a result of "competitive federalism").

361. *Id.* at 2378–79 (discussing the SEC's hesitance to allow projections because of its fear that investors would not know the difference between a forecast and hard financial

the top supporters have extended this analysis to the international regulation of securities.[362] They view efficiency as the ultimate goal and have faith in investors to push management to maximize efficiency.[363]

On balance, we would agree with the race to the bottom view, especially in the international realm. We believe the regulatory vacuum is more pronounced internationally because other differences among States and their populations make consensus unlikely. Nations approach securities regulation from different cultural perspectives, from different economic standpoints, and with different governmental structures and resources. In a national race to the bottom, where there may be several jurisdictions under a federal umbrella, some of these differences are less severe.

For example, the United States and the European countries have different views of the role of government versus the market as a regulator. As seen in the recent debate over credit rating agencies, the United States prefers preserving the role of market forces, while the European Union leans towards a greater government role or substantive regulation of the ratings process.[364] Standards may also differ because of governmental roles or structures. The Chinese government has a majority interest in most public companies.[365] Public accountants are unlikely to find serious

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data); *id.* at 2368–69 (stating that market conditions may once have necessitated mandatory antifraud rules, but that it is "silly" to assume that investors are incapable of distinguishing regulatory regimes that encourage fraud from those that protect against it).

362. Stephen J. Choi, *Promoting Issuer Choice in Securities Regulation*, 41 VA. J. INT'L L. 815, 820–24 (2001) (discussing "portable reciprocity"); Romano, *Need for Competition*, *supra* note 262, at 388. Romano also suggests that all restrictions on issuer choice must be removed for a "truly competitive international securities regulation regime" to be successful. ROBERTA ROMANO, THE ADVANTAGE OF COMPETITIVE FEDERALISM FOR SECURITIES REGULATION 148–49 (2002).

363. Winter, *supra* note 262, at 883. *See also id.* at 901–02 (stating that "[l]osses are an inevitable aspect of competitive markets" and further regulation will not rid the market of losses, it will only make the market less efficient); Romano, *Empowering Investors*, *supra* note 360, at 2366; Romano, *Need for Competition*, *supra* note 262, at 389–90 (both noting that institutional investors drive the U.S. market and that their sophistication will offset less sophisticated investors).

364. *See supra* notes 236–38 and accompanying text (discussing that government regulation of CRAs in the United States is controversial). *See also* Barber, *supra* note 256, at 3 (discussing the inadequacy of the European Union's self-regulatory framework and the legislative push for CESR to oversee CRA registrations, but also noting the fear that stricter regulation in the European Union than in the United States would result in inconsistent regulation); Unterman, *supra* note 69, at 124–25 (discussing that in the wake of recent failures within the CRA industry, Congress has responded not by reducing the market power exerted by CRAs, but rather by encouraging competition and requiring greater transparency and accountability).

365. Chi-Wei Huang, *Worldwide Corporate Convergence Within a Pluralistic Business Legal Order: Company Law and the Independent Director System in Contemporary*

fault with the accounting statements of a government-owned entity. Also, there is more incentive for the international race to the bottom. National jurisdictions see a big payoff in becoming the regulatory forum of choice.[366] That payoff in the international realm is global.[367]

It is also very difficult to exert sufficient leverage internationally in order to impose high standards. For example, even though the United States was able to overcome some cultural and normative differences surrounding the Swiss bank secrecy laws and views on insider trading,[368] it cannot impose its norms concerning obtaining evidence of fraud worldwide. There are other jurisdictions that are willing to replicate the Swiss laws and remain oblivious to U.S. concerns.[369]

China, 31 HASTINGS INT'L & COMP. L. REV. 361, 387 (discussing the "concentrated ownership regime" in Chinese corporations and noting that the problem of minority shareholder exploitation is exacerbated in China because so often the government is the controlling shareholder).

366. For example, those arguing that state competition in corporate law is a race to the bottom note that competition is driven by States' desires to maximize tax revenue from businesses incorporating within their borders, but that this competition leads to problematic deregulation in favor of management. Cary, *supra* note 262, at 668–69 ("For revenue reasons, 'creating a favorable climate' is declared to be the public policy of the state."). *See also* Greenwood, *supra* note 262, at 385 (noting that the competition for corporate charters is one that produces more sources of tax revenue for the state of incorporation).

367. Different countries may compete for issuers by specializing in investor protections, for example. Others may cater to the interests of management. But once a country becomes a favorite regulatory regime, it can charge foreign issuers a higher fee for use of its regulatory and enforcement services, which may not otherwise be available in the issuer's home country. Choi, *supra* note 362, at 820–23 (discussing that issuer choice would lead to competition among various countries for increased securities transactions within their borders because of the fees generated by those transactions and the benefits from a general increase in the regulating country's market capital).

368. Macey, *supra* note 157, at 1367–68 (discussing that the SEC was able to negotiate an information-sharing MOU with Switzerland even though Swiss law traditionally did not criminalize insider trading).

369. For example, Dennis Levine was an investment banker for Lehman Brothers Kuhn Loeb, Inc., and received inside information from another Lehman employee regarding the acquisition of Itek Corporation by Litton Industries, Inc. Litton Indus., Inc. v. Lehman Bros. Loeb Kuhn, Inc., 967 F.2d 742, 744 (2d Cir. 1992). In order to profit from this inside information, Levine made several purchases of Itek stock during the 1980s, but did so through a Bahamian bank. *Id.* at 745–46. Today, bank and tax secrecy are still prevalent in other countries, and the issue has even spurred support for the "Tax Haven Abuse Act," now in the Senate. *Europe, U.S. Battle Swiss Bank Secrecy*, *supra* note 48. The bill identifies thirty-four "offshore secrecy jurisdictions," including the Bahamas, the Cayman Islands, Lichtenstein, Panama, and Singapore. Stop Tax Haven Abuse Act, S. 681, 110th Cong. § 101(b)(50)(E), *available at* http://www/govtrack.us/congress/bill text.xpd?bill=s110-681 (last visited Jan. 25, 2009).

Stopping the race has traditionally required a leader that can insist upon some mandatory standards. Thus, supporters of increased market regulation feel that the SEC has successfully protected U.S. investors with mandatory disclosure rules, for example, and should continue to do so by imposing stricter regulations on management.[370] The problem is that in the international realm, a single regulator does not exist, and no one State currently has the muscle to insist upon mandatory standards.

Soft law offers regulatory cooperation as an alternative to competition. By using soft law, States can commit to standards developed by experts without necessarily binding themselves to an international obligation. As a result, States have time to allow normative preferences to shift domestically before committing themselves to hard law. It also gives States a politically viable means of compromise. While the United States for years resisted any public departure from U.S. GAAP, soft law paved the way for IFRS. Despite the fact that soft law can evolve over time, it is more useful that hard law alternatives because its initial development occurs swiftly in response to changing conditions.

CONCLUSION

Ultimately, we believe that globalization and integration of markets will leave States with two regulatory choices: competition or cooperation. In our view regulatory competition will lead to a race to the bottom and the absence of meaningful standards. Stopping a race to the bottom requires a hegemon that can insist on its standards. Although the U.S. continues to be a "hub of the international economy" it lacks the power it once had.[371] Thus, in order to have meaningful standards States must cooperate and compromise. Soft law makes cooperation and compromise possible. Soft law provides for flexibility and expertise, and can evolve without the political pressures that hinder cooperation among States. Soft law norms allow States to work towards convergence and harmonization without binding obligations. And soft law may ultimately harden once normative positions and rationalistic preferences have moved sufficiently

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370. *See* Cary, *supra* note 262, at 667–68 (noting that state competition in corporate governance law is the result of a "failure to recognize the difference between the goals of industrial capitalism and the abuses of finance capitalism"). *Contra* Romano, *Empowering Investors*, *supra* note 360, at 2367–68 (stating that the need to prevent a market failure does not equate to the necessity of "a monopolist regulator"); Ralph K. Winter, *Economic Regulation vs. Competition: Ralph Nader and Creeping Capitalism*, 82 YALE L.J. 890, 891 (1973) (noting "theoretically defective" government justifications for regulation).

371. *See* Daniel Dombey, *Washington Is Forced to Watch Other Powers Shape Events*, FIN. TIMES, Aug. 25, 2008, at 7.

to make a binding commitment politically acceptable. Or, soft law may remain soft, but still guide conduct in a stabilizing and helpful way. Thus, in our view international soft law securities regulation is a good product.

But it is not without its problems. Soft law faces a legitimacy challenge. If soft law regulation is to take hold, those affected by it must perceive it as legitimate, either because it works or because they believe that the manner in which it evolved took account of their interests and input. Effectiveness is difficult to judge. It is not clear that there is one universal standard of "effective" securities regulation. And even if there were, a scandal or crisis can cast doubt upon regulatory effectiveness very quickly causing distrust, backlash, and overregulation. Input legitimacy claims are also problematic. Private organizations that develop soft law norms have not typically worried about transparency or participation for nonmembers. Procedures to strengthen soft law's input credentials are already being adopted by bodies such as IOSCO and IASB, i.e., measures to increase participation and transparency. But more can be done.

International soft law also faces problems similar to those faced in its domestic analog, that is, capture, accountability, the potential for abuses, and conflicts of interest. While these are the same problems faced nationally in many jurisdictions, the global environment cautions for extra care to combat them. These problems, although of the same kind, are of a different degree simply because the stakes are bigger. The payoff for capture and abuse is greater. And the consequences are magnified as well. The systemic risks for failure are tremendous. More needs to be done about these concerns. We believe, though, that the systemic risks of rejecting soft law regulation are far greater. Without soft law regulation, we see little alternative to the race to the bottom and the absence of meaningful standards.

THE RIGHT TO REPARATIONS IN INTERNATIONAL HUMAN RIGHTS LAW AND THE CASE OF BAHRAIN

INTRODUCTION

The evolution of international law towards a system capable of promoting "global justice" has been accompanied by a growing consensus that States bear an obligation both to punish wrongdoers *and* to act on behalf of victims in the wake of widespread, systematic human rights abuses.[1] In fact, U.N. General Assembly Resolution 60/147, Basic Principles and Guidelines on the Right to a Remedy and Reparations for Victims of Gross Violations of International Human Rights Law and Serious Violations of International Humanitarian Law, sets forth "existing," complementary international legal obligations of States in this arena without introducing new obligations.[2] The right to a remedy is premised on three core rights: (1) the right to "equal and effective access to justice"; (2) "the right to adequate, effective and prompt reparation for the harm suffered"; and (3) "the right to truth."[3] Despite being a U.N. Member State since September 21, 1971,[4] the Kingdom of Bahrain ("Bahrain") is a nation with a disturbing legacy of unaddressed human rights abuses and impunity for perpetrators.[5] Such incongruence raises fundamental questions with respect to the current international legal frame-

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1. Richard Falk, *Reparations, International Law, and Global Justice: A New Frontier*, *in* THE HANDBOOK OF REPARATIONS 478, 478–79 (Pablo De Greiff ed., 2006). *See also* PRISCILLA B. HAYNER, UNSPEAKABLE TRUTHS 170 (2002).

2. G.A. Res. 60/147, U.N. Doc. A/RES/60/147 (Mar. 21, 2006) [hereinafter 2006 Principles]. In addition to the 2006 Principles, the U.N. General Assembly previously addressed the rights of victims in adopting the 1985 Declaration of Basic Principles of Justice for Victims of Crime and Abuse of Power. However, the 1985 Declaration focuses on the rights of victims of domestic crimes whereas the 2006 Principles are essentially "an international bill of rights of victims." M. Cherif Bassiouni, *International Recognition of Victim's Rights*, 6 HUM. RTS. L. REV. 203 (2006).

3. Bassiouni, *supra* note 2, at 260.

4. *See* United Nations List of Member States, http://www.un.org/members/list.shtml (last visited Sept. 1, 2007).

5. REDRESS, REPARATIONS FOR TORTURE: A SURVEY OF LAW & PRACTICE: BAHRAIN COUNTRY REPORT S. 2.1 (May 2003) [hereinafter REDRESS, REPARATIONS FOR TORTURE]. *See also* HUMAN RIGHTS WATCH, ROUTINE ABUSE, ROUTINE DENIAL: CIVIL RIGHTS AND THE POLITICAL CRISIS IN BAHRAIN 10 (1997) [hereinafter HRW, ROUTINE ABUSE, ROUTINE DENIAL]; REDRESS, SUBMISSION OF THE REDRESS TRUST TO THE MEETING ON BAHRAIN—THE HOUSE OF LORDS 2 (Aug. 2004).

work and the complex moral, legal, and political challenges involved in any reparations process.[6]

Located off of the eastern coast of Saudi Arabia in the Persian Gulf, Bahrain sits in the center of the highly complicated and volatile Middle East region.[7] With a population of approximately 718,000,[8] Bahrain is the smallest of the six Persian Gulf States that make up the Gulf Cooperative Council ("GCC").[9] However, due in large part to its historical antecedents—the Sunni al-Khalifa tribe wrested control of the archipelago from indirect Persian rule in 1782, and subsequently sought to consolidate and maintain power—Bahrain is considered "the most complex and stratified of the Gulf states."[10] Today, members of the al-Khalifa family and their "Sunni tribal allies" exercise most of the political and economic power in Bahrain.[11] At the bottom of the "social and political hierarchy" are the al-Baharinah indigenous Shiite Arabs and all Persians regardless of sect.[12] Despite comprising approximately seventy percent of Bahrain's population, Shiites continue to endure systematic discrimination.[13]

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6. *See* OUT OF THE ASHES: REPARATION FOR VICTIMS OF GROSS AND SYSTEMATIC HUMAN RIGHTS VIOLATIONS 345, 481–82 (K. De Feyter, S. Parmentier, M. Bossuyt & P. Lemmens eds., 2005); DINA SHELTON, REMEDIES IN INTERNATIONAL HUMAN RIGHTS LAW (2d ed. 2005).

7. There have been three major wars in the Gulf States alone over the past twenty-five years: the Iran-Iraq War (1980–1988), the Persian Gulf War (1991), and Operation Iraqi Freedom (2003–present). KENNETH KATZMAN, CONG. RESEARCH SERV., RL 31533, THE PERSIAN GULF STATES: ISSUES FOR U.S. POLICY 1 (2006) [hereinafter CRS REPORT RL 31533].

8. C.I.A. World Factbook: Bahrain, https://www.cia.gov/library/publications/the-world-factbook/geos/ba.html (last visited Dec. 19, 2007). *See also* INTERNATIONAL CRISIS GROUP, BAHRAIN'S SECTARIAN CHALLENGE 7 (2005) [hereinafter ICG REPORT]. Non-Bahrainis comprise nearly 290,000 people, or forty percent of the population, and account for sixty-four percent of the workforce. *Id.*; CRS REPORT RL 31533, *supra* note 7.

9. The other five GCC states are Kuwait, Oman, Qatar, Saudi Arabia, and the UAE.

10. ICG Report, *supra* note 8, at 1; C.I.A. World Factbook: Bahrain, *supra* note 8.

11. ICG Report, *supra* note 8, at 5. According to the International Crisis Group, members of the royal family occupy at least 100 of the top 572 government posts, including 24 of 47 cabinet-level posts, 15 of the top 30 in the Ministry of the Interior, 6 of the top 12 in the Ministry of Justice, and 7 of the top 28 in the Ministry of Defense. *Id*. *See also* C.I.A. World Leaders: Bahrain, https://www.cia.gov/library/publications/world-leaders-1/world-leaders-b/bahrain.html (last visited Dec. 19, 2007). After the al-Khalifa family and their "Sunni tribal allies" are other descendants of Sunni Arab tribes and then *hawalah*, Iranian Sunni and Arab immigrants to Bahrain of over a century or more. ICG Report, *supra* note 8, at 1.

12. ICG Report, *supra* note 8, at 1.

13. *Id*. The ongoing government ban of the 2006 "Al-Bandar report" released by the Gulf Centre for Democratic Development does little to dispel this perception. The report details a conspiracy led and funded by known official organizations, most notably the

The story of Bahrain's past and present bears telling for three primary reasons. First, on a universal level, it is important to raise awareness of the experiences of victims[14] of grave human rights violations and to promote accountability. Second, on a geopolitical level, the United States has a major stake in the stability of Bahrain[15] and developments in the

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Royal Court, to ensure the sustained political and economic dominance of the Sunni minority to the exclusion of Bahrain's Shiite majority. The report includes evidence of plans to fix elections, to undermine dissident groups, to disenfranchise Shiite populations, to restrict the operation of civic organizations, and to facilitate a change in the country's demographics through pro-Sunni immigration policies. International Freedom of Expression Exchange, *Authorities Reinforce Sweeping Media Ban, Internet Censorship on Controversial Report*, http://canada.ifex.org/en/content/view/full/88028/ (last visited Dec. 19, 2007).

14. For purposes of this Note, the term "victim" should be understood consistent with the 2006 Principles and defined as

> [p]ersons who individually or collectively suffered harm, including physical or mental injury, emotional suffering, economic loss or substantial impairment of their fundamental rights, through acts or omissions that constitute gross violations of international human rights law, or serious violations of international humanitarian law. Where appropriate . . . the term "victim" also includes the immediate family or dependents of the direct victim and persons who have suffered harm in intervening to assist victims in distress or to prevent victimization.

2006 Principles, *supra* note 2, para. 8.

15. CRS REPORT FOR CONGRESS 95-1013, *Bahrain: Reform, Security, and U.S. Policy* 3 (Apr. 23, 2007). In an effort to protect itself from its powerful neighbors, Bahrain cultivated a strategic alliance with the United States centered on defense issues. *Id.* The U.S. naval command has maintained a presence in Bahrain since 1938, and the Fifth Fleet is currently headquartered in Juffair, Bahrain. The headquarters is responsible for coordinating support missions by U.S. warships in the Iraq War, and conducting counter-terrorism and counter-narcotrafficking operations in the Arabian Sea. *Id.* at 4. After the terrorist attacks of September 11, 2001, the Bush administration took extensive measures to further strengthen the U.S.-Bahrain relationship. The two countries renewed a ten-year defense agreement in October 2001, which "provides U.S. access to Bahraini bases during a crisis, the pre-positioning of strategic material (mostly U.S. Air Force munitions), consultations with Bahrain if its security is threatened, and expanded exercises and U.S. training of Bahraini forces." *Id.* at 4. In March 2002, President Bush made Bahrain a major non-NATO ally, a status that allows for U.S. arms sales. *Id.* Moreover, the U.S. Congress identified access to Bahrain-based military installations and airspace as critical to U.S. military operations in Iraq, Afghanistan, and the Horn of Africa in addition to contingency operations or force projections in the Gulf and Southwest Asia. Human Rights Watch, *Bahrain: Events of 2006*, http://hrw.org/englishwr2k7/docs/2007/01/11/bahrai14699.htm (last visited Dec. 20, 2007). The Bush administration requested an estimated $17.3 million in military aid for Bahrain in 2007. *Id.*

Persian Gulf region more generally.[16] Third, on a historical level, a successful transitional justice experience in Bahrain could lend further support to the precedent established by the Equity and Reconciliation Commission ("IER") in Morocco, and encourage other Gulf States, such as Saudi Arabia, to make similar efforts to resolve mass human rights violations.

Beginning shortly after Bahrain achieved independence in 1971 and continuing through the mid-1990s, the Bahraini government undertook a campaign of political repression that targeted opposition activists, leftists, unionists, and others perceived as threats to the State.[17] Hundreds of Bahrainis and their families were forcibly exiled, and the use of torture was "endemic."[18] Under the leadership of King Hamad, who assumed power following the death of his father Amir 'Isa in 1999, Bahrain has undergone a series of political reforms and has slowly begun to confront its past.[19] In this vein, the King has expressed interest in pursuing national reconciliation and transitional justice to confront Bahrain's legacy of human rights abuses.[20] In January 2006, the decision was made to provide monthly payments of $660 (250 Bahraini dinars) to 250 families with either unemployed or elderly former exiles allowed back to the isl-

16. CRS REPORT RL 31533, *supra* note 7, at 26. Approximately fifty-seven percent of the world's proven oil reserves (715 billion barrels) and about forty-five percent of the world's proven natural gas reserves (2462 trillion cubic feet) are located in Iran, Iraq, and the GCC States. The United States imports about twenty percent of its net oil imports from the Gulf States. *Id.*

17. *See* HRW, ROUTINE ABUSE, ROUTINE DENIAL, *supra* note 5, at 11; REDRESS, REPARATIONS FOR TORTURE, *supra* note 5.

18. REDRESS, REPARATIONS FOR TORTURE, *supra* note 5. *See also* HRW, ROUTINE ABUSE, ROUTINE DENIAL, *supra* note 5, at 11; REDRESS, SUBMISSION OF THE REDRESS TRUST TO THE MEETING ON BAHRAIN—THE HOUSE OF LORDS, *supra* note 5.

19. Comm. Against Torture, *Consideration of Reports Submitted by State Parties Under Article 19 of the Convention (Continued)*, para. 33, U.N. Doc. CAT/C/SR.656 (May 24, 2005) [hereinafter CAT Comm. 1]. Government officials refer to the initiative as the "reform programme," which is intended to "address long-festering domestic tensions, to establish a constitutional regime and to introduce political reforms." The program includes the highly controversial amnesty laws Legislative Decree No. 10 of 2001 and Legislative Decree No. 56 of 2002. *Id.*

20. Comm. Against Torture, *Consideration of Reports Submitted by State Parties Under Article 19 of the Convention*, *Comments by the Government of Bahrain to the Conclusions and Recommendations of the Committee Against Torture*, U.N. Doc. CAT/C/BHR/CO/1/Add.1 (Feb. 8, 2007) [hereinafter CAT Bahrain Comments].

and as part of the reform program.[21] However, there is only one known instance to date of government compensation to a victim of torture.[22]

It is important to recognize the two different ways in which the term "reparations" is used.[23] Within the context of international law, the term connotes the array of measures available to redress the different harms that a victim may have suffered due to certain crimes.[24] Therefore, under international law, reparations may include restitution, compensation, rehabilitation, and satisfaction and guarantees of nonrecurrence.[25] Such measures, which include material and moral (or "symbolic") undertakings by a society in individual or collective form, seek to restore the victim to the *status quo ante* by expressing a society's "recognition, remorse and atonement for harms inflicted."[26] Material reparations may include monetary compensation, service packages providing healthcare or counseling to promote rehabilitation, restoration of property rights, or a pension.[27] Moral, or symbolic, reparations focus on allowing the victim's story to be told and promoting a sense of (nonlegal) justice, and may include official apologies, rehabilitation, and the creation of memorials or other acts of remembrance.[28] For reasons to be discussed later, symbolic reparations may prove more valuable in facilitating the healing sought through any material reparations process.[29]

However, the term is often used in a more narrow sense to refer to "the design of programs (i.e., more or less coordinated sets of reparative measures) with massive coverage."[30] Historically, most reparations pro-

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21. U.S. DEP'T OF STATE, COUNTRY REPORTS ON HUMAN RIGHTS PRACTICES 2006: BAHRAIN (2007), *available at* http://www.state.gov/p/nea/ci/81995.htm (last visited Sept. 1, 2007) [hereinafter U.S. DEP'T OF STATE 2006: BAHRAIN].

22. REDRESS, REPARATIONS FOR TORTURE, *supra* note 5, at 14.

23. Pablo De Greiff, *Justice and Reparations*, *in* THE HANDBOOK OF REPARATIONS, *supra* note 1, at 451, 453.

24. *Id.*

25. *Id.*

26. Naomi Roht-Arriaza, *Reparations Decisions and Dilemmas*, 27 HASTINGS INT'L & COMP. L. REV. 157, 157–58 (2004).

27. HAYNER, *supra* note 1, at 182 ("[F]or those left destitute from the loss of a breadwinner in the family, or left emotionally or physically shattered, financial reparation, basic medical benefits, and other support services will be necessary in order to begin to repair the damage."); De Greiff, *supra* note 23, at 453; Roht-Arriaza, *supra* note 26, at 157–58.

28. De Greiff, *supra* note 23, at 453

29. Roht-Arriaza, *supra* note 26, at 180.

30. De Greiff, *supra* note 23, at 453. In analyzing the design of reparations programs, De Greiff believes emphasis should be placed on three goals: recognition, civic trust, and social solidarity. *Id.* at 451.

grams have incorporated elements of both connotations of the term.[31] Such overlapping is logical given that settlement of court cases has often directly or indirectly resulted in the formation of "administrative compensation schemes."[32] This Note will address both contexts. Nevertheless, unless otherwise indicated, the term "reparations" will refer to the broader meaning as understood in international law.

This Note makes two central propositions. First, the existing international legal framework for reparations to victims of mass human rights violations is inadequate as evidenced by the current situation in Bahrain.[33] At least in the short term, legal recognition of a victim's right to reparations without an effective enforcement mechanism at the international level ultimately perpetuates the cycle of victimization for those whom the pronouncement of such principles seeks to protect.[34] Not only must Bahraini victims of state abuse suffer the indignities of their mistreatment while being denied access to justice at the domestic level, but they are also reassured of their rights by an international legal framework incapable of guaranteeing them justice, thereby reinforcing their position of helplessness.[35] Nevertheless, at the supranational level, there is an

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31. Roht-Arriaza, *supra* note 26, at 157, 165.

32. *Id*.

33. *See* Bassiouni, *supra* note 2, at 203, 260 (discussing a theory of victims' rights and advocating "for a strengthening of current victims' rights norms"). *See also* Roht-Arriaza, *supra* note 26, at 158 ("If reparations are so universally accepted as part of a state's human rights obligations, why have so few states emerging from periods of conflict or mass atrocity put viable programs into place?").

34. *See* Michael Reisman & Janet Koven Levit, *Reflections on the Problem of Individual Responsibility for Violations of Human Rights*, *in* THE MODERN WORLD OF HUMAN RIGHTS: ESSAYS IN HONOUR OF THOMAS BUERGENTHAL 419, 420–23 (Antonio A. Cançado Trindade ed., 1996). However, this says nothing about the potential positive implications of such a principle ripening into customary international law. *See* The Paquete Habana, 175 U.S. 677, 708 (1900) (relying on the customs and usages of civilized nations in concluding that "it is an established rule of international law . . . that coast fishing vessels . . . are exempt from capture as prize of war").

35. Reisman & Levit, *supra* note 34, at 421. Reisman and Levit address a further indignity that victims must suffer as a result of the "normative gray gap" between the international human rights framework and national law:

> [V]ictims of [gross and systematic human rights] violations actually suffer twice: first, in being the victims and second, in *their* obligation to participate, with all other citizens, in paying compensation . . . . When we say that the state is responsible and must compensate, we are really saying that the citizens of the State, including the victims, must pay to compensate for [human rights] violations.

emerging trend of enforcement for grave violations of international law, which represents a positive development for human rights and the rule of law.[36] Second, the implementation of a "comprehensive and coherent reparations program"[37] in Bahrain is ultimately in the best legal, moral, and political interests of the al-Khalifa regime and two of its closest allies, Saudi Arabia[38] and the United States.[39]

This Note is divided into three main sections. Part I discusses Bahrain's history of human rights abuses and major advances and setbacks in the nation's ongoing transitional justice or "national reconciliation" process. Part II discusses the effectiveness of the existing international legal framework in guaranteeing victims of massive and systematic human rights abuses the right to a remedy and reparations. Part III explores what an administrative reparations scheme for Bahraini victims might look like in light of progress made.[40] It draws upon lessons learned from the Moroccan transitional justice experience, the first of its kind in the Middle East,[41] and introduces some key political issues involved in financing any such reparations program. The Note concludes by examin-

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Id. See also REDRESS, REPARATIONS FOR TORTURE, *supra* note 5, at 8 ("Given the absence of a regional human rights mechanism in the Middle East, the United Nations is the main body monitoring Bahrain's compliance with its human rights obligations.").

36. *See* Bassiouni, *supra* note 2, at 203 (outlining a wide movement towards the recognition of the rights of victims of crime, whether domestic or international, or gross violations of human rights); Reisman & Levit, *supra* note 34, at 419, 436 (discussing the crystallization of an international norm that now explicitly includes human rights violations among the international crimes for which individuals bear responsibility); Roht-Arriaza, *supra* note 26, at 157, 163.

37. *See* De Greiff, *supra* note 23, at 452, 467–71.

38. *Navigating Nebulous Waters: Prospects for Transitional Justice in Bahrain* 5 (Aug. 1, 2007) (unpublished working paper, on file with the International Center for Transitional Justice, Middle East North Africa Unit) [hereinafter *Prospects for Transitional Justice in Bahrain*] ("At present, Saudi Arabia arguably wields more influence over Bahrain than any other country, both politically and economically. Moreover, as the political and spiritual center of Sunni Islam, Saudi Arabia has a vested interest in supporting the rule of the Sunni al-Khalifa against Iranian influence and any potential Shia uprising.").

39. *See* CRS REPORT FOR CONGRESS 95-1013, *supra* note 15, at 3. *See also* C.I.A. World Factbook: Bahrain, *supra* note 8 (Bahrain is neighbor to the primary Middle Eastern petroleum sources and occupies a strategic location in the Persian Gulf through which much of the Western world's petroleum must transit to reach open ocean).

40. *See generally* THE HANDBOOK OF REPARATIONS, *supra* note 1; *Prospects for Transitional Justice in Bahrain*, *supra* note 38, at 8–10, 27–31 (discussing the internal power dynamics of the regime, and relevant reforms and recent developments).

41. *See generally* International Center for Transitional Justice, *Morocco*, http://www.ictj.org/en/where/region5/591.html (last visited Dec. 19, 2007) [hereinafter ICTJ Morocco Overview].

ing the likely implications of Bahrain's current, limited course of action and what other nations seeking to confront similarly repressive pasts can learn from the Bahraini experience.

I. SYSTEMATIC HUMAN RIGHTS ABUSES AND THE BEGINNINGS OF TRANSITIONAL JUSTICE IN BAHRAIN

As a member of the international community of States, Bahrain is obligated to prevent the practice of torture within its sovereign territory and to remedy any such violations once they have occurred.[42] The Draft Articles on State Responsibility for Internationally Wrongful Acts establish that a State commits an internationally wrongful act when (1) conduct consisting of an action or omission is attributable to the State under international law; and (2) such conduct constitutes a breach of an international obligation of the State.[43] There is thus widespread consensus that a State bears an international legal obligation to provide reparations where state agents are responsible for the violative act.[44] In fact, even in instances where the State's direct involvement cannot be proven, the State is still responsible if it was complicit in the violations or failed to exercise due diligence in investigating or prosecuting the violations.[45]

The prohibition against torture is widely understood to have achieved *jus cogens* status.[46] Article 1 of the Convention Against Torture and Oth-

42. J. HERMAN BURGERS & HANS DANELIUS, THE UNITED NATIONS CONVENTION AGAINST TORTURE: A HANDBOOK ON THE CONVENTION AGAINST TORTURE AND OTHER CRUEL, INHUMAN OR DEGRADING TREATMENT OR PUNISHMENT 1 (1988) ("[T]he *Convention* is based upon recognition that [the prohibition against torture and other cruel, inhuman or degrading treatment or punishment] is already established under international law."); Universal Declaration of Human Rights, arts. 5, 8, G.A. Res. 217A, at 71, U.N. GAOR, 3d Sess., 1st plen. mtg., U.N. Doc A/810 (Dec. 12, 1948).

43. Draft Articles on Responsibility of States for Internationally Wrongful Acts, G.A. Res. 56/83, art. 2, UN Doc. A/Res/56/83 (Jan. 28, 2002).

44. *E.g.*, Roht-Arriaza, *supra* note 26, at 157, 163.

45. *Id*.

46. *See* Vienna Convention on the Law of Treaties art. 53, May 23, 1969, 1155 U.N.T.S. 332, 344 (defining a *jus cogens* norm, or a "peremptory norm of general international law," as "a norm accepted and recognized by the international community of States as a whole as a norm from which no derogation is permitted and which can be modified only by a subsequent norm of general international law having the same character"). *See, e.g.*, Siderman de Blake v. Republic of Arg., 965 F.2d 699, 714, 717 (9th Cir. 1992), *cert. denied* 507 U.S. 1017 (1993) (quoting the Vienna Convention on the Law of Treaties' definition of *jus cogens* and stating that the prohibition against torture has "the force of a *jus cogens* norm"); Al-Adsani v United Kingdom, 34 Eur. Ct. H.R. 11, 30 (recognizing the prohibition of torture as a rule of *jus cogens*); BETH VAN SCHAACK & RONALD C. SLYE, INTERNATIONAL CRIMINAL LAW AND ITS ENFORCEMENT: CASES AND MATERIALS 496 (2007).

er Cruel, Inhuman or Degrading Treatment or Punishment ("CAT") defines torture as

> any act by which severe pain or suffering, whether physical or mental, is intentionally inflicted on a person for such purposes as obtaining from him or a third person information or confession, punishing him for an act he or a third person has committed or is suspected of having committed, or intimidating or coercing him or a third person, or for any reason based on discrimination of any kind, when such pain or suffering is inflicted by or at the instigation of or with the consent or acquiescence of a public official or other person acting in an official capacity.[47]

Even though Bahrain did not accede to CAT until March 6, 1998,[48] and the provisions of the treaty cannot be applied *ex post facto*, the State still breached its obligation to prevent torture under customary international law.[49] Ironically, Article 19 of the 1973 Bahraini Constitution explicitly proscribed physical and mental torture and the use of confessions obtained under torture or degrading treatment.[50] Since ratifying CAT, Bahrain has the affirmative obligation to prevent torture by "tak[ing] effective legislative, administrative, judicial or other measures to *prevent* acts of torture under its jurisdiction."[51] This requires States Parties to criminalize the act of torture and complicity or participation in torture.[52]

In 1973, only two years after Bahrain achieved its independence, Amir 'Isa bin Salman al-Khalifa issued a decree officially making Bahrain an

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47. Convention Against Torture and Other Cruel, Inhuman or Degrading Treatment or Punishment art. 1(1), Dec. 10, 1984, S. Treaty Doc. No. 100-20, 1465 U.N.T.S. 85, [hereinafter CAT]. There are 146 State Parties to CAT. United Nations Treaty Collection, *Convention Against Torture*, http://treaties.un.org/Pages/ViewDetails.aspx?src=TREATY&id=129&chapter=4&lang=en [hereinafter UNTC CAT] (last visited Feb. 27, 2009). *See also* International Covenant on Civil and Political Rights art. 7, Dec. 16, 1966, S. Exec. Doc. E, 95-2, 999 U.N.T.S. 171 [hereinafter ICCPR]. There are 164 State Parties to the ICCPR. United Nations Treaty Collection, *International Covenant on Civil and Political Rights*, http://treaties.un.org/Pages/ViewDetails.aspx?src=TREATY&id=322&chapter=4&lang=en [hereinafter UNTC ICCPR] (last visited Feb. 27, 2009); U.N. Human Rights Comm., General Comment No. 20, Replaces General Comment 7 Concerning Prohibition of Torture and Cruel Treatment of Punishment (Article 7), para. 5, U.N. Doc. A/47/40 (1992).

48. UNTC CAT, *supra* note 47.

49. *See* Prosecutor v. Anto Furundžija, Case No. IT-95-17/1-A, Judgement, para. 111 (July 21, 2000) (concluding that Article 1 of CAT "reflects customary international law"); BURGERS & DANELIUS, *supra* note 42, at 1.

50. BAHR. CONST. of 1973, art. 19(d). The prohibition is replicated in Article 19(d) of the 2002 Amended Constitution. BAHR. CONST. of 2002, art. 19(d)

51. CAT, *supra* note 47, art. 2(1).

52. *Id.* art. 4(1).

Islamic State in which Islamic law, or *sharia*, is the main source of legislation.[53] Initial optimism within Bahraini civil society following the enactment of the new constitutional regime quickly dissipated after the issuance of the State Security Law of 1974.[54] The law provided the legal pretext for many of the human rights abuses perpetrated during the next two decades by empowering security forces to arrest and detain for up to three years any person who allegedly "perpetrated acts, delivered statements, exercised activities or [was] involved in contacts inside or outside the country, which are of a nature considered to be in violation of the internal or external security of the country."[55]

Following the Amir's decision in 1976 to dissolve the National Assembly—Bahrain's parliament—the government relied on the State Security Law and a policy of forced exile to silence opposition.[56] The repression intensified following the 1978–1979 Islamic Revolution in Iran.[57] The Revolution emboldened Bahrain's Shiite majority to challenge the status quo rule of the Sunni elite.[58] Fearing Iranian support for opposition groups and the possibility of a coup, the Bahraini Government cracked down.[59] State security forces detained dozens of Shiite leaders on allegations of plotting to overthrow the royal family.[60] Detainees were allegedly tortured and held incommunicado for months before they were all found guilty by the State Security Court in 1982.[61] Sentences ranged from seven years to life in prison.[62]

Torture was most prevalent in Bahrain during the mid-1990s at the height of the popular uprising that called for democratic reform and a return to a constitutional system of governance.[63] The report by the U.N. Special Rapporteur on Torture to the Human Rights Commission in 1997 describes the prevailing approach towards the practice during this epoch:

> [M]ost persons arrested for political reasons in Bahrain were held incommunicado, a condition of detention conducive to torture. The Security and Intelligence Service . . . and the Criminal Investigation Department . . . were alleged frequently to conduct interrogation of such

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53. BAHR. CONST. of 1973, art. 2.
54. HRW, ROUTINE ABUSE, ROUTINE DENIAL, *supra* note 5, at 11.
55. *Id*.
56. *Id.*
57. *Id.* at 12.
58. *Id.*
59. *Id.*
60. *Id.* at 11–12.
61. *Id*. at 12.
62. *Id*.
63. REDRESS, REPARATIONS FOR TORTURE, *supra* note 5, at 3–4.

> detainees under torture . . . said to be undertaken with impunity, with no known cases of officials having been prosecuted for acts of torture or other ill-treatment . . . .
>
> In addition to its use as a means to extract a 'confession,' torture was also reportedly administered to force detainees to sign statements pledging to renounce their political affiliation, to desist from future anti-government activity, to coerce the victim into reporting on the activities of others, to inflict punishment and to instill fear in political opponents. The methods of torture reported include: *falaqa* (beatings on the soles of the feet); severe beatings, sometimes with hose-pipes; suspension of the limbs in contorted positions accompanied by blows to the body; enforced prolonged standing; sleep deprivation; preventing victims from relieving themselves; immersion in water to the point of near drowning; burnings with cigarettes; piercing the skin with a drill; sexual assault, including the insertion of objects into the penis or anus; threats of execution or of harm to family members; and placing detainees suffering from sickle cell anemia (said to be prevalent in the country) in air-conditioned rooms in the winter, which can lead to injury to internal organs.[64]

Ian Henderson, a citizen of the United Kingdom and the head of the State Intelligence Service from 1966 to 1998, is widely believed to be responsible for the routine use of torture during his tenure.[65] Although Henderson himself admits that "vigorous interrogation" techniques were used, he categorically denies engaging in torture or ordering his forces to do so.[66]

In 1999, Amir Sheikh 'Isa bin Salman al-Khalifa died and was succeeded by his son, Sheikh Hamad bin 'Isa al-Khalifa. Recognizing that social peace was essential to securing foreign investment—the royal family's major source of income—and its political survival, Sheikh Hamad launched a series of reforms.[67]

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64. Special Rapporteur on Torture, *Report of the Special Rapporteur, Mr. Nigel S. Rodley, Submitted Pursuant to Commission on Human Rights Resolution 1995/37 B*, U.N. Doc. E/CN.4/1997/7 (Jan. 10, 1997).

65. REDRESS, REPARATIONS FOR TORTURE, *supra* note 5, at 9; Human Rights Watch, *U.K. Should Open Files on Bahrain Torture: Role of U.K. National Seen as Pivotal*, Jan. 10, 2000, http://www.hrw.org/en/news/2000/01/10/uk-should-open-files-bahrain-torture. Other individuals alleged to have committed, or overseen, torture include Adel Flaifel, Khalid al-Wazzan, Abdulaziz Ateyatallah al-Khalifa, and Alistair Bain McNutt. HRW, ROUTINE ABUSE, ROUTINE DENIAL, *supra* note 5, at 23.

66. Neil Mackay, *Scots Security Boss Branded "Master Torturer" of Bahrain*, BIG ISSUE (SCOTLAND), Jan. 8, 1997.

67. *Prospects for Transitional Justice in Bahrain*, *supra* note 38, at 18.

Prior to the adoption of a new constitution in February 2002, King Hamad issued two legislative decrees central to any discussion about justice and reparations for governmental abuses in Bahrain.[68] Legislative Decree No. 10 of 2001 established a "general amnesty . . . for crimes affecting national security . . . committed by citizens before the enactment of this Law."[69] The Decree led to the release of all political detainees, both pretrial and posttrial, and hundreds of people forcibly exiled were allowed to return.[70]

The initial positive effects of the amnesty were quickly overshadowed by Legislative Decree No. 56 of 2002, which clarifies the scope of Legislative Decree No. 10 and effectively grants immunity to security officers and state officials from prosecution for human rights abuses perpetrated prior to 2001.[71] The key provision stipulates that no cases arising under Legislative Decree No. 10 shall be heard by any "judicial authority," regardless of "the person filing it and irrespective of the capacity against whom it is filed, whether he is an ordinary citizen or a civilian or military public servant."[72]

II. THE RIGHT TO REPARATIONS IN INTERNATIONAL HUMAN RIGHTS LAW

Natural justice has long recognized that harms should be remedied.[73] In fact, some form of the right to redress can be found in "every organised society."[74] The right to a remedy for victims of violations of international

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68. Legislative Decree No. 10 of 2001 with Respect to General Amnesty for Crimes Affecting National Security; Legislative Decree No. 56 of 2002 with Respect to Interpreting Certain Provisions of Legislative Decree No. 10 of 2001 with Respect to General Amnesty for Crimes Affecting National Security [hereinafter Legislative Decree No. 56].

69. *Id*. The sole exception is in cases of crimes resulting in death. *Id.* art. 2.

70. U.N. Comm'n on Human Rights, *Civil and Political Rights, Including the Question of Torture and Detention: Report of the Working Group on Arbitrary Detention: Visit to Bahrain* 10, UN Doc. E/CN.4/2002/77/Add.2 (Mar. 5, 2002).

71. Legislative Decree No. 56, *supra* note 68; Comm. Against Torture, *Consideration of Reports Submitted by State Parties Under Article 19 of the Convention*, U.N. Doc. CAT/C/CR/34/BHR (June 21, 2005) [hereinafter CAT Comm. 2] (Expressing concern at the "blanket amnesty extended to all perpetrators of torture or other crimes by Decree No. 56 of 2002 and the lack of redress available to victims of torture"); REDRESS, REPARATIONS FOR TORTURE, *supra* note 5, at 14.

72. Legislative Decree No. 56, *supra* note 68, art. 1, para. 2.

73. Bassiouni, *supra* note 2, at 207; Roht-Arriaza, *supra* note 26, at 157.

74. Bassiouni, *supra* note 2, at 207. *See, e.g.*, Marbury v. Madison, 5 U.S. 137, 163 (1803) ("The very essence of civil liberty certainly consists in the right of every individual to claim the protection of the laws whenever he receives an injury. One of the first duties of government is to afford that protection.").

human rights law is set forth in numerous international instruments.[75] Article 8 of the Universal Declaration of Human Rights ("UDHR") extends the right to an "effective remedy" by the appropriate national tribunal for any violations of a person's fundamental rights as protected by the constitution or by law.[76] Article 2 of the International Covenant on Civil and Political Rights ("ICCPR") recognizes a "right to an effective remedy."[77] Article 6 of the International Convention on the Elimination of All Forms of Racial Discrimination ("ICERD") obligates States Parties to assure "effective protection and remedies" and access to "just and adequate reparation or satisfaction" for violations of the rights contained therein.[78] Lastly, Article 14 of CAT mandates a State Party to "ensure in its legal system that the victim of an act of torture obtains redress and has an enforceable right to fair and adequate compensation, including the means for as full rehabilitation as possible."[79]

The Permanent Court of International Justice ("PCIJ") in the *Chorzow Factory (Jurisdiction) Case* decisively articulated the legal duty to compensate for a recognized harm.[80] For its part, the International Court of

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75. 2006 Basic Principles, *supra* note 2, pmbl. In addition to human rights law, the right to a remedy is implicitly recognized in the context of international humanitarian law, including in (1) the Geneva Convention Relative to the Treatment of Prisoners of War; (2) the Geneva Convention Relative to the Protection of Civilian Persons in Time of War; and (3) Protocol I Additional to the Geneva Convention. Bassiouni, *supra* note 2, at 213–14.

76. Universal Declaration of Human Rights, *supra* note 42, art. 8.

77. ICCPR, *supra* note 47, art. 2. *See also id.* art. 9. Bahrain acceded to the ICCPR in 2006. UNTC ICCPR, *supra* note 47.

78. International Convention on the Elimination of All Forms of Racial Discrimination, *entered into force* Jan. 4, 1969, G.A. Res. 2106 A (XX), Annex, 20 U.N. GAOR Supp. (No. 14) at 47, U.N. Doc. A/6014 (1966), 660 U.N.T.S. 195. Bahrain acceded to the ICERD in 1990. United Nations Treaty Collection, *International Convention on the Elimination of All Forms of Racial Discrimination*, http://treaties.un.org/Pages/ViewDetails.aspx?src=TREATY&id=319&chapter=4&lang=en (last visited Feb. 27, 2009).

79. CAT, *supra* note 47, art. 14(1). The 2006 Basic Principles also ground the right in Article 3 of the Hague Convention Respecting the Laws and Customs of War on Land of 18 October 1907 (Convention IV); Article 91 of the Protocol Additional to the Geneva Conventions of August 12, 1949, and Relating to the Protection of Victims of International Armed Conflicts (Protocol I) of June 8, 1977; Article 39 of the Convention on the Rights of the Child; and Articles 68 and 75 of the Rome Statute of the International Criminal Court. 2006 Basic Principles, *supra* note 2, pmbl. For a discussion of the extensive U.N. efforts preceding the introduction of the 2006 Basic Principles, see SHELTON, *supra* note 6.

80. Case Concerning the Factory at Chorzow, 1927 P.C.I.J. (Ser. A) No. 9, at 29 ("[I]t is a principle of international law . . . that any breach of engagement involves an obligation to make reparation."). According to Richard Falk, the Advisory Opinion by the International Court of Justice concerning the Israeli security wall reaffirmed the validity of

Justice ("ICJ") applies the *Chorzow* approach of seeking to restore the situation to what "would have existed" had no breach occurred.[81] Similarly, current jurisprudence in both the Inter-American and European human rights systems is clear that the underlying principle behind reparations is "full restitution" (*restitutio in integrum*) and the reestablishment of the *status quo ante*.[82] While legally and normatively unequivocal, such reasoning illuminates the fundamental paradox inherent in any discussion of reparations: specifically, the fact that it is ultimately impossible to restore the victim of any grave violation of human rights to the *status quo ante*.[83]

National courts are supposed to serve as the gateway for victims seeking reparations for grave violations of human rights and humanitarian law.[84] In fact, an individual lacks standing to even bring a claim before most international bodies until he or she has exhausted available domestic remedies.[85] Ideally, national courts should operate in conjunction with international criminal tribunals and treaty obligations as part of a "flexible strategy" to enforce an "international consensus" against impunity for those who commit international crimes.[86]

However, experience has repeatedly proven the ineffectiveness of relying on national courts for such a purpose because the courts are "almost always. . . inoperative" during the conflict periods in which massive and systematic human right violations usually occur, and because "it takes quite some time for courts to assume an independent stance capable of

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this legal obligation in its finding that Israel has owed a duty to provide reparations to Palestinians harmed by the building of the illegal wall on their territory. Falk, *supra* note 1, at 482–83.

81. SHELTON, *supra* note 6, at 92. *But see* Christian Tomuschat, *Reparations for Victims of Grave Human Rights Violations*, 10 TUL. J. INT'L & COMP. L. 157, 166 (arguing that neither the PJIC nor the ICJ "has ever said that states are under an obligation to compensate their own citizens in cases where they have suffered harm at the hands of public authorities").

82. De Greiff, *supra* note 23, at 455. *See, e.g.*, Velásquez-Rodríguez v. Honduras, Judgment of July 29, 1988, Inter-Am. Ct. H.R. (Ser. C) No. 4, para. 174 (1988) ("The State has a legal duty to take reasonable steps to prevent human rights violations and to use the means at its disposal to carry out a serious investigation of violations committed within its jurisdiction, to identify those responsible, to impose the appropriate punishment and to ensure the victim adequate compensation.").

83. Roht-Arriaza, *supra* at 26, at 157–58 ("What could replace lost health and serenity; the loss of a loved one or of a whole extended family; a whole generation of friends; the destruction of home and culture and community and peace?").

84. *Id.* at 165.

85. *Id*.

86. *See* Arrest Warrant of 11 April 2000 (Dem. Rep. Congo v. Belg.), 2001 I.C.J. 63, 78 (Feb. 14) (Joint Separate Opinion of Judges Higgins, Kooijmans, and Buergenthal).

finding powerful forces (usually the government itself) liable for violations."[87] In many cases, amnesty laws, relevant statutes of limitations, and procedural mechanisms block victims from pursuing civil claims or prohibit criminal prosecution.[88]

As a result, many victims of grave human rights violations have had more success pursuing their claims in foreign courts.[89] Particularly in the wake of World War II, several countries have "statutorily institutionalized" the principle of universal jurisdiction to hold perpetrators of grave human rights violations accountable.[90] The universality principle recognizes that certain crimes are so reprehensible that they harm all people, and therefore any nation may act on behalf of the international community to prosecute and punish those responsible, regardless of where the crimes were committed.[91] A national court may thus exercise universal jurisdiction only over those crimes regarded as serious violations of in-

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87. Roht-Arriaza, *supra* note 26, at 165.

88. *Id*. The failure by States to ensure victims their right to reparation is particularly problematic where the substantive breach violated a *jus cogens* norm under customary international law, such as the prohibition against torture. Thus, while States may argue that the right to reparation for victims of torture is a secondary right that is derogable, at least one commentator has rejected such reasoning as untenable because it enables States to "in fact derogate from a peremptory norm by breaching it and not enforcing the respective consequences[,] an outcome [that] is conceptually incompatible with the very concept of *jus cogens*." Alexander Orakhelashvili, *Peremptory Norms and Reparation for Internationally Wrongful Acts*, 3 BALTIC Y.B. INT'L L. 19, 28 (2003).

89. Roht-Arriaza, *supra* note 26, at 166.

90. Reisman & Levit, *supra* note 34, at 434. For a comprehensive survey of state practice at the national level in approximately 120 countries relevant to universal jurisdiction prosecutions, see AMNESTY INTERNATIONAL, UNIVERSAL JURISDICTION—THE DUTY OF STATES TO ENACT AND ENFORCE LEGISLATION (Sept. 2001). *See also* HUMAN RIGHTS WATCH, UNIVERSAL JURISDICTION IN EUROPE: THE STATE OF THE ART (June 2006).

91. *See, e.g.*, Rome Statute of the International Criminal Court, July 1, 2002, 2187 U.N.T.S. 90; Statute of the International Tribunal for Rwanda, U.N. Doc. S/RES/955 (1994); Statute of the International Tribunal for the Prosecution of Persons Responsible for Serious Violations of International Humanitarian Law Committed in the Territory of the Former Yugoslavia Since 1991, U.N. Doc. S/RES/827 (May 25, 1993); Agreement for the Prosecution and Punishment of the Major War Criminals of the European Axis, and Charter of the International Military Tribunal, Aug. 8, 1945, 82 U.N.T.S. 280. *See also* Demjanjuk v. Petrovsky, 776 F.2d 571, 582 (6th Cir. 1985) ("A state may exercise jurisdiction to define and punish certain offenses recognized by the community of nations as of universal concern."); Filártiga v. Peña-Irala, 630 F.2d 876, 890 (2d Cir. 1980) ("In the modern age, humanitarian and practical considerations have combined to lead the nations of the world to recognize that respect for fundamental human rights is in their individual and collective interest."); Regina v. Bow St. Magistrates, Ex p. Pinochet Ugarte (No. 3), [2000] 1 A.C. 147, 198 ("The jus cogens nature of the international crime of torture justifies states in taking universal jurisdiction over torture wherever committed.").

ternational law.[92] Offenses rising to this level include war crimes, genocide, hostage taking, and torture.[93]

Perhaps the most effective mechanism to date has been through civil claims under the U.S. Alien Tort Claims Act ("ATCA"), also referred to as the Alien Tort Statute.[94] The ATCA provides that "the district courts shall have original jurisdiction of any civil action by an alien for a tort only, committed in violation of the law of nations or a treaty of the United States."[95] Foreign nationals may thus seek relief for harm they have suffered "in violation of the law of nations" or a treaty to which the United States is a party.[96] States are immune to suit under ATCA, however, and therefore plaintiffs may only bring suit against violators "in their individual capacity."[97] Beginning with the seminal *Filártiga v. Peña-Irala* decision in 1980, foreign nationals have won numerous multimillion dollar judgments or verdicts against individual perpetrators including torturers, ex-generals, heads of state, and war criminals.[98] However, U.S. courts may only exercise jurisdiction over a defendant where the court possesses *in personam* jurisdiction, and thus the defendant must be

92. *See* Ex p. Pinochet Ugarte (No. 3), 1 A.C. at 148, 198. *See also* Arrest Warrant of 11 April 2000, 2001 I.C.J. at 81 (finding universal jurisdiction appropriate for "those crimes regarded as the most heinous by the international community").

93. Arrest Warrant of 11 April 2000, 2001 I.C.J. at 78.

94. Roht-Arriaza, *supra* note 26, at 157, 166.

95. Alien Tort Claims Act, 28 U.S.C. § 1350 (2009). In 1992, President George H.W. Bush signed into law the Torture Victim Protection Act of 1991 ("TVPA"). The TVPA reinforces the ATCA by authorizing both U.S. and non-U.S. victims of torture and extrajudicial killing to bring a cause of action in the federal courts against those responsible. Torture Victim Protection Act of 1991, 28 U.S.C. § 1350 (2009); Human Rights First, *The Alien Claims Act and the Torture Victim Protection Act: Important Tools in the Fight Against Impunity*, http://www.humanrightsfirst.org/international_justice/w_context/w_cont_12.htm (last visited Dec. 16, 2007).

96. Human Rights First, *supra* note 98 ("U.S. courts have interpreted violations of the 'law of nations' under the ATCA to include crimes against humanity, war crimes, genocide, torture, rape, and summary execution.").

97. Bassiouni, *supra* note 2, at 235.

98. Roht-Arriaza, *supra* note 26, at 167 (noting that while large judgments under the ATCA are generally uncollectible, they serve other purposes such as "allow[ing] victims to publicly tell their stories, publiciz[ing] the violations at issue[,] . . . official[ly] recogni[zing] that the plaintiffs were wronged," deterring perpetrators from traveling to certain countries or assuming high-ranking government positions, and catalyzing domestic action to address the violation); Human Rights First, *supra* note 99 ("[The] ATCA has been used effectively on behalf of victims of gross human rights abuses perpetrated by well-known political and military figures—such as Ferdinand Marcos, Radovan Karadzic, and two Salvadoran generals—as well as by lesser-known government officials in different parts of the world.").

physically present in the United States.[99] Given this jurisdictional requirement, it seems unlikely—though not impossible—that Bahraini torture victims will have an opportunity to pursue claims under the ATCA.

Reparations in the context of transition from a period of authoritarianism to one of relative democracy is still a new concept within the field of international law. Thus, if international law is largely understood to "codif[y] behavioral trends in state practice and shifting political attitudes on the part of governments with the intention of stabilizing and clarifying expectations about the future," then the fact that the current system remains largely ineffective in holding Member States responsible for denying victims of massive rights violations their right to reparations is more easily understood.[100] Nevertheless, as long as "trends of *national* practice" in similar circumstances and "wider global trends toward individual accountability for crimes against humanity" remain entirely subservient to "domestic discretion" (and inaction), the right to reparation will continue to carry little practical significance for victims.[101] If this is the case, then perhaps Richard Falk will remain justified in "view[ing] reparations as primarily an expression of *moral* and *political* forces at work in different contexts."[102]

III. The Current Bahraini Approach

A. Bahrain's Limited Progress

At present, the case of Bahrain serves as an example of a country whose "new" leadership is willing to renounce its oppressive past without taking conclusive action to address it.[103] While Bahrain has taken

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99. Filártiga v. Peña-Irala, 630 F.2d 876, 878 (2d Cir. 1980) ("[D]eliberate torture perpetrated under the color of official authority violates universally accepted norms of the international law of human rights, regardless of the nationality of the parties. Thus, whenever an alleged torturer is found and served with process by an alien within [U.S.] borders, [the ATCA] provides federal jurisdiction."). *See also* Bassiouni, *supra* note 2, at 234.

100. Falk, *supra* note 1, at 480.

101. *Id*.

102. *Id*. at 485.

103. *Id.* at 495. The phrase "new leadership" is used loosely here, as many government officials from the preceding era of repression remain in positions of power despite the passing of the Amir and his son Hamad's succession to power. The long-standing position of the Prime Minister, the Amir's brother and the most powerful man in Bahrain according to many accounts, is telling in this regard. The Prime Minister is generally considered to be opposed to any "dramatic" reform. A power struggle has thus emerged between the Prime Minister and the King's son, Crown Prince Salman, who is head of the Economic Development Board and more reform minded. The King has seemingly re-

measures over the last decade to comply with its various treaty obligations, the government continues to obfuscate its unwillingness to ensure that victims of torture have access to redress or other compensation.[104] Bahrain's civil code specifies that "[e]very unlawful act that has caused damage to others makes an obligation upon the person who committed it to pay compensation."[105] However, the law also shields public officials from liability where they were acting in an official capacity or based upon superior orders.[106] Torture is also prohibited under multiple provisions of the penal code.[107] Official statements praising the national reconciliation process stand in stark contrast to the government's "failure to investigate promptly, impartially, and fully the numerous allegations of torture and ill-treatment and to prosecute alleged offenders," and its refusal to provide "complete and disaggregated information about the number of detainees who have suffered torture or ill-treatment, including any deaths in custody, the results of investigations into the causes, and whether any officials were found responsible."[108]

Furthermore, the al-Khalifa regime seemingly remains averse towards viewing the situation as one of massive human rights violations, the scope of which might necessitate the use of nontraditional judicial mechanisms, such as a government-administered reparations program.[109] Rather, the regime has suggested that victims of torture or ill-treatment have failed to exhaust access to redress through the Bahraini legal sys-

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mained above the fray thus far, though he has sided with his son on certain issues. CRS REPORT FOR CONGRESS 95-1013, *supra* note 15, at 1; *Prospects for Transitional Justice in Bahrain*, *supra* note 38, at 9–10. *See also* CRS REPORT RL 31533, *supra* note 7, at 21.

104. Human Rights Watch, *Bahrain: Events of 2006*, http://hrw.org/englishwr2k7/docs/2007/01/11/bahrai14699.htm (last visited Dec. 20, 2007). On September 2, 2007, Prime Minister Shaikh Khalifa bin Salman Al Khalifa cautioned that "democracy, openness and freedom of opinion should not be used as a pretext to violate the law, sow sectarian sedition, or falsify truths in international arenas, claiming internal liberties are curbed." Invoking a popular government refrain, the Prime Minister explained that "[p]latforms for expressing opinions are open 'to accommodate all stances and trends as long as they serve the national interests rather than personal designs' . . . . He also warned against what one Bahraini newspaper termed 'misusing the parliament to raise controversial issues.'" *Id.*

105. Decree Law No. 19/2001, art. 158.

106. *Id.* art. 169.

107. REDRESS, REPARATIONS FOR TORTURE, *supra* note 5, at 10.

108. CAT Comm. 2, *supra* note 71, paras. 6–7. Other subjects of concern included the "large number of allegations of torture . . . committed prior to 2001," the blanket amnesty extended to all alleged perpetrators of torture or other crimes by Decree No. 56 of 2002, the lack of redress available to victims of torture, and the inadequate availability in practice of civil compensation and rehabilitation for victims of torture prior to 2001. *Id*.

109. *See Id.*

tem.[110] In reality, amnesty legislation has blocked attempts by torture victims to bring claims.[111] While the sheer magnitude of abuses in Bahrain does not reach levels witnessed in postconflict States such as Germany, Argentina, or Peru, the numbers are such that even an earnest attempt to address all of the cases through the national legal system would inherently challenge certain bedrock norms—in particular, the premise that "norm-breaking behavior is more or less exceptional."[112]

Temporarily setting aside the fact that there is no evidence of victims receiving access to justice through the Bahraini civil system and no known instances of the State prosecuting perpetrators, a case-by-case approach raises other issues as well.[113] According to De Greiff, the two biggest problems are that it serves to "disaggregate" both victims and the reparations process as a whole.[114] Historically, victims do not all receive equal access to the courts, and disparities in damage awards inherently create a "hierarchy" of victims.[115] Moreover, an individualized approach poses challenges from a publicity standpoint. Decisions pertaining to the disclosure of case-specific facts may make it difficult to provide consistent publication of information about awards.[116] The task of effectively conveying to the public the "nature and magnitude" of reparations measures is compounded by this disaggregation.[117] Finally, there is also the

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110. CAT Comm. 1, *supra* note 19, para. 34. The Bahraini delegation before the Committee Against torture stated:

> Nobody had filed a claim for civil compensation based on allegations of torture and nobody had brought a claim before the Constitutional Court alleging that Decree No. 56 of 2002 was unconstitutional. That proved the unsound nature and lack of credibility of claims for compensation that failed to exhaust domestic remedies. In effect, such claims merely damaged the interests of those who had suffered human rights violations.

Id.

111. Presentation by Carla Ferstman, Director of Redress, *Accountability for Human Rights Violations in Bahrain*, Aug. 23, 2006, at 2, *available at* http://www.redress.org/reports/Presentation%20on%20Bahrain%2023%20Aug%2006%20_final_.pdf (noting that "a number of claims have indeed been filed" and blocked).

112. De Greiff, *supra* note 23, at 454.

113. CAT Comm. 2, *supra* note 71, para. 6 (expressing concern at the "apparent failure to prosecute alleged offenders, and in particular the pattern of impunity for torture and other ill-treatment committed by law enforcement personnel in the past"); Presentation by Carla Ferstman, *supra* note 111, at 2 (addressing the inability of torture victims to bring claims as a result of the amnesty legislation).

114. De Greiff, *supra* note 23, at 458.

115. *Id*.

116. *Id*.

117. *Id*.

risk that the completion of legal proceedings may not be coordinated with other reparative efforts that may play an equally important role in providing full restitution to victims.[118]

B. Financing Massive Reparations and Questions of Political Economy

Transitional societies seeking to finance administrative reparations programs while consolidating democratic reforms typically face challenges resulting from the "political dimensions" of such an undertaking, and the omnipresent "scarcity of resources" dilemma.[119] While Bahrain is certain to encounter a host of political, economic, and social obstacles in financing a massive reparations program, the country's power structure and the conditions underlying its transition do present certain opportunities. Prominent among these is that, while the 1990s in Bahrain can aptly be characterized as a time of domestic upheaval and state repression, such circumstances differ considerably from those in a society simultaneously transitioning from war to peace, such as the case in El Salvador or Guatemala.[120]

As a "relatively well-off" country with "a limited and easily identifiable set of victims," Bahrain also fits the more traditional profile for governments that have implemented administrative reparations programs to address massive human rights violations.[121] Noteworthy in this regard is that, similar to the experiences of nations such as Argentina and Chile, governmental abuses in Bahrain were committed "against a largely unarmed opposition," absent conditions of armed conflict.[122]

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118. *Id*.

119. Alexander Segovia, *Financing Reparations Programs: Reflections from International Experience*, *in* THE HANDBOOK OF REPARATIONS, *supra* note 1, at 650, 652–53. The "political dimension" encompasses the negotiations among key stakeholders necessary to mobilize and allocate financial resources. *Id.* at 653.

120. Roht-Arriaza, *supra* note 26, at 174–75; Segovia, *supra* note 122, at 653.

121. Roht-Arriaza, *supra* note 26, at 169. According to the U.N. Development Programme's 2008 Human Development Index ("HDI") Rankings, Bahrain ranks 32nd out of 179 countries, making it a "high human development" country ahead of most of its Gulf neighbors and most developing countries. U.N. Development Programme's 2008 Human Development Index Rankings, http://hdr.undp.org/en/statistics/ (last visited Feb. 16, 2009). The HDI provides a composite measure of three dimensions of human development: living a long and healthy life (measured by life expectancy), being educated (measured by adult literacy and enrollment at the primary, secondary, and tertiary level), and having a decent standard of living (measured by purchasing power parity income).

122. Roht-Arriaza, *supra* note 26, at 169.

Although Bahrain enjoys relative economic prosperity,[123] any program of reparations will require the government to reallocate its current spending priorities and/or seek additional financial support.[124] This is likely to remain a major political challenge without any significant changes to Bahrain's internal power dynamics[125] and in light of difficulties to date establishing consensus amongst national parties on the scope of any potential compensation payments by the government.[126] However, the recent implementation of a controversial one percent income tax on all public and private sector employees to help fund a national unemployment insurance plan indicates that the government has the ability to mobilize the necessary resources where the political will exists.[127] Ultimately, any progress on this front will require "the support of the Crown Prince and those loyal to him as this block was instrumental in advancing the key reforms of 2000, and national reconciliation is a critical precondition to the Crown Prince's larger political agenda of modernizing Bahrain."[128]

Reparations, by their very nature, require the State to acknowledge its wrongful conduct by recognizing and compensating the victims.[129] The Bahraini government has proved tremendously reluctant to acknowledge and accept responsibility.[130] Instead, it has offered only blanket condemnation[131] for the "situation" combined with limited progress.[132] Such re-

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123. C.I.A. World Factbook: Bahrain, *supra* note 8. "Facing declining oil reserves, Bahrain has turned to petroleum processing and refining and has transformed itself into an international banking center." In 2007, Bahrain had an estimated real growth rate (GDP) of 6.7%. *Id.*

124. Segovia, *supra* note 119, at 655.

125. *See supra* note 103.

126. *MPs Deadlocked over Riots Relief*, GULF DAILY NEWS, Apr. 11, 2007. Members of parliament were unable to reach agreement on a proposal to compensate victims of political unrest during the 1990s. Potential beneficiaries discussed included victims of abuse as well as property owners who suffered damages. *Id.*

127. Carnegie Endowment for Int'l Peace Arab Reform Bulletin: July/Aug. 2007, *Bahrain: First Gulf Income Tax; Press Law; Truth and Reconciliation Committee*, http://www.carnegieendowment.org/arb/?fa=showIssue&backIssue=7/1/2007 (last visited Feb. 16, 2009). The income tax is the first of its kind for an Arab Gulf State. Under the law, both citizens and noncitizens are required to contribute, though only citizens will receive benefits. *Id.*

128. *Prospects for Transitional Justice in Bahrain*, *supra* note 38, at 39.

129. Segovia, *supra* note 119, at 655.

130. *See* CAT Comm. 2, *supra* note 71.

131. *See, e.g.*, CAT Bahrain Comments, *supra* note 20, para. A(3) (The national reconciliation process "put an end to internal strife and brought the country out of the political and social crisis which had beset it, closing a chapter on the past and helping to create a climate conducive to the enjoyment of public freedoms.").

luctance is undoubtedly tied to the fact that "programs of reparation are part of a more general human rights agenda, which involves the defense of traditionally marginalized social groups."[133] Sectarian tension in Bahrain continues to simmer because the ruling Sunni elite have systematically marginalized Bahrain's Shiite majority.[134] Therefore, any program of reparations in Bahrain is inextricably tied to the access and exercise of power.[135] This connection helps to explain the reticence exhibited by the Bahraini elite in earnestly addressing the past—particularly the Prime Minister—and why the ruling regime has taken only carefully calculated measures designed to ease pressure without producing any fundamental changes to the Bahraini power structure and its hold on power.[136]

Hypothetically speaking, would nations with a strong interest in the stability of Bahrain—such as the United States or Saudi Arabia—ever contribute financially to a program of reparations in Bahrain?[137] Historically, foreign governments have made only limited financial contributions in support of such programs.[138] One explanation for this trend is that foreign States view financing reparations as a responsibility belonging to the State in transition.[139] Another explanation is that given the political nature of reparations programs, foreign governments are hesitant to get involved in a situation that could result in conflict with a govern-

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132. On November 11, 2007, the cabinet announced the creation of a National Human Rights Authority. The body will be responsible for setting relevant policies, addressing human rights violations, and communicating with international organizations and nongovernmental organizations. Arab Reform Bulletin, Vol. 5, Issue 9: Nov. 2007, *Bahrain: Human Rights Authority; Journalists on Trial; Marriage Age Set*, Carnegie Endowment for Int'l Peace, http://www.carnegieendowment.org/publications/index.cfm?fa=view&id=19783&prog=zgp&proj=zdrl,zme.

133. Segovia, *supra* note 119, at 655.

134. *See* ICG REPORT, *supra* note 8. According to a 2006 assessment by the Economist, while Bahrain has a per capita income of close to $20,000, a third of the native Bahraini workforce earns less than $600 a month—suggesting a significant disparity in the distribution of wealth within the country's native population. *Playing by Unfair Rules; Bahrain*, ECONOMIST, Nov. 25, 2006.

135. *See generally* Segovia, *supra* note 119, at 655.

136. CRS REPORT RL 31533, *supra* note 7, at 20. While promising, Bahrain's political reforms are consistent with efforts ongoing in the other Gulf states, none of which "aim to fundamentally restructure power in any of these states." *Id.* at summary.

137. This question does not imply that either the United States or Saudi Arabia bear any legal responsibility under international law for the practice of torture in Bahrain. This is an entirely different inquiry requiring analysis under the rules on state responsibility and the attribution of wrongful conduct to a State. Heidy Rombouts, Pietro Sardaro & Stef Vendeginste, *in* OUT OF THE ASHES: REPARATION FOR VICTIMS OF GROSS AND SYSTEMATIC HUMAN RIGHTS VIOLATIONS, *supra* note 6, at 345, 482.

138. Segovia, *supra* note 119, at 659.

139. *Id.*

ment or an influential sector of a country such as the military.[140] It thus seems highly unlikely that the United States would be willing to contribute to any such effort. Saudi Arabia is also unlikely to contribute financially, particularly given its own shameful human rights record[141] and recent internal civil unrest.[142]

C. The Moroccan Transitional Justice Experience

A large-scale reparations program is not an unprecedented measure for a State in the Middle East and North Africa ("MENA") region. Since 1990, Morocco has implemented various transitional justice mechanisms in an effort to confront its repressive past, specifically the gross human rights abuses committed by the State in the decades following Moroccan independence in 1956.[143] While Morocco's experience is certainly unique and should not be understood as mapping directly to other MENA States, it offers critical insights about "both the promise and limits of truth-telling and reparations" and is beneficial to any discussion of transitional justice in Bahrain.[144]

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140. *Id.*

141. Human Rights Watch, *Overview of Human Rights Developments: Saudi Arabia 2006*, http://hrw.org/englishwr2k7/docs/2007/01/11/saudia14717.htm (last visited Dec. 19, 2007) ("Overall human rights conditions remain poor in Saudi Arabia . . . . Saudi law does not protect many basic rights and the government places strict limits on freedom of association, assembly, and expression. Arbitrary detention, mistreatment and torture of detainees, restrictions on freedom of movement, and lack of official accountability remain serious concerns.").

142. The U.S. war in Iraq and the corresponding empowerment of Iraqi Shiites and high levels of sectarian violence that resulted have produced "acute fears of potential Shiite unrest" in Saudi Arabia. CRS REPORT RL 31533, *supra* note 7, at 5.

143. ICTJ Morocco Overview, *supra* note 41. Victims of government repression included leftists, Islamists, Saharawi independence activists, unionists, military dissidents, intellectuals, and others considered to be threats to the State. INT'L CTR FOR TRANSITIONAL JUSTICE, WORKSHOP ON THE GOALS AND CHALLENGES OF REPARATIONS AS A TRANSITIONAL JUSTICE MEASURE IN IRAQ 44 (2007) [hereinafter ICTJ WORKSHOP] (on file with the International Center for Transitional Justice, Middle East North Africa Unit).

144. ICTJ WORKSHOP, *supra* note 143, at 44. For a discussion on the uniqueness of the Moroccan experience, see King Mohamed VI, The Speech of His Majesty the King Mohamed VI Announcing the Formation of the Commission for Equity and Reconciliation (Jan. 7, 2004), *available at* http://www.ier.ma/article.php3?id_article=1297 ("Reflecting on the different international experiences in this particular field, one must acknowledge that Morocco, acting with wisdom and courage, has managed to come up with a model of its own."). *See also* MOROCCAN EQUITY AND RECONCILIATION COMM'N, SUMMARY OF THE FINDINGS OF THE FINAL REPORT 12 (Dec. 2005) (In examining "the issue of reparations through the experiences of truth commission that were formed across the world . . . the Commission concluded that there is no one model that can be adopted."); *An Interview with Hanny Megally*, ALL AFRICA, Aug. 4, 2006 ("Each country has its own specificity as

Morocco's initial transitional justice efforts began in 1990, under the late King Hassan II, who presided over the most intense era of repression commonly known as the "years of lead" and lasting from the 1960s until the early 1990s.[145] To quell mounting criticism, the King established the Human Rights Advisory Council (*Conseil Consultatif des Droits de l'Homme*) ("CCDH"), and the government released hundreds of political dissidents throughout the early part of the decade while taking limited measures to reform its incommunicado detention policies.[146] Despite making formal reservations to each, Morocco ratified CAT, the Convention on the Elimination of All Forms of Discrimination Against Women, and the Convention on the Rights of the Child in 1993.[147]

Similar to Bahrain, the death of King Hassan in 1999 and the succession to the throne of his more reform-minded son, Mohammed VI, presented a new opportunity to confront many of the unresolved issues tied to governmental abuses.[148] King Mohammed VI ordered the formation of an independent Indemnity Commission ("IC") within the CCDH in order to compensate Moroccans "'who suffered moral or physical prejudice as a result of enforced disappearance or arbitrary detention.'"[149] Over the course of four years, the IC decided more than 5000 cases and awarded a

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to how it will go about addressing a legacy of past abuses."); Habib Toumi, *Bahrain 'Must' Have Its Own Justice System*, GULF NEWS, Apr. 26, 2007 (quoting Joe Stork, Director of Human Rights Watch Middle East and North Africa Division, in discussing transitional justice generally in Bahrain: "[t]he process has to be home-grown because every country has its own realities and Bahrainis have to work together to build their own").

145. ICTJ Morocco Overview, *supra* note 41.

146. *Id.* According to Human Rights Watch: "[i]n the late 1980's Hassan II began releasing batches of political prisoners . . . . In 1991, Hassan II freed about 270 persons whom the security services had 'disappeared' as long as nineteen years earlier. In 1994, the King amnestied more than 400 political prisoners. Opposition figures returned to Morocco after years of exile . . . ." HUMAN RIGHTS WATCH, MOROCCO'S TRUTH COMMISSION: HONORING PAST VICTIMS DURING AN UNCERTAIN PRESENT 6–7 (Nov. 2005) [hereinafter HRW MOROCCO].

147. HRW MOROCCO, *supra* note 146, at 7.

148. Susan Slyomovics, *No Buying off the Past: Moroccan Indemnities and the Opposition*, 229 MIDDLE EAST REPORT 34 (Winter 2003). *See generally* Heidy Rombouts, Pietro Sardaro & Stef Vendeginste, *supra* note 137, at 345, 481–82. "Regime succession" is a typical precursor to reparations for gross and systematic human rights violations, and it is a well established principle of international law that "neither a change of government nor a major regime change accompanied by a political transition and a constitutional reform of the state" disengages the State's liability for human rights violations committed by a previous regime. *Id.*

149. Susan Slyomovics, *A Truth Commission for Morocco*, MIDDLE EAST REP. 218 (Spring 2001).

total of approximately $100 million in reparations.[150] However, the IC was criticized on "legal, moral and emotional" grounds.[151] While the indemnity scheme acknowledged "implicitly, rather than explicitly, an official policy of illegal state practices," compensation did little to meet the demands of victims seeking truth and justice, particularly those calling for the punishment of perpetrators.[152] Moreover, the IC was derided for its lack of transparency, for the complicity of its administrators in past governmental human rights violations, and for its limited mandate, which precluded the body from resolving thousands of cases.[153]

In 2004, King Mohammed VI took another major step by establishing the Commission for Equity and Reconciliation (*Instance Equité et Réconciliation*) ("IER").[154] He declared the IER to be "equivalent to a Truth, Justice and Reconciliation Commission."[155] The scope of the IER's mandate was much broader than that of the IC, extending to "gross human rights violations that occurred between 1956 and the end of 1999."[156] As a result, the IER had broad authority to assess, research, investigate, arbitrate, and make recommendations on claims not only for forced disappearance and arbitrary detention, but also for torture, sexual abuse, and deprivation of the right to life due to unrestrained use of state force and forced exile.[157] The IER was also responsible for continuing

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150. ICTJ Morocco Overview, *supra* note 41.

151. Slyomovics, *supra* note 148, at 35.

152. *Id.* As Houria Esslami, sister of political activist and doctor Mohamed Esslami who was "disappeared" in 1997, explained:

> [I]ndemnification should be the last stage of this dossier. In the first place, it is necessary to acknowledge all the disappeared, free those still living, speak the truth about the reasons for their disappearance and incriminate those responsible. It is only at that moment that one can speak about indemnification . . . .

Id.

153. *Id.* The fact that the Commission did not have access to the extensive files of the security services and the Interior Ministry proved particularly damaging. ICTJ Morocco Overview, *supra* note 41.

154. Commission for Equity and Reconciliation, Mandate and Tasks, http://www.ier.ma/article.php3?id_article=1305 (last visited Dec. 19, 2007). The Commission's mandate was from January 2004 to November 2005. The Commission was made up of a president and sixteen members, all appointed by the King upon recommendations by the CCDH. Nine of the members, including its president, were from the CCDH. Many of its members including its now-deceased president, Driss Benzekri, were former prisoners and torture survivors. ICTJ WORKSHOP, *supra* note 143, at 47.

155. MOROCCAN EQUITY AND RECONCILIATION COMM'N, *supra* note 144, at 1.

156. *Id.*

157. *Id.*

the work of the IC by compensating victims and their heirs.[158] While the IER was only granted "non-judiciary powers" of investigation, "public authorities were obliged to cooperate because of [the Commission's] royal support."[159] The IER was also prohibited from identifying individual perpetrators and could thus only identify institutions responsible for abuses.[160]

During the course of its activities, the Commission considered more than 22,000 applications and held "victim-centered, public hearings" televised throughout country.[161] The IER released its final report in December 2005.[162] The report details the responsibility of both State and nonstate actors for gross violations committed, and offers suggestions and recommendations for providing victims with the necessary "moral and medical rehabilitation and social reinsertion."[163] Given the extent of suffering endured by certain communities and regions, the Commission focused extensively on communal reparations as well. The Commission thus urged the "adoption of socio-economic and cultural development projects" tailored to those cities and regions, and "specifically recommended the conversion of former illegal detention centers."[164] The report also outlines specific measures that the Moroccan government and civil society can undertake to guarantee nonrepetition in the future.[165] Finally, the report addresses the need for official acknowledgement of wrongdoing by recommending that the Prime Minister apologize publicly for past abuses.[166]

The IER reparations program ultimately covered approximately 16,000 individuals.[167] About $85 million in reparations was distributed to beneficiaries.[168] These beneficiaries received compensation checks, which

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158. Commission for Equity and Reconciliation, *supra* note 157. As part of its task to unveil the truth, the Commission is responsible for "[r]edressing damages to the victims and/or their inheritors through material compensation, rehabilitation, social integration, and all other adequate means of reparations." *Id.*

159. ICTJ Morocco Overview, *supra* note 41.

160. ICTJ WORKSHOP, *supra* note 143, at 45.

161. ICTJ Morocco Overview, *supra* note 41. The IER held seven public hearings, which were widely attended and at times included the King's senior advisers, government officials, opposition party leaders, diplomats, international press, and civil society representatives. ICTJ WORKSHOP, *supra* note 143, at 47.

162. ICTJ WORKSHOP, *supra* note 143, at 44.

163. ICTJ Morocco Overview, *supra* note 41; ICTJ WORKSHOP, *supra* note 143, at 44; MOROCCAN EQUITY AND RECONCILIATION COMM'N, *supra* note 144, at 1.

164. MOROCCAN EQUITY AND RECONCILIATION COMM'N, *supra* note 144, at 2.

165. ICTJ Morocco Overview, *supra* note 41.

166. *Id.*

167. *Id.*

168. *Id.*

included a letter of apology from the State.[169] Minimum payouts to victims were set at 15,000 dirham (approximately $200 in 2006).[170] In addition, all victims were eligible to receive health care.[171] The Moroccan government funded the bulk of the reparations program with some assistance from the European Union.[172]

Due to the restriction against identifying individual perpetrators, the IER has been criticized for maintaining impunity.[173] The subsequent failure to prosecute or recommend the prosecution of individuals has reinforced the belief "some victims may feel that reparations without accountability is only limited justice."[174]

The IER was also criticized for not doing more to publicize its work and ensure victims adequate notification of the application deadline.[175] This is partially attributable to the large size of Morocco and the many remote communities disconnected from the national media.[176] Any reparations program in Bahrain should draw from the Moroccan experience by undertaking a comprehensive public information strategy aimed at making Bahraini victims aware of available compensation and the relevant deadlines. This should not be difficult given Bahrain's "highly developed" communications infrastructure and the small size of the country.[177]

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169. ICTJ WORKSHOP, *supra* note 143, at 48. The one-page letter acknowledged and apologized for government human rights violations. The package also included a ruling on the victim's individual case, detailing "the specific violations to which the victim was subjected and the amount allocated as compensation." *Id*.

170. *Id.*

171. *Id.*

172. *Id.*

173. *Id.* at 49. For many victims,

> moral and legal measures of reparations are fundamental, while monetary compensation is controversial and problematic. . . . [V]ictims ask for official and societal acknowledgement that they were wronged, restoration of their good name, [and] knowledge of who and how it was done. . . . [C]ompensation was never enough, or even the most important thing. They especially note the hollowness of material reparations when there has been no pronounced reluctance to prosecute those responsible.

Roht-Arriaza, *supra* note 26, at 180 (discussing the findings of the comparative study by the Chilean human rights organization *Corporación de Promoción y Defensa de los Derechos del Pueblo*).

174. ICTJ WORKSHOP, *supra* note 143, at 49.

175. *Id.* The IER received 8000 applications after the one-month deadline. *Id.*

176. *Id.*

177. C.I.A. World Factbook: Bahrain, *supra* note 8. Bahrain has a "highly developed" communications infrastructure and a total land area of 665 sq km (compared to Morocco's 446,300 sq km). *Id.* Bahrain is also one of the most urbanized countries in the world,

CONCLUSION

Both the story of victim's rights under international law and the story of Bahrain's transitional justice experience are far from written. Efforts to close the gap between the rhetoric of human rights and the enforcement of such rights must remain a top priority. The inability of Bahraini torture victims to access justice at either the regional or international level underscores this need. The U.N. General Assembly's adoption of the 2006 Basic Principles marks an important step in the evolution of human rights law towards a more "victimcentric" framework,[178] but the doctrine must be translated into action in order to protect "the inherent dignity . . . of all members of the human family" on which "freedom, justice and peace in the world" is based.[179]

In Bahrain, recent human rights developments serve as a reminder that there are many obstacles to overcome in guaranteeing respect for essential human rights at the domestic level.[180] Nevertheless, there are also positive signs that some degree of justice may be forthcoming for Bahraini victims of state abuse. In June 2007, eleven Bahraini human rights organizations and opposition groups took the unprecedented step of forming a reconciliation pressure group to lobby the government for the creation of a truth and reconciliation committee ("TRC") to address human rights abuses committed by the government from the 1970s to the 1990s.[181] However, there has been no indication that the TRC will become official through government support or participation, or by grant-

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as its small population of 708,000 is heavily concentrated in the country's two major cities, Manama and al-Muharraq, and in main towns such as Jidd Hafs, Sitra, al-Rifaa, and Madinat. HRW, ROUTINE ABUSE, ROUTINE DENIAL, *supra* note 5, at 9.

178. Bassiouni, *supra* note 2, at 204.

179. Universal Declaration of Human Rights, *supra* note 42, prmbl.

180. *See* Bahrain Center for Human Rights, *BCHR: Arbitrary Detention and Unfair Trials in Bahrain During 2006*, http://www.bahrainrights.org/en/node/1626 (last visited Dec. 4, 2007) ("The year 2006 has witnessed an extreme decline in public freedoms in Bahrain, especially in regards to freedom of expression and opinion and the freedom of assembly."); International Freedom of Expression eXchange, *Bahrain: Twenty-Six IFEX Members Slam Government's Latest Attack on Free Expression*, http://canada.ifex.org/en/content/view/full/88152/ (last visited Dec. 19, 2007) (calling upon the Bahraini authorities to "halt their attacks upon freedom of expression, to abolish abusive laws, and to respect their commitment to international charters and covenants, in particular Article 19 of the ICCPR.").

181. Carnegie Endowment for Int'l Peace Arab Reform Bulletin: July/Aug. 2007, *supra* note 127. Suggestions for the TRC's potential mandate included truth-finding and compensation payments to those who sustained injuries or were subjected to torture, deportation, or arbitrary arrest. Members also called for punishment of those allegedly responsible for torture in direct contravention of Decree 56, which pardoned all political prisoners and perpetrators responsible for human rights violations. *Id.*

ing TRC investigators access to files or personnel.[182] Still, a follow-up coalition meeting was held in September 2007 and included the participation of representatives from the International Center for Transitional Justice.[183] While the TRC's launch date was set for December 10, 2007, the anniversary of the UDHR,[184] no announcement has been made at the time of writing.

Bahrain appears to be at a crossroads. For the Al-Khalifa regime, prolonged inaction without officially confronting and remedying past abuses risks igniting wide-scale civil unrest comparable to levels witnessed in the 1990s, or worse.[185] Such a risk is compounded by the growing influence of Shiite Iran in regional affairs, and regional destabilization caused by the ongoing sectarian violence in nearby Iraq.[186] Widespread civil unrest in Bahrain would also be detrimental to the United States and Saudi Arabia, which depend on the ruling regime and the stability of the island kingdom in pursuing their respective geopolitical and economic interests.[187] On the other hand, official measures of reparation would build

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182. *Prospects for Transitional Justice in Bahrain*, *supra* note 38, at 2. The government remains steadfast in its position that the 2002 pardon remains valid, and that the pardon includes all parties. As such, explained Social Development Minister Fatima al-Balooshi, "[T]he law does not allow for review of cases that fall within the timeframe of the pardon . . . ." *DPA: Bahraini NGO's, Opposition Launch Truth and Reconciliation Panel*, DEUTSCHE PRESS-AGENTUR, June 27, 2007.

183. Carnegie Endowment for Int'l Peace Arab Reform Bulletin: Oct. 2007*, Bahrain: NDI Returns; Cabinet Change; Anti-Corruption Efforts*, http://www.carnegieendowment.org/arb/?fa=showIssue&backIssue=10/1/2007 (last visited Feb. 16, 2009).

184. *Id.*

185. For coverage of escalated clashes between state Security forces and protesters, see Michael Slackman, *Sectarian Tension Takes Volatile Form in Bahrain*, N.Y. TIMES, Mar. 27, 2009; *Bahrain: Shi'ite Riots Orchestrated*, MIDDLE EAST NEWSLINE, June 12, 2007; Human Rights Watch, *Bahrain: Jailed Protesters Show Signs of Severe Abuse*, June 1, 2007, http://hrw.org.english/docs/2007/06/01/bahrail6051_txt.htm; *Three Policemen Injured in Third Day of Bahrain Violence*, KHALEEJ TIMES, May 22, 2007.

186. *See* CRS REPORT RL 31533, *supra* note 7.

187. *See* CRS REPORT FOR CONGRESS 95-1013, *supra* note 15; *Prospects for Transitional Justice in Bahrain*, *supra* note 38.

upon the encouraging precedent established in Morocco while demonstrating that political survival and respect for human rights are not mutually exclusive in the Middle East of tomorrow.

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THE DEVELOPMENT OF INTERNATIONAL NORMS FOR INSURANCE REGULATION

Elizabeth F. Brown[*]

ABSTRACT

The development of international norms for insurance has not progressed as far or as deeply as the development of international norms for banking. Several factors have affected this process. First, the efforts to develop such norms are relatively new. The International Association of Insurance Supervisors ("IAIS") has existed for less than fifteen years while the Basel Committee on Banking Supervision has existed for over thirty years. Second, the membership of the IAIS makes it harder for that organization to achieve consensus on principles and standards than for the Basel Committee. The IAIS has members from almost 140 nations, including both developed and less developed nations, while the Basel Committee is comprised of only thirteen members from only developed nations.

Finally, the fact that insurance is regulated by the states within the United States has hindered the ability of the United States to conduct effective international negotiations on insurance regulation. The individual states have not adopted uniform insurance laws. As a result, they do not necessarily espouse the same positions when participating in international bodies like the IAIS. In addition, the federal government has difficulty translating the soft law standards developed by the IAIS into hard law in treaties and international agreements because it currently lacks the power to force the states to change their insurance laws to conform to the negotiated standards. The states also cannot translate the soft law standards developed by the IAIS into hard international laws because they currently are not authorized to conduct negotiations for treaties or binding international agreements on insurance. Until the United States creates a body capable of conducting international negotiations that can bind the states, the development of international insurance standards will continue to proceed more slowly than the development of standards for other financial services sectors.

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INTRODUCTION

The development of international norms and standards for many types of insurance is a relatively new phenomenon when compared with the development of international norms and standards for other commercial activities, such as trade in goods or banking. This is perhaps because many types of insurance were considered to be governed primarily by local, rather than international, conditions. Life insurance, property and casualty insurance, and health insurance comprise the largest sectors within insurance based on premiums. In each case, local laws and local conditions have a significant impact on shaping the risks insured against by insurance firms. The local character of insurance markets has been the major justification as to why insurance is regulated almost exclusively by the states within the United States, rather than by the federal government.

Nevertheless, a number of factors are putting increasing pressure on governments and market participants to develop international norms and standards for insurance. First, financial services[1] markets are increasingly interconnected which means that the risks posed by one region or sector can more easily spill out and affect other regions and sectors. This interconnectedness is due, in part, to the increasing number of fungible financial products and services. Hybrid products that contain elements of traditional banking, securities, or insurance products are being created more frequently now than ever before. These products are breaking down the distinctions among the banking, securities, and insurance sectors. The result is that financial services now form a continuum, rather than distinct silos, for banking, insurance, and securities.

Financial products also are linking previously separate sectors as products from one sector are repackaged to spread and diversify the risks. The current financial crisis has highlighted this fact as mortgages, a traditional banking product, were sold to special purpose vehicles ("SPVs") that bundled them together and issued securities that would pay based on the income stream generated by the mortgage payments. The risk that

1. In this Article, financial services refers to any activity considered financial in nature pursuant to section 103 of the Gramm-Leach-Bliley Act of 1999 ("GLBA"), including banking, securities, merchant banking, and insurance products and services. Gramm-Leach-Bliley Act § 103, 12 U.S.C. § 1843 (1999). This definition of financial services is not universally applied by other organizations. For example, the Basel II Capital Accord excludes insurance activities from the definition of "financial activities" and excludes insurance entities from the definition of "financial entities." BANK FOR INT'L SETTLEMENTS, BASEL COMM. ON BANKING SUPERVISION, INTERNATIONAL CONVERGENCE OF CAPITAL MEASUREMENT AND CAPITAL STANDARDS: A REVISED FRAMEWORK 7 n.5 (2004), *available at* http://www.bis.org/publ/bcbs118.pdf.

those securities would default was insured against either by the SPV taking out bond insurance on the securities or by the purchasers entering into credit default swaps.

Second, technology is also making it easier to purchase products and services from distant suppliers. Insurance companies already use e-mail and blogs to sell their products.[2] Insurance marketing consulting firms, like IdeaStar Inc., are encouraging insurance firms to consider how to market their products using Facebook, Linkedin, Twitter, and YouTube, all of which reach a global audience.[3] Insurance publications discuss other ways that insurance firms can expand their online traffic, such as using search engine optimization techniques to improve their search engine rankings and contracting with related websites for fees generated by users of those sites clicking through to the insurance companies' websites.[4] In addition, the Internet allows individual consumers to compare the prices and products of insurance companies from around the world. All of these developments are weakening the ties that traditionally made insurance a financial product dominated by local or regional concerns.

Third, as the markets in the United States and the European Union mature, the multinational insurance and financial conglomerates are expanding their operations in emerging markets and ratcheting up the global competition for market shares in insurance. The European Union comprised thirty-seven percent of the worldwide life, property, and casualty insurance premiums in 2007, while the United States comprised thirty-two percent.[5] The areas showing the largest potential for growth in the near future are nations in Asia, other than Japan, and Latin America.[6]

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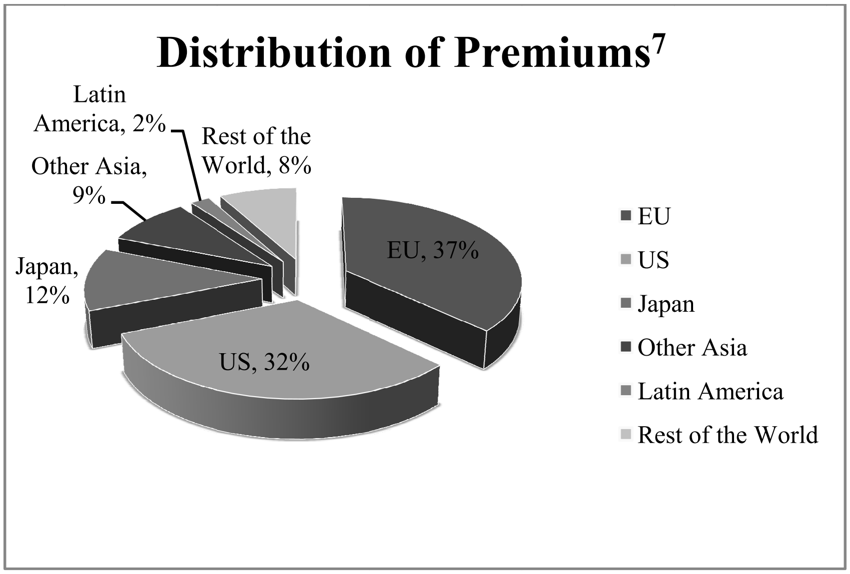
2. For example, Insurance Broadcasting provides a directory of insurance blogs, including a number of blogs associated with insurance businesses. *See* Insurance Broadcasting, Insurance Blog Directory, http://insuranceblogdirectory.com/?gclid=CJXT-bLgvpkCFQXGsgod0XX-5Q (last visited Apr. 18, 2009).

3. *See* IdeaStar, *Insurance Affinity Marketing Strategies and the Decline of Snail Mail*, Mar. 23, 2009, http://www.insurance-technologies.com/News/decline-of-snail-mail.aspx.

4. Al Slavin, *Contact Me . . . If You Can*, BEST'S REV., Mar. 2009, at 26, 27.

5. John A. Cooke & Harold D. Skipper, An Evaluation of the US Insurance Regulation in a Competitive World Insurance Market 3 (June 27, 2008) (unpublished manuscript, presented at AEI Conference: The Future of Insurance Regulation, *available at* http://www.rmi.gsu.edu/insurance_regulation/rel_papers/CookeSkipper_RegulationInternational.pdf).

6. *Id*. at 4.



These factors have encouraged the development of international standards for insurance regulation. For the most part, these standards have taken the form of nonbinding norms, or soft law, rather than binding treaty obligations, or hard law. This Article will examine what the sources are for international insurance norms; why the U.S. regulatory structure acts as an impediment to converting soft law international insurance regulation standards into hard law in the form of binding international agreements; and what the possible solutions to this problem are.

I. SOURCES OF INTERNATIONAL INSURANCE NORMS

International norms can be developed in one of three ways. De jure standard setting can be developed through treaties, like the General Agreement on Trade in Services ("GATS"), or other binding international agreements.[8] These efforts usually involve a national government imposing a common standard on subnational actors. Alternatively, de facto standard setting can arise when individual governments adopt similar laws without engaging in any coordination or cooperative activities with one another.[9] The common features of these laws emerge because they

7. *Id.* at 4 & fig.1.

8. *See* Robert B. Ahdieh, *Foreign Affairs, International Law, and the New Federalism: Lessons from Coordination* 25 (Emory Univ. Law & Econ. Research Paper No. 08-30; Emory Univ. Pub. Law Research Paper No. 08-43; Princeton Univ. Law & Pub. Affairs Working Paper No. 08-008; Columbia Univ. Law Sch. Pub. Law Research Paper No. 08-184, 2008), *available at* http://ssrn.com/abstract=1272967.

9. *See id*.

are attempting to address the same sorts of problems. Insurance laws around the world tend to incorporate regulations that address both prudential and market conduct risks.[10] As a result, they tend to have similar features, although they can still vary greatly. Finally, group or committee standard setting can result in soft law, such as nonbinding principles or guidelines, developed by intergovernmental forums like the IAIS or industry groups like the International Union of Credit and Investment Insurers.[11]

The way the United States regulates insurance has proven to be a significant impediment to the development of hard international law in that area. The states within the United States are the main insurance regulators. They, however, lack the authority under the U.S. Constitution to negotiate binding international agreements on insurance.[12] The federal government, which has the authority under the U.S. Constitution to negotiate such agreements,[13] has no agency tasked with regulating insurance that could conduct such negotiations. The U.S. Trade Representative's Office, which negotiated GATS, lacks the authority to bind the states and to ensure that they will enact the necessary domestic laws to codify any concession that it might make.[14] As a result, the international agreements on insurance negotiated to date contain substantial exemptions for U.S. states' insurance laws.[15] The breadth of these exemptions means that, in many cases, the principles embodied in GATS and other trade agreements are not binding on the states within the United States and the extent to which the states meet these principles is more a function of soft law rather than hard law.

A number of international forums currently promote the development of soft law international norms in the area of insurance. The primary forum is the IAIS, which has over 190 members (including the insurance commissions from all fifty states within the United States). The Joint Forum, which is comprised of the IAIS, the Basel Committee on Bank Supervision ("Basel Committee"), and the International Organization of Securities Commissions ("IOSCO"), sets guidelines for issues that are common to banking, securities, and insurance, such as the regulation of

10. Cooke & Skipper, *supra* note 5, at 1–2.

11. *See* Ahdieh, *supra* note 8, at 25–26.

12. The U.S. Constitution gives Congress the power to regulate commerce with foreign powers and prohibits the states from negotiating international agreements with foreign powers without the consent of Congress. U.S. CONST. art. I, §§ 8, 10.

13. *Id.* art. I, § 8.

14. Cooke & Skipper, *supra* note 5, at 18.

15. *Id*. at 18–19 & n.27.

financial conglomerates.[16] Some hybrid products, like variable annuities, are regulated by both insurance and securities regulators.[17] As a result, the activities of IOSCO have an impact on the development of regulatory standards for some insurance products.[18]

The IAIS, IOSCO, and the Basel Committee are also members of the Financial Stability Forum ("FSF"), which brings together the national financial supervisory authorities in order "to assess vulnerabilities affecting the international financial system; to identify and oversee action needed to address these; and to improve co-ordination and information exchange among the various authorities responsible for financial stability."[19] Among other things, the FSF promotes the implementation of international standards by national financial supervisory authorities, including those governing insurance.[20] On April 2, 2009, the membership of the FSF was expanded to include Spain and the European Commission, and the FSF was renamed the Financial Stability Board ("FSB").[21] In addition, the FSB's mandate grew to include, among other things, undertaking strategic reviews of the policy development work being done by IAIS, IOSCO, and the Basel Committee, setting guidelines for creating international "supervisory colleges" to monitor the largest financial services firms, and assisting the IMF on Early Warning Exercises concerning financial crises.[22]

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16. Press Release, IOSCO, Joint Forum—Amplified Mandate (June 14, 2002), *available at* http://www.iosco.org/news/pdf/IOSCONEWS3.pdf; IOSCO Joint Forum, http://www.iosco.org/joint_forum/ (last visited Apr. 18, 2009).

17. *See* VARIABLE ANNUITY MODEL REGULATION § 4 (Nat'l Ass'n of Ins. Comm'rs 1996) (discussing procedures for separate accounts); Press Release, SEC, SEC and NASD Release Joint Staff Report on Broker-Dealer Sales of Variable Insurance Products (June 9, 2004), *available at* http://www.sec.gov/news/press/2004-80.htm.

18. For example, IOSCO issued a lengthy report on international derivatives regulation. INT'L ORG. OF SEC. COMM'NS, REPORT ON THE INTERNATIONAL REGULATION OF DERIVATIVE MARKETS, PRODUCTS AND FINANCIAL INTERMEDIARIES (1996), *available at* http://www.iosco.org/library/pubdocs/pdf/IOSCOPD65.pdf.

19. Financial Stability Forum—Mandate, http://www.fsforum.org/about/mandate.htm (last visited Apr. 18, 2009); Financial Stability Forum—Overview, http://www.fsforum.org/about/overview.htm (last visited Apr. 18, 2009).

20. *See* Financial Stability Forum, http://www.fsforum.org/ (last visited Apr. 18, 2009). For a list of members of the FSF, see Financial Stability Forum—Overview, *supra* note 19.

21. Press Release, Fin. Stability Forum, Financial Stability Forum Re-established as the Financial Stability Board 1 (Apr. 2, 2009), *available at* http://www.fsforum.org/press/pr_090402b.pdf.

22. *Id.* at 2; Elena Moya, *Financial Stability Board: How It Will Work*, GUARDIAN, Apr. 4, 2009, http://www.guardian.co.uk/world/2009/apr/04/financial-stability-board-g20.

The Organisation for Economic Co-operation and Development ("OECD") promotes insurance regulation standards through its Insurance and Private Pensions Committee.[23] The OECD has adopted the Code of Liberalization of Current Invisible Operations ("Invisibles Code").[24] This code deals with standards for the intangible trade in insurance, securities, banking, and investments.[25] The International Actuarial Association ("IAA") and International Accounting Standards Board ("IASB") play roles by developing the actuarial and accounting standards for insurance firms and products.[26]

In order to illustrate the impact that international organizations can have on the development of insurance norms, this Article will examine the roles played by GATS and other trade agreements, the IAIS, and the developing EU directives on insurance.

A. General Agreement on Trade in Services and Other Trade Agreements

The desire of multinational insurance companies and other financial services firms to access markets overseas led to the inclusion of services in international trade negotiations since the 1980s.[27] The United States first addressed services in its Free Trade Agreement with Israel in 1985 by including a nonbinding declaration on the need to develop national

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23. OECD, Directorate for Financial and Enterprise Affairs, Insurance: About, http://www.oecd.org/about/0,3347,en_2649_34851_1_1_1_1_1,00.html (last visited Apr. 18, 2009).

24. Org. for Econ. Co-operation & Dev. [OECD], *Code for Liberalisation of Current Invisible Operations* (2008), *available at* http://www.oecd.org/dataoecd/41/21/2030182.pdf. The Invisibles Code articulates several principles, including the right of establishment of insurance, the right to provide services cross-border, and an individual's right to buy insurance from any company. *See id.* annex A, app. to annex I, annex II. It also contains exceptions to preserve public order and security. *Id.* art. 3. The United States also has an exemption for any "action by a State of the United States which comes within the jurisdiction of that State." *Id.* annex C. This exemption basically excludes state regulation of insurance from compliance with this code.

25. *See id*. annex A (providing a detailed list of operations covered by the Invisibles Code).

26. About the IAA, Who Are We?, http://www.actuaries.org/index.cfm?LANG=EN&DSP=ABOUT&ACT=WHO (last visited Apr. 18, 2009); IASB—Insurance Contracts, http://www.iasb.org/Current+Projects/IASB+Projects/Insurance+Contracts/Insurance+Contracts.htm (last visited Apr. 18, 2009).

27. *See* Kern Alexander, *The GATS and Financial Services: Liberalisation and Regulation in Global Financial Markets*, *in* THE WORLD TRADE ORGANIZATION AND TRADE IN SERVICES 561, 564, 568 (Kern Alexander & Mads Andenas eds., 2008) (discussing that, in response to banking crises, international financial institutions sought to promote not only market access, but also greater financial stability through trade negotiations).

treatment and market access in the trade in services.[28] The Uruguay Round of the General Agreement on Tariffs and Trade ("GATT") was the first attempt to negotiate a multilateral agreement on services and resulted in GATS.[29]

All of the 153 members of the World Trade Organization ("WTO") are signatories to GATS.[30] In addition, nations around the world have entered into a variety of free trade agreements, like the North American Free Trade Agreement ("NAFTA").[31] GATS and the free trade agreements are built on four principles that were originally developed to deal with the trade in goods under GATT: (1) national treatment, (2) most-favored-nation status, (3) market access, and (4) transparency. National treatment requires that domestic rules ensure that foreign suppliers receive treatment no less favorable than domestic suppliers.[32] Most-favored-nation ("MFN") status prohibits one country's suppliers from being accorded treatment more favorable than any other nation's suppliers.[33] Market access requires that nations guarantee the right of a foreign supplier to enter the market.[34] Finally, transparency requires that rules regarding market access and the domestic operation of an insurance company be clear, ascertainable, and openly administered.[35] GATS does not address principles or standards for prudential regulations, market conduct regulations, or systemic regulations for insurance.[36]

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28. Free Trade Agreement, Isr.-U.S., Apr. 22, 1985, 24 I.L.M. 653, 679–80 (1985).

29. Alexander, *supra* note 27, at 567–69.

30. WTO: Understanding the WTO—Members, http://www.wto.org/english/thewto_e/whatis_e/tif_e/org6_e.htm (listing the 153 WTO Members). *See also* Final Act Embodying the Results of the Uruguay Round of Multilateral Trade Negotiations, ¶ 4, Apr. 15, 1994, 33 I.L.M. 1125 (1994) (stating that, but for plurilateral agreements, the WTO Agreement is "open for acceptance as a whole," including GATS).

31. North American Free Trade Agreement, U.S.-Can.-Mex., Dec. 17, 1992, 32 I.L.M. 289 (1993); John Cooke, *Alternative Approaches to Financial Services Liberalisation: The Role of Regional Trade Agreements*, *in* THE WORLD TRADE ORGANIZATION AND TRADE IN SERVICES, *supra* note 27, at 615, 615–34.

32. General Agreement on Trade in Services art. XVII, Apr. 15, 1994, 33 I.L.M. 1167 [hereinafter GATS].

33. *Id.* art. II.

34. *Id.* art. XVI.

35. *See id.* art. III.

36. In fact, one of the major exceptions to the applicability of the four GATS principles is the prudential carve-out, which allows nations to adopt regulations that violate one or more of the four GATS principles in order to maintain the solvency of the insurance industry. For a history of the prudential carve-out, see generally Wei Wang, *The Prudential Carve-out*, *in* THE WORLD TRADE ORGANIZATION AND TRADE IN SERVICES, *supra* note 27, at 601, 601–04.

GATS and the free trade agreements allow nations to continue to apply laws or regulations that conflict with one or more of the four basic principles if these laws or regulations fit within one of the following eight exceptions: (1) laws necessary to protect public morals or maintain public order;[37] (2) laws necessary to protect human, animal, or plant life or health;[38] (3) laws necessary to secure compliance with other laws or regulations;[39] (4) laws inconsistent with national treatment provided that the difference in treatment is aimed at ensuring the equitable or effective imposition or collection of direct taxes with respect to foreign services or service suppliers;[40] (5) laws inconsistent with MFN treatment, provided the difference in treatment is the result of an agreement on the avoidance of double taxation;[41] (6) government programs not supplied on a commercial basis or in competition with the private sector (e.g., health insurance or unemployment insurance);[42] (7) prudential measures needed to protect investors, policyholders, or others to whom a fiduciary duty is owed, or needed to stabilize the financial system;[43] and (8) express reservations set forth in schedules that do not conform to the obligations set forth in GATS.[44] The breadth of these exceptions can swallow the GATS principles. Consequentially, whether a nation or state within the United States complies with these GATS principles may be a matter of soft law rather than hard law. For example, the United States has express reservations for many state regulations on insurance in a schedule to GATS.[45] As a result, a number of state regulations violate the GATS principles of national treatment, market access, and transparency.[46] However, there does not appear to be any inconsistencies between state regulations and MFN status.[47]

State laws that are inconsistent with the principle of national treatment include reinsurance cessions that differently affect domestic and out-of-

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37. GATS, *supra* note 32, art. XIV.
38. *Id*.
39. *Id.*
40. *Id.*
41. *Id.*
42. *Id.* art. XIII.
43. *Id.* Annex on Financial Services, ¶ 2(a).
44. *See id.* arts. XX–XXI.
45. The World Trade Organization provides a list of U.S. limitations on market access and national treatment in the area of insurance in its Trade in Services Database, http://tsdb.wto.org/Default.aspx (select "07.A. All Insurance and Insurance-related Services" from "Jump to a specific sector for a given Member" drop-down menu; then select "USA" from "Choose Member" menu; then click "go") (last visited Apr. 18, 2009).
46. Cooke & Skipper, *supra* note 5, at 7–16.
47. *Id.* at 14.

state insurers, domestic preference tax laws, and credit for reinsurance and collateralization.[48] These collateralization obligations are particularly problematic when one considers that the United States accounts for almost half of the total reinsurance premiums worldwide.[49] About thirty-eight percent of all ceded reinsurance premiums worldwide are subject to the U.S. states' requirements for collateral.[50]

The states also have a number of laws or programs at odds with the GATS principle of market access. These include the sheer number and variety of insurer licensing requirements, state monopoly insurers such as Minnesota's workers' compensation reinsurer, government owned or sponsored insurers, compulsory or restrictive reinsurance cessions, extra-territorial application of state laws, barriers to exit, domestic preference tax laws, and citizenship/residency requirements.[51] While the states' laws governing insurance facially meet the GATS standard of transparency, the large number and complexity of the insurance regulations in the fifty states can make the U.S. market opaque for foreign companies seeking to enter it.[52]

In addition to these bilateral and multilateral trade agreements, the insurance supervisors of a number of nations have signed memoranda of understanding ("MOUs") with each other. By their nature, MOUs are a form of soft law as they usually encourage cooperation without imposing any legally enforceable obligations on either party.[53] The National Association of Insurance Commissioners ("NAIC"), the coordinating organization for the state insurance commissioners within the United States, has signed MOUs regarding regulatory cooperation with the Association of Latin American Insurance Supervisors, Brazil, China, Egypt, Hong Kong, Iraq, Korea, Russia, Thailand, and Vietnam.[54] While the NAIC can provide technical assistance on insurance regulation to other nations,

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48. *Id*. at 14–16.

49. *Id*. at 16.

50. *Id*.

51. *Id.* at 8–16.

52. *Id*. at 16.

53. *See* John H. McNeill, *International Agreements: Recent U.S.-U.K. Practice Concerning the Memorandum of Understanding*, 88 AM. J. INT'L L. 821, 822 (1994).

54. Press Release, Nat'l Ass'n of Ins. Comm'rs, NAIC Signs MOU with Thailand: Agreement Enhances Regulatory Cooperation with Southeast Asia (June 1, 2008), *available at* http://www.naic.org/Releases/2008_docs/mou_thailand.htm. The language of these MOUs does not provide for any enforcement mechanism should one side or the other fail to cooperate. For example, see Memorandum of Understanding Between the Office of the Insurance Commission, Thailand and the National Association of Insurance Commissioners of the United States of America, *available at* http://www.naic.org/documents/govt_rel_mou_thailand.pdf.

it does not have the authority to bind any of the states in international negotiations on insurance standards. State insurance regulators in the United States are typically not authorized by state legislatures to engage in promoting global regulatory cooperation and might face criticism for wasting state money if they spend significant time on such activities.[55]

B. International Association of Insurance Supervisors

The IAIS is the primary international organization that promotes insurance regulatory standards. Compared to the Basel Committee and IOSCO, the IAIS is a relatively new organization. It was founded in 1994, while the Basel Committee and IOSCO are outgrowths of organizations formed in 1974.[56] The IAIS has over 190 members from about 140 countries.[57] It has such a large membership because the NAIC and each of the insurance regulators from the fifty-six U.S. jurisdictions are members.[58]

Not every nation in the world is a member of the IAIS. Insurance supervisors that "underwrite, sell or otherwise provide insurance" are not eligible for membership in IAIS.[59] In addition, some Islamic nations have developed a regulatory regime for insurance that attempts to bring insurance products into conformity with the requirements of Islamic law.[60] Islamic law prohibits the charging of interest (*riba*), contracts involving risk or uncertainty because one or more of the terms is undefined (*gharar*), and gambling or speculation (*maīsir*).[61] The requirements of Islamic law make it difficult to comply with the standards for conventional insurance being developed by the IAIS. Such differences may explain why

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55. Cooke & Skipper, *supra* note 5, at 19.

56. About IOSCO, http://www.iosco.org/about/index.cfm?section=history (last visited Apr. 18, 2009); History of the Basel Committee and Its Membership, http://www.bis.org/bcbs/history.htm (last visited Apr. 18, 2009); IAIS—About the IAIS, http://www.iaisweb.org/index.cfm?pageID=28 (last visited Apr. 18, 2009).

57. INT'L ASS'N OF INS. SUPERVISORS, ANNUAL REPORT 2007–08 at iii, *available at* http://www.iaisweb.org/__temp/2007-2008_Annual_report.pdf.

58. Each of the fifty states, the District of Columbia, and each U.S. territory is a member of the IAIS. *See* IAIS Members, http://www.iaisweb.org/index.cfm?pageID=31 (last visited Mar. 16, 2009) (noting that the "NAIC [and fifty-six] jurisdictions" in the United States are IAIS members).

59. Int'l Ass'n of Ins. Supervisors [IAIS], *By-laws*, art. 6(2) (2005), *available at* http://www.iaisweb.org/__temp/By-laws_2005_edition.pdf.

60. ALY KHORSHID, ISLAMIC INSURANCE: A MODERN APPROACH TO ISLAMIC BANKING (2004).

61. *Id.* at 42.

several Islamic nations, including Indonesia, Iran, and Yemen, are not members of the IAIS.[62]

The supervisory and regulatory agencies for nations interested in the Islamic financial services industry formed their own international organization in 2002, the Islamic Financial Services Board ("IFSB").[63] The IFSB has 178 members, "includ[ing forty-two] regulatory and supervisory authorities as well as [the] International Monetary Fund, [the] World Bank, [the] Bank for International Settlements," several development banks, and about 130 market participants operating in thirty-four countries.[64] The IFSB sets standards for regulating Islamic financial products, which includes banking and securities products as well as insurance products.[65] Recognizing the need for international cooperation to regulate Islamic insurance providers, the IFSB and the IAIS released a Joint Issues Paper on Issues in Regulation and Supervision of *Takaful* (Islamic Insurance) in June 2006.[66] They recently built on this effort by signing on December 4, 2008, a working agreement to enhance cooperation between the two organizations concerning prudential regulations for entities that provide *takaful*.[67]

The IAIS has issued principles, standards, and guidance papers on a range of insurance regulatory issues, such as capital adequacy, licensing, and financial conglomerates.[68] The principles and standards promulgated by the IAIS must be approved by two-thirds of its members at a general meeting.[69] Because of its large number of members and consensus style of approval for principles and standards, the IAIS principles and standards represent a floor when it comes to insurance regulation.

The Insurance Core Principles ("ICPs"), which focus on prudential requirements, form the central principles promulgated by the IAIS.[70] IAIS members consider the ICPs as roughly equivalent to the standards set for

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62. *See* IAIS Members, *supra* note 58.

63. IFSB, About IFSB, http://www.ifsb.org/background.php (last visited Mar. 17, 2009).

64. *Id*.

65. *Id*.

66. Press Release, Islamic Fin. Servs. Bd., IFSB-IAIS Working Agreement Aims to Enhance Cooperation and Understanding in Mutual Areas of Supervision of the *Takaful* Industry (Dec. 4, 2008), *available at* http://www.ifsb.org/preess_full.php?id=101&submit=more.

67. *Id.*

68. IAIS—Overarching Standard Setting Papers, http://www.iaisweb.org/index.cfm?pageID=37 (last visited Mar. 17, 2009).

69. IAIS, *By-laws*, *supra* note 59, art. 12(1).

70. IAIS, *Insurance Core Principles and Methodology* (Oct. 2003), *available at* http://www.iaisweb.org/view/element_href.cfm?src=1/94.pdf.

banks under Basel I and Basel II. Since 2005, the IAIS has produced a series of policy papers to provide guidance to its members regarding how to implement the ICPs.[71]

In 2005, the IAIS adopted two papers that outline a framework for insurance supervision and the cornerstone principles for insurance supervision.[72] This framework divides the supervisory structure into three levels: Level 1—Preconditions; Level 2—Regulatory Requirements; and Level 3—Supervisory Actions.[73] The IAIS identified two preconditions for establishing an effective insurance supervisory framework: (1) an environment that contains "developed and efficient financial market[s]" and an institutional and legal framework for financial services supervision; and (2) "clearly defined principal, supervisory objectives, and . . . a supervisory authority . . . that[] has adequate powers," is independent, is transparent and accountable, has sufficiently trained staff, and handles confidential information appropriately.[74] The IAIS also identified three "regulatory requirements," or areas that need to be regulated by the insurance supervisor. These areas are (1) financial requirements, (2) governance requirements, and (3) market conduct requirements.[75] Finally, the IAIS discussed why supervisory assessment and intervention are critical in order to guarantee that insurers adequately deal with the risks in their portfolios and comply with the regulatory requirements.[76]

One of the goals of the regulatory requirements is to develop a common structure and common standards for insurers' solvency.[77] In 2007, the IAIS published a paper outlining its views on what the common structure for assessing an insurer's solvency ought to be.[78] The common

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71. IAIS—Overarching Standard Setting Papers, *supra* note 68.

72. IAIS, *A New Framework for Insurance Supervision*: *Towards a Common Structure and Common Standards for the Assessment of Insurer Insolvency* (Oct. 2005), *available at* http://www.iaisweb.org/view/element_href.cfm?src=1/87.pdf [herinafter IAIS, *Framework*]; IAIS, *Towards a Common Structure and Common Standards for the Assessment of Insurer Solvency: Cornerstones for the Formulation of Regulatory Financial Requirements* (Oct. 2005), *available at* http://www.iaisweb.org/view/element_href.cfm?src=1/88.pdf.

73. IAIS, *Framework*, *supra* note 72, at 5 fig.1.

74. *Id*. at 5–6.

75. *Id.* at 6. Financial requirements concern the "financial aspects of an insurer's operations" including its capital adequacy and solvency. *Id*. Governance requirements concern "how an insurer is governed." *Id.* Market conduct requirements concern "how an insurer conducts its business and presents itself to the market." *Id*.

76. *Id.* at 7.

77. *Id*.

78. IAIS, *The IAIS Common Structure for the Assessment of Insurer Solvency* (Feb. 2007), *available at* http://www.iaisweb.org/view/element_href.cfm?src=1/85.pdf [hereinafter IAIS, *Structure Paper*].

structure uses a risk-based methodology that includes both quantitative elements for capital adequacy and solvency, as well as qualitative elements for governance, market conduct, and disclosure.[79] The common structure contains fifteen structure elements, which include one structure element at Level 1—Preconditions, twelve structure elements at Level 2—Regulatory Requirements, one structure element at Level 3—Supervisory Actions, and one overarching structure element concerning disclosure.[80] The structure element for Level 1 focuses on the need for the insurance supervisor to have adequate power to make and enforce insurance regulations to assess and manage risks.[81] The structure elements for Level 2 are broken down into financial requirements, market conduct requirements, and governance requirements.[82]

Ten out of the twelve structure elements for Level 2 deal with financial requirements. These elements would require that solvency regulations address all relevant risks, "including underwriting risk, credit risk, market risk, operational risk[,] and liquidity risk."[83] The elements require quantifiable risks to be addressed "in sufficiently risk sensitive regulatory financial requirements."[84] Such requirements should "provide . . . incentives for optimal alignment of risk management by the insurer and [the] regulation."[85] The IAIS does not mandate that insurance supervisors use one method for achieving this goal. Instead, the IAIS Structure Paper notes that insurance supervisors may use any of the following methods:

> • regulatory financial requirements, ranging from sophisticated risk sensitive requirements to simple ratios or even nominal minimum requirements including necessary safety measures
>
> • quantitative limits to risk exposures
>
> • qualitative requirements
>
> • additional quantitative or qualitative requirements arising from supervisory assessment.[86]

Nevertheless, the IAIS envisions the insurer's responsibility as managing risk and the insurance regulator's responsibility as guaranteeing that

79. *Id*. at 4.
80. *Id*. at 5–9.
81. *Id*. at 5.
82. *Id*. at 5–8.
83. *Id*. at 5.
84. *Id*.
85. *Id*.
86. *Id*. at 16.

the insurer meets this obligation.[87] Thus, the IAIS encourages supervisors to require that an insurer "translate its risk exposure as far as practicable into quantitative measures which provide a sound and consistent basis for the setting of premium levels, determining technical provisions and deciding on the economic capital it finds optimal from its risk management perspective."[88] IAIS standards would allow supervisors to give individual insurers a great deal of latitude in terms of assessing and reserving for the risks they face. In fact, the IAIS believes that such risk-sensitive regulatory requirements are preferable to fixed ratios or limits because they provide insurers with better incentives for managing risk, discourage regulatory arbitrage, and enable the better use of resources.[89]

IAIS structure elements for Financial Requirements also encourage insurance supervisors and insurers to use the "total balance sheet approach" when assessing risks.[90] This approach is meant to be consistent with the total balance sheet approach adopted by the IAA.[91] The IAIS's approach "recogni[z]e[s] the interdependence [of an insurer's] assets, liabilities, capital requirements, and capital resources."[92] At a minimum, the IAIS expects the total assets of an insurer minus the total liabilities of an insurer to "exceed the [insurer's] required capital for solvency purposes."[93] The IAIS's structure elements call for basing the valuation of an insurer's assets and liabilities on their current economic value consistent with their current market prices.[94] The IAIS recognizes that all insurance assets and liabilities may not be traded on deep, liquid markets and that mark-to-model methodologies will need to be used to estimate their economic value in those cases.[95]

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87. *Id*. at 14.

88. *Id*.

89. *Id*. at 16–17.

90. *Id*. at 19.

91. The IAA articulated its concept of total balance sheet approach in A Global Framework for Insurer Solvency Assessment, in which it noted: "an insurer's true financial strength for solvency purposes requires appraisal of its total balance sheet on an integrated basis under a system that depends upon realistic values, consistent treatment of both assets and liabilities and does not generate a hidden surplus or deficit." INT'L ACTUARIAL ASS'N, INSURER SOLVENCY ASSESSMENT WORKING PARTY, A GLOBAL FRAMEWORK FOR INSURER SOLVENCY ASSESSMENT (2004), *available at* http://www.actuaries.org/LIBRARY/papers/global_framework_insurer_solvency_assessment-public.pdf.

92. IAIS, *Structure Paper*, *supra* note 78, at 19.

93. *Id.* at 19.

94. *Id*. at 19–20.

95. *Id*. at 20–22.

IAIS rules only require that the risk margin,[96] and not the service margin,[97] be taken into account when calculating technical provisions and other insurance liabilities. This approach conflicts with the approach recommended by the IASB. The IASB expects insurers to measure their liabilities based on three factors:

> (a) explicit, unbiased, market-consistent, probability-weighted and current estimates of the contractual cash flows[;]
>
> (b) current market discount rates that adjust the estimated future cash flows for the time value of money[;]
>
> (c) an explicit and unbiased estimate of the margin that market participants require for bearing risk (a risk margin) and for providing other services, if any (a service margin).[98]

As a result, liabilities for solvency purposes under the IAIS approach are lower than liabilities for accounting purposes under the IASB approach. Many state insurance regulators in the United States require that the service margin also be taken into account when estimating technical provisions and other liabilities. Some in the European Union have opposed including a service margin because they feel that it falls outside of the market value for insurance liabilities.[99] The IAIS standards more closely reflect the European approach rather than the American approach or the IASB approach.

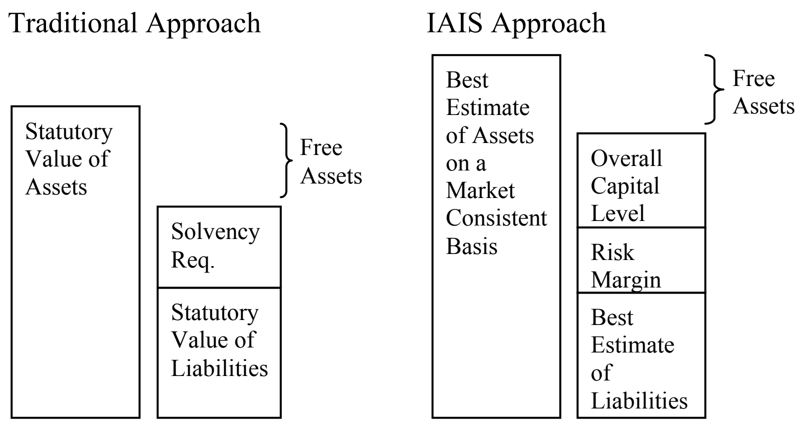
IAIS structure elements provide that capital requirements for an insurer must take into account not only the level of liabilities, including the risk margin for those liabilities, but also asset-liability mismatch risk and volatility risks. For some countries adopting the IAIS standards would result in substantial changes in their solvency regulations for insurance companies. Below is an example of how the valuing of assets and liabilities under a traditional formula-based solvency approach would differ from the market-consistent approach advocated by the IAIS:

96. Risk margin reflects the estimated margin required for insurers to bear risks.

97. Service margin reflects the estimated margin required for insurers to perform services other than bearing the risk of loss.

98. INT'L ACCOUNTING STANDARDS BD., DISCUSSION PAPER: PRELIMINARY VIEWS ON INSURANCE CONTRACTS 11 (May 2007), *available at* http://www.iasb.org/NR/rdonlyres/08C8BB09-61B7-4BE8-AA39-A1F71F665135/0/InsurancePart1.pdf.

99. The EU Solvency II proposal does not include a service margin when calculating the value of technical provisions and other liabilities.



Most nations around the world do not yet regulate insurance company solvency using the risk-based approach advocated by the IAIS in its Structure Paper. The European Union has proposed a regulatory regime called Solvency II which would be very similar to the one espoused by the IAIS.[100] The states within the United States, however, use a combination of "formula-based minimum reserves and factor-based minimum capital requirements" that have been adjusted in recent years to include some risk-based modeling approaches.[101] The NAIC adopted a Solvency Modernization Initiative Work Plan to examine to what extent U.S. insurance regulations will need to change in response to IAIS principles or other developments around the world, such as the EU Solvency II proposal.[102]

The failure of American International Group ("AIG") and the U.S. investment banks to predict accurately the risks to which they were exposed based on their internal models has raised doubts about the effectiveness of current risk management models, and the use of mark-to-

100. *Solvency II: Setting a Global Standard*, REACTIONS, Jul/Aug 2008. *See also* European Commission, Internal Market, Insurance, Basic Architecture, http://ec.europa.eu/internal_market/insurance/solvency/architecture_en.htm (last visited Apr. 19, 2009) (describing Solvency II).

101. Andrew F. Griffin & Mike Lombardi, *Financial Services: Toward a Global Solvency Standard*, EMPHASIS 2006/2, at 20, *available at* http://www.towersperrin.com/tp/getwebcachedoc?webc=TILL/USA/2006/200605/SolvenyQ2523.pdf.

102. *Solvency II: Setting a Global Standard*, *supra* note 100; NAT'L ASS'N OF INS. COMM'RS, PLEN. SESS. MINUTES NAIC "SOLVENCY MODERNIZATION INITIATIVE" WORK PLAN (June 2, 2008), *available at* http://www.naic.org/documents/committees_e_080903_solvency_2_work_plan.pdf.

market accounting practices.[103] The concerns raised by the current global financial crisis led the G20 Summit to establish two working groups that would deal with issues related to insurance—one to re-evaluate the regulatory requirements for insurers and the other to enhance international cooperation.[104] The IAIS has set up a task force to examine what changes need to be made to deal with international insurers and the special risks they pose, what prudential requirements to impose to deal with contagion effects from failing firms, what regulations should be developed to deal with currently unregulated entities, and how to achieve regulatory consistency with other sectors like banking and securities.[105] As a result of these investigations, IAIS solvency standards and other regulatory standards are likely to be revised in the near future.

C. European Union Directives

The European Union represents the single biggest market for insurance, as it generates thirty-seven percent of the worldwide premiums.[106] As a result, its laws and regulations play a large role in shaping the standards by which insurance companies operate worldwide. The EU is in

103. Pursuant to the congressional requirement in the Emergency Economic Stabilization Act of 2008, the SEC issued a report in December on the impact of mark-to-market accounting in the current financial crisis. SEC. & EXCH. COMM'N, OFFICE OF THE CHIEF ACCOUNTANT, DIV. ON CORP. FIN., REPORT AND RECOMMENDATIONS PURSUANT TO SECTION 133 OF THE EMERGENCY ECONOMIC STABILIZATION ACT OF 2008: STUDY ON MARK-TO-MARKET ACCOUNTING (Dec. 30, 2008), *available at* http://www.sec.gov/news/studies/2008/marktomarket123008.pdf. This report concluded that mark-to-market accounting had not played a significant role in the current crisis and that the benefits to investors from the transparency provided by mark-to-market accounting outweighed any costs associated with the practice. *Id*. at 7–8. The report did make some recommendations about how fair value and mark-to-market accounting could be improved. *Id*. at 7–10. This report, however, has not halted the ongoing debate about whether mark-to-market accounting contributed to the current financial crisis. Even before the current financial crisis began, some academics raised the possibility that mark-to-market accounting might cause a financial crisis when one would not have occurred using traditional accounting. For example, see Franklin Allen & Elena Carletti, *Mark-to-Market Accounting and Liquidity Pricing* (Fin. Inst. Ctr., Wharton Sch. of Bus., Univ. of Pa., No. 06-15, 2006), *available at* http://fic.wharton.upenn.edu/fic/papers/06/0615.pdf.

104. G20, About G20, http://www.g20.org/about_working_groups.aspx (last visited Apr. 23, 2009) (listing all four working groups). In its response to the G20 Washington Action Plan, the IAIS has identified pertinent "action items" for the insurance industry that the working groups should address. INT'L ASS'N OF INS. SUPERVISORS, IAIS FOLLOW-UP RESPONSE TO THE G20 WASHINGTON ACTION PLAN 1, 7 (Feb. 13, 2009), *available at* http://www.iaisweb.org/__temp/IAIS_follow-up_response_to_G20__February_2009.pdf [hereinafter IAIS FOLLOW-UP RESPONSE].

105. IAIS FOLLOW-UP RESPONSE, *supra* note 104, at 3.

106. Cooke & Skipper, *supra* note 5, at 3.

the process of adopting Solvency II, a new insurance directive defining the framework principles for insurance regulation within the European Union.[107] Implementation of Solvency II involves a four-step process.[108] The first level focuses on the adoption of the primary legislation that will define these framework principles.[109] The second level requires the Commission, with the assistance of a regulatory committee and an advisory committee, to adopt the technical measures for implementing these principles.[110] The third level requires cooperation among the national regulators within the EU to ensure the consistent interpretation of the rules and regulations implementing the framework principles.[111] Finally, the fourth level requires consistent enforcement of the rules.[112]

Like Basel II, Solvency II envisions organizing the framework principles around three pillars.[113] Pillar I would define the financial requirements including the capital adequacy and solvency requirements for insurance firms.[114] Pillar II would define the supervisory activities of each national authority.[115] Pillar III would outline the reporting and public disclosure requirements for insurance firms and supervisory authorities.[116]

As in Basel II and the IAIS solvency structure, Solvency II would redefine the capital adequacy requirements to allow firms to use risk models to more accurately determine their exposure to risk and the capital necessary to maintain their solvency. Solvency II would employ two criteria: the Solvency Capital Requirement ("SCR") and the Minimum Capital Requirement ("MCR").[117] Under the SCR, firms would be allowed to use either a standard form based on different models approved by their national supervisory authority or their own internal models after getting them approved by their national supervisory authority.[118] The MCR

107. *See* European Commission, Internal Market, Insurance, Solvency and Solvency II, http://ec.europa.eu/internal_market/insurance/solvency/index_en.htm#sol2 (last visited Apr. 18, 2009).

108. UK Financial Services Authority, Solvency 2, http://www.fsa.gov.uk/pages/About/What/International/solvency/index.shtml (last visited Feb. 18, 2009).

109. *Id*.

110. *Id*.

111. *Id*.

112. *Id*.

113. RYM AYADI & CHRISTOPHER O'BRIEN, THE FUTURE OF INSURANCE REGULATION AND SUPERVISION IN THE EU: NEW DEVELOPMENTS, NEW CHALLENGES: FINAL REPORT OF A CEPS TASK FORCE 66–69 (2006).

114. *Id.* at 66–67.

115. *Id.* at 66, 69.

116. *Id.* at 67, 69.

117. *Id*. at 67.

118. *Id*. at 68.

would be set by the national supervisory authorities and would act as a floor in terms of capital adequacy. If a firm fell below the MCR, it would trigger supervisory action.[119] The EU may reconsider which models it will allow firms to use and may set higher MCR standards in the wake of the current financial crisis.

Solvency II will likely influence how insurance regulators outside of the EU regulate insurance, particularly those in the United States. This is due to the fact that many multinational insurance companies operate in the EU and may want the standards that apply in the EU to apply to their global operations. In addition, Solvency II would require that non-EU insurance companies be regulated by a supervisory authority equivalent to the national authorities within the EU in order to allow their capital held outside of the EU to be counted towards meeting their capital requirements under Solvency II.[120] It is unclear at this time if U.S. state regulators would be deemed "equivalent" under Solvency II or to what extent they would have to change their laws and regulations to be deemed "equivalent." Thus, Solvency II may pressure U.S. regulators to adopt the same or similar standards for regulating insurance so that U.S. insurance companies with international operations are not handicapped when they try to compete in the Europe Union.

II. THE U.S. REGULATORY STRUCTURE AS AN OBSTACLE TO DEVELOPING INTERNATIONAL NORMS

As the United States is the largest single national insurance market in the world, the way it regulates insurance has a significant impact on the global standards for insurance regulation. The inability of the Unites States to establish uniform standards domestically hinders its ability to persuade other nations to adopt uniform standards internationally.[121] In addition, the U.S. approach to regulating insurance currently makes it difficult for it to engage in the type of give-and-take necessary to conduct successful international negotiations.[122] To better comprehend why the U.S. regulatory structure hinders the development of international norms, one needs to understand how the United States ended up with its current regulatory structure and the problems with this structure.

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119. *Id*.

120. *Commission Amended Proposal for a Directive of the European Parliament and of the Council on the Taking-up and Pursuit of Business of Insurance and Reinsurance (Solvency II)*, at 26, COM(2008) 119 final (Feb. 26, 2008).

121. Cooke & Skipper, *supra* note 5, at 18–19. *See also id.* at 22–23 (noting that an optional federal charter would help alleviate this problem).

122. *Id*. at 18–19.

A. Brief History of the U.S. Regulatory Structure

Historically, U.S. federal and state governments have regulated financial services primarily based on the institution providing the financial service or product. This type of regulation is referred to as institutional or entity regulation.[123] The states established separate regulators to regulate first banks, then insurance companies, and finally securities firms.

States began regulating insurance during the latter half of the 1800s. The first state board established to regulate insurance was the New Hampshire Board of Insurance Commissioners formed in 1851.[124] "In 1873, [only] twelve states had 'some form of institutionalized insurance regulation'"; by 1905, twenty-two states had such regulation.[125] State insurance regulation during this period was not exactly effective, in part, due to the fact that many administrators were either corrupt, halfhearted, or ineffectual.[126] In addition, no coherent economic theory underlay most insurance regulation. Instead, most regulations were a product of interest group politics, policyholders' fears concerning the economic power of the insurance companies, and a belief that such companies were out to defraud the public.[127]

State regulations have never been completely consistent or uniform. In fact, as the insurance companies expanded across state lines, some within the industry sought federal regulation as a means of supplanting the burden of complying with different state regulations.[128] It was presumed that federal regulation would be weaker than the existing state regulations.[129]

Movement in the direction of federal regulation was halted by the decision of the U.S. Supreme Court in *Paul v. Virginia*,[130] which held that "[i]ssuing a policy of insurance is not a transaction of commerce" and, therefore, the federal government lacked the power to regulate insurance under the Commerce Clause.[131] In 1944, however, the U.S. Supreme Court in *United States v. South-Eastern Underwriters Ass'n* reversed its

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123. Elizabeth F. Brown, E Pluribus Unum—*Out of Many, One: Why the United States Needs a Single Financial Services Agency*, 14 U. MIAMI BUS. L. REV. 1, 11 (2005).

124. Susan Randall, *Insurance Regulation in the United States: Regulatory Federalism and the National Association of Insurance Commissioners*, 26 FLA. ST. U.L. REV. 625, 630 n.18 (1999). Many of the first commissions were not independent agencies or entities, but were instead comprised of other state officials with other duties. LAWRENCE M. FRIEDMAN, A HISTORY OF AMERICAN LAW 332 (3d ed., 2005).

125. FRIEDMAN, *supra* note 124.

126. *Id.* at 333.

127. *Id.* at 331–33.

128. Randall, *supra* note 124, at 630.

129. *Id.*

130. Paul v. Virginia, 75 U.S. 169 (1868).

131. *Id.* at 183.

earlier decision in *Paul v. Virginia*.[132] This time the U.S. Supreme Court held that insurance did constitute interstate commerce and was subject to federal regulation under the Commerce Clause.[133]

In spite of the decision in *South-Eastern Underwriters*, insurance was the only area of the financial services industry that did not come under at least partial federal regulation as an element of the New Deal.[134] This was due largely to the efforts of the NAIC. The NAIC, a voluntary body comprised of the insurance commissioners from all of the states, the District of Columbia, and the U.S. territories, viewed the decision in *South-Eastern Underwriters* as an assault on the states' power to regulate insurance and proposed a bill to reserve this power to the states.[135] The bill was enacted in 1945 as the McCarran-Ferguson Act,[136] and stated that federal law would not regulate insurance activities, provided those activities were (1) related to the "business of insurance," (2) regulated by state law, and (3) not designed to intimidate, coerce, or boycott.[137] The NAIC drafted model laws governing insurance with the All-Industry Committee, a group of insurance industry representatives organized by the NAIC, and worked to ensure that most of the states had adopted these laws by the early 1950s.[138]

In the 1960s, the insolvencies of several property-liability insurers sparked an interest to regulate insurance at the federal level.[139] Senator Edward Brooke, a Republican from Massachusetts, proposed the Federal Insurance Act, which would have allowed insurers to seek either a federal or a state charter.[140] Congress did not enact this proposal. Instead, in 1969, the NAIC proposed model legislation for state guaranty funds.[141] By 1982, all fifty states, the District of Columbia, and Puerto Rico had adopted some form of state guaranty fund legislation, although not all of

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132. *See* United States v. S.-E. Underwriters Ass'n, 322 U.S. 533, 552–53 (1944).

133. *Id.*

134. SHEILA BAIR, UNIV. OF MASS. ISENBERG SCH. OF MGMT., CONSUMER RAMIFICATIONS OF AN OPTIONAL FEDERAL CHARTER FOR LIFE INSURERS 6–9 (2004), *available at* http://www.isenberg.umass.edu/finopmgt/uploads/textWidget/2494.00004/documents/bair-cons-ramifications.pdf [hereinafter BAIR, MASSACHUSETTS STUDY]; Randall, *supra* note 124, at 633–34.

135. Randall, *supra* note 124, at 629, 633.

136. Ch. 20, § 1, 59 Stat. 33 (1945) (current version at 15 U.S.C. §1011 (2004)).

137. Randall, *supra* note 124, at 633–34.

138. *Id.* at 634.

139. BAIR, MASSACHUSETTS STUDY, *supra* note 134, at 7.

140. *Id.* at 7. *See also* Federal Insurance Act, S. 1710, 95th Cong. (1977).

141. BAIR, MASSACHUSETTS STUDY, *supra* note 134, at 7; III—Insolvencies/Guaranty Funds, http://www.iii.org/media/hottopics/insurance/insolvencies/ (last visited Mar. 27, 2009).

these laws followed the NAIC model act.[142] The Federal Insurance Act bill was not the last time that the insurance sector faced the threat of federal regulation of insurance.

The federal government began regulating employer-sponsored retirement plans, and medical, life, and disability insurance following the enactment of the Employee Retirement Income Security Act ("ERISA") in 1974.[143] ERISA's requirements supersede any other applicable state insurance requirements. ERISA is administered through the Pension Benefit Guaranty Corporation, a federal agency that provides insurance to guarantee future pension payments.[144]

In the 1980s and early 1990s, several insurance company bankruptcies prompted renewed interest in federal regulation of insurance.[145] In 1990, a report by the House Subcommittee on Oversight and Investigations of the Committee on Energy and Commerce found that the existing state regulations regarding insurance company solvency were inadequate.[146] Representative John Dingell, a Democrat from Michigan, proposed creating a dual system for insurance company solvency regulation, including the creation of a federal guaranty fund for federally chartered insurance companies.[147] This proposal also failed to be enacted after the NAIC and

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142. III—Insolvencies/Guaranty Funds, *supra* note 141. For example, New York's law uses a pre-assessment or pre-insolvency method for raising the necessary financing to pay off claims rather than the post-assessment or post-insolvency method proposed in the NAIC model act. *Id.* Under the New York law, the guaranty fund requires each insurance company to pay an amount into the fund based on a percentage of the net direct premiums written by the company during the year, and these funds are held to pay off future claims that may arise if an insurance company becomes insolvent. Under the NAIC model act, the state guaranty fund does not make any assessments until an insurance company becomes insolvent and then only assesses the amount needed from the other insurance companies to pay the claims of the insolvent company's policyholders. In addition, the NAIC model act does not create a state guaranty fund for annuities, life, disability, accident and health, surety, ocean marine, mortgage guaranty, and title insurance, but some state guaranty funds do cover claims against companies that write these types of insurance. *See id.*

143. BAIR, MASSACHUSETTS STUDY, *supra* note 134, at 7.

144. KENNETH J. MEIER, THE POLITICAL ECONOMY OF REGULATION: THE CASE OF INSURANCE 39 (1988).

145. *See* Jonathan R. Macey & Geoffrey P. Miller, *The McCarran-Ferguson Act of 1945: Reconceiving the Federal Role in Insurance Regulation*, 68 N.Y.U. L. REV. 13, 15 (1993).

146. BAIR, MASSACHUSETTS STUDY, *supra* note 134, at 8. *See also* STAFF OF H. COMM. ON ENERGY & COMMERCE, SUBCOMM. ON OVERSIGHT & INVESTIGATIONS, 101ST CONG., FAILED PROMISES: INSURANCE COMPANY INSOLVENCIES (Comm. Print 1990). The report is also known as the "Dingell Report," after Representative John Dingell, a Democrat from Michigan. BAIR, MASSACHUSETTS STUDY, *supra* note 134, at 8

147. BAIR, MASSACHUSETTS STUDY, *supra* note 134, at 8.

the many states adopted "risk-based capital requirements [for insurers similar to the banking requirements], a financial regulation accreditation program, and an initiative to codify statutory accounting principles."[148]

As a result of the decline in profitability of commercial banking, commercial banks sought to expand their products and services into more profitable financial services.[149] Beginning in 1983 with South Dakota, many states liberalized the rules governing state banks, permitting them to carry on insurance activities.[150] In 1991, Congress adopted the Federal Deposit Insurance Corporation Improvement Act,[151] which prohibited banks from engaging in insurance underwriting even if permitted under state law.[152] The Office of the Comptroller of the Currency ("OCC") in the U.S. Treasury Department through an interpretative release allowed national banks to sell annuities and to act as insurance agents if located in a town with less than 5000 residents.[153]

In 1999, Congress enacted the Gramm-Leach-Bliley Act ("GLBA"),[154] which repealed portions of the Glass-Steagall Act of 1933,[155] the Bank Holding Company Act of 1956,[156] and other laws in order to permit banks, securities firms, insurance companies, and other entities engaged in the provision of financial services to form financial conglomerates[157]

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148. *Id.*

149. *Id.*

150. Martin E. Lybecker, *The "South Dakota" Experience and the Bush Task Group's Report: Reconciling Perceived Overlaps in the Dual Regulation of Banking*, 53 BROOK. L. REV. 71, 72 (1987).

151. Pub. L. No. 102-242, § 303, 105 Stat. 2236, 2350 (codified in 12 U.S.C.S. § 1831a).

152. *Id*. § 303(a).

153. Interpretive Letter No. 753, Office of the Comptroller of the Currency, Letter Approving First Union National Banks Notification of Intent to Establish Operating Subsidiaries to Engage in Insurance Activities (Nov. 4, 1976), *available at* http://www.occ.treas.gov/interp/nov/int753.htm. *See also* 12 C.F.R. § 7.1001 (2009).

154. Pub. L. No. 106-102, § 1, 113 Stat. 1338 (1999) (codified in scattered sections of 12, 15, 16, 18 U.S.C.).

155. Ch. 89, 48 Stat. 162 (1933). The Glass-Steagall Act is the name given to four sections of the Banking Act of 1933, 12 U.S.C. § 377 (1933). The GLBA repealed section 20 of Glass-Steagall, which prevented any Federal Reserve member bank from affiliating with an entity principally engaged in securities, and section 33, which banned interlocking managements between Federal Reserve member banks and securities firms. Gramm-Leach-Bliley Act § 101, 12 U.S.C. §§ 377–78 (1999).

156. Ch. 240, 70 Stat. 133 (1956) (codified in 12 U.S.C. §§ 1841–49).

157. The Basel Committee on Banking Supervision and the Joint Forum on Financial Conglomerates define financial conglomerates as "any group of companies under common control whose exclusive or predominant activities consist of providing significant services in at least two different financial sectors." TRIPARTITE GROUP OF BANK, SEC. & INS. REGULATORS, THE SUPERVISION OF FINANCIAL CONGLOMERATES ¶ 36 (July 1995),

that would enable them to cross-sell each other's products and services. With the GLBA, Congress essentially ratified the movement away from institutional regulation towards functional regulation and the dismantling of the barriers among banks, securities firms, and insurance companies that rulemaking by the existing state and federal financial service regulatory agencies had already begun to undertake.[158]

Functional regulation focuses on the products or services being offered, rather than the institution offering them, to determine which regulator ought to regulate the products or services.[159] For example, under the GLBA, Congress envisioned the SEC regulating investments in securities regardless of whether the investment services were offered through a bank or through an independent brokerage firm. Within the institutional regulatory regime, banking regulators traditionally regulated securities offered through banks.[160]

This movement away from institutional regulation under the GLBA, however, did not occur in the area of insurance. Congress left insurance regulation primarily in the hands of the state insurance commissions. Section 104 of the GLBA reaffirmed that the states would retain control over the regulation of insurance products and services.[161] The GLBA did put a few limitations on the otherwise unfettered ability of the states to regulate insurance. For example, GLBA Section 104(c) prohibits states from preventing or restricting a depository institution or an affiliate of such institution from being affiliated with any person except in certain limited circumstances related to insurers.[162] The GLBA still permits

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available at http://www.bis.org/publ/bcbs20.pdf?noframes=1. This Article will use this definition when referring to financial conglomerates. Financial conglomerates are distinguishable from "mixed conglomerates," in which groups of commercial or industrial enterprises include a financial institution as part of their structure. *Id.* While mixed conglomerates may raise some of the same regulatory and supervisory issues as financial conglomerates, such concerns are beyond the scope of this Article.

158. *See* Brown, *supra* note 123, at 10–25.

159. *Id.* at 11.

160. Originally, sections 3(a)(4) and 3(a)(5) of the Securities Exchange Act of 1934 excluded banks from the definitions of broker and dealer and left the regulation of banks engaging in securities activities to the banking regulators. Securities Exchange Act of 1934 §§ 3(a)(4)–(5), 15 U.S.C. §§ 78c(a)(4)–(5) (1998). The GLBA amended those sections to eliminate the exception for banks. Gramm-Leach-Bliley Act §§ 201–02. If a bank's securities activities do not fall into one of the other categories of permissible bank securities activities set forth in the GLBA, then the bank is required to transfer those broker-dealer activities to an affiliated broker-dealer.

161. Gramm-Leach-Bliley Act § 104.

162. *Id.* § 104(c). Prior to the GLBA's enactment, nine states and one territory prohibited banks from affiliating with insurance companies. CONFERENCE OF STATE BANK SUPERVISORS, A PROFILE OF STATE CHARTERED BANKING 117–19 (17th ed. 1998). Those

states to collect, review, and take actions (including approval or disapproval) on applications that concern the proposed acquisition, change in control, or continued control of an insurer domiciled in the state; that require a person seeking to acquire control of an insurer to maintain or restore the insurer's capital requirements under the state's capital regulations, or that restrict the change in control in the ownership of stock of the insurer, or a company formed for the purpose of controlling the insurer, after the insurer has converted from a mutual to a stock form, so long as such restrictions do not discriminate against depository institutions or their affiliates.[163]

The GLBA also required states to establish uniform or reciprocal requirements for licensing of insurance agents within three years after the enactment of the act.[164] The GLBA mandated that the NAIC had to determine whether a majority of states had to meet this requirement.[165] If NAIC was unable to do so, then the National Association of Registered Agents and Brokers ("NARAB") would be established as a nonprofit corporation to act as a mechanism through which "uniform licensing, appointment, continuing education, and other insurance producer sales qualification requirements and conditions" could be adopted.[166]

Perhaps not surprisingly, when given a choice between reciprocity and uniformity, the states chose reciprocity.[167] Reciprocity only requires that states accept the licensing decisions of other states, even though their requirements might be different, while uniformity would have required states to apply the same set of licensing requirements. Currently, the

states and territory were Alaska, Arkansas, Colorado, Georgia, New York, Puerto Rico, Tennessee, Vermont, and West Virginia. *Id.*

163. Gramm-Leach-Bliley Act § 104(c)(2). The GLBA also preserves the rights of states to restrict certain insurance activities by depository institutions or insurers licensed in the state regardless of where they are domiciled. *Id.* § 104(d). In the event of a dispute between federal and state insurance regulators, the GLBA provides a dispute resolution mechanism under which either regulator is permitted to seek expedited review from the U.S. Court of Appeals for the District of Columbia or the state's proper U.S. Circuit Court of Appeals. *Id.* § 304. *See also* 15 U.S.C. 6714 (2004).

164. Gramm-Leach-Bliley Act § 321. *See also* 15 U.S.C. 6751.

165. Gramm-Leach-Bliley Act § 304. *See also* 15 U.S.C. 6714.

166. Gramm-Leach-Bliley Act §§ 322–23. *See also* 15 U.S.C. 6752–53.

167. *Testimony Before the Subcomm. on Capital Markets, Insurance and Government Sponsored Enterprises, Comm. on Financial Serv., H. of Rep., State Insurance Regulation: Efforts to Streamline Key Licensing and Approval Processes Face Challenges*, at 2 (June 18, 2002) (statement of Richard J. Hillman, Director, Financial Markets and Community Investment, General Accounting Office) [hereinafter *Hillman Testimony*].

NAIC has certified forty-three states as meeting the reciprocity requirements under the GLBA.[168]

Nevertheless, major states, like California, Florida, and New York, still have not complied with the reciprocity requirements.[169] The major stumbling blocks against reciprocity among all fifty states concern fingerprinting and surplus lines bond requirements for nonresident producers, which are considered important consumer protection issues in the states that require them, particularly California and Florida.[170]

Finally, the GLBA permits banks, securities firms, insurance companies, and other entities engaged in financial services to become affiliated under the umbrella of a financial holding company ("FHC") and allowed these firms to cross-sell each other's products.[171] The GLBA designated the Federal Reserve, which supervises bank holding companies, to become the supervisor for the FHCs, although the financial subsidiaries of the FHCs would continue to be regulated by the relevant authority for their product or service.[172] The Act also specifies that FHCs and their subsidiaries may engage in certain activities that are financial in nature, including securities underwriting and dealing, insurance underwriting, insurance agency activities, and merchant banking.[173] An FHC also may engage in any activity that the Federal Reserve, in consultation with the Secretary of the Treasury, determines to be financial in nature, incidental to finance, or complementary to a financial activity, provided that such activity does not pose a substantial risk to the safety and soundness of the FHC.[174]

The number of domestic FHCs declined from 612 in 2003, to 597 in 2007.[175] The vast majority of the companies registered as FHCs were

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168. NAT'L ASS'N OF INS. COMM'RS, PRODUCER LICENSING ASSESSMENT AGGREGATE REPORT OF FINDINGS 2 (2008), *available at* http://www.naic.org/Releases/2008_docs/producer_licensing_assessment_report.pdf [hereinafter NAIC, RECIPROCITY REPORT].

169. *See id.* n.1.

170. *See id.* exhibit A, at 3–4 (finding that background checks and surplus lines bonds are "inconsistent with the reciprocity requirements under GLBA").

171. Gramm-Leach-Bliley Act § 103(a).

172. *Id.* § 113 For example, an insurance company owned by an FHC would still be subject to state insurance regulators.

173. *Id.* § 103. For certain financial activities, FHCs may be subject to joint regulation by the Federal Reserve and another regulatory authority. *See id.* §§ 112–13.

174. *Id.* § 103.

175. INS. INFO. INST. & FIN. SERVS. ROUNDTABLE, THE FINANCIAL SERVICES FACT BOOK 2009, at 45 (2009).

bank holding companies before the enactment of the GLBA.[176] Only a few insurance firms that were not previously affiliated with a commercial bank before the enactment of GLBA elected to become FHCs.[177] MetLife falls into this category.[178] Many of the largest financial conglomerates with substantial insurance businesses have not registered as FHCs, including AIG, because insurance firms were not subject to the limitations on affiliations that banking firms were subject to before the adoption of the GLBA.[179]

Just because insurance companies are not registering as FHCs does not mean that they are engaging in a limited range of financial services. For example, before the current financial crisis began, thirty-four insurance companies, including AIG, entered into banking-related activities by acquiring thrifts.[180] In the wake of the enactment of the Emergency Economic Stabilization Act of 2008, several other insurance companies acquired thrifts in order to become eligible under the Act to receive funds as thrift holding companies from the Capital Purchase Program and the Temporary Liquidity Guarantee Program of the Federal Deposit Insurance Corporation.[181] The Office of Thrift Supervision ("OTS") in the

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176. BD. OF GOVERNORS OF THE FED. RESERVE SYS. & U.S. DEP'T OF THE TREASURY, REPORT TO THE CONGRESS ON FINANCIAL HOLDING COMPANIES UNDER THE GRAMM-LEACH-BLILEY ACT 3 (2003).

177. *Id.*

178. *Id.*

179. *See* FRB: Financial Holding Companies as of March 27, 2009, www.federalreserve.gov/generalinfo/fhc/ (last visited Apr. 6, 2009). In fact, only one of the top five companies classified as diversified financials by *Fortune* in 2007 has registered as FHCs. *Id.* Steve Bartlett, the President and Chief Executive Officer of the Financial Services Roundtable, commented in his testimony before the Senate Committee on Banking, Housing and Urban Affairs on July 13, 2004:

> One of the central features of GLBA was the creation of financial holding companies. . . . The financial holding company structure significantly expanded the scope of activities permissible for banking firms; it did not offer insurance firms and securities firms a similar benefit. Outside of the financial holding company structure, securities and insurance firms are subject to few limitations on affiliations. Thus, it is not surprising that only a handful of securities and insurance firms have become financial holding companies.

Testimony to the Comm. on Banking, Housing and Urban Affairs of the U.S. S., at 8 (July 13, 2004) (statement of Steve Bartlett, President and Chief Executive Officer, Financial Services Roundtable).

180. INS. INFO. INST. & FIN. SERVS. ROUNDTABLE, THE FINANCIAL SERVICES FACT BOOK 2006, at 58–59 (2006) (listing thirty-four insurance companies that acquired thrifts).

181. News Bulletin, Morrison & Foerster, Insurance Companies Adopt Thrift Holding Company Structure to Become Eligible for Treasury Capital Purchase Program and FDIC

U.S. Treasury Department, not the Federal Reserve, acts as the primary regulator for thrift holding companies that own a federally chartered thrift.[182] The near bankruptcy of AIG has raised questions about whether the OTS is equipped to regulate complex financial conglomerates.[183]

The fact that financial conglomerates can gain access to bailout funds by either becoming a bank holding company or a thrift holding company undermines the intent of the GLBA that financial conglomerates should become FHCs and be regulated by the Federal Reserve. Congress may need to reconsider who regulates financial conglomerates at the federal level and how regulations can be harmonized to prevent firms like AIG from engaging in regulatory arbitrage to find the weakest regulator.

B. State Efforts at Uniformity

Attempts by Congress, the NAIC, and elements within the insurance industry to encourage uniform state insurance regulations have not proven particularly successful. The states cannot agree on the most basic issues, such as a uniform definition for insurance. Several states do not even try to define insurance in their statutes.[184] In these states, one must look to state common law for a definition.[185]

In states that do define insurance or a contract of insurance in their statutes, many of the definitions are short and cryptic. The California Insurance Code, for example, defines insurance as "a contract whereby one undertakes to indemnify another against loss, damage, or liability arising from a contingent or unknown event."[186] This definition is extremely broad and could encompass a variety of other financial services products. Guaranties, warranties, suretyships, indorsements, pledges, mortgages, conditional sales, indemnity, and insurance all have the common purpose of protecting someone from the harms of possible future events.[187] Not all of these products, however, are regulated by state insurance commissioners. Other states employ longer, but not necessarily more useful, definitions in their statutes. New York defines an insurance contract as

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Liquidity Guarantee (Nov. 23, 2008), *available at* http://www.mofo.com/news/updates/files/081123Insurance.pdf.

182. Office of Thrift Supervision—About the ORT, http://www.ots.treas.gov/?p=AboutOTS (last visited Apr. 18, 2009).

183. Jeff Gerth, *Was AIG Watchdog not up to the Job?*, PROPUBLICA, Nov. 10, 2008, http://www.propublica.org/feature/was-aig-watchdog-not-up-to-the-job.

184. ERIC M. HOLMES & JOHN ALAN APPLEMAN, INSURANCE LAW AND PRACTICE, 2d § 1.3 (2008).

185. *Id.*

186. CAL. INS. CODE § 22 (Deering 2008).

187. HOLMES & APPLEMAN, *supra* note 184.

> any agreement or other transaction whereby one party, the "insurer", is obligated to confer benefit of pecuniary value upon another party, the "insured" or "beneficiary", dependent upon the happening of a fortuitous event in which the insured or beneficiary has, or is expected to have at the time of such happening, a material interest which will be adversely affected by the happening of such event.[188]

New York further defines a fortuitous event as "any occurrence or failure to occur which is, or is assumed by the parties to be, to a substantial extent beyond the control of either party."[189]

Given these differences in how insurance is defined, states sometimes disagree over whether a particular product should be regulated as insurance, securities, or banking products. State insurance supervisors have contemplated regulating certain derivatives as insurance even though these products are frequently treated as falling within the regulatory scope of securities or futures regulators.[190] Derivatives cover a wide range of products. These products essentially involve an agreement, option, or instrument that requires the buyer to take delivery or assume a specified amount of one or more underlying interests, or that has a price, performance, value, or cash flow based primarily upon the actual or expected price, level, performance, value, or cash flow of one or more underlying interests.[191] Derivatives include options, futures, swaps, warrants, hedges, and securitizations.[192] The sellers use these transactions to reduce their risks due to changes in price, performance, value, or cash flow of the underlying interests.

Derivatives are often used as substitutes for insurance regardless of whether they are regulated as insurance.[193] Credit default swaps, weather

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188. NY INS. LAW § 1101(a)(1) (Consol. 2008).

189. *Id.* § 1101(a)(2).

190. *See, e.g.*, JAN JOB DE VRIES ROBBÉ & PAUL U. ALI, SECURITISATION OF DERIVATIVES AND ALTERNATIVE ASSET CLASSES: YEARBOOK 2005, at 82 (2005) (discussing the draft NAIC White Paper recommending that weather derivatives be regulated as insurance even though the International Swaps and Derivatives Association, the Weather Risk Management Association, and the Bond Markets Association preferred that they be treated as securities or futures).

191. KEITH REDHEAD, FINANCIAL DERIVATIVES: AN INTRODUCTION TO FUTURES, FORWARDS, OPTIONS AND SWAPS 1–3 (1997).

192. *Id.* at 1.

193. For a fuller discussion of some of these instruments, see Tamar Frankel & Joseph W. LaPlume, *Securitizing Insurance Risks*, 19 ANN. REV. BANKING L. 203 (2000); Peter Carayannopoulos, Paul Kovacs & Darrell Leadbetter, *Insurance Securitization: Catastrophic Event Exposure and the Role of Insurance Linked Securities in Addressing Risk* (ICLR Research Paper Series No. 27, 2003), *available at* http://www.iclr.org/pdf/securi tization.pdf; J. David Cummins, *CAT Bonds and Other Risk-Linked Securities: State of the Market and Recent Developments* (Temple Univ., 2007), *available at* http://ssrn.com/

derivatives, real estate hedges, and insurance securitization in the form of asset-backed bonds all function like insurance.[194] The market for credit default swaps has exploded in the past decade, reaching almost $62 trillion in 2008.[195] Credit default swaps have avoided regulation because they have been deemed to fall in the gaps among the insurance, securities, and futures regulatory authorities. For example, New York State has flip-flopped in the past year regarding whether to regulate credit default swaps as insurance. For years, New York State chose not to regulate credit default swaps as insurance. On September 22, 2008, the New York Insurance Department changed its mind and decided that, beginning in January 2009, credit default swaps "in cases where the buyer of the swap also owns the underlying bond it is meant to back" would be classified as insurance in New York.[196] Less than two months later, New York suspended its plan to regulate credit default swaps in light of the initiatives to regulate over-the-counter derivatives, including credit default swaps, announced by the President's Working Group on Financial Markets and the MOU signed by the Federal Reserve Board of Governors, the SEC, and the Commodities Futures Trading Commission to supervise credit default swap counterparties.[197]

If a product meets a state's definition of insurance, then both the product and the firm offering it must be licensed by the state in order to sell

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abstract=1057401; Richard W. Gorvatt, *Insurance Securitization: The Development of a New Asset Class* 133 (Cas. Actuarial Soc'y, "Securitization of Risk" Discussion Paper Program, 1999), *available at* www.casact.org/pubs/dpp/dpp99/99dpp133.pdf; Changki Kim, Taehan Bae & Reginald J. Kulperger, *Securitization of Motor Insurance Loss Rate Risks* (Australian Sch. of Bus., Research Paper No. 2008ACTL03, 2008), *available at* http://ssrn.com/abstract=1134606.

194. *E.g.*, INS. INFO. INST. & FIN. SERVS. ROUNDTABLE, THE FINANCIAL SERVICES FACT BOOK 2006, at 133 (discussing credit derivatives); *id.* at 84 (discussing weather derivatives). *See also* Frankel & LaPlume, *supra* note 193, at 205–06; Carayannopoulos, Kovacs & Leadbetter, *supra* note 193; Gorvatt, *supra* note 193, at 144–48; Kim, Bae & Kulperger, *supra* note 193, at 2–3; Simone Barbibeau, *Four Ways to Hedge Against Falling Home Prices*, THESTREET.COM, Feb. 22, 2008, www.thestreet.com/print/story/10404177.html. Insurance securitization can take a number of forms other than the issuance of asset-backed bonds. It can also involve forwards, futures, options, puts, and swaps. Some of these instruments are used to transfer risk, such as bonds and swaps, while others are used to provide contingent capital, such as catastrophic equity puts.

195. Danny Hakim, *New York to Regulate Credit Default Swaps*, N.Y. TIMES, Sept. 22, 2008, at C10.

196. *Id*.

197. Press Release, Eric Dinello, Superintendent of Ins., N.Y. State Ins. Dep't, Recognizing Progress by Federal Government in Developing Oversight Framework for Credit Default Swaps, New York Will Stay Plan to Regulate Some Credit Default Swaps (Nov. 20, 2008), *available at* http://www.ins.state.ny.us/press/2008/p0811201.htm.

the product within that state.[198] So if New York had not suspended its decision to classify some credit default swaps as insurance, firms selling them in New York would have needed to be licensed as insurers. The states within the United States have a confusing series of licensing and post-licensing requirements for both the firm offering the product and the product itself. The exact type of licenses required varies from state to state. Some states issue a general insurance producer license, which allows an individual or an entity to sell several insurance services, while others issue separate licenses for agents and brokers or issue separate licenses for each insurance line.[199]

Traditionally, states have operated their insurance commissions as regulatory monopolies and have not engaged in regulatory competition, which exists to some degree between state and federal government agencies that issue bank charters, and among states for the incorporation of businesses.[200] Other than the periodic threats by the federal government that it will begin regulating insurance if the states fail to adopt reciprocal or uniform licensing requirements, the states have had few incentives to change their licensing procedures. If a company wants to offer insurance in a particular state, the company must comply with the licensing and post-licensing regulations for that state.[201]

In addition to requiring different types of licenses, states have a range of requirements when potential insurance producers complete their applications. In some cases, these variations among the states' applications are due to important differences on policy questions. New York and California require criminal background checks before allowing a person to sell insurance within their borders, but many other states do not require such

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198. BAIR, MASSACHUSETTS STUDY, *supra* note 134, at 11.

199. NAT'L ASS'N OF INS. COMM'RS, 2002 INSURANCE DEPARTMENT RESOURCES REPORT 52 (2003). The NAIC defines "producer" as a person or entity "[l]icensed to offer several insurance services." *Id*. In most cases, a producer will be a company, rather than an individual.

200. Henry Butler and Larry Ribstein have proposed recreating the type of regulatory competition among states for incorporating businesses in the area of insurance. *See* Henry N. Butler & Larry E. Ribstein, *The Single-License Solution*, REGULATION (Winter 2008–2009), at 36, 36. Their proposal, like the Congressional proposals to federalize insurance regulation, treats insurance as a unique financial service that requires a separate regulatory agency from the ones that regulate banking and securities. *See id.* It does not recognize that financial services are part of a continuum in which products and services in one sector, such as insurance, are increasingly fungible with products and services in another, such as securities. As a result, their proposal does not address the existing trends within the financial services industry, but would reinforce the current compartmentalization of financial services regulation along a blend of institutional and functional regulation.

201. *See Hillman Testimony*, *supra* note 167, at 7 (noting that even if licensing regulations are removed, there may still be post-licensing hurdles for insurance companies).

checks.[202] In other cases, these variations have little or no rational basis. In Nevada, for example, pink paper is required when insurance companies file documentation pages for filing fees.[203] Some states, such as Iowa, Kentucky, and Ohio, will return filings if they have not been stapled in the prescribed manner or assembled in the proper order.[204]

Forty-three states do grant some form of reciprocity if a company has been granted a license in another state.[205] States with major markets, like California, Florida, and New York, however, have not signed on to these reciprocity agreements.[206] These agreements also do not extend to post-licensing requirements.[207]

In 2004, the University of Massachusetts Isenberg School of Management completed a study ("Massachusetts Study"), which found that the multiple state reviews resulted in duplicative and inefficient regulatory efforts among the states.[208] States have attempted to justify these duplicative reviews as necessary to protect consumers, but the Massachusetts Study concluded that the extremely high caseloads for staff assigned to review producer licensing applications indicated that these applications may only be receiving a cursory review.[209] On average, staff members had to review 1284 new applications per year.[210] Such cursory reviews may fail to alert staff to producer problems, which is troubling "given . . . that producer misconduct generates the largest volume of complaints."[211]

The process might be a bit easier in the future for life insurance, annuities, disability income, and long-term care insurance because the Interstate Insurance Product Regulation Commission ("IIPRC") began cover-

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202. *Id.* at 2, 5–6.

203. Andrew G. Simpson, *Leave-No-State-Regulation-Behind*, INS. J., Sept. 6, 2004, http://www.insurancejournal.com/magazines/east/2004/09/06/editorsnote/45946.htm.

204. *Id*.

205. NAIC, RECIPROCITY REPORT, *supra* note 168, at 2 & n.1.

206. *See Hillman Testimony*, *supra* note 167, at 2, 5–6.

207. *See id*. at 7.

208. BAIR, MASACHUSSETS STUDY, *supra* note 134, at executive summary. The study was funded by unrestricted grants from MassMutual, Equitable Life, Lincoln National Life, Northwestern Mutual, Principal Financial Group, Prudential Life Insurance, and the American Council of Life Insurers. The study identified several major problems with the existing state system of insurance regulation. The study focused solely on life insurance and not the other forms of insurance, although it did concede that other insurers, particularly property and casualty insurers, faced many of the same regulatory inefficiencies. *Id*. & n.project team.

209. *Id*. at executive summary.

210. *Id*.

211. *Id*.

ing these products in 2007.[212] The IIPRC was formed under the Interstate Insurance Compact proposed by the NAIC.[213] The IIPRC provides a central filing point for institutions seeking licenses for insurance products from the states that are parties to the compact. [214] The IIPRC initially had to rely on product filing examiners and other staff, who are on loan from member states.[215] It did not get its own permanent staff until the spring of 2008.[216] Only thirty-two states, plus Puerto Rico, have signed the Interstate Insurance Compact and, once again, the states with the largest insurance markets, California, Connecticut, Florida, and New York, are not signatories to this agreement.[217] It may be some time before an assessment can be made as to whether the IIPRC has significantly improved the process for obtaining product licenses.

In addition to having to complete multiple producer licensing and product licensing applications, an insurance company will find that it may take up to two years under normal circumstances to have all of the state insurance regulators review and approve the company's applications.[218] While the NAIC has made the adoption of national, uniform regulations one of its goals, the states have not made significant progress towards developing such regulations.[219] Reciprocity arrangements, which a majority of states adopted in the wake of the GLBA, have shortened the time that it takes to complete the nonresident producer licensing process.[220] Nevertheless, according to the Massachusetts Study, insurers

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212. News Release, Interstate Ins. Prod. Regulation Comm'n, Interstate Insurance Compact Open for Business (June 2, 2007), *available at* http://www.insurancecompact.org/releases/open_for_business.htm.

213. A Summary of the IIPRC Background and Development, http://www.insurancecompact.org/history.htm (last visited Mar. 30, 2009).

214. News Release, Interstate Ins. Prod. Regulation Comm'n, *supra* note 212.

215. *Id*.

216. IIPRC, About the IIPRC, http://www.insurancecompact.org/about.htm (last visited Mar. 30, 2009).

217. IIPRC, Commission Member States, http://www.insurancecompact.org/documents/about_member_states.pdf (last visited Mar. 30, 2009).

218. BAIR, MASSACHUSETTS STUDY, *supra* note 134, at 37 (noting that seventeen percent of companies surveyed reported that new company licenses took more than two years). *See also Insurance Product Approval: The Need for Modernization: Hearing Before the Subcomm. on Capital Markets, Insurance, and Government Sponsored Enterprises of the H. Comm. on Financial Servs.*, 107th Cong. 54–55 (2001) (opening statement by Richard H. Baker, Chairman) [hereinafter *Baker Statement*].

219. *See Baker Statement*, *supra* note 218 (noting that "insurers are subject to a patchwork quilt of State regulation").

220. BAIR, MASSACHUSETTS STUDY, *supra* note 134, at 29.

reported in 2003 that it took them six to nine months to get a product approved in the five largest states in which they did business.[221]

If it takes two years for traditional insurance products to be approved by all of the state regulators, innovative products may take even longer, particularly if they are hybrid financial products that have characteristics similar to traditional banking or securities products.[222] Hybrid products may require the approval of the federal or state banking or securities authorities, in addition to the approval of the state insurance commissioners.[223]

The problems caused by the licensing delays particularly disadvantage smaller insurance companies. These delays hinder the ability of smaller companies to expand operations.[224] Survey data indicate that, under the current system, regulatory costs are proportionately higher for small insurers.[225] Licensing delays discourage some forms of product and regulatory innovation. Some products are not brought to market because the costs of overcoming the initial regulatory approvals are high, and once they have been overcome, other firms may easily copy the product and sell it themselves.[226] In these instances, the first mover bears the bulk of the costs while later movers reap the rewards. In addition, as the Massachusetts Study noted, "Difficulties and time delays in securing form filing approvals inhibits the ability of life insurers to modify products in response to consumer demand and impairs competition with banks and securities firms that do not have to undergo advance merit review of permitted product offerings."[227]

Given that states cannot agree on uniform standards within the United States, it is doubtful that they would work well together when negotiating

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221. *Id*. at 37–43, executive summary.

222. The program that offered the home equity insurance in Syracuse, New York, had to ensure that it complied both with New York's insurance regulations and New York's banking laws. *See* Andrew Caplin et al., *Home Equity Insurance: A Pilot Project* 2, 24–28 (Yale Int'l Ctr. for Fin., Working Paper No. 03-12, 2003), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=410141.

223. *Id*. at 26–27. For example, the program could not include the home equity insurance policy as part of the mortgage contract because that would have violated New York's banking restrictions against Price-Level Adjusted Mortgages.

224. BAIR, MASSACHUSETTS STUDY, *supra* note 134, at 11–12, 51, 68.

225. *Id*. at 11–12.

226. The first insurance company would have a period of time during which it would be the sole provider of a new product because state regulators keep rate filings and product filings confidential until they are approved. While competitors would sustain lower legal and administrative costs to get a product approved than the first firm, they would still have to bear the costs of determining how to underwrite it, reserve for it, market it, and administer it.

227. BAIR, MASSACHUSETTS STUDY, *supra* note 134, at executive summary.

international standards in the form of either soft law standards or principles, or hard law found in treaties and other binding international agreements. David Snyder, Assistant General Counsel of the American Insurance Association, noted, "Despite the strong efforts of some regulators, the state regulatory system is structurally incapable of representing U.S. interests effectively, because it must defend the inefficient U.S. regulatory system and it lacks the legal authority to bind the United States."[228] The states have recently attempted to increase their visibility in the IAIS. While the states within the United States only held one of the seats on the old IAIS executive committee, they now hold three of the twenty-one seats on the newly enlarged IAIS executive committee.[229] In addition, a fourth U.S. regulator, who chairs a technical subgroup, sits as a nonvoting member on the committee.[230] Sandy Praeger, the Kansas Insurance Commissioner, is leading the IAIS's New Focus Task Force, which will be developing future goals of the IAIS.[231]

C. Possible Solutions

1. Office of Insurance Information and New Powers for USTR

In March 2008, the U.S. Treasury issued its Blueprint for a Modernized Financial Regulatory Structure ("Blueprint").[232] Each of the regulatory structures the Treasury proposed would correct the existing inability of the United States to engage in meaningful international negotiations on insurance issues. The Blueprint calls for the creation of an Office of Insurance Oversight "to deal with international [insurance] regulatory issues . . . [and to] advise the Secretary of the Treasury on major domestic and international [insurance] policy issues."[233]

In response to the Treasury's proposal, Representative Paul Kanjorski introduced the Insurance Information Act of 2008,[234] which would create the Office of Insurance Information. This office would provide information on insurance issues to Congress and to Executive Branch agencies.

228. Meg Fletcher, *U.S. Regulators Seek to Increase Visibility*, INS. NEWS NET, Jan. 5, 2009, at 3.

229. *Id.*

230. *Id.*

231. *Id.*

232. U.S. DEP'T OF TREASURY, BLUEPRINT FOR A MODERNIZED FINANCIAL REGULATORY STRUCTURE (2008), *available at* http://www.treas.gov/press/releases/reports/Blueprint.pdf [hereinafter U.S. TREASURY BLUEPRINT].

233. *Id.* at 132–33.

234. Insurance Information Act of 2008, H.R. 5840, 110th Cong. (2d Sess. 2008). This act was introduced by Representative Paul Kanjorski (a Democrat from Pennsylvania).

In addition, the Insurance Information Act would give the federal government the power to negotiate treaties and international agreements setting insurance regulatory standards and practices that would preempt state insurance laws.[235]

The Insurance Information Act could effectively serve as a back-door means for implementing the same type of uniform rules that the proposed State Modernization and Regulatory Transparency Act ("SMART Act")[236] would have created. Former Representative Michael Oxley (a Republican from Ohio) and Representative Richard Baker (a Republican from Louisiana) conceived the SMART Act as a means of getting the states to overcome the lack of uniform regulations and the high costs of the state regulation of insurance.[237] Representative Oxley tried to model the SMART Act after those provisions in the GLBA that threatened to create a federal regulator if the states failed to enact certain types of laws and regulations within a fixed timeframe.[238] Those provisions in the GLBA spurred the states to enter into reciprocity agreements that reduced the number of state licensing applications insurers had to file.

The SMART Act, if it had been enacted, would have required the states to adopt the NAIC model laws regarding market conduct within three years, or required that these model acts become law automatically at the end of the three-year period and preempt any contradictory laws.[239] It also would have required states to adopt the NAIC model laws governing licensing of insurers, producers, and reinsurers within two to three years or their laws would be preempted by the NAIC laws.[240] In addition, the SMART Act would have required the states to end their regulation of rates after two years.[241]

The SMART Act, however, was never even introduced into Congress as a bill. The insurance industry's response to it was mixed and the states opposed it. What really doomed its introduction was its questionable constitutionality. The U.S. Supreme Court in *New York v. United States* stated that Congress cannot compel the states to enact or enforce a feder-

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235. *Id*. § 313(e).

236. State Modernization and Regulatory Transparency Act, Staff Discussion Draft (2004), *available at* http://www.alta.org/advocacy/news.cfm?newsID=2689 (follow "Title" hyperlinks to access individual sections) [hereinafter SMART Draft].

237. *Rep. Oxley Outlines Road Map to State-Based Insurance Regulatory Reform*, STATES NEWS SERVICE, Mar. 15, 2004.

238. *See id.* Nonetheless, Representative Oxley specifically stated that while the success of such a program hinged on federal-state cooperation, Congress "will not create a Federal regulator." *Id.*

239. SMART Draft, *supra* note 236, § 204.

240. *Id*. §§ 301, 403, 900.

241. *Id*. § 1601(e).

al regulatory program.[242] In addition, the Court in *Printz v. United States* asserted that the federal government cannot require state officers to address particular problems.[243] Both of these cases raised the specter that the states would have been able to launch a successful lawsuit to have the SMART Act struck down as invalid if Congress had ever enacted it.

The Insurance Information Act would not suffer from these problems. In *Missouri v. Holland*, the Supreme Court held that Congress can impose national norms on the states through its treaty power.[244] *Missouri* concerned the Migratory Bird Act of 1918, which implemented a convention between the United States and Great Britain, while the latter still controlled Canada; this Act protected migratory birds that were on the verge of extinction from excessive hunting.[245] Congress had previously tried to protect wildlife in various acts only to have the Supreme Court strike them down as exceeding Congress's constitutional authority under the Commerce Clause.[246] Senator Elihu Root proposed that Congress sidestep this problem by negotiating an international agreement with Great Britain covering migratory birds and then having Congress pass a statute to implement the agreement under its treaty powers.[247] The Insurance Information Act would allow Congress to follow the *Missouri* example by enacting legislation similar to the SMART Act as long as Congress could justify it as necessary to implement an international agreement.

While the NAIC has endorsed the Insurance Information Act, some state legislators are opposed to it because they fear it will strip them of their ability to set insurance standards and regulations.[248] They fear that standards negotiated by the federal government will be weaker than those currently administered by the states, thus harming consumers.

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242. New York v. United States, 505 U.S. 144, 149 (1992).

243. Printz v. United States, 521 U.S. 898, 944–45 (1997).

244. Missouri v. Holland, 252 U.S. 416, 432 (1920).

245. *Id.* at 431–32.

246. Likewise, state laws that appear to intrude on Congress's power under the Commerce Clause have been upheld as valid exercises of state authority. *See, e.g.*, Greer v. Connecticut, 161 U.S. 519, 522, 528–29 (1896) (holding that wild game within the territory of a state was held by the state in trust for its citizens).

247. David M. Golove, *Treaty-Making and the Nation: The Historical Foundations of the Nationalist Conception of the Treaty Power*, 98 MICH. L. REV. 1075, 1255 & n.604 (2000) (citing Senator Robinson's quote of Senator Root's comments (51 CONG. REC. 8349 (1914)).

248. *See* Sara Hansard, *NAIC May Support Federal Office of Insurance Information*, INVESTMENTNEWS, June 23, 2008, http://www.investmentnews.com/apps/pbcs.dll/article?AID=/20080623/REG/733305324/1009/TOC.

The Subcommittee forwarded the Insurance Information Act to the full Financial Services Committee on July 9, 2008, but Congress did not pass the bill before the end of its term.[249] Several congressional supporters sent a letter on January 23, 2009, to Timothy Geithner urging him to create the Office of Insurance Information once he was confirmed as Treasury Secretary.[250] Other groups have publicly opposed having the Office of Insurance Information created by fiat and demanded that it only be created through an act of Congress.[251] If Treasury Secretary Geithner does not unilaterally create the Office of Insurance Information, then the Insurance Information Act will be reintroduced in the 111th Congress and stands a reasonable chance of enactment.

2. Office of National Insurance

If Congress does not enact the Insurance Information Act, it could still improve the United States' ability to negotiate international agreements if it created an Office of National Insurance ("ONI") and set up an optional federal charter system for insurance. The U.S. Treasury Blueprint recommended such a scheme as an intermediate step in reforming the U.S. regulatory structure for financial services. This optional federal charter system would operate in a manner similar to the dual-chartering system currently used for banks.[252] The proposal called for the creation of ONI within the Treasury and for it to be headed by a single National Insurance Commissioner.[253] The Blueprint included a disclaimer that the Treasury is not opining upon or evaluating the merits of any pending legislation before Congress to create an optional federal charter.[254] The Treasury did recommend that any legislation authorizing the creation of

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249. GovTrack.us, H.R. 5840 [110th]: Insurance Information Act of 2008, http://www.govtrack.us/congress/bill.xpd?bill=h110-5840 (last visited Apr. 18, 2009).

250. Sara Hansard, *House Members Push for Insurance Info Office*, INVESTMENTNEWS, Jan. 23, 2009, http://www.investmentnews.com/apps/pbcs.dll/article?AID=/20090123/REG/901239979/1029/INSURANCE. Representatives Melissa Bean, a Democrat from Illinois, Ed Royce, a Republican from California, Dennis Moore, a Democrat from Kansas, Michael Castle, a Republican from Delaware, Andrew Carson, a Democrat from Indiana, John Campbell, a Republican from California, and John Adler, a Democrat from New Jersey, signed the letter. *Id*.

251. Arthur D. Postal, *Federal Oversight Foes Oppose Move for Treasury to Create OII Unilaterally*, NAT'L UNDERWRITER, Feb. 2, 2009, http://www.propertyandcasualtyinsurancenews.com/cms/nupc/Weekly%20Issues/issues/2009/04/News/P04FEDS.

252. U.S. TREASURY BLUEPRINT, *supra* note 232, at 126.

253. *Id*. at 126, 131–32.

254. *Id*. at 128 n.110.

an optional federal chartering system should provide for "solvency regulation, market competition, and consumer protection."[255]

Nevertheless, the optional federal charter envisioned by the Blueprint looked similar to the one detailed in the proposed National Insurance Act of 2007 ("NIA"),[256] which Congress was already considering. The 110th Congress never enacted the NIA before the end of its term.[257] Two of the NIA's original sponsors, Representative Melissa Bean of Illinois and Representative Edward Royce of California, introduced a new optional federal insurance charter bill into Congress on April 2, 2009.[258] This bill, the National Insurance Consumer Protection Act ("NICPA"),[259] contains many of the same features as the NIA, but would also create a systemic regulator for financial institutions.

The NICPA provides insurers with the option of seeking a state charter or a federal charter to write life or property/casualty insurance policies. It would create a new federal insurance agency, the ONI, which is modeled after the OCC and is also located within the Treasury Department.[260] The ONI would be run by one commissioner appointed by the President for a five-year term.[261]

The ONI would regulate national insurers, national insurance agencies, federally licensed producers, and reinsurers.[262] Regulations promulgated

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255. *Id*. at 129–31.

256. The National Insurance Act was first introduced to Congress as the National Insurance Act of 2006, S. 2509, 109th Cong. (2d Sess. 2006). Senators John Sununu (a Republican from New Hampshire) and Tim Johnson (a Democrat from South Dakota) cosponsored this bill. A virtually identical companion bill was introduced to the House of Representatives by Representative Edward Royce (a Republican from California). NIA was reintroduced to Congress as the National Insurance Act of 2007, S. 40, 110th Cong. (1st Sess. 2007) [hereinafter NIA], and by Representatives Royce and Melissa Bean as H.R. 3200, 110th Cong. (1st Sess. 2007). The major change between the National Insurance Act of 2006 and that of 2007 is that the latter bill makes clear that health insurance is included among the types of insurance (life and property/casualty) that can receive a federal charter. For purposes of this Article, NIA will refer to the language in S. 40.

257. GovTrack.us, S. 40 [110th]: National Insurance Act of 2007, http://www.govtrack.us/congress/bill.xpd?bill=s110-40 (last visited Apr. 18, 2009).

258. Press Release, Rep. Melissa Bean, Bean and Royce Push for Insurance Reg Reform (Apr. 2, 2009), *available at* http://www.house.gov/apps/list/press/il08_bean/04_02_09_nicpa.html [hereinafter Bean Press Release].

259. National Insurance Consumer Protection Act, H.R. ____, 111th Cong., (1st Sess. 2009), *available at* http://www.house.gov/apps/list/press/il08_bean/National_Insurance_Consumer_Protection_Act_Bean_Royce.pdf [hereinafter NICPA]. Unlike the NIA, the NICPA only would provide charters for life and property/casualty insurers and reinsurers, not health insurers and reinsurers. *Id.* § 301.

260. *Id.* § 101(a).

261. *Id.* § 101(b)(1)–(2).

262. *Id*. §§ 102, 111–17, 301, 401, 501–03.

by the ONI would preempt state laws for the ONI-regulated entities with regard to licensing, examinations, reporting, and regulations concerning the sale or underwriting of insurance, but would not preempt state laws governing property, taxes, workers' compensation, or motor vehicle insurance.[263] Although insurers subject to state regulation would retain the antitrust exemption under the McCarran-Ferguson Act, national insurers and other entities regulated by ONI would lose this exemption except in connection with the development and use of standardized forms, or to the extent that they are subject to state law.[264]

Furthermore, the ONI would give the federal government the power to negotiate international agreements establishing standards for national insurers without necessarily requiring that such agreements preempt state law.[265] Under the Act, the commissioner may engage in negotiations regarding international or multilateral agreements covering insurance but he is required to consult with the president and the U.S. trade representative.[266] Unlike the NIA, the NICPA does not expressly state that the commissioner may include a state insurance regulators' representative in such negotiations, although it does not prohibit him from doing so.[267]

While the NICPA would improve the ability of the United States to negotiate international agreements on insurance regulation, Congress probably will not enact it without making significant changes to its consumer protection provisions. The NIA failed to be enacted by the 110th Congress, in part, due to concerns over the weakness of the consumer protections provided for in the Act. Representative Barney Frank, who chairs the House Financial Services Committee, was on record as opposing any optional federal charter bill that does not adequately protect consumers.[268] Unfortunately, the sponsors of the NICPA have made cosmetic changes, such as inserting "Consumer Protection" into the name of the Act, to try to hide the fact that the NICPA actually provides even weaker consumer protections than the NIA.

The name of the NICPA is misleading. It implies that the Act is based on the Insurance Consumer Protection Act of 2003 ("ICPA"),[269] which

263. *Id*. §§ 109, 321–23.

264. *Id*. § 702.

265. *Id*. § 203.

266. *Id*. § 203(c).

267. *Compare id.* § 203(c), *with* NIA, *supra* note 256, § 1102(b)(5)(C).

268. Press Release, Networks Fin. Inst., Ind. State Univ., 4th Annual Insurance Reform Summit: Optional Federal Charters, Consumer Protection and Terrorism Insurance Dominate Discussion (Mar. 8, 2007), *available at* http://www.networksfinancialinstitute.org/News/Pages/PressReleasesArchive.aspx?PressReleaseID=7.

269. Insurance Consumer Protection Act of 2003, S. 1373, 108th Cong. (1st Sess. 2003) [hereinafter ICPA].

former Senator Fritz Hollings of South Carolina introduced into the 108th Congress. The ICPA differs significantly from the NICPA. First, the ICPA required national insurers to be regulated by the federal government; it did not allow them to engage in regulatory arbitrage by allowing them the option of choosing their regulator as the NIA does.[270] Second, the ICPA would have repealed the McCarran-Ferguson Act and eliminated the insurance industry's antitrust exemption while the NICPA only provides for a limited repeal of the exemption for nationally chartered insurers.[271]

Third, the ICPA brought up to the federal level most of the major state consumer protection regulations, including price regulations on insurance products and services.[272] The NICPA, on the other hand, eliminates price regulation of insurance products for nationally chartered insurers and only requires the commissioner to adopt by regulation the market conduct standards found in two NAIC model laws, the Unfair Trade Practices Act and the Unfair Claims Settlement Practices Act.[273] This is a major departure from state regulation as every state but Illinois has some form of price regulations for insurance products.[274] The NICPA requires the commissioner to consider NAIC standards, model laws, practices, and procedures when formulating regulations for ONI-regulated entities, but does not require that he actually adopt NAIC standards with regard to accounting and disclosure, auditing, risk management, internal controls, investments, capital and liquidity, actuarial opinions, or reinsurance.[275]

While the absence of price regulations is consistent with NIA,[276] the NICPA's requirements regarding NAIC standards appear weaker than the NIA's provisions. The 2006 and 2007 versions of the NIA would have required the commissioner to promulgate consumer protection regulations consistent with the standards and model laws developed by the NAIC.[277] The commissioner would have two years to issue these regula-

270. *Id.* § 211; NICPA, *supra* note 259, §§ 301, 303.

271. ICPA, *supra* note 269, § 283; NICPA, *supra* note 259, § 702.

272. ICPA, *supra* note 269, §§ 221–23, 231–38, 281–83.

273. NICPA, *supra* note 259, §§ 109(b)(3)(C), 313(a). The NIA also prohibited the ONI from promulgating price regulations on insurance products. The absence of price regulations in both bills is due to the fact that these bills are based on legislation originally proposed in 2001 by the American Council of Life Insurance, the American Bankers Insurance Association, and the American Insurance Association. NATIONAL INSURANCE ACT OF 2001 (Am. Bankers Ins. Ass'n, Proposed Legislation 2001), *available at* http://www.aba.com/aba/pdf/ABIA_OFCL2001Draft.pdf.

274. Bean Press Release, *supra* note 258.

275. NICPA, *supra* note 259, § 314.

276. *See* NIA, *supra* note 256, § 1125 (lacking price regulations).

277. *Id.* § 1212.

tions, and they would have to remain in place for five years after their effective date.[278] After this five-year period, the commissioner would be free to set whatever consumer protections standards that he chose. These provisions cover a broader range of NAIC models and put limits on the commissioner's ability to amend the regulations implementing these model laws at the federal level. In contrast, the language in the NICPA only requires the commissioner to adopt two NAIC model laws by regulation and does not appear to put any limits on the commissioner's ability to amend these regulations after they are adopted.

It is doubtful that Representative Frank and others, such as the Consumer Federation of America, who were uncomfortable with the level of consumer protections in the NIA, will find the NICPA acceptable.[279] As a result, it is unlikely that the Congress will enact the NICPA without substantially amending its consumer protection provisions.

3. Delegating Negotiating Authority

Another way of correcting the problem that the U.S. regulatory structure for insurance poses for concluding binding international agreements would be to have Congress pass a law allowing the states, either directly or through the NAIC, to negotiate international insurance agreements.[280] Even if Congress gives this authority to the NAIC, it will not completely correct the problem because the NAIC currently has no power to force the states to adopt any standards that it espouses. In order to create binding international agreements, all of the states would have to consent to be bound by any agreement that the NAIC concluded and to adopt the laws necessary to implement it.

Allowing the individual states to negotiate directly with foreign nations concerning international insurance regulatory standards would be problematic. First, states would need to be convinced that undertaking such negotiations is in their interests. As previously mentioned, state legislatures typically include little or no funds within insurance commission budgets for the promotion of international cooperation on insurance mat-

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278. *Id.* § 1212(c).

279. The Consumer Federation of America has consistently opposed the adoption of a dual insurance chartering system on the grounds that it "would create a federal regulation that would have little if any authority to regulate price or product" and would merely enact a "wish list of insurer interests." David Hess, *Insurers Split over Federal Regulation Proposal at Hearing*, CONGRESSDAILY, Oct. 23, 2003.

280. U.S. CONST. art. I, § 10 allows states to enter into agreements with foreign powers with the consent of Congress. Since the NAIC is a collective organization of state insurance commissioners, allowing it to negotiate with foreign nations may fall within this part of the U.S. Constitution.

ters. Second, other nations are unlikely to want to deal with fifty different state actors. For example, it is not clear that international organizations like the WTO would accept a delegation comprised of fifty representatives, each from a different state with different negotiating positions. Given their inability to adopt uniform standards within the United States, they probably would not be willing or able to agree on a uniform position for international negotiations.

These negotiations between states and other nations could be further complicated if Congress decides to pass a law allowing insurers to be licensed in any state, but to operate in all fifty states.[281] Such a law would make insurance regulation in the United States look like the laws governing incorporation. The advantages of such a scheme are that it would allow insurers to deal with a single set of rules because they would only have to comply with the insurance laws of the state in which they are chartered, while encouraging regulatory competition among states.[282]

The true desirability of this type of regulatory competition depends on whether it encourages a race-to-the-top or a race-to-the-bottom. It is likely that creating this kind of regulatory competition in the insurance sector would produce a race-to-the-bottom because insurance companies would probably seek out the state with the weakest regulatory standards in order to maximize their profits.[283] Consumers certainly could try to apply market pressure on companies by not buying insurance from those chartered in extremely weak regulatory regimes. It is doubtful, however, that consumers will know or understand the differences in the insurance regulatory regimes of all fifty states well enough to make informed decisions.

Such competition is likely to produce winners and losers and, in effect, narrow the field of states with which foreign governments would feel the

281. Butler and Ribstein have proposed such a reform. *See* Butler & Ribstein, *supra* note 200, at 36.

282. *Id*.

283. Butler and Ribstein recognize that this is a potential problem. They have tried to build in safeguards that would provide a floor level of regulation in the areas of solvency regulation and consumer protection. *Id*. at 40–41. These minimum regulations do not prevent a race to the bottom; they only restrict how much deregulation states will be allowed to engage in to attract insurance firms to license in their jurisdictions. The limits set by Butler and Ribstein are lower than what states like New York and California already require. For example, they do not appear to require that criminal background checks be part of the process to become licensed as an insurance provider. Both New York and California require criminal background checks for firms seeking to offer insurance within their borders. *See Hillman Testimony*, *supra* note 167, at 6 (specifically referencing California). As a result, consumers in those states would be worse off if insurers traded their New York and California licenses for licenses in states meeting the minimum requirements set by Butler and Ribstein.

need to negotiate. It is possible that one state could come to dominate insurance chartering the way that Delaware dominates corporate charters.[284] If this occurred, foreign nations would likely only negotiate with that state and perhaps the two or three other states with the largest insurance markets, such as California, Florida, New York, and Texas. Under these circumstances, the other states may feel compelled to adopt the same standards in order to maintain their competitive position, or at least avoid weakening it further.

Such a scheme runs counter to how the Framers of the Constitution envisaged U.S. foreign affairs. Article I of the Constitution gives Congress the power to "regulate commerce with foreign nations,"[285] and Article II gives the president the power to make treaties with the advice and consent of two-thirds of the Senate.[286] While the Constitution expressly permits the states to enter into international agreements with other nations with the consent of Congress,[287] this provision has rarely been utilized.

CONCLUSION

If moving from soft law norms and standards for insurance regulation to hard law in the form of treaties or binding international agreements is desirable, then the U.S. regulatory structure needs to be reformed to enable it to participate effectively in international negotiations. The current division between the states' ability to regulate insurance and the federal government's authority to conduct international negotiations has stymied efforts to date to move beyond the status quo in the area of insurance regulation. The easiest and most likely way to resolve this issue is for Congress to reintroduce and pass the Insurance Information Act.

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284. Mark J. Roe, *Delaware's Competition*, 117 HARV. L. REV. 588, 590 (2003) (discussing Delaware's dominance).
285. U.S. CONST. art. I, § 8.
286. *Id.* art. II, § 2.
287. *Id.* art. I, § 10.

EXPORTING MORALITY WITH TRADE RESTRICTIONS: THE WRONG PATH TO ANIMAL RIGHTS

INTRODUCTION

In 1998, an undercover Humane Society[1] investigation revealed that the largest coat retailer in America, Burlington Coat Factory, had been selling men's parkas trimmed with dog fur imported from China.[2] Posing as American fur traders, investigators discovered that millions of dogs and cats throughout Asia were being slaughtered inhumanely for their pelts, while American consumers remained naive to the difference in stores because, when dyed, dog and cat fur is virtually indistinguishable from fox, rabbit, or coyote fur.[3] The New York Times picked up the story immediately, and as public outrage ensued, the Humane Society took its findings to Congress.[4] On November 9, 2000, the Dog and Cat

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1. The Humane Society is a nonprofit U.S. animal protection group, which was established in 1954. For more information, see Humane Society of the United States, http://www.hsus.org/about_us/ (last visited Nov. 24, 2008).

2. *Retailer Recalls Parkas Trimmed in Dog Fur*, N.Y. TIMES, Dec. 16, 1998, at B11 [hereinafter *Recall*].

3. *Id.*

4. The following Congressional Findings were spurred by the Humane Society's 1998 report:

> An estimated 2,000,000 dogs and cats are slaughtered and sold annually as part of the international fur trade. Internationally, dog and cat fur is used in a wide variety of products, including fur coats and jackets, fur trimmed garments, hats, gloves, decorative accessories, stuffed animals, and other toys.
>
> . . . The United States represents one of the largest markets for the sale of fur and fur products in the world . . . .
>
> . . . .
>
> . . . Publicly available evidence reflects ongoing significant use of dogs and cats bred expressly for their fur by foreign fur producers for manufacture into wearing apparel, toys, and other products that have been introduced into United States commerce . . . .
>
> . . . .
>
> . . . The trade of dog and cat fur products is ethically and aesthetically abhorrent to United States citizens. Consumers in the United States have a right to know if products offered for sale contain dog or cat fur and to ensure that they are not unwitting participants in this gruesome trade.

Dog and Cat Protection Act of 2000: Findings and Purposes, Pub. L. No. 106–476, § 1442, 114 Stat. 2163 (2000) [hereinafter Findings]. *See also* Humane Society of the Unit-

Protection Act ("DCPA") made it unlawful to import any "dog or cat fur product" into the United States.[5]

Having demonstrated that culture shock can be home delivered in the "flattening"[6] global world, Chinese fur-farming practices left American pet lovers scowling eastward in bewilderment. The DCPA was a response to public *injury*; had anthrax been discovered lurking in imported coats, consumers may have been no more provoked to xenophobia. But dog fur differs significantly from anthrax in that it poses no harm to human health. Thus, if not for the Humane Society drumming up hyperbolic headlines, Americans could have continued buying and wearing dog fur unknowingly and perhaps indefinitely. To believe that the United States is devoid of dog and cat fur today is to assume that the DCPA has been enforced flawlessly. But more recent investigations indicate otherwise; over the past two years, dog fur has been discovered on the racks at J.C. Penney,[7] Macy's,[8] Nieman Marcus, and many other stores.[9] Rejecting the age-old aphorism that "what you don't know can't hurt you," the Humane Society has been lobbying for a "Dog and Cat Fur Prohibition Enforcement Act" since 2007.[10] This begs an obvious question—how many Americans unwittingly sport dog fur at present?—but there are many other important questions that have not been addressed in regard to this uniquely American legislative initiative premised on moral superiority.

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ed States, Dog and Cat Fur: Aftermath of an HSUS Investigation, http://www.hsus.org/furfree/dogs_cats/betrayal/dog_and_cat_fur_aftermath.html (last visited Nov. 24, 2008).

5. The Dog and Cat Protection Act of 2000 provides, in relevant part:

> In general, [i]t shall be unlawful for any person to
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> . . . import into, or export from, the United States any dog or cat fur product; or
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> . . . introduce into interstate commerce, manufacture for introduction into interstate commerce, sell, trade, or advertise in interstate commerce, offer to sell, or transport or distribute in interstate commerce in the United States, any dog or cat fur product.

Dog and Cat Protection Act of 2000, 19 U.S.C. § 1308 (2000).

6. *See generally* THOMAS L. FRIEDMAN, THE WORLD IS FLAT (2006) (discussing globalization).

7. *Fur Flies as Penney Restocks Dog-fur Coats*, MSNBC, Jan. 12, 2007, http://www.msnbc.msn.com/id/16597610.

8. *Macy's Pulls Sean John Hooded Jackets over Use of Dog Fur*, FOX NEWS, Dec. 26, 2006, http://www.foxnews.com/story/0,2933,238864,00.html.

9. *Humane Society Urges Crackdown on Dog Fur*, MSNBC, Mar. 13, 2007, http://www.msnbc.msn.com/id/17584385/.

10. Humane Soc'y of the U.S., *Dog Scandal Pushes New Fur Labeling Bill*, Feb. 7, 2007, http://www.hsus.org/furfree/news/fur_labeling_bill_introduced.html. *See also* H.R. 891, 110th Cong. (2nd Sess. 2007).

It is a truism that Westerners broadly and vehemently oppose animal cruelty and that Americans are generally fond of domesticated dogs—however, a consensus in opposition to cruel treatment is far from an agreement on the proper scope of animal "rights." Activists call for the broadest possible scope of protection,[11] while scientists, consumers, consumer advocates, legislators, and journalists take varying, less comprehensive stances.[12] The 1998 Humane Society investigation that led to the DCPA was but another call to arms—an attempt to mobilize a generally indifferent public to stand up and do something about global animal suffering. A report describing puppies "strangled, bludgeoned, clubbed or bled to death"[13] for their fur seems certain to garner unique attention in a nation where "pet lovers" are a large and uncontroversial group; but this group offers passive sympathy, which, to activists who literally embody the animal welfare cause, may seem unfortunately insufficient.[14] Many activists seek nothing short of an end to human consumption of omelets and milk,[15] but it is worth considering whether ordinary Americans would have been as outraged in 2000 had headlines told of dogs killed painlessly amidst a detrimental animal overpopulation in a region where selling fur to a thriving American fashion market was the only way many poverty-stricken farmers could feed their families.[16]

It is implicit that fewer Americans protest when foxes, rabbits, or coyotes are killed for coats. And it is demonstrable that self-described

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11. *See* discussion *infra* Part I.B.

12. Various arguments stand in the way of an extremist animal rights agenda. For instance, some scientists have claimed that animal testing is "the only way of conducting important research into worldwide diseases such as HIV." Demian Hobby, *Activist Cleared as Oxford Opens Animal Testing Facility*, JOURNAL, Nov. 23, 2008, http://www.journal-online.co.uk/article/5086-activist-cleared-as-oxford-opens-animal-testing-facility. It has also been argued that veganism can cause dangerous if not fatal protein deficiency, to such an extent that vegan pregnancy may be "irresponsible." Nina Planck, *Death by Veganism*, N.Y. TIMES, May 21, 2007, at A19. Furthermore, regulators and consumer-protection groups may argue that a more appropriate public priority is to protect humans from animals rather than to protect animals from humans. *See Agriculture Dept. Wants Meat Inspectors to Focus on Food Safety*, N.Y. TIMES, Aug. 31, 2000, at A23 (quoting an associate within the U.S. Department of Agriculture who said in 2000, "We're trying to make sure our resources are devoted to food safety . . . . That's our first priority . . . .").

13. *Recall*, *supra* note 2.

14. *See generally* Michael Specter, *The Extremist*, NEW YORKER, Apr. 14, 2003, at 52 (profiling an "extremist" animal rights group leader).

15. *See id.* at 54, 56.

16. Chinese State Forestry Administration Deputy Chairman Zhao Xuemin has spoken out against the dog and cat fur trade, but has noted that it is unfortunately driven by economic hardship. *China Pledges to Stop Cat and Dog Fur Trade*, IRELAND. ONLINE, May 24, 2006, http://breakingnews.iol.ie/news/?c=ireland&jp=cwgbaucweyql.

animal sympathizers (those who want to save dogs but enjoy steak) are much less interested in helping animals when it means they must incur life-changing costs in the process.[17] Sympathizers lured to the activist movement by outrageous images of cruelty may begin to have second thoughts when the totality of the animal rights agenda becomes clear.[18] The only way to escape hypocrisy is to assert that the proper scope of animal rights is a question on which reasonable minds can disagree.

Disagree they do, and even though activism has been growing in power and persuasiveness,[19] drastic reforms still seem unimaginably distant. Some activists, bolstered by scholars and scientists, have concluded that humans should treat animals as equals.[20] Still, others who take on the issue assert that the debate remains mired in nuance.[21] Legislators have been left to act on the majoritarian sentiments of the moment, and thus, activists have been left to act on the morals of the majority.

To Americans who do not plan to abandon their hamburgers, the DCPA may serve as guilt reduction. Surely, Americans know when they sit down to eat pork chops that a living animal[22] was born, raised, and then killed—perhaps painfully—for the sake of the meal. And with activists' reminders all the more frequent and public, it may feel quite redeeming to find an animal welfare law that is easy to get on board with—a law that will seemingly help animals but will not require alterations to the customary and ingrained ways of living in America.

In the end, however, it seems shortsighted to claim possession of a simple and clear (and globally applicable) answer to broad questions of human duty to animals. There are too many obscure factors and viewpoints that must be included in the calculus, and it is too easy to unknowingly allow ingrained prejudicial beliefs to dictate one's judgment. Some observers may form conclusions about animal treatment in the East without even scratching the surface of fundamental questions like, why

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17. Cass R. Sunstein, *A Tribute to Kenneth L. Karst: Standing for Animals (with Notes on Animal Rights)*, 47 UCLA L. REV. 1333, 1364 (2000) (arguing that while U.S. laws prevent infliction of gratuitous pain on animals, animals still lose whenever their interests require balancing against human interests).

18. *Reductio ad absurdum*, the logical extension of the animal rights agenda is that animals are our equals and harming an animal is the same as harming a human. *See* Specter, *supra* note 14, at 58.

19. *See infra* note 58 and accompanying text.

20. *See generally* PETER SINGER, ANIMAL LIBERATION 1 (1975) (arguing that the "ethical principle on which human equality rests requires us to extend equal consideration to animals too").

21. *See supra* note 12 and accompanying text. *See also* discussion *infra* Part I.B.

22. *See, e.g.*, E.B. WHITE, CHARLOTTE'S WEB (1952) (chronicling Wilbur the talking pig's miraculous avoidance of slaughter).

would such treatment differ geographically? To what extent should Western legal regimes premise their ideals on "universal truths"? When is it okay to impose one's moral code on others? To what extent can humans parse meaningful differences among similar species of animals? To what extent would those differences be relevant to the treatment of animals? Should there be a hierarchy by which some animals are treated more favorably than others? Why is it "wrong" to wear dog fur but not fox fur in America? When is emotional harm as severe as physical harm when resulting from imported products? And, finally, when exactly is it okay to prohibit the importation of foreign products on the basis of morality under the long-standing General Agreement on Tariffs and Trade ("GATT")?[23]

All of these questions deserve more than passing consideration before laws with broad international impact are enacted at the behest of emotion. This Note will argue that the Dog and Cat Protection Act of 2000 is an ill-conceived federal statute and that Congress should not waste time or federal resources enacting, let alone debating, the presently pending Dog and Cat Prohibition Enforcement Act.[24] This argument should not be construed as a judgment as to the scope or nature of the duty humans owe to animals; rather, it is a judgment regarding the nature of morality-based trade restrictions and is rooted in pragmatic policy analysis of normative moral reasoning, competitive economic efficiency, and the principles of international free trade agreements.

Part I of this Note will critique normative moral theory with respect to its fundamental role in animal welfare proselytizing, its applicability to legal theory, and its usefulness as a basis for legal decision making. Part II will discuss international trade disputes arising over morality-based domestic import restrictions in order to examine why the GATT has consistently been interpreted to err on the side of free trade and consumer choice. Finally, Part III will argue that the DCPA is not only an ineffective and unenforceable law but also potentially counterproductive to the goals of the Western animal welfare movement and overly costly to global trade infrastructure in light of more effective alternatives.

I. ACTIVISM AND NORMATIVE MORAL REASONING: PIG, SHEEP, DOG, FOREIGNER, AMERICAN?

Even in progressive American families, children will not be scolded for ranking their favorite animals. They may judge these animals arbitra-

23. *See* discussion *infra* Part II.

24. This presently pending statute would improve enforcement of the DCPA. *See* discussion *infra* Part III.B.

rily by attributes like "pretty colors," "scary tusks," or "awesome shell," and cartoons and other media may help them form misleading conceptions about animal personalities, but this is okay. There is no need for alarm so long as they are not ranking humans. Science has done good work clearing up long-held misconceptions about skin-tone and ethnicity-based differences,[25] and today, billions of humans expressing themselves through hundreds of collaborating governments seem to agree on the existence of something called fundamental or "natural" human rights.[26] Encompassing many of these rights is the amorphous notion of "liberty," conceived and elaborated on by an oft-touted laundry list of classic thinkers and writers who have had unparalleled influence on the Western world.[27]

When "natural" rights exist in or are enforced via constitution[28] or international agreement,[29] these rights can be seen as mere terms in a contract binding those who have agreed to be bound.[30] But when it is asserted that such rights belong to or must be imposed on those who have

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25. *See* MATT RIDLEY, THE RED QUEEN: SEX AND THE EVOLUTION OF HUMAN NATURE 13 (1993) ("[D]ifferences [among] the average members of different races are actually tiny and are mostly confined to a few genes that affect skin color, physiognomy, or physique.").

26. The Universal Declaration of Human Rights ("Universal Declaration"), enacted in 1948, binds 192 Member States of the United Nations. The preamble to the Universal Declaration provides that the "recognition of the inherent dignity and of the equal and inalienable rights of all members of the human family is the foundation of freedom, justice and peace in the world." Universal Declaration of Human Rights, G.A. Res. 217A (III), at 71, U.N. GAOR, 3d Sess., 1st plen. Mtg., U.N. Doc. A/810 (Dec. 12, 1948) [hereinafter UDHR].

27. *See, e.g.*, JOHN LOCKE, TWO TREATISES OF GOVERNMENT 283 (Peter Laslett ed., Cambridge University Press) (1824) ("The natural liberty of man is to be free from any superior power on earth, and not to be under the will or legislative authority of man, but to have only the law of nature for his rule. The liberty of man, in society, is to be under no other legislative power, but that established, by consent, in the commonwealth."); JOHN STUART MILL, ON LIBERTY 14 (Random House 2002) (1859) (arguing that human liberty comprises, among other things, freedom of "thought and feeling," "absolute freedom of opinion," and freedom to express, publish, and unite).

28. *See generally* U.S. CONST. amend I–X (providing that certain rights cannot be abridged by Congress, for example, "freedom of speech" and freedom from "unreasonable search and seizure").

29. *See* UDHR, *supra* note 26, ¶ 3 (providing that no U.N. Member State shall deprive its human citizens of certain rights, for example, "life, liberty and security of person").

30. *See* LOCKE, *supra* note 27 and accompanying text.

not sought to be bound,[31] the asserter is laying claim to the possession of universally applicable "truth."[32] To hold "self-evident"[33] that liberty is universally inherent to human nature is to claim that nonliberal sentiments (and thus, nonliberal societies) are necessarily "wrong"—wrong in the same way that "two plus two equals five" is wrong. This is the assertion of "moral realism" (also known as "universalism") at its logical ends.[34]

"Moral relativism," on the other hand, fights nature with "nurture," and proposes that moral codes do not merit sweeping claims at objective truth.[35] Relativists argue that cultures can simply possess "different" moral codes, that morality is shaped by the "exigencies of life" in a given society, and that those who believe otherwise are simply blinded by the codes ingrained in their own social set.[36] The debate between universalism and relativism is as fundamental to the question of animal rights as it has been to the question of human rights, at least in regard to the stance Westerners take toward those in the global community who operate "differently."[37] Per these superficially simple definitions, it may be obvious that animal rights activists tend toward a theory of moral universalism. This section does not pine for a theory of relativism but, rather, puts forth a nuanced conception of morality as a locally adaptive system of social control. Expanding on a view presented by Judge Richard Posner in his book *The Problematics of Moral and Legal Theory*, this section argues that, alone, a society's ingrained moral codes serve as a generally poor premise for the enactment of restrictions on international product importation.

A. Metaethics and Animal Utilitarianism

Moral universalism and moral relativism are the two most prominent metaethical perspectives on normative moral theory.[38] Normative theory first asks, "By what standards should conduct be labeled 'right' or

31. Meaning the governments of foreign nations that have not sought to join, for instance, the United Nations (and thus have not sought to be bound by the Universal Declaration).

32. *See* discussion *infra* Part I.A.

33. THE DECLARATION OF INDEPENDENCE para. 2 (U.S. 1776).

34. For a discussion of moral realism, see RICHARD A. POSNER, THE PROBLEMATICS OF MORAL AND LEGAL THEORY 17 (1999).

35. *Id.* at 6–8.

36. *Id.* at 19.

37. Stanford Encyclopedia of Philosophy, "Moral Realism" (2005), http://plato.stanford.edu/entries/moral-realism.

38. *Id.*

'wrong'"?[39] Metaethics then asks whether "rightness" and "wrongness" exist independent of human judgment.[40] In addition to universalism and relativism, there are other derivative metaethical perspectives such as "pluralism,"[41] "subjectivism,"[42] and "skepticism,"[43] and each presents a different understanding of the elusive nature of truth with respect to moral inquiry.

Within normative theory, the two most prominent standards for labeling conduct "right" or "wrong" are "deontology" and "consequentialism."[44] Deontology posits that conduct should be valued in reasoned consideration of one's duty to others.[45] For example, Immanuel Kant's[46] "Categorical Imperative" provides that one should act "only on that maxim" for which he or she would "at the same time will that it should become a universal law."[47] Kant criticized the inhumane treatment of animals on the basis that empathy is essential to human adherence to the imperative.[48] Consequentialism, on the other hand, assigns value to conduct solely on the basis of its consequences.[49] Utilitarianism is a theory of consequentialism that proposes a battle between "pleasure" and "pain" (words as amorphous as liberty), and provides that humans should live so as to achieve the greatest good for the greatest number.[50] Utilitarianism has undergirded countless historical notions of justice and social duty, including, most notably, general deterrence theories of criminal punish-

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39. *Id. See also* BLACK'S LAW DICTIONARY 1086 (8th ed. 2004).

40. *See* Stanford Encyclopedia of Philosophy, "Metaethics" (2007), http://plato.stanford.edu/entries/metaethics.

41. "Moral pluralism" claims that there can be more than one scale to weigh "value"; thus, values can be incommensurable such that an attempt to balance them is misguided. For instance, consider the question of whether "justice" is better than "loyalty" (or whether law professor is a "better" profession than philosophy professor). *See* POSNER, *supra* note 34, at 8.

42. "Moral subjectivism" claims that one's "morality" can be judged only per compliance with whatever moral code one has chosen for oneself. *Id.* at 9.

43. "Moral skepticism" speculates that moral truth is completely unknowable. *Id.*

44. *See* Stanford Encyclopedia of Philosophy, "Deontological Ethics" (2007), http://plato.stanford.edu/entries/ethics-deontological.

45. *Id.*

46. *See* BERTRAND RUSSELL, HISTORY OF WESTERN PHILOSOPHY 637–52 (1946).

47. IMMANUEL KANT, FUNDAMENTAL PRINCIPLES OF THE METAPHYSIC OF MORALS (1785). *See also* JOHN RAWLS, A THEORY OF JUSTICE (1971) (arguing that morality is intuited in what all humans would willingly subject themselves to).

48. *See* Christine M. Korsgaard, *Fellow Creatures: Kantian Ethics and Our Duties to Animals* 14–16 (2004), *available at* http://www.people.fas.harvard.edu/~korsgaar/CMK.FellowCreatures.pdf.

49. *See* Stanford Encyclopedia of Philosophy, "Consequentialism" (2006), http://plato.stanford.edu/entries/consequentialism.

50. *See* JOHN STUART MILL, UTILITARIANISM 239 (Random House 2002) (1871).

ment.[51] Moreover, utilitarianism has been the value scale of choice for one of the most prolific academic animal rights activists of all, Princeton University bioethics professor Peter Singer.[52] Singer includes animals in his utilitarian morality calculus such that the addition of their "pain" would weigh in drastically to render mankind terribly immoral.[53]

While Singer is the academic animal rights pioneer—the "activist" who lends extra credibility to the cause—he is not the face of outraged protest. His 1975 book *Animal Liberation*, however, was the catalyst that moved Ingrid Newkirk to found the notoriously controversial group People for the Ethical Treatment of Animals ("PETA").[54] Today even the Humane Society, for all its feats, is shrinking in both power and popularity next to the organization known for covertly infiltrating fashion shows and unfurling signs that read (in one instance) "Gisele: Fur Scum."[55] Both PETA and the Humane Society offer "lobbying" guides on their websites to explain how regular citizens can effectively engage Congressional representatives, but PETA's website also includes an "everyday activism" guide, which explains how regular citizens can stir up controversy and outrage on their own, all the time.[56] PETA.org provides "all the information that you'll need to hold a successful demonstration."[57]

Ingrid Newkirk, as PETA's leader, is the resident captain of activism, and she commands an ever-burgeoning fleet.[58] According to Newkirk, animal sympathizers who decry abuse but then fail to renounce their

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51. *See* JOSHUA DRESSLER, UNDERSTANDING CRIMINAL LAW 14–15 (2006). *See also* MILL, *supra* note 50, at 283 ("And hence the sentiment of injustice came to be attached, not to all violations of law, but only to violations of such laws as *ought* to exist, including such as ought to exist but do not.").

52. *See* SINGER, *supra* note 20, at 5. *See also* Richard A. Posner & Peter Singer, *E-mail Debates of Noteworthy Topics: Animal Rights*, SLATE, Jun. 12, 2001, http://www.slate.com/id/110101/entry/110109/.

53. Singer claims that humans engage in "speciesism," which is just like sexism or racism. He argues that the "only acceptable limit to [human] moral concern is the point at which there is no awareness of pain or pleasure." In other words, humans owe a duty not to cause pain to anything that can feel pain. *See* Posner & Singer, *supra* note 52.

54. Specter, *supra* note 14, at 60.

55. *Id.* at 52.

56. Humane Society Citizen Lobbyist Center, http://www.hsus.org/legislation_laws/citizen_lobbyist_center/ (last visited Nov. 24, 2008); PETA's Legislative Guide, http://www.peta.org/actioncenter/leg.asp (last visited Nov. 24, 2008).

57. PETA's Everyday Activism Guide, http://www.peta.org/actioncenter/act.asp (last visited Nov. 24, 2008).

58. Newkirk founded PETA in 1980; today the group boasts over two million members, annual donations in excess of $25 million, and over 50 million hits received at its various websites. For more information, see People for the Ethical Treatment of Animals, About, http://www.peta.org/about/ (last visited Nov. 24, 2008).

leather belts are but hypocrites who remain a large part of the global animal welfare problem.[59] It is Newkirk's mission to make full vegans of all who will listen,[60] so PETA seeks to lure as many followers as possible, often with shock tactics.[61]

One of PETA's most shocking (and perhaps effective) ploys has been to display on its website actual video footage of dogs abused and slaughtered in China.[62] It is perhaps a truism that sympathizers are best baited to the cause with horrifying images of animal suffering.[63] But in soliciting and receiving support from sympathizers who, despite being outraged at such footage, inevitably remain meat eaters (i.e., "murderers"), PETA has been forced to compromise the totality of its principles to an extent—to put the "steak equals death" chants on brief pause.[64]

When a magazine reported several years ago that Ben Affleck had bought a chinchilla coat for Jennifer Lopez, PETA mailed Affleck a graphic video (and explanatory letter) detailing the process by which nearly one hundred chinchillas are killed to make a single garment:

> The preferred method of killing chinchillas is by genital electrocution: a method whereby the handler attaches an alligator clamp to the animal's ear and another to her genitalia and flips a switch, sending a jolt of electricity through her skin down the length of her body. The electrical current causes unbearable muscle pain, at the same time working as a paralyzing agent, preventing the animal from screaming or fighting.[65]

Affleck wrote back: "You have opened my eyes to a particularly cruel and barbaric treatment of animals. I can assure you I do not endorse such treatment and will not do anything in the future that supports it."[66] Years later, while Ben's brother Casey is listed among "Famous Hollywood Vegetarians," Ben is not.[67]

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59. *See* Specter, *supra* note 14, at 58.

60. *See id.*

61. For instance, PETA has employed models and celebrities to pose for implied nude photos that tout the slogan, "I'd rather go naked than wear fur." *Id.*

62. A Shocking Look Inside Chinese Fur Farms, http://www.peta.org/feat/ChineseFur Farms/index.asp (last visited Nov. 24, 2008).

63. *See* Posner and Singer, *supra* note 52.

64. Specter, *supra* note 14, at 67.

65. *Id.* at 52.

66. *Id.*

67. International Vegetarian Union—Famous Vegetarians, http://www.ivu.org/people/actors/index.html (last visited Nov. 24, 2008).

The cost Americans are willing to incur in changing their lives and habits for animals remains minimal despite appalling videos.[68] Humans may feel noble when they cry out against cruelty for the domesticated pets of the West—but their sympathies may best be described as selective attention, cognitive dissonance, or even willful ignorance when they continue choosing to wear or eat other animals. There are minimal grounds on which to argue that importing fox, rabbit, coyote, wolf, or chinchilla fur is morally justifiable compared to importing "dog" fur. A Burlington Coat Factory spokesman said defensively in 2000, "[W]e were outraged . . . . [T]he purchase order actually called for coyote trim."[69] A spokeswoman for the Fur International Council of America (a profur group, no less) explained, "[O]ur position is that dog and cat fur should not be sold in the United States . . . . *Culturally, it goes against our grain to do so. It's just not something we want to see happening.*"[70] Furthermore, under the Congressional "Findings and Purposes" listed with the legislative history of the DCPA, the law was justified on the basis that "the trade of dog and cat fur products is ethically and aesthetically abhorrent to United States citizens."[71]

To be fair, there are plenty of domestic laws rooted in moral norms.[72] But laws that restrict trade serve to impose American moral norms on foreign societies. When nations hold distinctly incompatible moral codes, each side surely feels "right" in the same way that each side feels "right" in the incomparably divisive American debate over abortion.[73] Both sides wish to label the other morally inferior, and all arguments aspire to the persuasiveness of objective, mathematical truth.[74] When Americans

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68. *See supra* note 17 and accompanying text.

69. *Recall*, *supra* note 2 (emphasis added).

70. *Id*. *See also* Fur Information Council of America, http://www.fur.org/about_fica.cfm (last visited Nov. 24, 2008) (providing "facts that counter the distortions and misrepresentations" proffered by animal welfare groups).

71. *See supra* note 4 and accompanying text.

72. Plenty of laws resemble moral dictates, but most also serve overarching societal functions. For instance, it may be a moral norm that stealing is "wrong," but laws against theft also serve order, property interests, and predictability. *See* POSNER, *supra* note 34, at 108 ("[T]he reason for the overlap between morality and law is that they are parallel methods . . . for bringing about the kind and degree of cooperation that a society needs in order to prosper.").

73. *Compare* Don Marquis, *Why Abortion Is Immoral*, 86 J. PHIL. 183 (1989) (arguing that abortion is "in the same moral category as killing an innocent adult human being"), *with* Sidney Buchanan, *The Abortion Issue: An Agonizing Clash of Values*, 38 HOUS. L. REV. 1481, 1487 (2002) (arguing that it is morally horrifying to force a pregnant woman to carry a fetus against her will).

74. *See supra* note 73 and accompanying text. Ronald Dworkin is one of the foremost legal proponents that there exists an objectively knowable "right" versus "wrong." *See*

apply economic sanctions to "inferior" foreign moral codes, they are not enacting laws backed by majority vote; they are imposing one conception of global truth over another.[75] Federalists would argue that this describes the Court's decision in *Roe v. Wade*;[76] but when the Court strikes a statute on review concluding that "what was popular" in a given instance "was not 'right,'" "right" is given a meaning independent of human judgment only insofar as it defines a presently prevailing "interpretation"[77] of a social contract[78]—a contract by which all concerned parties had already agreed to be bound.[79]

Vegans are not a U.S. majority,[80] so the DCPA clearly required support from those who eat meat and wear leather (and maybe even those who wear other types of fur). One's opinion on abortion rights may wholly depend on one's moral convictions, but of those who unequivocally oppose abortion, few would place conditions on a fetus's right to life on the basis of its ancestry or lineage. Meanwhile, lineage is the lone difference between wolves (which are hunted in America) and domesticated dogs.[81] Still, even if a group's moral code is logically consistent and

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generally Ronald Dworkin, *Objectivity and Truth: You'd Better Believe It*, 25 PHIL. & PUB. AFF. 87 (1996).

75. In a world where morality is decidedly objective and universal, the "professors propose, and the judges impose." POSNER, *supra* note 34, at 117.

76. In this well-known and divisive case, the Supreme Court held that the right to have an abortion is implicitly guaranteed under the Due Process Clause of the Fourteenth and Fifth Amendments to the U.S. Constitution. But as Chief Justice Rehnquist noted in dissent, "[T]he very existence of the debate is evidence that the 'right' to an abortion is not [as] universally accepted as the appellant would have us believe." Roe v. Wade, 410 U.S. 113, 174 (1973) (Rehnquist, J., dissenting).

77. *See* U.S. CONST. art. VI, cl. 2 (establishing that the Constitution is the supreme law of the land). *See also* Marbury v. Madison, 5 U.S. 137 (1803) (recognizing that the Constitution vests the Supreme Court with the power to strike legislation that is repugnant to the Constitution). When a judge decides that a right to abortion does not flow from the Constitution, he or she is not ostensibly expressing an independent opinion on whether or not humans should have a right to abortion. *See generally* ARISTOTLE, ON INTERPRETATION § 14 ("It is an error to suppose that judgments are to be defined as contrary in virtue of the fact that they have contrary subjects.").

78. *See supra* note 27 and accompanying text.

79. The U.S. Constitution can be amended by two-thirds of the federal legislature or by three-fourths of state legislatures or conventions. U.S. CONST. art. V.

80. As of 2006, only an estimated 1.4% of U.S. adults considered themselves "vegan." Charles Stahler, *How Many Adults Are Vegetarian?*, VEGETARIAN J. (2006), http://www.vrg.org/journal/vj2006issue4/vj2006issue4poll.htm.

81. "The history of the domestic dog traces back at least 15,000 years, and possibly as far back as 100,000 years, to its original domestication from the grey wolf in East Asia." Kerstin Lindblad-Toh et al., *Genome Sequence, Comparative Analysis and Haplotype Structure of the Domestic Dog*, 438 NATURE 803 (2005).

uncontroversial, claims to its objective, universal truth may be no less misguided.

B. Posner and "Pragmatic Moral Skepticism"

Judge Richard Posner has opined that "many moral claims are just the gift wrapping of theoretically ungrounded and ungroundable preferences and aversions."[82] This strong assertion came in an attack on what Posner terms "academic moralism"—attempts by "ivory tower" professors to play a role in "improving the moral judgments" of everyone, from themselves and their students to judges, Americans, and foreigners.[83] Posner's chief gripe with these "moralists" lies in his claim that, while it is useful to study morality, normative proselytizing "has no prospect of improving human behavior."[84] "Knowing the moral thing to do furnishes no motive . . . for doing it," he contends.[85]

In his book, *The Problematics of Moral and Legal Theory*, Posner establishes his own compelling "theory *about* morality," which he says differs from a "moral theory" in that it *does not* dictate how humans should behave.[86] He calls it "Pragmatic Moral Skepticism," and it comprises an amalgam of relativism and pluralism, plus an abundance of "skepticism" over the usefulness of moral theorizing in general.[87] In short, Posner argues that while moral "sentiments" like "pity" and "disgust" may very well be universal, common attempts to craft reasoned universal "truths" (e.g., "murder is wrong") produce mere tautologies (i.e., "wrongful killing is wrong") or abstractions that are too vague to be useful (e.g., "don't lie all the time").[88] Ultimately, Posner asserts that moral codes are contingent on locality,[89] but he does not go so far as to say that these codes should be immune to judgment from outsiders (he refers to such a perspective as "vulgar relativism").[90] Rather, Posner

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82. POSNER, *supra* note 34, at 11.

83. *Id.* at 5, 8.

84. *Id.* at 7. *Cf.* RONALD DWORKIN, FREEDOM'S LAW: THE MORAL READING OF THE AMERICAN CONSTITUTION (1997) (arguing that moral reasoning should play a role in constitutional interpretation).

85. POSNER, *supra* note 34, at 7 ("[M]otive and motivation have to come from outside morality. Even if this is wrong, the analytical tools employed in academic moralism—whether moral casuistry, or reasoning from the canonical texts of moral philosophy, or careful analysis, or reflective equilibrium, or some combination of these tools—are too feeble to override either narrow self-interest or moral intuitions.").

86. *Id*. at 14 (emphasis added).

87. *Id*. at 1, 12.

88. *Id*. at 6, 19.

89. *Id*. at 6.

90. *Id*. at 8.

praises the value of thoughtful moral criticisms but with the important caveat that they should be grounded in "functional" (as opposed to normative) rationales.[91]

For instance, Posner speculates that Nazi genocide is so much more widely condemned today than "the genocidal policies the United States pursued toward the American Indians" because the former was clearly not "adaptive to any plausible or widely accepted need or goal" of the locality,[92] whereas the latter, in functional terms, was "beneficial" in that Americans continue benefiting from the seized land today.[93] As another example, Posner notes that we object to human sacrifice partly because we know it "does not avert drought, flooding, famine, earthquakes, or other disasters and is thus a poor means to a society's ends."[94] Posner explains:

> [W]hen human sacrificers do not make falsifiable claims for the efficacy of the practice, so that the issue becomes a choice of ends rather than a choice of means to an agreed end (making the crops grow), our critical voice is stilled. Or rather, it becomes a voice expressing disgust—a reaction to difference—rather than a voice uttering reasoned criticisms.[95]

Posner's analyses speak to the mentations of the meat-eating animal "sympathizers" who supported the DCPA even given the proposition that eastern farmers depend on trade in dog and cat pelts for their livelihoods. His critique of normative moral theory serves to condemn the cogency and usefulness of the "universalist" moral rhetoric that activists as well as "academic moralists" rely on in pushing their agendas.

In 2001, via eight letters published by *Slate*, Peter Singer engaged in a written debate with Posner to challenge his moral skepticism as it relates to animal welfare.[96] Posner, in turn, challenged Singer's utilitarianism. In a hypothetical, Posner suggested that, if the only way to stop a dog from biting a small child is to inflict more pain on the dog than the child would suffer from the bite, utilitarian philosophy dictates that the dog must be left to bite.[97] Singer agreed.[98] Posner said that this conclusion

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91. *Id*. at 21.

92. *Id.*

93. *Id*. *See also* HOWARD ZINN, A PEOPLE'S HISTORY OF THE UNITED STATES 9 (1980) (considering the prevailing image of Christopher Columbus in U.S. history as a "quiet acceptance of conquest and murder").

94. POSNER, *supra* note 34, at 21.

95. *Id*. at 22.

96. *See* Posner & Singer, *supra* note 52.

97. *Id*.

98. *Id*.

goes against a moral intuition "deeper than any reason that could be given for it and impervious to any reason" that could be given against it.[99]

Posner agrees with Singer that humans should indeed incur costs to reduce the gratuitous suffering of animals.[100] But he rejects the use of force to coerce humans to incur these costs, especially when the use of force is rationalized by one group's tenuous claim to superior knowledge of "moral truth."[101] Posner advocates "persuasion" as the best means of improving animal treatment, and he has touted "graphic depictions" like those in Singer's book and on PETA's website for their ability to inspire human empathy for the plight of suffering animals.[102] Regarding Ben Affleck's sentimental reply to PETA (and subsequent failure to become a vegetarian), Posner might have suggested mailing him additional video clips of the slaughter of all his favorite meals.

Posner would admit that passive persuasion alone will not imminently revolutionize the treatment of animals around the world,[103] but in weighing the alternative (the force of law), he would probably first find it worth exploring the roots of disparate global views on the scope of animal rights. "Squeamishness is a big factor in morality," Posner has argued, quoting Hamlet ("[t]he hand of little employment hath the daintier sense").[104] "In poor societies most people have seen human corpses and have participated in killing, at least of animals. They are inured to blood and gore, and so they do not recoil."[105] Meanwhile, Americans are largely detached from the process by which food travels from the slaughterhouse

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99. *Id*.

100. *Id*.

101. *See id*. Law and Philosophy Professor Gary Francione has also rejected the use of force as impractical:

> On the social and legal level, there needs to be a paradigm shift as a social matter before the legal system will respond in a meaningful way. I disagree with those who maintain that the legal system will lead in the struggle for animal rights or that significant legal change will occur in the absence of the development of a political and social movement in support of animal rights and the abolition of animal exploitation.

Gary L. Francione, *Reflections on Animals, Property, and the Law and Rain Without Thunder*, 40 LAW & CONTEMP. PROBS. 9, 42 (2007).

102. *See* Posner & Singer, *supra* note 52. While this may sound like a decidedly Kantian argument, Posner's emphasis is that exposure to facts is the best catalyst for change. *See id. See also infra* text accompanying note 103.

103. Posner argues that humans already grasp thoroughly that animals feel pain and that "to inflict pain without a reason is bad"; thus, it is an altogether different task to persuade humans to *stop* causing animals pain. *Id*.

104. POSNER, *supra* note 34, at 56.

105. *Id*.

to their grocers' freezers. Posner has gone on to say, "We congratulate ourselves on being morally more refined than our predecessors," when in reality, we simply make use of technology to kill from afar.[106] "Science—not moral insight—has made us more civilized (by our lights)."[107]

These observations serve Posner's resounding conclusion that "even if moral theorizing can provide a usable basis for some moral judgments, it should not be used for making *legal* judgments."[108] Ultimately, Posner views law and morality as separate systems of social control with distinct and often detached goals (despite the frequent appearance of overlap).[109] He claims that neither system can lay claim to a framework of globally universal truth, and he argues that "[i]t is not a scandal when the law fails to attach a sanction to immoral conduct or when it attaches a sanction to conduct that is not immoral."[110] The grounds for criticism, he maintains, reside in the "function" of a given law or moral tenet per its adaptability to a "plausible or widely accepted need or goal."[111]

II. THE GATT AND WORLD TRADE IN MORALITY

A widely accepted goal of many international agreements is the reduction of encumbrances to free trade, which has been viewed as largely adaptable to the goal of enhancing global prosperity.[112] In light of short-term domestic concerns like unemployment and international economic power, free trade remains a contentious political issue in the United States;[113] however, modern economists largely agree that free international trade is not only a boon to its voluntary participants, but also an

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106. *Id*.
107. *Id*.
108. *Id.* at 3 (emphasis added). Moreover, Posner was referring to *domestic* legal judgments which (since they are rendered locally) are even less likely than international judgments to contravene the prevailing moral codes of the groups they impact. *Id.*
109. *Id.* at 110.
110. *Id.* at 108–10 (noting that an involuntary contract breach is punishable but not considered "immoral" in the United States, whereas adultery is considered immoral but not punishable).
111. *Id.* at 6, 21 (explaining that under an "*adaptionist*" framework, morality can be judged "by its contribution to the survival, or other ultimate goals, of a society," and that this is a nonmoral judgment akin to criticizing a hammer per how "well or poorly adapted" it is to "its goal of hammering nails into wood or plaster").
112. *See infra* text accompanying note 116.
113. *See infra* note 118 and accompanying text.

exceptional benefit to the growth of developing economies.[114] This latter view can be simplified: free-trade leads to the reduction of global poverty.[115] Today's relatively unencumbered "global trading community" was born in the wake of World War II when twenty-three nations signed the 1948 General Agreement on Tariffs and Trade in order to liberalize international commerce and eradicate "self-defeating mercantilist protection" among contracting members.[116] Originally, the GATT served as a platform for countries to negotiate tariff reductions "item-by-item," and with the peer-pressure typical of popular group consensus, the GATT developed a strong antiprotectionist spirit that fueled decades of "pro-trade bias" among contracting members and dispute resolution panels.[117]

Today, calls for protectionism have not quite ceased. Domestic American workers, fearful of "outsourcing," have leveled widespread criticism at politicians who support free trade agreements,[118] but in the decades since the GATT's inception, sincere protectionism has become something of a global anachronism, and many of today's disputed import

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114. *See* WILLIAM J. BAUMOL & ALAN S. BLINDER, MICROECONOMICS: PRINCIPLES AND POLICIES 445 (9th ed. 2003) (explaining that international trade is economically desirable). *See also infra* text accompanying note 116.

115. *See infra* text accompanying note 116.

116. *See generally* General Agreement on Tariffs and Trade, Oct. 30, 1947, 61 Stat. A-11, 55 U.N.T.S. 194 [hereinafter GATT]. *See also* SUNGJOON CHO, FREE MARKETS AND SOCIAL REGULATION: A REFORM AGENDA OF THE GLOBAL TRADING SYSTEM 1–2 (2003) (noting the rationale behind the adoption of the GATT). Under a mercantilist philosophy, trade was seen as a zero-sum game. Protectionism was advocated on the premise that a nation builds wealth by supplying more exports while demanding fewer imports. This theory was first condemned in the eighteenth century by Adam Smith, and then nineteenth century economist David Ricardo shattered the premise when he explained the theory of "comparative advantage," which demonstrates how trade can increase value for two nations even when one *could* produce all its own goods. For example, say Portugal can produce wine for $1.00 and cloth for $2.00, whereas England can produce wine for $3.00 and cloth for $2.00. Portugal and England *could* produce both goods on their own at total costs of $3.00 and $5.00, respectively. But Portugal can produce two bottles of wine at $2.00, and England can produce two pieces of cloth at $4.00. When Portugal trades wine for English cloth, both nations save $1.00 total. The lesson is that trade can be mutually beneficial if nations specialize in goods production for which they hold a comparative advantage, even if one is more efficient than the other in every industry. *See* BAUMOL & BLINDER, *supra* note 114, at 444 ("[T]rade is a win-win situation.").

117. *See* CHO, *supra* note 116, at 2.

118. Steelworkers called for protection in 2001 and asked that duties or quotas be imposed on foreign-made steel. *See* Joseph Kahn, *Trade Panel Backs Steel Makers, Enabling Broad Sanctions*, N.Y. TIMES, Oct. 23, 2001, at C1. *See also* Robert E. Reich, *The Poor Get Poorer*, N.Y. TIMES, Apr. 2, 2006 ("Most economists and policy makers now accept Ricardo's [comparative advantage] argument, although the popular debate over the merits of free trade continues.").

restrictions are premised on other domestic goals that at least appear sufficiently well-intentioned.[119] Still, very few "domestic goals" have been persuasive enough to warrant international approval when challenged, and consistent invocation of the GATT's "pro-trade bias" has meant that "non-trade social concerns, such as human health and environmental protection, have been treated as mere exceptions to general obligations" and have been subject to narrow interpretation under "stringent tests."[120] Indeed, prior to the formation of the World Trade Organization ("WTO") in 1994,[121] not one domestic import restriction was deemed justifiable under the GATT's general exceptions provided for in Article XX.[122]

Only recently has the GATT's pro-trade bias seemed to "soften,"[123] though some commentators suggest that this is merely a result of increased information costs (which render risks of harm from certain products more difficult to detect)[124] and shifts among societal norms regarding environmental protection.[125] This softening is evident in the 1994 Preamble to the WTO Charter, which touts desirable goals (like "sustainable development") that "certainly [go] beyond the narrow anti-protectionist motto embedded" in the pre-WTO GATT.[126] Additionally, agreements born alongside the WTO preemptively tackle the ongoing conflict between free trade and state regulation; for instance, the 1994 Agreement

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119. The measures seem "well-intentioned" in the sense that they do not appear discriminatory toward other nations and are simultaneously defensible as a sovereign nation's legitimate internal preferences.

120. *See* CHO, *supra* note 116, at 2–3. Cho also notes that the "textual dichotomy" of the agreement has led interpreters to ignore the merits of domestic regulatory goals until an initial determination has been made as to whether "general obligations" have been violated. *Id.* This would be the case even if the "domestic regulatory goal" was to prevent importation of poisoned food; one could argue that a ban on exporting poisoned food should be a "general obligation" and not an afterthought exception to a blanket ban on import restrictions.

121. The WTO was established in 1994 to serve as a global organization to facilitate international trade. As of 2008, it is comprised of 153 member nations. *See* Marrakesh Agreement Establishing the World Trade Organization, Apr. 15, 1994, 1867 U.N.T.S. 154, 33 I.L.M. 1144. For more information, see WTO, What Is the WTO?, http://www.wto.org/english/thewto_e/whatis_e/whatis_e.htm (last visited Apr. 27, 2009).

122. *See* CHO, *supra* note 116, at 3. For discussion of Article XX, see *infra* Part II.B.2.

123. *See* CHO, *supra* note 116, at 3.

124. Increased information costs are a result of technological advances as well as increased specialization that goes hand-in-hand with greater division of labor. *Id*. *See also* THOMAS SOWELL, KNOWLEDGE AND DECISIONS 7–8 (1996). *See also* MacPherson v. Buick Motor Co., 217 N.Y. 382 (1916) (spelling the end of the doctrine of caveat emptor).

125. *See* CHO, *supra* note 116, at 3 ("More domestic regulations have been issued in response to the popular demands of the welfare state.").

126. For instance, it may be easier today to ban imports deemed harmful to the environment. *Id*. at 4.

on Sanitary and Phytosanitary Measures established harmonized scientific risk assessment methods that can be employed to objectively justify import restrictions based on a product's risk to health or the environment.[127]

Still, contemporary panel decisions (and commentators' arguments for additional reforms)[128] indicate that the GATT and recent derivative WTO agreements remain largely and undeniably pro-trade.[129] While the GATT may be growing more receptive to legitimate domestic regulatory goals, there are bright-line rules in place preventing lengthy slides down the slippery slope. Restrictions that protect human health or the environment can be analyzed empirically; however, there is no truly objective standard for judging the merits of an invisible, subjective, and unquantifiable "harm." And the GATT is inherently skeptical of such "harms," lest they be embellished as a veiled attempt at protectionism.[130] Furthermore, regulations still must comply with the GATT's general obligations unless they fit squarely within an explicit Article XX exception.[131] This section argues that, even applying the most favorable casuist interpretations of the relevant GATT provisions, the DCPA would not pass muster before a dispute resolution panel.

A. China and the GATT

Before examining specific GATT provisions, it is necessary to establish China's role with respect to the agreement. China was one of the original twenty-three parties to sign the GATT in 1948,[132] but after a revolution splintered the nation in 1949, a new government in Taiwan

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127. *See id. See also* Agreement on the Application of Sanitary and Phytosanitary Measures, Apr. 15, 1994, Marrakesh Agreement Establishing the World Trade Organization, Annex 1A, Legal Instruments—Results of the Uruguay Round, 33 I.L.M. 1165, 1165–68 (1994), *available at* http://www.wto.org/english/docs_e/legal_e/15-sps.pdf. *See also* CHO, *supra* note 116, at 4.

128. *See, e.g.*, Peter Stevenson, *The World Trade Organisation Rules: A Legal Analysis of Their Adverse Impact on Animal Welfare*, 8 ANIMAL L. 107, 126 (2002) (calling for dispute settlement leniency when trade restrictions are enacted in the interest of animals). *See also* CHO, *supra* note 116 (advocating the loosening of the GATT pro-trade bias to make room for more "sustainable development" initiatives).

129. *See* discussion *infra* Part II.B.1–2.

130. *See* David Barboza, *China Posts a Surplus Sure to Stir U.S. Alarm*, N.Y. TIMES, July 11, 2006, at C1 (explicating American concerns over trade imbalance with China). *See also supra* note 118 and accompanying text.

131. *See* discussion *infra* Part II.B.1–2.

132. *WTO Successfully Concludes Negotiations on China's Entry*, WTO NEWS, Sep. 17, 2001, http://www.wto.org/english/news_e/pres01_e/pr243_e.htm [hereinafter China-WTO].

quickly announced its abandonment of the agreement, and an era of political instability left the nation internationally unfastened.[133] Today, China is composed of two decreasingly adversarial "States"—the People's Republic of China ("PRC") and the Republic of China ("ROC")—both of which have since regained membership to the GATT, albeit separately and not until very recently.[134]

The PRC, which was ranked second among world exporters by the WTO in 2008,[135] is the entity commonly referred to as "China"; it is much larger than the ROC and controls most of the nation's mainland as well as Hong Kong and Macau.[136] The ROC, on the other hand, (ranked sixteenth among exporters) controls only a handful of smaller territories and is often referred to as "Chinese Taipei," Taipei being its capital in Taiwan.[137]

Even though Hong Kong and Macau are essentially controlled by the PRC, they are largely self-governed.[138] In fact, before either the PRC or ROC regained membership to the GATT, Hong Kong and Macau became independent members in 1986 and 1991 respectively, and both entities became founding members of the WTO in 1994.[139] The PRC (under the name "China") did not accede to the WTO until December 11, 2001,[140] and the ROC (under the name "Chinese Taipei") not until January 1, 2002.[141]

Investigators have found that fur farming of dogs and cats is practiced primarily in the impoverished northeastern provinces of the PRC like

133. U.S. Dep't of State Bureau of E. Asian & Pac. Affairs, *Background Note: China* (Jan. 2009), http://www.state.gov/r/pa/ei/bgn/18902.htm [hereinafter *Background Note: China*]; U.S. Dep't of State Bureau of E. Asian & Pac. Affairs, *Background Note: Taiwan* (Apr. 2009), http://www.state.gov/r/pa/ei/bgn/35855.htm [hereinafter *Background Note: Taiwan*]; China-WTO, *supra* note 132.

134. WTO: Understanding the WTO—Members, http://www.wto.org/english/thewto_e/whatis_e/tif_e/org6_e.htm (last visited May 16, 2009).

135. The European Union was ranked first, and the United States was ranked third. International Trade Statistics 2008, World Trade Organization 13 (2008).

136. *Background Note: China*, *supra* note 133.

137. *Background Note: Taiwan*, *supra* note 133.

138. *See supra* note 133; U.S. Dep't of State Bureau of E. Asian & Pac. Affairs, *Background Note: Macau* (Mar. 2009), http://www.state.gov/r/pa/ei/bgn/7066.htm; U.S. Dep't of State Bureau of E. Asian & Pac. Affairs, *Background Note: Hong Kong* (Mar. 2009), http://www.state.gov/r/pa/ei/bgn/2747.htm.

139. WTO: Understanding the WTO—Members, *supra* note 134; China-WTO, *supra* note 132.

140. WTO: Understanding the WTO—Members, *supra* note 134.

141. *Id.*

Heilongjiang and Shandong.[142] One Chinese official within the nation's State Forestry Administration, Zhao Xuemin, proved sympathetic to Western animal welfare ideals when he pledged in 2006 to fight for an end to what he terms a "barbaric" practice, but Xuemin acknowledged the implicit difficulty of such a fight when he noted that fur farming in China is fueled by economic hardship.[143] If the fur trade combats regional poverty, other Chinese officials weighing broader economic concerns may recognize much greater incentives to ensure the practice's survival and may even be impelled to challenge foreign trade laws aimed at impeding the industry. Though the DCPA was enacted one year prior to China's accession to the WTO, China could now use its membership status to file a WTO complaint against the United States over the trade restrictive measure.

B. Interpreting the Relevant GATT Provisions

When the WTO was established in 1994, its founders designed an adjudicatory system through which aggrieved member nations could air and settle their disputes.[144] Through the Dispute Settlement Understanding ("DSU"), the founders declared that a delegate could complain to the WTO upon belief that his or her nation was the victim of a trade agreement violation,[145] and the WTO would then assemble a qualified and impartial dispute resolution panel to hear arguments and ultimately issue a binding interpretive decision.[146] The DSU also established a seven-person Appellate Body with authority to review and reverse panel decisions if necessary.[147]

Before examining the relevant opinions these bodies have handed down, an overview of GATT interpretive methodology is instructive.

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142. Gary Feuerberg, *Dogs and Cats Skinned Alive for Their Fur in China*, EPOCH TIMES, Feb. 21, 2007, *available at* http://en.epochtimes.com/news/7-2-21/51905.html. *See also* BARBARA MAAS ET AL., FUN FUR?: A REPORT ON THE CHINESE FUR INDUSTRY 3 (2005).

143. *See supra* note 16 and accompanying text.

144. *See* Understanding on Rules and Procedures Governing Settlement of Disputes, Apr. 15, 1994, Marrakesh Agreement Establishing the World Trade Organization, Annex 2, Legal Instruments—Results of the Uruguay Round, 33 I.L.M. 1226 (1994) [hereinafter DSU]. For an explanation of GATT dispute settlement procedure prior to the establishment of the WTO, see *infra* text accompanying note 172.

145. *See* DSU, *supra* note 144, art. 1.

146. *Id.*

147. *Id.* art. 17.1–.3. Appellate cases are presided over by any three of the seven justices. The DSU provides that the Appellate Body's composition is to be "broadly representative of the membership of the WTO" and free of conflicting interests and other obstacles to justice, in order to ensure equitable adjudication. *Id.*

Article 3.2 of the DSU charges panel members with clarifying the provisions of existing international agreements "in accordance with customary rules of interpretation of public international law."[148] The "customary rules," as the Appellate Body explained in its first issued opinion from 1996, refer to those that the Vienna Convention on the Law of Treaties ("Vienna Convention") laid out in 1969.[149] The Vienna Convention provides that "[a] treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose."[150] While this instruction remains somewhat vague, it delineates three general interpretive approaches: "textual," "contextual," and "teleological."[151] Both commentators and adjudicators have debated these approaches at length in regard to their relative merits, the proper sequence of their application,[152] and the extent of their interdependence.[153] But while a review of this debate may imply that certain interpretive approaches garner more favor than others, such formalist characterizations as to "favored" or "disfavored" approaches may be misleading.[154] Panelists are necessarily pragmatic in that, without regard to form, they favor objectively verifiable arguments and disfavor

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148. *See* DSU, *supra* note 144, art. 3.2.

149. *See* Appellate Body Report, *United States—Standards for Reformulated and Conventional Gasoline*, ¶ 6.7 WT/DS2/AB (Apr. 29, 1996) [hereinafter *Gasoline*]. *See also* LAURA NIELSEN, THE WTO, ANIMALS AND PPMS 198 (2007).

150. Vienna Convention on the Law of Treaties, art. 31, May 23, 1969, 1155 U.N.T.S. 331.

151. *See* NIELSEN, *supra* note 149, at 200.

152. *Compare* Claus-Dieter Ehlermann, *Six Years on the Bench of the "World Trade Court*,*"* 36 J. WORLD TRADE 605, 615–16 (2002), *and* Appellate Body Report, *Japan—Taxes on Alcoholic Beverages*, at 12, WT/DS8/AB/R, WT/DS10/AB/R, WT/11/AB/R (Oct. 4, 1996) (arguing that "textual" interpretation—determined by a dictionary—is the best approach, while "telos" should be considered secondarily and "context" lastly), *with* Panel Report, *United States—Sections 301–310 of the Trade Act of 1974*, ¶ 7.22, WT/DS152/R (Dec. 22, 1999) (arguing that the three approaches may be equally valuable and, while it is natural to look first to the text and then to its context and purposes, the approaches should be applied holistically without regard to order).

153. *See* IAN SINCLAIR, THE VIENNA CONVENTION AND THE LAW OF TREATIES 121 (2d ed. 1984) (claiming that the true meaning of a text can only be ascertained by "taking into account all the consequences normally and reasonably flowing from that text"). *Cf.* Michael Lennard, *Navigating by the Stars: Interpreting the WTO Agreements*, 5 J. INT'L ECON. L. 17, 21 (2002) ("The Vienna Convention[,] while including some elements of the other methods, is clearly designed as a fundamentally 'textual' approach; the text is given primacy and is the basic lens through which the 'intention' of negotiators is objectively discerned.").

154. *See* Lennard, *supra* note 153, at 21 ("The Vienna Convention rules emphasize that what is being sought is essentially the *objectively ascertained* intention of the parties *as manifested in the text of the agreements*; the 'expressed intent' rather than the 'subjective intent,' of the parties.").

substantively speculative arguments.[155] Thus, the persuasiveness of an approach will rise and fall case by case per the substance and weight of the underlying facts. Still, while textual interpretation per "ordinary meaning" may not always be dispositive, it is at least the agreed-upon starting point.[156]

There are three provisions of the GATT that would be relevant in a panel review of the DCPA. The first two are "general obligations" that broadly forbid the enactment of trade restrictions.[157] The third provision lists narrow exceptions that can redeem a regulation if it contravenes one of the aforesaid obligations.[158] The first obligation, Article XI.1, provides that "[n]o prohibitions or restrictions . . . whether made effective through quotas, import or export licenses or *other measures*, shall be instituted or maintained by any contracting party *on the importation* of any product of the territory of any other contracting party . . . ."[159] This provision was aimed primarily at "quotas," but its inclusion of the phrase "other measures" has rendered it presumptively applicable to blanket import bans as well.[160] It is additionally significant that this provision was intended to apply only to measures enforced directly at a nation's border.[161]

The second "general obligation" provision, Article III.4, requires that imported products be "accorded treatment no less favourable than that accorded to *like products* of national origin."[162] This provision originally targeted "internal" measures—meaning the treatment of imports after they pass through customs[163]—but an interpretive note that was later annexed to Article III.4 explained that the provision could be invoked as to border-enforced regulations as well.[164] This has caused some jurisprudential confusion among dispute settlement panels as to which (if not both) of the two obligation provisions would be implicated by a regulation like the DCPA.[165]

The DCPA need only fail under one obligation to trigger analysis of the Article XX exceptions; thus, failure under Article XI.1 would render

155. *See id.* Empirical evidence is perhaps an international language.

156. *See id.*

157. *See* discussion *infra* Part II.B.1.

158. *See* discussion *infra* Part II.B.2.

159. GATT, *supra* note 116, art. XI.1. This blanket ban on import prohibitions and restrictions is meant to ensure free market access for all member nations. *See* CHO, *supra* note 116, at 27.

160. *See* CHO, *supra* note 116, at 27–28.

161. *See id*. at 29.

162. GATT, *supra* note 116, art. III.4.

163. *See* CHO, *supra* note 116, at 29.

164. GATT, *supra* note 116, Annex A–1.

165. *See* CHO, *supra* note 116, at 29–33.

survival under Article III.4 irrelevant.[166] Furthermore, the DCPA's incompatibility with Article XI.1 (a presumptively unyielding blanket ban on import restrictions) is conspicuous enough to take for granted.[167] Accordingly, the primary focus of this section will be the DCPA's dubious chance of survival under Article XX; however, there remains a chance that a panel could ignore Article XI.1 and analyze the DCPA under Article III.4 only.[168] This is somewhat unlikely, as will be demonstrated, but nevertheless, it is necessary to consider Article III.4 at some length, and in doing so, the DCPA's failings with respect to both Articles III.4 and XI.1 will be illustrated.

1. Articles XI.1 and III.4: GATT General Obligations

The previously disputed U.S. trade restriction most closely analogous to the DCPA was a 1991 amendment to the Marine Mammal Protection Act ("MMPA") that prohibited the importation of yellowfin tuna captured using a fishing practice often fatal to dolphins.[169] In the eastern tropical Pacific Ocean, tuna swim directly below dolphins, and when fishermen use dolphins to locate tuna, their nets have been liable to inadvertently trap and kill the dolphins as well.[170] After the United States rejected its tuna imports in 1991 as dolphin-deadly, Mexico requested a panel hearing to examine whether the MMPA prohibition violated Articles XI and III.[171]

A panel was assembled and a decision was rendered in this dispute in 1991 ("*Tuna-Dolphin I*") declaring that the MMPA amendment violated Article XI.1 of the GATT.[172] The panel deemed the U.S. import prohibi-

166. *See* discussion *infra* Part II.B.1.

167. *See* CHO, *supra* note 116, at 27 ("The inflexible quality of the article has naturally resulted in jurisprudential treatment in which the mere existence of a trade restriction itself would suffice to find a violation of the Article.").

168. *See* discussion *infra* Part II.B.1.

169. *See* Report of the Panel, *United States—Restrictions on Imports of Tuna*, DS21/R (Aug. 16, 1991) GATT B.I.S.D. (39th Supp.) at 155 (1991) [hereinafter *Tuna–Dolphin I*].

170. *Id*. ¶¶ 2.1–.2.

171. *Id*. ¶ 1.

172. *Id*. It is important to note that this decision was not officially adopted into GATT jurisprudence. While dispute resolution proceeded identically (by panel formation) under the GATT prior to the existence of the DSU, panel decisions were formerly not deemed binding unless adopted by a consensus of all GATT members. For the specifics of the pre-WTO dispute resolution procedure, see GATT, *supra* note 116, art. XXIII. When the panel issued its opinion in *Tuna-Dolphin I*, U.S. and Mexican representatives entered into negotiations and agreed that Mexico would not seek adoption of the decision in exchange for a U.S. commitment to redesign its legislation. *See* Paul J. Yechout, *In the Wake of Tuna II: New Possibilities for GATT-Compliant Environmental Standards*, 5 MINN. J. GLOBAL TRADE 247, 259 (1996). The result was a 1992 amendment to the MMPA known

tion facially inconsistent with Article XI's general obligation of free market access, and further explained that this finding rendered consideration of Article III unnecessary.[173] Most notably, however, the panel chose to explain in dicta that the measure would have been inconsistent with Article III nonetheless.[174] Focusing on tuna solely as a "product," the panel concluded that the exported end result—edible tuna—was the same regardless of how the fish was captured.[175] "A determination of 'likeness' under Article III.4 is, fundamentally, a determination about the nature and extent of a competitive relationship between and among products," panelists have explained.[176] Emphasis is to be placed on the extent to which, according to a consumer, the product is objectively substitutable.[177]

Of course, one would argue that consumers do not find dog fur substitutable for fox fur. However, this claim is somewhat undermined given that consumers have been satisfied with dog fur purchases so long as they have remained ignorant.[178] Consumers acquired dog fur indiscrimi-

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as the International Dolphin Conservation Act, which lifted the import ban with respect to any nation that would agree to a five-year moratorium on the controversial practice. *See id. See also* 16 U.S.C. § 1411 (1994). This outcome demonstrates that some nations are amenable to compromise despite another's (admitted) violation of the GATT. *See* Yechout, *supra*, at 172. But one might justifiably raise concerns about the outcome given disparate economic bargaining power between the United States and Mexico. U.S. contract law polices such disparities carefully when judges consider whether contracts should be deemed voidable for lack of consideration or unconscionable as against public policy. *See generally* ARTHUR L. CORBIN, CORBIN ON CONTRACTS 188 (8th ed. 2001) (discussing unconscionable bargains); *id.* at 221–23 (discussing mutuality of obligation). *See also* Steve Charnovitz, *The Moral Exception in Trade Policy*, 38 VA. J. INT'L. L. 689, 733 (1998) ("[A]symmetry of market power . . . give[s] larger countries more coercive power."). To this point, one may ask whether American policy makers thoroughly imagine all potential implications of trade bans; if politicians consider illegal immigration a pressing problem in the United States, they might consider that import bans can make it even more difficult for citizens in poorer nations to earn wages. But the more pressing point here is that, though not adopted, the panel decision rendered in the *Tuna-Dolphin I* dispute has nonetheless been deemed probative and indicative of how qualified panelists may address similar issues. *Id.* at 723.

173. *See Tuna-Dolphin I*, *supra* note 169, ¶¶ 5.14–.18.

174. *Id*. ¶¶ 5.14–.15.

175. *Id*.

176. *See* Appellate Body Report, *European Communities—Measures Affecting Asbestos and Asbestos Containing Products*, ¶ 99 WT/DS135/AB/R (Mar. 12, 2001) [hereinafter *Asbestos AB*].

177. Distinguishing a product harmful to consumers (e.g., a product containing Asbestos) from dolphin-deadly tuna is instructive; objectively verifiable harmfulness renders the former not substitutable. *See id*. ¶ 145.

178. *See Recall*, *supra* note 2 (discussing the deception of retailers).

nately and would have continued to do so had the Humane Society never released its findings.[179] In fact, consumers may continue to do so today if DCPA enforcement is ineffectual.[180] Consumers may disapprove of the practices that brought them their edible tuna and wearable coats, but panelists have explained that Article III.4 calls for a comparison of imported and domestic products without regard to the "practices, policies and methods" of their production within the exporting nation.[181] This principle is justifiable in that international traders usually depend to an extent on the stability and predictability of ongoing relationships.[182] Responding rationally to market demand, exporters may make substantial investments in product production, believing (perhaps quite justifiably) that their demand is not liable to instantaneously and arbitrarily evaporate.[183] A fur farmer in China may view dogs and foxes as identical wild beasts, all the more identical when their furs are dyed and processed to adorn garments. This level of abstraction may be difficult for Americans to swallow, but it renders tenable the argument that the DCPA causes "fur" produced and sold domestically to be given more "favourable" treatment than "fur" imported from China.

Granted, one may cry foul on the grounds that, if "all fur" is the same, then "all jewelry" is the same, and cubic zirconium is thus substitutable for diamond. But this rebuttal is misdirected. When different products are deceptively identical, the prime rationales for protecting consumers relate to real difference in function, pecuniary value, or risk.[184] Normative arguments become decreasingly persuasive the more two products can be seen as having a comprehensibly substitutable function, given that "function" can include considerations of value and risk.[185] In other

179. This speculation may best be supported in that not one consumer complained after purchasing dog fur prior to the Humane Society report, see *id*., and it remains activists and not consumers uncovering the continued prevalence of dog and cat fur sold in U.S. stores. *See supra* notes 7–10.

180. *See supra* notes 7–10.

181. A second dispute over the U.S. dolphin-deadly tuna import ban arose in 1994 when the European Communities complained to the GATT; the panel then reaffirmed its previous conclusions about Article III.4. *See, e.g.*, Report of the Panel, *United States—Restrictions on Imports of Tuna*, ¶ 5.9, DS29/R (Jun. 16, 1994).

182. *See* CHO, *supra* note 116, at 27 (citing Report of the Panel, *Japan—Measures on Imports of Leather*, L/5623 (Mar. 2, 1984) GATT B.I.S.D. (31st Supp.) at 113, ¶ 55 (1984).

183. *Id*.

184. These bases are self-evident under the contract law theory of "expectation damages," which attempt to give the plaintiff the "benefit of the bargain" he or she had entered, meaning, to put him or her in the position he or she would have been in if the defendant performed in accordance with the agreement. *See generally* CORBIN, *supra* note 172.

185. In other words, the function of a diamond is to *have* a certain value, and the function of dog food is to feed a dog *without* causing the dog harm or undue risk of harm.

words: are generic pants made in China "like" Armani pants? Under Article III.4, the answer is yes. Otherwise, either could be arbitrarily banned from the United States.

Dr. Laura Nielson, author of *The WTO, Animals and PPMs*,[186] has noted that a dispute comparing the fur of endangered animals to that of nonendangered animals may be much more likely to survive Article III.4.[187] The two products could be deemed distinct in that one poses potential harm by depleting a resource.[188] This is a fair argument, but it is more aptly invoked as a justification under the Article XX(g) exception for resource conservation.[189] And such a justification would be invoked *after* a regulation's failure under Articles XI or III.[190] As such, this hypothetical may be most illustrative of the pro-trade bias inherent to the GATT general obligations[191] and may also be viewed as a rationale for that bias, given that there is a separate GATT provision—Article XX—for raising claims that clearly have little to do with the functional substitutability of products.[192] Nielsen concluded that it remains unclear whether the fur of endangered animals is "like" that of nonendangered animals for the purposes of Article III.4.[193] This coincidentally implies that Nielson would find the existing jurisprudence at least equally unclear on whether the fur of nonendangered dogs is "like" the fur of nonendangered foxes.[194] Still, speculation may be unnecessary. Article III.4 ambiguities have invited substantial debate, but the provision may not prove significant in a DCPA challenge.[195]

What is the function of a carpet? *See* Vista St. Clair, Inc. v. Landry's Comm. Furnishings, Inc., 57 Or. App. 254 (1982) (refusing to deem that a defective discolored carpet was worth zero dollars because plaintiff made "use" of the carpet nonetheless).

186. "PPMs" refers to Nielsen's consideration of trade restrictions that are based on "Product or Production Method." *See* NIELSEN, *supra* note 149, at xxii.

187. *Id*. at 151.

188. *Id*. (analogizing the panel's reasoning in the *Asbestos* dispute).

189. Article XX(g) provides an exception for trade restrictions "relating to the conservation of exhaustible natural resources if such measures are made effective in conjunction with restrictions on domestic production or consumption . . . ." *See* GATT, *supra* note 116, art. XX(g). *See also* CHO, *supra* note 116, at 32–33.

190. *See* CHO, *supra* note 116, at 32.

191. *See* NIELSEN, *supra* note 149, at 151 (stressing specifically the broad coverage of Article XI).

192. *See* CHO, *supra* note 116, at 32 (reasoning that defendants are most likely to focus solely on Article XX once an import ban is found to violate either of the two obligations).

193. *See* NIELSEN, *supra* note 149, at 151.

194. *See id.*

195. Article III.4 would only come into play if a panel reversed course drastically and determined that Article XI does not apply to "other measures." *See supra* note 159 and accompanying text; *infra* note 201 and accompanying text.

The most recent panel decision in which a complainant challenged a trade restriction under both Articles XI and III was the *Asbestos* dispute.[196] France had banned the importation of products containing Asbestos,[197] and when Canada complained to the WTO, a panel determined, first, that the regulation was most properly subject to Article III.4; second, that the regulation violated Article III.4; third, that the regulation was nonetheless redeemable under Article XX; and fourth, that Article XI therefore did not require consideration.[198] From the panel's methodology in this decision, it has since been inferred that regulatory measures imposed on both domestic production *and* importation (i.e., measures like the asbestos ban and the DCPA)[199] are only subject to analysis under Article III.4 (and not Article XI.1).[200] This is a desirable reading for defendant nations given that Article XI.1 would facially invalidate any import ban barring an Article XX exception,[201] but there are a number of reasons that this inference is flawed.[202] Dr. Nielsen has recognized, most blatantly, that the inapplicability of Article XI.1 to total[203] bans would

196. *See* Panel Report, *European Communities—Measures Affecting Asbestos and Asbestos Containing Products*, WT/DS135/R (Sep. 18, 2000) [hereinafter *Asbestos*].

197. *See id*. ¶ 8.1.

198. *See id*. ¶¶ 8.99, 8.241.

199. The DCPA also bans domestic manufacture and trade in dog and cat fur. *See supra* note 5 and accompanying text.

200. *See* CHO, *supra* note 116, at 33 ("[I]t can be said that the decision in *Asbestos* constitutes the authoritative case law on this point."). Moreover, this is one basis on which the United States would disclaim invalidity of the DCPA. *See* Findings, *supra* note 4 ("The imposition of a ban on the sale, manufacture, offer for sale, transportation, and distribution of dog and cat fur products, regardless of their source, is consistent with the international obligations of the United States because it applies equally to domestic and foreign producers . . . .").

201. *See* CHO, *supra* note 116, at 27–28 (noting that the inclusion of the phrase "other measures" in the text of Article XI.1 has been interpreted broadly in accordance with the GATT pro-trade bias).

202. For instance, the panel admitted it was unclear on whether Canada was even claiming that Articles XI.1 and III.4 should be analyzed collectively given that Canada failed to follow a procedural guideline for making *alternative* allegations. *See Asbestos*, *supra* note 196, ¶ 8.100. Furthermore, in its opinion considering Canada's appeal of the panel's Article XX ruling, the Appellate Body couched the panel's neglect of Article XI as a mere matter of "judicial economy." *Asbestos AB*, *supra* note 176, ¶ 5 ("Having found that the [Asbestos ban] is subject to, and inconsistent with, the obligations set forth in Article III.4 of the GATT 1994, the Panel *did not deem it necessary* to examine the claims of Canada under Article XI of the GATT 1994.") (emphasis added). Most notably, a pure textual analysis of Article XI renders it unequivocally applicable to *all* restrictions. *See* NIELSEN, *supra* note 149, at 151; *supra* note 201 and accompanying text. *See also* GATT, *supra* note 116, art. XI.1.

203. "Total," meaning bans applicable to foreign *and* interstate commerce.

render the existence of certain Article XX exceptions redundant or irrelevant.[204] For instance, Article XX(a) provides an exception for morality-based trade restrictions,[205] and such restrictions must necessarily be imposed on domestic as well as imported products lest the moral premise be immediately contradicted.[206] Thus, if Article XI.1 were to apply only to discriminatory measures,[207] the moral exception would have no reason to exist.[208]

Furthermore, Article III.4 was originally applied, for instance, in disputes over "dual retail systems" through which imported and domestic products received unequal distribution or other forms of unfair internal treatment.[209] While the 1994 note to Article III has indeed caused jurisprudential confusion,[210] the *Asbestos* panel report may have maligned the distinctions between Article XI.1 and Article III.4. The note provides, in relevant part, that "[a]ny internal tax or other internal charge, or any law, regulation or requirement . . . collected or enforced . . . at the time or point of importation, is nevertheless to be regarded as an internal tax or other internal charge, or a law, regulation or requirement . . . ." The note's text evinces a clear intention to secure a loophole—to ensure that internal discriminatory preferences cannot skirt Article III.4 analysis on the basis that they were imposed at the border and were thus not internal.[211] More so than the existence of Article XX(a) presupposes a reason for its existence, the definitive purpose behind the note to Article III.4[212] (compared with the separate and distinct purpose behind Article XI.1)[213] implies that the two provisions have no reason to overlap redundantly.

In sum, the DCPA should fail under Article III.4's "like product" inquiry if subjected to it, but, like the MMPA amendment in *Tuna-*

204. *See* NIELSEN, *supra* note 149, at 152.

205. *See* GATT, *supra* note 116, art. XX(a). *See* discussion *infra* Part II.B.2.

206. In other words, it would be difficult (i.e., blatantly hypocritical) to argue that a product cannot be imported for moral reasons if the product were not also prohibited from interstate commerce. *See* NIELSEN, *supra* note 149, at 152.

207. "Discriminatory," meaning measures that ban one nation's product without banning the same product from other nations or domestically.

208. *See* NIELSEN, *supra* note 149, at 152.

209. *See* Appellate Body Report, *Korea—Measures Affecting Imports of Fresh, Chilled and Frozen Beef*, ¶¶ 130–51, WT/DS161/AB/R (Jan. 10, 2001) [hereinafter *Korea-Beef*].

210. *See* CHO, *supra* note 116, at 29–33.

211. *See id.* at 30 (citing GENERAL AGREEMENT ON TARIFFS AND TRADE, ANALYTICAL INDEX—GUIDE TO GATT LAW AND PRACTICE 136 (1994)).

212. The note to Article III.4's purpose is to secure the loophole so that Article III.4 is certain to apply to *all* internal measures (to prevent internal discrimination).

213. Article XI.1's purpose is to prevent external discrimination.

Dolphin I, the DCPA should most probably be analyzed under Article XI.1, in which case it would be presumptively invalidated barring the Article XX exception. Still, even if the DCPA were to be tested under Article III.4 (and were to survive), there are strong textual, contextual, and teleological arguments to be made for subsequent invalidation under Article XI.1.[214] It follows that the United States should focus more on the persuasiveness of its Article XX affirmative defenses than on arguments directly relating to either general obligation provision.[215]

2. Article XX: "Exceptions" to the GATT General Obligations

In an article published in the journal *Animal Law*, British animal welfare activist Peter Stevenson argues that, in enacting laws like the MMPA and DCPA, countries are not attempting to "force other countries to change their standards"; they are simply seeking the "liberty to prohibit *within their own territory* the marketing of products (whether domestically produced or imported) derived from practices which involve animal suffering."[216] Touting the preamble to the DCPA, which states that U.S. consumers have a right to "ensure that they are not unwitting participants in [a] gruesome trade,"[217] Stevenson has congratulated the United States for embracing the argument that "a country should be able to act as an *ethical* consumer."[218] Stevenson's sentiment is widely shared[219] and, at first glance, it even appears compatible with the text of the GATT. As mentioned above, Article XX sets out a limited number of exceptions to the agreement's general member obligations, including an exception for "morality."[220] The Article XX provisions relevant to the DCPA are as follows:

> Subject to the requirement that such measures are not applied in a manner which would constitute a means of arbitrary or unjustifiable discrimination between countries where the same conditions prevail, or

214. *See* NIELSEN, *supra* note 149, at 151–52.
215. *See* CHO, *supra* note 116, at 32 ("Once an import ban is found to violate either provision, the defendants are most likely to rely on Article XX . . . in arguing that the measure in question is a justified exception under *either* provision"). *See, e.g.*, Appellate Body Report, *United States—Import Prohibition of Certain Shrimp and Shrimp Products*, WT/DS58/AB/R (Oct. 12, 1998) [hereinafter *U.S.-Shrimp*] (illustrating a dispute in which the United States admitted a probable violation under Article XI.1 and moved straight to affirmative defenses).
216. Stevenson, *supra* note 128, at 126.
217. *See* Findings, *supra* note 4.
218. Stevenson, *supra* note 128, at 126.
219. This is self-evident given the enactment of the DCPA by a U.S. legislative majority.
220. *See* GATT, *supra* note 116, art. XX.

> a disguised restriction on international trade, nothing in this Agreement shall be construed to prevent the adoption or enforcement by any contracting party of measures:
>
> (a) necessary to protect public morals;
>
> (b) necessary to protect human, animal or plant life or health . . . .[221]

Looking first at the exception under Article XX(b), one may immediately assume that "animal life or health" is a surprisingly explicit roadblock to a DCPA challenge. This appearance is deceiving. A regulation examined under Article XX must pass a multipart test; not only must its aim be provided for explicitly (for example, "animal protection"), but the panel must deem the method by which it would be achieved "necessary" and find it to be in accordance with the requirements of the Article XX headnote.[222] While the latter two prongs of this test will prove difficult for the DCPA, the first prong will be surprisingly problematic as well. Though the DCPA was tailored directly to the text of Article XX(b),[223] it is almost certain to fail on an unobvious threshold inquiry.

Before asking the "necessity" question (which primarily considers whether there is a way to accomplish the domestic regulatory goal at issue in a manner less restrictive of trade), a panel will illuminate an Article XX textual ambiguity. The United States may claim the DCPA is necessary to protect animal life or health, but in what nation?[224] This issue arose in *Tuna-Dolphin I* when the United States argued that Article XX(b) allowed for U.S. laws that protect the lives of Mexican dolphins.[225] The panel firmly rejected this proposition on the basis that Article XX(b) refers to protection of *domestic* animals only.[226] Thus, only if Mexican tuna-fishing threatened dolphins located within U.S. territory would the ban have been justifiable.[227] The DCPA suffers the same flaw in its attempt to save dogs not located within U.S. jurisdiction. A number of commentators, including Steve Charnovitz, former Director of the

221. *Id*. Article XX provides for additional exceptions, but they are not relevant to an examination of the DCPA's validity.

222. This test was prescribed in the first panel opinion under the newly established WTO DSU. *See Gasoline*, *supra* note 149, at 296.

223. Findings, *supra* note 4 ("Such a ban is also consistent with provisions of international agreements to which the United States is a party that expressly allow for measures designed to protect the health and welfare of animals.").

224. The DCPA is an admitted attempt to protect "health and welfare of animals" in *foreign* nations. *See supra* note 221 and accompanying text.

225. *See Tuna–Dolphin I*, *supra* note 169, ¶¶ 5.25–.28.

226. *Id*.

227. *Id*.

Yale Global Environment and Trade Study,[228] have stood behind the *Tuna-Dolphin I* panel's assertion that Article XX(b) cannot be invoked to protect life or health "extrajurisdictionally."[229] The primary rationales for this argument invoke debate over economic coercion[230] and sovereignty[231]—considerations that are identically relevant when examining the DCPA under Article XX(a).[232]

The DCPA's survival of the necessity test under both Articles XX(b) and XX(a) hinges on a determination that the United States can justifiably coerce behavior in a foreign nation. Presumably, a majority of American citizens do not want dog or cat fur to be imported into the country.[233] To realize this goal, they have chosen to burden suppliers of dog fur[234]—Chinese fur exporters. Whether the rationale of this goal is a XX(b) aim to save animal lives in China,[235] a XX(a) aim to protect the sensibilities of unwitting American fur consumers,[236] or a XX(a) aim to coercively export U.S. morality to China,[237] all would be better served if the burden was placed not on foreigners but directly on American importers and retailers. This is why the DCPA would probably fail the "necessity" test under either XX(a) or XX(b).[238]

If Congress required fur distributors and retailers to test the fur they import, American consumers could retain the *choice* of purchasing dog

228. For more information on the Yale Global Environment and Trade Study, which employed experts who sought to reconcile environmental protection with trade liberalization, see http://envirocenter.research.yale.edu/programs/completed-projects (last visited Nov. 28, 2008).

229. *See* Charnovitz, *supra* note 172, at 731 (calling efforts to prescribe behavior in foreign countries paternalistic).

230. *Id.* at 733.

231. *See infra* note 244 and accompanying text.

232. *See* discussion *infra* Part II.B.2.

233. Again, this is self-evident per enactment of the DCPA by a legislative majority.

234. *See* DCPA, 19 U.S.C § 1308. *See also supra* text accompanying note 4.

235. *See* GATT, *supra* note 116, art. XX(b) ("necessary to protect human, animal or plant life or health").

236. See GATT, *supra* note 116, art. XX(a) ("necessary to protect public morals").

237. *Id*.

238. In a 2000 decision, the Appellate Body defined the "necessity" text via textual interpretation, determining that the word "necessary" can mean, at one extreme, "indispensible" to a goal, and on the other end, merely "making a contribution to" a goal. The Appellate Body concluded that, for the purposes of Article XX jurisprudence, "necessary" lies closer to "indispensible." *See Korea-Beef*, *supra* note 209, ¶¶ 159–60. In a 2005 dispute, the Appellate Body ruled that a complaining party can raise a specific less-restrictive alternative, and the defendant then has to prove that its present measure remains necessary in light of the alternative. *See* Appellate Body Report, *United States—Measures Affecting the Cross-Border Supply of Gambling and Betting Services*, WT/DS285/AB/R (Apr. 7, 2005).

and cat, and if they so chose, they would do so knowingly and purposefully.[239] If American distaste for dog and cat fur were genuine, consumer demand would diminish authentically and, U.S. garment importers would begin shunning dog and cat fur exporters just as they would shun exporters of outdated fashion.[240] Soon enough, those exporters would start shunning dog and cat fur themselves. This alternative is not only less restrictive of trade but also more adaptive to genuine achievement of the underlying goal (regardless of the goal's exact rationale).[241] If this option was not pursued by Congress in 2000 because it would have imposed costs on American business instead of foreign business, then the DCPA could fail under the Article XX headnote prohibition of "disguised" protection or "unjustifiable discrimination."[242] Regardless, the existence of such an alternative suggests that the DCPA's necessity is highly questionable, and the necessity test would not even be implicated should a

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239. Invalidating a cigarette import ban enacted by Thailand in 1990, a panel ruled that strict labeling and ingredient disclosure requirements would have been a preferable, less-restrictive alternative. *See* Report of the Panel, *Thailand—Restrictions on Importation of and Internal Taxes on Cigarettes*, DS10/R (Nov. 7, 1990) GATT B.I.S.D. (37th Supp.) at 200, ¶¶ 75–81 (1990). A panel's preference for such an alternative may evince a preference for choice versus force (i.e., informed individual decision making versus forced collective decision making), *or* it may simply be that market decisions made by fully informed consumers to avoid a product are almost always a less trade-restrictive alternative to achieving the same goal of a forced ban. This may even hold true for illegal drugs, as, for instance, while U.S. citizens are free to drink as much alcohol as they so choose, only a small percentage actually become alcoholics.

240. The United States seemingly keeps bell-bottoms off retailer shelves today without use of import bans.

241. Of course, the goal of "exporting morality" would be achieved superficially, but there is no reason to think Chinese attitudes toward cats and dogs (and ingrained beliefs about animals and animal welfare in general) would change; any changes in animal treatment would merely represent a response to change in U.S. consumer preferences.

242. Given publicized U.S. concerns over growing trade imbalance with China, see *supra* note 130 and accompanying text, it is easy to imagine a disguised protectionist motive behind the DCPA. But more practically, one could accuse the United States of engaging in arbitrary discrimination against eastern nations—arbitrary because the DCPA does not ban *all* fur, it only bans fur likely to come from nations with subjectively different norms and socioeconomic conditions. Consider this statement from the panel in *U.S.-Shrimp*:

> [I]t is not acceptable, in international trade relations, for one WTO Member to use an economic embargo to *require* other Members to adopt essentially the same comprehensive regulatory program, to achieve a certain policy goal, as that in force within that Member's territory, *without* taking into consideration different conditions which may occur in the territories of those other Members.

U.S- Shrimp, *supra* note 215, ¶¶ 163–64.

panel immediately invalidate the DCPA as an "extrajurisdictional" overreach.[243]

For the DCPA to survive as a GATT exception, a panel would need to take a tenuous stand on the nature of sovereignty.[244] In his article "Moral Exception in Trade Policy," Charnovitz acknowledges economist Richard N. Cooper's contention that "the international community cannot, and should not be able to, force a country to purchase products, the production of which offends the sensibilities of its citizenry."[245] This is basically the same argument made by Stevenson, excerpted above.[246] Though Charnovitz does not raise a direct objection, this reasoning is arguably disingenuous if one examines what it means to "force a country" to purchase products. The United States government is not the "purchaser" of fur. Fur is only imported into the United States because U.S. consumers value it enough to create demand. Cooper imagines a citizenry that is somehow forced to demand what it finds offensive.[247] This argument holds water if the product is addictive or otherwise manipulative of consumer preference, but in the case of dog fur, his argument becomes circular. A citizen offended by an utterly nonessential product will never be "forced" to purchase it unless he or she inadvertently confuses it with a less offensive substitute.[248] If he or she does confuse it, either the prod-

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243. *See Tuna–Dolphin I*, *supra* note 169, ¶¶ 5.25–.28

244. One would have to implicitly recognize a U.S. stake (and thus, a "say") in the treatment of animals in a foreign country, and this is a repudiation of the very notion of state sovereignty. Article 3 of the U.N. General Assembly Declaration on Social Progress and Development sets out a list of conditions necessary for the social progress and development of a nation, including the

> . . . [p]ermanent sovereignty of each nation over its natural wealth and resources;
>
> . . . The right and responsibility of each State and, as far as they are concerned, each nation and people[,] to determine freely its own objectives of social development, to set its own objectives of social development, to set its own priorities and to decide in conformity with the principle of the Charter of the United Nations the means and methods of their achievement without external interference . . . .

Declaration on Social Progress and Development, G.A. Res. 2542 (XXIV), art. 3(d)–(e), U.N. GAOR, 24th Sess., Supp. No. 30, U.N. Doc. A/7630 (Dec. 11, 1969).

245. *See* Charnovitz, *supra* note 172, at 732 (citing RICHARD N. COOPER, ENVIRONMENT AND RESOURCE POLICIES FOR THE WORLD ECONOMY 30 (1994)).

246. *See* Stevenson, *supra* note 128, at 126.

247. *See* Charnovitz, *supra* note 172, at 732.

248. This point rebuts any possible comparisons between a fur market and a human organ market. Professor Margaret Jane Radin argues that a market for organs would leave the poor helplessly induced to sell (while the dying would be forced to buy). *See*

ucts are so indistinguishable (and the distinction so benign) that the substitution is all but irrelevant, or the products *are* distinguishable. In the latter case, if the distinction is still benign,[249] demanders are probably the "cheapest cost avoiders"[250] (as opposed to suppliers) when it comes to preventing the mix-up, especially if prevention is desirable solely out of moral contempt. Cooper's reasoning is inapplicable when disgust is all that is at stake; in such instances, force need not be imposed on suppliers *or* demanders; desired outcomes will be achieved by market action or will otherwise be exposed as too superficial to matter.[251] As will be argued below, the type of force imposed by the DCPA is not only unnecessary but also ineffective and potentially counterproductive.[252] Furthermore, these same implications undergird the teleological argument that the GATT should be interpreted to err on the side of trade.[253] Indeed, the DCPA faces yet another obstacle in light of the objectively verifiable (and justifiable)[254] teleological impetus for narrow interpretation of Article XX exceptions under "stringent tests."[255]

MARGARET JANE RADIN, CONTESTED COMMODITIES: THE TROUBLE WITH TRADE IN SEX, CHILDREN, BODY PARTS, AND OTHER THINGS (1996). However, since no human will ever depend on fur as a life necessity, it would be disingenuous to characterize purchasers of a certain type of fur as "helplessly induced."

249. "Benign" is used in the sense that "moral outrage" is the only imaginable consequence of inadvertent substitution. Granted, the implication is not that dogs are "substitutable" for foxes, rabbits, or coyotes; but it is noteworthy that American shoppers will think this the case if they are not told otherwise. Moreover, it is noteworthy that if not for the extensive Humane Society undercover investigation overseas, it is possible that not one consumer, consumer protection advocate, investigative journalist, American fur importer, or retailer would have made the discovery.

250. According to Guido Calabresi, one who can prevent harm at the least expense should be charged with doing so. *See* JOHN C.P. GOLDBERG ET AL., TORT LAW: RESPONSIBILITIES AND REDRESS 129–30 (2004).

251. If enough consumers—at least enough to sustain a fur market—would buy fur given some unknowable probability that it came from a dog or cat, this behavior would perhaps demonstrate a moral calculation explicitly contradictory to the legislatively professed (majority) desire to keep dog fur out of the country. In other words, consider that all consumers buying fur coats assume a fifty-percent chance that they will be buying dog. Then consider that all consumers buying fur coats assume wearing fur has a fifty-percent chance of causing cancer. Consumers will either largely continue buying, meaning the force of law is not warranted (because it is incompatible with majority preference), or they will cease buying the product, meaning the force of law is not necessary.

252. *See* discussion *infra* Part III.

253. The GATT was established on the principle that all voluntary transactions are (logically) of mutual benefit (or they would not occur). *See* BAUMOL & BLINDER, *supra* note 114, at 444; Cho, *supra* note 116, at 2.

254. "Justifiable" because the GATT is not an objective list of rules, it is an "agreement"; thus, its text may not always explicate its object and purpose, let alone the express

Though much has been written about the GATT Article XX(a) morality exception, not one morality-based import ban has ever been directly challenged by a member nation.[256] The reason for this is unclear, but Charnovitz puts forth a plausible explanation regarding political considerations.[257] When the European Commission, for instance, banned the importation of fur from animals captured with leg traps, the United States (as a nation that used leg traps) threatened a WTO challenge. The United States and the European Commission settled the disagreement without WTO intervention, however,[258] and Charnovitz speculates that "although the U.S. government probably felt confident that it could win on legal grounds in Geneva, it knew that it would lose political ground in Washington if the animal welfare groups joined the anti-WTO coalition."[259]

If China were to challenge the United States over the DCPA, Westerners naive to GATT nuance would probably be as outraged as they were in the wake of the 1998 dog-fur scandal.[260] China may be avoiding the issue for fear of the publicity, but it is also possible that, within the nation, the power to initiate the complaint does not lie in the same hands as the interest to do so. Or perhaps those most familiar with the economic impact of the DCPA are not also intimately familiar with the nature of China's membership rights under the DSU and the GATT. Most likely, however, Chinese officials possess the requisite information but believe that the cost of the DCPA to poverty-stricken Chinese citizens, though significant, does not outweigh the nonpecuniary cost of a publicized protest.[261] If this is the case, the United States has successfully perpetrated economic punishment[262] with little more justification than that offered by

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intentions of those who voluntarily agreed to be bound by it. *See* Lennard, *supra* note 153, at 21.

255. *See id. See also* Cho, *supra* note 116, at 2–3.

256. *See* Charnovitz, *supra* note 172, at 731.

257. *See id.* at 740.

258. *See id*. at 736–40.

259. *Id*. at 740.

260. *See Recall*, *supra* note 2.

261. If China challenged the DCPA, some Americans may merely increase calls for economic sanctions or greater restrictions on importation of Chinese products. *See, e.g.*, Martin Tolchin, *House, Breaking with Bush, Votes China Sanctions*, N.Y. TIMES, June 30, 1989 (reporting that Congress voted unanimously to impose economic sanctions on China upon learning of increasing human rights violations within the nation).

262. In 2000, just months before the DCPA was enacted, Cass Sunstein illuminated the economic implications of the ban:

> [A ban on the importation of dog fur] places certain companies that are prepared to sacrifice the well-being of animals at a competitive disadvantage, by

the Fur Information Council of America as to its objection to the sale of dog fur in the United States: *"It's just not something we want to see happening.*"[263]

III. PRAGMATIC ACTIVISM CAN BE CONTROVERSIAL TOO

While the DCPA would probably fail a doctrinal challenge under the GATT, there are additional reasons to conclude that morality-based trade restrictions are contrary to domestic and international policy goals. Thus far, it has been argued that unencumbered international trade serves mutuality of economic prosperity[264] and that morality is "a product of the exigencies of life in a given society."[265] From these premises, there is considerable support for the contrarian argument that purchasing an abundance of dog fur imports from impoverished foreigners is actually the most advisable and realistic approach toward the DCPA's purported goals of aligning foreign moral codes with prevailing U.S. norms and improving *future* animal treatment globally (i.e., reducing future dog and cat fur imports). This is a significantly speculative claim, but it is perhaps easier to support than its polar opposite—a call for additional restrictions and improved enforcement of the DCPA. The latter proposal is as wrongheaded as it is popular among activists at present, and this section will examine its practical (and theoretical) flaws, arguing first, that free trade is the best path to "improving" global morals, and second, that trade restrictions are no better at keeping dog and cat fur off U.S. shelves than they are at keeping cocaine out of the hands of millions of Americans.[266]

> forbidding those companies from engaging in practices that would help them in the marketplace.
>
> . . . .
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> . . . [This] would plainly help companies that sell ordinary or synthetic fur coats, because such companies would face less competition. The existing cases on competitor standing suggest that [ordinary or synthetic fur coat] companies would be fully entitled to sue to produce legally required enforcement action. Or suppose that a statute designed to protect animal welfare is obeyed by some commercial actors but not by others; suppose too that compliance is costly and hence those who disobey the statute are at a competitive advantage (as is highly likely).

Sunstein, *supra* note 17, at 1346.

263. *Supra* note 70.

264. *See supra* note 114 and accompanying text.

265. *See* discussion *supra* Part I.B.

266. *See Not Winning the War on Drugs*, N.Y. TIMES, Jul. 2, 2008, at A18 ("While seizures are up, so are shipments.").

A. Free Trade "Improves" Morals

Judge Posner would argue that when A seeks to "improve" the morals of C, this just means A would like C's morals to become more like hers.[267] Still, Posner would point out that this does not immediately repudiate A's mission. A may seek to persuade C that adopting a different moral code would be more adaptive to C's goals or needs, and if A were right, C would be foolish to ignore the advice. For instance, say C lives on a farm, and economic conditions in his country render his income too meager to afford him the most basic necessities his family requires for survival. C's wife, son, and daughter subsist on very little, and as conditions become worse, C learns of a way he could earn extra money; he could capture, skin, and sell the pelts of the wild dogs that overpopulate the woods near his farm. C, however, would consider it immoral to do this. A may be able to convince C that the norm he is bound by has begun to detrimentally contravene the most basic human impetus of survival (a definitively plausible "goal"), and thus, C should skin the dogs and sell their pelts.[268]

Facially, Chinese conformity to American norms can no more be deemed an "improvement" than can American conformity to Chinese norms, absent a functional argument.[269] In other words, it is useless to imagine the two nations as siblings, one of which is *normatively better-behaved.* At best, one can try to understand *why* norms differ among cultures, but even the resulting explanations may be too speculative. Regardless of whether a norm is "adaptive to a plausible need or goal," the origin of the norm (meaning the societal conditions present that caused, or at least allowed for, its spread) may be indeterminable.[270] Still, some logical inferences are plausible. For example, if A and B are both necessary conditions for X, then the existence of X presupposes A and B. With respect to norms regarding the treatment of animals, similar deductions are possible. If it is demonstrable that international free trade serves the mutuality of economic prosperity (i.e., wealth), and that wealth is necessary for the spread of animal welfare ideals,[271] it might be logical to propose next that free trade improves the overall treatment of animals

267. *See* discussion *supra* Part I.B.

268. One Chinese official who seeks an end to the inhumane slaughter of dogs and cats has implied that this hypothetical is not far from reality in the impoverished parts of his nation. *See* discussion *supra* Part II.A; *supra* note 16 and accompanying text.

269. *Cf.* POSNER, *supra* note 34, at 21 (explaining that the only grounds for criticizing a moral norm is per whether or not it is "adaptive to any plausible or widely accepted need or goal of the societies in question").

270. *Id*. at 21–23.

271. *See* discussion *infra* Part III.A.

within a society. This claim actually finds some support in humanistic psychology, specifically within Abraham Maslow's 1943 paper "A Theory of Human Motivation."[272]

Maslow's approach to psychology is significant because, while theoretical, it is similar to Posner's approach to morality. Maslow holds certain basic human ends as biologically universal, but acknowledges that the means adopted toward those ends may vary by culture, and thus, he examines behavior per its pursuit of these intuitive motivating ends only.[273] Maslow's most noteworthy contribution is his "hierarchy of needs," which posits that human behavior is driven largely by needs that can be ranked in order of importance.[274] At the bottom of Maslow's hierarchy are the essential physiological needs like food and water; then, moving up the ladder, humans strive for "safety," "belonging," "esteem," and finally, "self-actualization."[275] Maslow's theory is relevant because it explains persuasively why a nation with a higher per capita standard of living would have more animal welfare activists. In such societies, it is faster and easier for citizens to travel up the hierarchy of need satisfaction in order to move on to more complex "self-actualizing" goals.[276]

As a profession—and even as a hobby—activism requires funding. At the very least, this means activists require sufficient food, water, safety, shelter, and clothing.[277] Animal welfare activism will not be viable in a society unless many other needs can easily be met first with stable consistency.[278] Furthermore, since activism is not productive of wealth, it cannot exist unless other members of society divert a surplus of wealth to

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272. Maslow taught psychology at Brandeis University from 1951 to 1969.

273. *See* Abraham Maslow, *A Theory of Human Motivation*, 50 PSYCHOL. REV. 370, 371–72 (1943) ("Motivation theory is not synonymous with behavior theory. The motivations are only one class of determinants of behavior. While behavior is almost always motivated, it is also almost always biologically, culturally and situationally determined as well.").

274. *See id*. at 394.

275. *See id*.

276. *See id*. at 393 ("[O]ur needs usually emerge only when more prepotent needs have been gratified.").

277. *See id*.

278. *See* SOWELL, *supra* note 124, at 7 ("Food reaches [the civilized accountant's] local supermarket through processes of which he is probably ignorant . . . . He lives in a home constructed by an involved process whose technical, economic, and political intricacies are barely suspected, much less known to him."). *See also* POSNER, *supra* note 34, at 27 ("A nation that lacks the resources necessary to educate its entire population will have to make painful choices . . . . It would be fatuous to think such a nation morally . . . backward and to suppose that its situation could be improved by preaching to it.").

its funding.[279] In sum, animal welfare is not likely to be a legitimately widespread societal goal until wealth and stability are legitimately widespread within society. Moreover, even if sufficient wealth is attained in a society, childhood education (familial and public) must at the very least remain neutral on the subject of animals. Just as Americans have ingrained beliefs about dogs and cats, other cultures can impart starkly different perceptions—e.g., that dogs and cats are *evil*—and this could prevent the development of mass sympathy for their plight.

To be sure, these claims are intuitive, but by extension, they serve the argument that free trade improves the plight of animals not only by increasing societal wealth but also by exposing traders to the differences that exist among cultures. Exposure to adversarial ideas, as John Stuart Mill famously argued, is necessary to the pursuit of "truth"[280] and can also incite renewed curiosity as to the truth of one's own ingrained beliefs.[281] Still, while "trade" and "wealth" exhibit a discernible causal relationship, causation among the coexistence of "wealth," "ideas," and "behavior" is admittedly difficult to pin down.[282] But some correlations are noteworthy nonetheless. For instance, it is frequently argued that the liberalization of China's economy has gone hand in hand with the nation's recent "human rights improvements."[283] And some political and

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279. PETA depends on millions of dollars in donations to function. *See supra* note 58 and accompanying text.

280. *See* MILL, *supra* note 27, at 38 ("He who knows only his own side of the case knows little of that."). *See also id.* at 37 ("[O]n every subject on which difference of opinion is possible, the truth depends on a balance to be struck between two sets of conflicting reasons.").

281. *See id*. *See also* POSNER, *supra* note 34, at 228 (explaining that exposure to ideas that contravene one's presuppositions "incites doubt, and doubt incites inquiry, making [one] less of a dogmatic, [and] more of a pragmatic or at least open-minded" decision maker).

282. *See* ROBERT ALAN DAHL, POLYARCHY: PARTICIPATION AND OPPOSITION 70–71 (1971).

283. President Bill Clinton believed "liberalized trade could weaken the Chinese leadership's grip on society as the nation's private sector grows and its contact with the outside world increases." *Clinton Signs China Trade Bill*, CNN.COM, Oct. 10, 2000, http://archives.cnn.com/2000/ALLPOLITICS/stories/10/10/clinton.pntr/. Moreover, as a 2008 Background Note published by the U.S. State Department's Bureau of East Asian and Pacific Affairs claimed, "The market-oriented reforms China has implemented over the past two decades have unleashed individual initiative and entrepreneurship. The result has been the largest reduction of poverty and one of the fastest increases in income levels ever seen." *Background Note: China*, *supra* note 133.

economic theorists argue not only that trade is a boon to peace but also that history demonstrates trade barriers can be catalysts of war.[284]

Even if many such speculations are not sufficiently verifiable, it is reasonable to ask that Congress, at the very least, deliberate on the broader, less foreseeable implications of import bans when constituents begin calling for them. The debate between "force" and "persuasion" need not end when the majority rules out persuasion; the next step should be a careful cost-benefit analysis between the choices of "force" and "*inaction*."

B. The Dog and Cat Protection Act Is Unenforceable

Ironically, the DCPA may actually be equivalent to "inaction" in that its enforceability is dubious at best.[285] Thus, even if one rejects the above syllogistic speculation—that the DCPA is counterproductive to the spread of wealth and ideas and thus counterproductive to the spread of animal welfare ideals—one may at least admit that the law has been wasteful of time and U.S. resources. Writing about federal animal welfare laws, Cass Sunstein has recognized the widespread lack of enforcement.[286] "It would be an overstatement to say that the relevant provisions are entirely symbolic[,]" Sunstein claims, "[b]ut because they are dependent on prosecutorial decisions, and because few prosecutors have them as a high priority, they have a largely expressive function. They say much more than they do. They express an aspiration, but one that is routinely violated in practice, and violated with impunity."[287]

The DCPA is not the first federal law governing the importation of fur, and many zealous activists are working to ensure that it will not be the last.[288] At present, the Humane Society urges its website visitors to support the Dog and Cat Prohibition Enforcement Act ("DCPEA"), which is presently pending in the House of Representatives.[289] The prime

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284. *See, e.g.*, Henry F. Grady, *The Consequence of Trade Barriers*, 198 ANNALS AM. ACAD. POL. & SOC. SCI. 35, 42 (1938) (explaining that trade barriers lead to "frictions and trade rivalries which may lead to war"); *id*. at 40 (noting that the practical elimination of foreign trade can have the same effect on an economy as war).

285. *See* Jean C. Yasuhara, Note, *"Cruella De Vil" Revisited: The International Dog and Cat Fur Trade*, 22 LOY. L.A. INT'L & COMP. L. REV. 403, 421 (2000).

286. *See* Sunstein, *supra* note 17, at 1339.

287. *Id*.

288. PETA and the Humane Society ask visitors of their websites to support various pending legislative initiatives by contacting their congressional representatives. *See supra* note 56.

289. *See* H.R. 891, 110th Cong. (2d Sess. 2007); Dog and Cat Prohibition Enforcement Act Fact Sheet, http://www.hsus.org/web-files/PDF/legislation/110_furlabeling_HR891.pdf (last visited Nov. 28, 2008). The statute is also pending in the Senate under the title "Truth in Fur Labeling Act." S. 610, 110th Cong. (2d Sess. 2007).

reason to support this law, the activists insist (or, openly admit), is that the measures currently in place to keep dog and cat fur out of the United States are not sufficiently effective.[290] The DCPEA is designed to seal a "loophole" in a 1951 law—the Fur Products Labeling Act ("FPLA")[291]—which requires that animal fur-bearing garments sold in the United States be properly labeled as to the species of animal if the value of the adorned fur exceeds $150.[292] The loophole, as the activists point out, arises in that a $500 coat trimmed with $149 worth of fur is not subject to the statute.[293]

Before looking closer at the merits of the pending DCPEA, a pressing question looms: if $149 worth of fur shows up at the border without a label, how do customs officials know whether it is dog, cat, rabbit, coyote, or fox? In reality, it seems they cannot.[294] In fact, DCPA enforcement may have been practically impossible since the law's inception.[295] One commentator remarked succinctly that until border officials can instantaneously conduct fur DNA testing, they will be as helpless as consumers in differentiating the products.[296] Meanwhile, overzealous enforcement efforts may lead to profiling and unwarranted obstruction of imports from Asian States.[297] How would the DCPEA improve the present scenario? It would amend the 1951 FPLA so that *all* fur-bearing products would require labels indicating the "species," regardless of the fur's monetary value.[298]

The most striking aspect of this straightforward measure is its conspicuous absence from the 2000 DCPA; even today, Burlington Coat Factory prices the overwhelming majority of its coats below $150 total.[299] But that observation is not worth dwelling on; the question going forward is whether the DCPEA would bring efficacy to the laws that have preceded it, and furthermore, whether such efficacy would come with hidden implications.

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290. *See supra* notes 7–10.
291. *See* Fur Products Labeling Act, 15 U.S.C. § 69 (1951).
292. *Id*.
293. *See* Humane Society Truth in Fur Labeling Act Fact Sheet, http://www.hsus.org/web-files/PDF/legislation/truth-in-fur-labeling-act_s3610.pdf (last visited Nov. 28, 2008).
294. Yasuhara, *supra* note 285.
295. *Id*.
296. *Id*.
297. *Id*.
298. *See* H.R. 891, 110th Cong. (2d Sess. 2007). *See* S. 610, 110th Cong. (2d Sess. 2007).
299. *See generally* Burlington Coat Factory Online Shopping, www.burlingtoncoatfactory.com (last visited Nov. 28, 2008) (selling 223 coats, only ten of which were priced over $150).

At this point, an analogy to the U.S. market for illegal drugs is unavoidable. While the DCPEA would be easy to enforce—all unlabeled fur would promptly be turned away—the law's overall effectiveness is premised on the notion that exporters will label their fur truthfully. Cocaine exporters are surely aware on some level that their product can potentially harm its purchasers, yet they remain driven (presumably by profit, if not by dependence on prior investment) to push the drug across U.S. borders by any means necessary.[300] Should the DCPEA prove too difficult to skirt with false labeling, fur farmers, who know their products are not even harmful to purchasers, may have greater incentives than drug dealers to turn to smuggling.[301] For one, the proven existence of a market for their fur may cause them to feel unfairly oppressed by what they perceive as arbitrary and unjustifiable cultural prejudice.[302] This could inspire sentiments of anti-Western self-righteousness, which harm perceptions of U.S. power while bestowing moral validation upon those who disobey.[303]

Furthermore, smuggling fur is liable to be easier than smuggling drugs, especially if false labeling would be as difficult to police as could be expected. While one may presume that the DCPEA would preemptively deter false labeling, this should only be true for exporters who trade in more than just dog fur. For these traders, an injunction and damaged reputation could impact future legitimate business deals, but for those with no alternatives other than to deal in dog fur or earn wages via domestic employment, taking the risk would be rational.[304] Whether they are caught mislabeling or never try, the result is the same; fur farmers would have to smuggle the products in the underground economy or find other ways to earn income.

The DCPEA is ultimately victim to a catch-22. The law is a response to the problem that border officials cannot distinguish unlabeled dog fur from unlabeled fox fur, but its effectiveness is premised on the ability of border officials to distinguish dog fur from fox fur when they are both labeled fox fur. In other words, the law is premised on the efficacy of the

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300. *See Not Winning the War on Drugs*, *supra* note 266 and accompanying text.

301. *See generally* Susan Fiske et al., *Anti-American Sentiment and America's Perceived Intent to Dominate: An 11-Nation Study*, 28 BASIC & APPLIED SOC. PSYCHOL. 363, 363 (2008) (reporting that foreigners perceive the United States as competent but "cold" and "arrogant," and arguing that such perceptions of America decrease U.S. security).

302. *See id*.

303. *See id*.

304. This assumption is rooted in Rational Choice Theory, which posits that an actor will generally behave so as to maximize personal utility. *See* Stanford Encyclopedia of Philosophy, "Philosophy of Economics" (2008), http://plato.stanford.edu/entries/economics/#5.

"honor system" in labeling. Meanwhile, foreigners may find more honor in disobeying the law, lest they be inclined to willfully sigh in resignation at their unfortunate moral inferiority.

To be sure, Section 1308(c)(5) of the DCPA additionally authorizes federal officials to pay "rewards" to citizens who furnish information regarding violation of the statute.[305] Ironically, this may be the most effective way to enforce the law (albeit a questionable use of taxpayer funds). But more notably, this provision actually serves as additional evidence of the difficulty of enforcing the DCPA at the border; and as more evidence of such difficulty becomes clear, the likelihood that exporters will falsely label increases.[306] Finally, and most significantly, if the DCPEA actually could be enforced effectively, this would only strengthen the incentive for Chinese officials to challenge the DCPA at the WTO. Ultimately, impoverished foreigners will wish to export fur to the United States so long as genuine demand renders it profitable.

CONCLUSION

Some Western animal rights activists preach intractable ideals under the guise of progressivism, but they do so with a fervor and single-mindedness unbecoming of the thoughtful worldview they aspire to. Whereas the case for progressivism is often made by pointing to conservative extremes that are clung to unthinkingly and inflexibly, the case for pragmatism may best be made by demonstrating that progressive extremes can likewise be clung to unthinkingly and inflexibly.[307] If the DCPA is an indication, attempts to spread Western animal welfare ideals globally may be contemporarily doomed, but the ideological tunnel vision and pervasive lack of pragmatism among activist initiatives may be a greater obstacle to the movement's spread than resistance from imagined legions of "cold-hearted" opponents.

A call for pragmatism has been central to the foregoing critique of the DCPA. The moral universalism of the animal welfare agenda has been challenged as naively presumptuous of Western superiority and substantively flawed for its reliance on normative rather than functional moral criticism. As such, moral universalism has been condemned as an impro-

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305. DCPA, 19 U.S.C. § 1308.

306. *See supra* note 266 and accompanying text.

307. *Compare SC Priest: No Communion for Obama Supporters*, MSNBC, Nov. 13, 2008, http://www.msnbc.msn.com/id/27705755/ (reporting that a Roman Catholic priest told his parishioners that voting for Barack Obama, a supporter of abortion rights, "constitutes material cooperation with intrinsic evil"), *with* Specter, *supra* note 14, at 57–58 (reporting that PETA's founder Ingrid Newkirk once remarked, "[T]he world would be an infinitely better place without humans in it at all.").

per premise for the enactment of laws restrictive of trade—the result of which is nothing more than coercive economic punishment based on a powerful nation's subjective (and largely hypocritical) disapproval of a weaker nation's norms. Furthermore, the DCPA has been shown to contravene the provisions and underlying pro-trade principles of the GATT, meaning China could successfully challenge the law by filing a complaint with the WTO. Finally, the DCPA has been deemed most impractical in that, if it were not so demonstrably unenforceable, it would perhaps be even less productive of its goal. All in all, free trade has been endorsed for its rejection of force in favor of voluntary and transparent international dealings.

The Humane Society has advocated for the pending DCPEA's increased labeling requirements by noting that "[c]onsumers making well-informed decisions based on complete information is a cornerstone of a functioning market economy."[308] The DCPEA contradicts this worthy principle, however, in that, even if dog fur arrives at customs properly labeled as such, it would be rejected without regard to whether some U.S. consumers would be willing to purchase it knowingly from a retailer. Ultimately, placing the burden on U.S. fur buyers (as opposed to suppliers) to test and properly label imported fur would be less restrictive of trade and better-suited to the regulatory goals of the DCPA. This is not the type of burden that need be imposed with respect to all imported products the U.S. legislature wishes to ban. But to those who would ask how best to draw that line, the GATT has already responded by setting out "narrow" Article XX exceptions to the agreement's general obligations. These exceptions properly distinguish valid and invalid regulations per their "necessity" in preventing some form of objectively verifiable damage. Furthermore, the GATT is the best arbiter of the type of damage that merits prevention because any such determination represents a contractual consensus among the parties subject to it and not merely one nation's attempt at objective rule promulgation. As such, GATT jurisprudence offers the most pragmatic approach to equitable trade relations.

Perhaps the defining difference between ideologues and pragmatists is the latter's willingness to change course when new facts so dictate. In his book, *The Audacity of Hope*, forty-fourth President of the United States Barack Obama made a case for pragmatism in comparing "values" with "ideology."[309] "Values are faithfully applied to the facts before us," he

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308. Humane Society Truth in Fur Labeling Act Fact Sheet, *supra* note 293.

309. President Barack Obama was a constitutional law professor at the University of Chicago Law School from 1992 to 2004. *See* University of Chicago, Statement Regarding Barack Obama, http://www.law.uchicago.edu/faculty/obama (last visited Nov. 28, 2008).

said, "while ideology overrides whatever facts call theory into question."[310] In the interest of Western values and sound policy, animal welfare activists, sympathetic citizens, and lawmakers should collectively change course by ceasing advocacy of legislation that would improve enforcement of the DCPA or otherwise restrict international trade. Granted, a call for the imposition of costs on domestic businesses for the sake of animals may never be as popular among U.S. animal sympathizers (or as effective at luring them to the cause) in comparison to emotional calls for sanctioning the "repugnant" (that is, "different") practices of foreign societies. But a more open-minded approach to the animal welfare agenda may be absolutely necessary if Western ideals regarding the treatment of animals are ever to take hold globally. Thus, for those who claim to care for the plight of *all* animals (including humans) but have not yet expelled the dissonance of dog-trumps-fox favoritism, it might be wise to let nuance and pragmatic reasoning trump emotion when international trade policy enters the equation.

Gary Miller[*]

310. BARACK OBAMA, THE AUDACITY OF HOPE 59 (2006).

* B.A., New York University (2007); J.D., Brooklyn Law School (expected June 2010); Editor-in-Chief of the *Brooklyn Journal of International Law* (2009–2010). I am grateful to my parents for their tireless (ever-ongoing!) efforts to teach me "right" from "wrong," and for their resolve to love and support me even if I never learn. I also owe many thanks to Judge Richard Posner for existing, and to Derek Kelly, Laura Scully, and Victoria J. Siesta of the 2008–2009 *Brooklyn Journal of International Law* Executive Board for their invaluable assistance in preparing this Note for publication. Any remaining errors or omissions are my own. Finally, I owe the remainder of my gratitude to my other half, Adriana Kowaliw, for willingly serving as my sounding board, for being caustically honest or empathically delicate as needed, and most importantly, for challenging me.

PATENTING HUMAN EMBRYONIC STEM CELLS: WHAT IS SO IMMORAL?

INTRODUCTION

Stem cell research is at the center of an international ethical and political debate. Stem cells are unspecialized cells, meaning they have the potential to develop into multiple types of cells in the body.[1] Because of this unspecialized quality and stem cells' ability to divide for indefinite periods in lab culture,[2] a significant portion of the scientific community believes that stem cell research is the key to finding new treatments for a variety of human diseases, conditions, and injuries.[3] But stem cells come in different degrees of unspecialization and from a variety of sources, some of which are objectionable to segments of the population. At the forefront of the stem cell debate are human embryonic stem cells ("hESCs"),[4] whose cultivation typically requires an initial destruction of a human embryo.[5] Yet hESCs are the least differentiated type of stem cell, capable of giving rise to any cell type in the human body. Therefore, hESC research, according to many, is far more likely to lead to life-saving treatments than the research of any other stem cell type.[6]

The hESC controversy draws lines through the population similar, but not identical, to those in the abortion rights battle. Opponents of abortion rights commonly assert that a human fetus[7] has the right to life. Although hESC research, in its current state, also involves the destruction of potential human life, it does so at a far earlier stage in human development: to

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1. *See* NAT'L INST. OF HEALTH, U.S. DEP'T OF HEALTH & HUMAN SERVS., STEM CELL BASICS (2009), *available at* http://stemcells.nih.gov/staticresources/info/basics/SCprimer2009.pdf [hereinafter STEM CELL BASICS].
2. *See id.* at 1, 22.
3. *See id*. at 13.
4. Researchers Matthew Kaufman and Martin Evans are credited with deriving the first stem cells, from mice, in 1981; it was more than a decade later when the first hESCs were derived. *See* NAT'L INST. OF HEALTH, U.S. DEP'T OF HEALTH & HUMAN SERVS., STEM CELLS: SCIENTIFIC PROGRESS AND FUTURE RESEARCH DIRECTIONS, at ES-3, 11–12, 30 (2001), *available at* http://stemcells.nih.gov/staticresources/info/scireport/PDFs/fullrptstem.pdf.
5. *See* H.W. Denker, *Potentiality of Embryonic Stem Cells: An Ethical Problem Even with Alternative Stem Cell Sources*, 32 J. MED. ETHICS 665 (2006).
6. *See* Gautam Naik, *Stem-Cell Advance May Skirt Ethical Debate: Scientists Return Adult Cells Back to Embryonic State: 'We'll All Get More Money,'* WALL ST. J., June 7, 2007, at B1.
7. The embryo typically develops into the fetus at about eight weeks after fertilization. *See* STEM CELL BASICS, *supra* note 1, at 19.

develop hESC lines,[8] researchers typically harvest the human blastocyst, a preimplantation[9] embryo consisting of about 150 cells and comprised of an outer layer of cells, a fluid-filled cavity, and an inner cell mass.[10] The human blastocyst is essentially a hollow ball, smaller than a pinhead, completely lacking in any features recognizable as human.[11] Because occasionally a blastocyst may be fatally flawed, the probability of a blastocyst developing to the stage of viability is significantly lower than that of a fetus developing to a viable baby.[12] While the line between "fetus" and "child" is hazy, the line between "blastocyst" and "child" is even less clear. Supporters of embryonic stem cell ("ESC") research have a mission quite different from that of abortion rights activists. Human ESC research is performed for the purpose of improving or saving the lives of the now-living and yet-to-be-born. This goal is entirely unrelated to whether a woman has a constitutional right to choose whether to carry out her pregnancy.[13]

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8. An embryonic stem cell line is defined as "embryonic stem cells, which have been cultured under *in vitro* conditions that allow proliferation without differentiation for months to years." *Id*.

9. Preimplantion means before the embryo has attached itself to the uterine wall. *Id*. at 22.

10. The blastocyst is one of the earliest stages of human development, forming around a week after fertilization. The outer layer of cells is known as the trophoblast, which gives rise to the placenta and other supporting tissues. The fluid-filled cavity is known as the blastocoel. The inner cell mass eventually develops into the fetus. *See* NIH, MedlinePlus Medical Encyclopedia: Fetal Development, http://www.nlm.nih.gov/medline plus/ency/article/002398.htm (last visited Mar. 4, 2009); STEM CELL BASICS, *supra* note 1, at 18–23. For more information and high quality photos of early stages of human development, see Advanced Fertility Center of Chicago, IVF Blastocyst Pictures & Blastocyst Stage Embryo Grading Photos & Images, http://www.advancedfertility.com/blastocyst images.htm (last visited Mar. 4, 2009).

11. *See* Australian Stem Cell Centre, Fact Sheet 6: Ethics of Stem Cell Research, http://stemcellcentre.edu.au/media-centre_resource-library.aspx (last visited Mar. 4, 2009).

12. Theoretically, any healthy human embryo has the potential to develop into a human child if implanted properly. Still, a significant percentage of human sex cells contain genetic or chromosomal abnormalities that may prevent an embryo from developing properly. *See* David K. Gardner & William B. Schoolcraft, *Controversies in Assisted Reproductions and Genetics*, 15 J. ASSISTED REPRODUCTION & GENETICS 455, 455 (1998); Naik, *supra* note 6. About fifteen to twenty percent of pregnancies end in miscarriage; more than eighty percent of miscarriages occur during the first trimester. *See* BabyCenter, Understanding Miscarriage, http://www.babycenter.com/0_understanding-miscarriage_ 252.bc (last visited Mar. 4, 2009).

13. Because of these disparities, some pro-lifers support hESC research, despite the prerequisite destruction of a human embryo. *See, e.g.*, Michael D. Shear, *Conservatives Ready to Battle McCain on Convention Platform*, WASH. POST, July 7, 2008, at A1; Jeff Zeleny, *House Votes to Expand Stem Cell Research*, N.Y. TIMES, June 8, 2007, at A24.

Because of the clinical promise of hESCs, hESC-based inventions constitute valuable intellectual property.[14] While the humanistic benefits are what make embryonic stem cells research so appealing to scientists, it is the patent system that provides the true incentives for the pharmaceuticals industry and universities to invest in research that guarantees a reasonable opportunity for economic gain.[15]

The Wisconsin Alumni Research Foundation ("WARF") owns three U.S. patents relating to the first ESC lines derived from human blastocysts.[16] The first of these patents issued on December 1, 1998, as U.S. Patent No. 5,843,780 ("'780 patent"). WARF has licensed its patent rights to Geron Corporation,[17] which holds the exclusive rights to develop any of the five hESC lines claimed in WARF's patents.[18]

WARF also filed a European patent application[19] that was nearly identical in content to the '780 patent. Despite this near identity, the European application faced quite different obstacles before the European Patent Office ("EPO"), which is bound by the laws of the European Patent

14. As of 2002, there were over 2,000 patent applications involving stem cells of any origin, a quarter of which were directed to ESCs. Over a third of the general stem cell applications and a quarter of all embryonic stem cell applications were granted. EUROPEAN GROUP ON ETHICS IN SCI. & NEW TECH. TO THE EUROPEAN COMM'N, ETHICAL ASPECTS OF PATENTING INVENTIONS INVOLVING HUMAN STEM CELLS 10 (May 7, 2002), *available at* http://ec.europa.eu/european_group_ethics/docs/avis16_en.pdf [hereinafter EGE OPINION].

15. *See* James C. De Vellis, *Patenting Industry Standards: Balancing the Rights of Patent Holders with the Need for Industry-wide Standards*, 31 AIPLA Q. J. 301, 310 (2003).

16. Dr. James A. Thomson invented the first embryonic stem cell lines derived from human blasocysts. *See* James A. Thomson et al., *Embryonic Stem Cell Lines Derived from Human Blastocysts*, 282 SCIENCE 1145 (1998). The U.S. Patent and Trademark Office granted three patents for Dr. Thomson's inventions. Dr. Thomson in turn assigned these three U.S. patents to WARF. The three Thomson U.S. patents are as follows: U.S. Patent No. 5,843,780 (issued Dec. 1, 1998); U.S. Patent No. 6,200,806 (issued Mar. 13, 2001); and U.S. Patent No. 7,029,913 (issued Apr. 18, 2006).

17. *See* News Release, Geron Corp., Geron Supports WARF's Claims to Human Embryonic Stem Cell Patents, Apr. 2, 2007, http://www.geron.com/media/pressview.aspx?id=795.

18. *See* Andrew Pollack, *'Politically Correct' Stem Cell Is Licensed to Biotech Concern*, N.Y. TIMES, Dec. 11, 2002, at C8; Sheryl Gay Stolberg, *U.S. Concedes Some Cell Lines Are Not Ready*, N.Y. TIMES, Sep. 6, 2001, at A1.

19. WARF's European patent application, European Patent Application No. 96903521.1, was a regional stage entry of PCT International Application No. PCT/US96/00596 (filed Jan. 19, 1996), which claimed priority and was a continuation-in-part of U.S. Patent Application Serial No. 08/376,327 (filed Jan. 20, 1995).

Convention ("EPC").[20] While the U.S. Patent and Trademark Office ("USPTO") granted the '780 patent relatively quickly,[21] the EPO outright refused to examine the European application on the ground that the invention was "contrary to morality."[22] After years of appeals, the Enlarged Board of Appeal ("Enlarged Board")—the highest level of legal authority in the EPO, responsible for resolving the most important issues of European patent law—ruled on November 25, 2008, that European patent law banned the patenting of ESC inventions whose preparation necessarily involved the destruction of human embryos.[23]

This disparity in treatment underscores a significant divergence between the U.S. and European patent systems.[24] Unlike the USPTO,[25] the

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20. In this Note, "EPO" refers to the European Patent Office, not the European Patent Organization. The EPO is an organ of the legal entity, the European Patent Organization. The EPO was established under Chapter III of the EPC. Convention on the Grant of European Patents (European Patent Convention), Oct. 5, 1973, 1065 U.N.T.S. 254 [hereinafter EPC 1973]. A revised version of the EPC 1973 went into force on December 13, 2007. Convention on the Grant of European Patents (European Patent Convention) as revised by the Act revising Article 63 EPC of 17 December 1991 and the Act revising the EPC of 29 November 2000, *available at* http://documents.epo.org/projects/babylon/eponet.nsf/0/E4F8409B2A99862FC125736B00374CEC/$File/EPC_13th_edition.pdf [hereinafter EPC 2000]. *See also* Stacey J. Farmer & Martin Grund, *Revision of the European Patent Convention and Potential Impact on European Patent Practice*, 36 AIPLA Q.J. 419 (2008).

21. The '780 patent was issued on December 1, 1998; its application was filed on January 18, 1996. Unhappy with Geron's licensing fees, two consumer groups fought back by filing petitions for reexamination of WARF's patents, asserting that WARF's claims were obvious in light of previous stem cell research. The USPTO granted the petition and preliminarily invalidated the claims of the three WARF patents. WARF appealed and won with respect to all three patents. *See* Andrew Pollack, *3 Patents on Stem Cells Are Revoked in Initial Review*, N.Y. TIMES, Apr. 3, 2007, at C2; Grady Frenchick, *WARF Is Likely to Hold on to Stem Cell Patent Right*, WIS. TECH. NETWORK, Apr. 12, 2007, http://wistechnology.com/article.php?id=3844; Press Release, WARF, Patent Office Upholds Remaining WARF Stem Cell Patents, Mar. 11, 2008, http://www.warf.org/uploads/media/Patent_Office_Upholds_Remaining_WARF_SC_Patents_03-11-08.pdf.

22. *See* Case T-1374/04, [2007] E.P.O. O.J. 313 (Technical Bd. App. 2006).

23. Case G-2/06, unpublished op. at 27–28 (Enlarged Bd. App. Nov. 25, 2008), *available at* http://legal.european-patent-office.org/dg3/pdf/g060002ex1.pdf. *See also* Press Release, EPO, No European Patent for WARF/Thomson Stem Cell Application, Nov. 27, 2008, http://www.epo.org/about-us/press/releases/archive/2008/20081127.html.

24. For an overview of the main differences between U.S. and European patentability requirements, see Samantha A. Jameson, *A Comparison of the Patentability and Patent Scope of Biotechnological Inventions in the United States and the European Union*, 35 AIPLA Q.J. 193 (2007).

25. *See* Ex parte Murphy, 200 U.S.P.Q. 801 (Pat. & Trademark Off. Bd. App. 1977) ("Just as the court in *In re Watson* and in *In re Anthony* made clear that the Patent and Trademark Office is not the governmental agency charged with the responsibility for

EPO is bound by morality provisions. Specifically, Article 53(a) of the EPC prohibits granting a patent for an invention "the commercial exploitation of which would be contrary to 'ordre public' or morality."[26] In addition, Rule 28(c) of the EPC[27] explicitly prohibits patenting inventions concerning "uses of human embryos for industrial or commercial purposes."[28]

While the Enlarged Board's decision is legally sound, it is disturbing that a question of morality—a factor generally unrelated to the classic patentability requirements[29]—has prevented an invention of proven scientific importance and economic value from receiving patent protection in any European state. While Europe appears more close-knit than ever,[30] it is still a pluralistic society. Each of the Member States of the European Patent Organization[31] is its own sovereign State, with its own national patent laws and its own understanding of what "morality" means.[32] While an individual European State may choose to craft its do-

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determining drug safety, we think this Office should not be the agency which seeks to enforce a standard of morality with respect to gambling, by refusing, on the ground of lack of patentable utility, to grant a patent on a game of chance if the requirements of the Patent Act otherwise have been met.") (citations omitted).

26. EPC 2000, *supra* note 20, art. 53(a). On December 13, 2007, a revised version of the EPC entered into force. The previous 1973 version of the EPC worded Article 53(a) slightly differently, prohibiting inventions "*the publication or exploitation* of which would be contrary to 'ordre public' or morality." EPC 1973, *supra* note 20, art. 53(a). (emphasis added). According to the Enlarged Board, "The changes are not relevant to the issues considered in this decision." Case G-2/06, at 2, 27. This Note similarly ignores the discrepancy.

27. Implementing Regulations to the Convention on the Grant of European Patents, Dec. 7, 2006, R. 28, *available at* http://documents.epo.org/projects/babylon/eponet.nsf/0/E4F8409B2A99862FC125736B00374CEC/$File/EPC_13th_edition.pdf [hereinafter EPC Regs.]. The provisions of Rule 28 used to be contained in Rule 23d. Implementing Regulations to the Convention on the Grant of European Patents, Dec. 13, 2001, R. 23d. In the revised version of the EPC, Rule 23d was renumbered as Rule 28. Because this change went into effect between the Technical Board of Appeal's decision in 2006 and the Enlarged Board of Appeal's decision in 2008, the decisions cited in this Note refer to these provisions differently. Case G-2/06, at 2. For the ease of the reader, this Note refers to these provisions hereinafter only as Rule 28.

28. EPC Regs., *supra* note 27, R. 28(c).

29. In other words, some combination of novelty, inventive step, nonobviousness, utility, and industrial applicability.

30. *See* Tony Judt, *The Nation: Fortunes of War: Europe Finds No Counterweight to U.S. Power*, N.Y. TIMES, Apr. 20, 2003, at 41.

31. EPO, Member States of the European Patent Organisation, http://www.epo.org/about-us/epo/member-states.html (last visited Mar. 4, 2009).

32. *See, e.g.*, Case C-377/98, Kingdom of the Netherlands v. Eur. Parliament & Council of the Eur. Union, 2001 E.C.R. I-7079. *See generally* COMM'N OF THE EUROPEAN COMMUNITIES, COMMISSION STAFF WORKING PAPER: REPORT ON HUMAN EMBRYONIC

mestic law to limit the patentability of "immoral" inventions, an outright ban by the EPO robs a State of that choice, regardless of whether the invention would be contrary to the morality of that particular State. Moreover, refusing patents in hESC inventions slows the pace of research at a time when stem cell technology is still in its infancy and large pharmaceutical companies are already somewhat hesitant to invest heavily.[33]

Part I of this Note begins with a general overview of stem cells, including stem cell science, the current state of stem cell research, and ethical concerns facing ESC research. Part II continues with an explanation of the morality exception to patentability present in European patent law. Part III discusses WARF's European patent application, including why the EPO suspended the examination of the application; the procedural history of the case before the Enlarged Board; and the decision of the Enlarged Board. Part IV compares the European and U.S. patent systems and the ramifications of codifying moral issues into patent law. This Note argues that patent offices should not have the authority to make morality determinations because a patent office's expertise is in technology and classic issues of patentability, and mixing patent, a classically objective area of law, with the predominantly subjective arena of moral values undermines the legal certainty of the patent system and its effectiveness in promoting research and investment. This Note concludes by offering a few alternatives to the EPO's current practice of automatically refusing morally dubious patent applications that may serve the purposes of patent law more effectively.

I. Overview of Stem Cell Science and Ethical Concerns

Stem cells are unspecialized cells that can differentiate into specialized cells upon receiving specific chemical signals.[34] Unspecialized cells exist at several stages: totipotent stem cells are capable of developing into a complete organism; pluripotent stem cells are capable of differentiating into any specialized cell type in the body, but are incapable of forming the complete organism; and multipotent stem cells are capable of differentiating into more than one, but not every, type of specialized cell.[35]

STEM CELL RESEARCH 43 (2003), *available at* http://europa.eu.int/comm/research/conferences/2003/bioethics/index_en.html [hereinafter CEC REPORT] (comparing the hESC research regulations of EU Member States).

33. *See, e.g.*, Eric Noe, *Stem-Cell Industry, Research Evolving: With Limits on Federal Funding for Stem Cells, Researchers Look for Private and Business Backing*, ABC NEWS, Nov. 23, 2004.

34. The more unspecialized a stem cell, the greater the number of cell types into which it can differentiate. STEM CELL BASICS, *supra* note 1, at 3–4.

35. *Id.* at 21, 23.

Specialized cells, on the other hand, are incapable of differentiating into other types of cells and often replicate slowly, if at all.[36] Accordingly, scientists are trying to manipulate stem cells to regenerate or repair tissues whose specialized cells were damaged, destroyed, or never formed in the first place.[37]

Stem cells can be found in the body at both adult and embryonic stages of life, but in different quantities and qualities.[38] The inner cell mass of the blastocyst—the early, hollow, spherical stage of the embryo—consists of ESCs, which ultimately differentiate into the various 200 or so specialized cell types in the body as the embryo matures into the fetus.[39] Scientists have learned to isolate these pluripotent ESCs and grow them *in vitro* while seemingly retaining the cells' pluripotency indefinitely.[40]

There is a strong movement pushing for continued and increased ESC research, with the hope that scientists will develop methods of treating or curing a wide variety of genetic disorders, diseases, medical conditions, and physical injuries.[41] The major aim of ESC research is to perfect a method of controlling and precisely directing the differentiation of ESCs in order to transplant the healthy differentiated cells into a suffering patient.[42]

But stem cells also exist in adult (i.e., postembryonic) animals; these stems cells are referred to as adult stem cells.[43] There is plenty of re-

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36. *Id*. at 3–4.

37. *Id*. at 13.

38. *Id*. at 12.

39. European Commission, About Stem Cells, http://ec.europa.eu/research/quality-of-life/stemcells/about.html (last visited Mar. 4, 2009); STEM CELL BASICS, *supra* note 1, at 4–5.

40. STEM CELL BASICS, *supra* note 1, at 5–7.

41. *See* Zeleny, *supra* note 13. *But see* Sheryl Gay Stolberg, *Bush Vetoes Bill Removing Stem Cell Limits, Saying "All Human Life Is Sacred*,*"* N.Y. TIMES, June 21, 2007, at A21.

42. NIH, Stem Cells and Diseases, http://stemcells.nih.gov/info/health.asp (last visited Mar. 4, 2009).

43. For example, hematopoietic stem cells (adult stem cells) from the bone marrow give rise to red blood cells, white blood cells, and platelets. STEM CELL BASICS, *supra* note 1, at 4. Stem cells have also been found in extra-embryonic tissues, such as umbilical cord blood stem cells and amniotic stem cells. *See* Paolo De Coppi et al., *Isolation of Amniotic Stem Cell Lines with Potential for Therapy*, 25 NATURE BIOTECH. 100 (2007); Erica Lloyd, *Umbilical Cord Blood: The Future of Stem Cell Research?*, NAT'L GEOGRAPHIC NEWS, Apr. 6, 2006, *available at* http://news.nationalgeographic.com/news/2006/04/0406_060406_cord_blood.html. In addition, in a well publicized case of fabricated research, Korean scientist Hwang Woo Suk claimed in 2004 to have derived embryonic stem cells from the adult cells of a patient, which could have skirted the ethical

search going into adult stem cells, and there are those who believe that adult stem cells will provide benefits similar to, or even greater than, those of embryonic stem cells.[44] However, because adult stem cells are generally multipotent, they are incapable of differentiating into as many cell types as pluripotent ESCs. Therefore, much of the scientific community sees less clinical potential for adult stem cells.[45]

In addition, there is ongoing research into other sources of stem cells,[46] especially those sources that do not require the destruction of human "life."[47] For example, scientists are attempting to "reprogram" adult stem cells back to a less developed, embryonic-like state.[48] This would bypass the ethical concerns posed by ESCs. Additionally, adult stem cells would provide a potential advantage over ESCs in that they would already

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issues attached to deriving embryonic stem cells from living embryos. Although Dr. Hwang's research was later discredited, recently Boston scientist concluded that Dr. Hwang, without even realizing it, had in fact derived his embryonic stem cells from an unfertilized egg through parthenogenesis, a scientific first. *See* Nicholas Wade, *Within Discredited Stem Cell Research, A True Scientific First*, N.Y. TIMES, Aug. 3, 2007, at A16.

44. *See* Matthew Weed, *Discourse on Embryo Science and Human Cloning in the United States and Great Britain: 1984–2002*, 33 J.L. MED. ETHICS 802, 808 (2005). Still, there is some evidence that certain adult stem cell types are pluripotent. Stem cell plasticity is "[t]he ability of stem cells from one adult tissue to generate the differentiated cell types of another tissue." STEM CELL BASICS, *supra* note 1, at 21.

45. *See* Naik, *supra* note 6. *But see* Weed, *supra* note 44, at 804, 808 (reviewing various claims that breakthroughs in adult stem cell technology will eventually make unnecessary the ethically undesireable use of hESCs).

46. *See* PRESIDENT'S COUNCIL ON BIOETHICS, A WHITE PAPER: ALTERNATIVE SOURCES OF HUMAN PLURIPOTENT STEM CELLS (2005), *available at* http://bioethics.gov/reports/white_paper/alternative_sources_white_paper.pdf [hereinafter WHITE PAPER] (discussing the ethical and scientific soundness of alternative sources of human pluripotent stem cells, including pluripotent stem cells derived from "dead" embryos; pluripotent stem cells via blastomere extraction from living human embryos, i.e., extracting a few stem cells from the preblastocyst embryo while retaining its viability; pluripotent stem cells derived from biological artifacts, i.e., artificial, "less than human" embryos similar enough to "true" human embryos to derive pluripotent stem cells from them; and pluripotent stem cells derived from somatic cell dedifferentiation, i.e., reprogramming differentiated adult stem cells to restore an undifferentiated pluripotency typical of embryonic stem cells).

47. *See* DOMESTIC POL'Y COUNCIL, ADVANCING STEM CELL SCIENCE WITHOUT DESTROYING HUMAN LIFE (2007), *available at* http://georgewbush-whitehouse.archives.gov/dpc/stemcell/2007/stemcell_040207.pdf.

48. *See generally* WHITE PAPER, *supra* note 46.

match the patient's genetic makeup and would therefore be less prone to rejection by the patient's immune system.[49]

In the early part of this decade, a group of scientists reported the discovery of a type of adult stem cell derived from bone marrow that could be reprogrammed to differentiate into any tissue type.[50] However, the study was eventually discredited when it was discovered that some of the group's findings were falsified.[51] Notably, in November 2007, scientists reported the discovery of a technique using viruses that converts adult skin cells into cells that behave like ESCs, able to replicate indefinitely and differentiate into any cell type.[52] While the technique potentially represents a major breakthrough for nonembryonic stem cells, it also has a major deficiency: it can potentially lead to mutations and cancers.[53] Although scientists are searching for techniques that do not use cancer-causing viruses, an efficient method has not yet been perfected.[54]

While ESC research may be more promising than adult stem cell research, ESCs have generated a considerable amount of public dissent due

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49. *See, e.g.*, UCSF Children's Hospital, Bone Marrow Transplant, http://www.ucsfhealth.org/childrens/medical_services/cancer/bmt/treatments/leukemia.html (last visited Mar. 4, 2009).

50. Yuehua Jiang et al., Abstract, *Pluripotency of Mesenchymal Stem Cells Derived from Adult Marrow*, 418 NATURE 41 (2002), *available at* http://www.nature.com/nature/journal/v418/n6893/full/nature00870.html.

51. Yuehua Jiang et al., *Corrigendum: Pluripotency of Mesenchymal Stem Cells Derived from Adult Marrow*, 447 NATURE 880 (2007). *See* Peter Aldhous & Eugenie Samuel Reich, *Stem-Cell Researcher Guilty of Falsifying Data*, NEW SCIENTIST, Oct. 7, 2008, http://www.newscientist.com/article/dn14886-stemcell-researcher-guilty-of-falsifying-data.html.

52. *See* Andrew Pollack, *After Stem-Cell Breakthrough, the Real Work Begins*, N.Y. TIMES, Nov. 27, 2007, at F1.

53. The new technique involves inserting into a patient's isolated skin cells viruses carrying genes that cause the cells to revert to an embryonic-like stage. The modified cells would then be administered back to the patient. However, these same viruses can incorporate themselves randomly into the patient's genes, potentially causing mutations and cancers. *See id*. *See also* Peter Aldhous, *Stem Cell Breakthrough May Reduce Cancer Risk*, NEW SCIENTIST, Feb. 27, 2008, *available at* http://www.newscientist.com/article/dn13384-stem-cell-breakthrough-may-reduce-cancer-risk.html; Alan I. Leshner & James A. Thomson, *Standing in the Way of Stem Cell Research*, WASH. POST, Dec. 3, 2007, at A17.

54. *See* Peter Aldhous, *Ethical Stem Cells Stripped of 'Cancer' Genes*, NEW SCIENTIST, Mar. 1, 2009, http://www.newscientist.com/article/dn16684-ethical-stem-cells-stripped-of-cancer-genes.html; Peter Aldhous, *Stem Cells Created Without Cancer-Causing Viruses*, NEW SCIENTIST, Sep. 25 2008, *available at* http://www.newscientist.com/article/dn14816-stem-cells-created-without-cancercausing-viruses.html; Rob Stein, *Scientists Report Advance in Stem Cell Alternative*, WASH. POST, Sep. 26, 2008, at A17.

to ethical concerns.[55] One of the shortcomings of ESC research is the difficulty in retaining the viability of the embryo undergoing stem cell extraction.[56] The process of deriving stem cells from the blastocyst typically spells death for the embryo. Because any developing human embryo could ultimately result in the birth of a child, hESC research has drawn its major opponents from religious groups, whose ethical convictions against hESC research mirror those held by groups against abortion.[57] A similar but separate argument against hESC research is that hESC researchers fail to respect human dignity by treating potential human life like that of a lab rat.[58] Still, others fault ESC researchers for touting ESCs as an imminent cure for all diseases. Proponents of ESC research are accused of setting unrealistic goals and underhandedly raising the hopes of those in need of life-saving treatment, when potential treatments are arguably years, or even decades, away from fruition.[59]

There is a precautionary concern with the long-term consequences of granting patents directed to hESCs: granting property rights in human derivatives would be a slippery slope toward commercialization and

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55. *See* NIH, Research Ethics and Stem Cells, http://stemcells.nih.gov/info/ethics.asp (last visited Mar. 4, 2009).

56. While the current general practice for deriving embryonic stem cells entails destroying the embryo, with no attempt to retain viability, recent research suggests that embryonic stem cells may be prepared one day without destroying the embryo. *See* Young Chung et al., *Human Embryonic Stem Cell Lines Generated Without Embryo Destruction*, 2 CELL STEM CELL 113 (2008); Andy Coghlan, *Stem Cell Breakthrough Leaves Embryos Unharmed*, NEW SCIENTIST, Jan. 10, 2008, *available at* http://www.newscientist.com/article/dn13170-stem-cell-breakthrough-leaves-embryos-unharmed.html. *But see* Andy Coghlan, *'Hype' Accusation Blights Stem Cell Breakthrough*, NEW SCIENTIST, Aug. 29, 2006, *available at* http://www.newscientist.com/article/dn9873-hype-accusation-blights-stem-cell-breakthrough.html.

57. *See, e.g.*, Robert P. George, *Our Struggle for the Soul of Our Nation*, http://www.thepublicdiscourse.com/viewarticle.php?selectedarticle=2009.01.22.001.pdart (last visited Mar. 4, 2009); Rebecca Taylor, *Abortion, Stem Cells, and Cloning*, MARY MEETS DOLLY, Oct. 25, 2007, *available at* http://www.lifeissues.net/writers/tayl/tayl_01abrstemcellscloning.html.

58. *See, e.g.*, Press Release, Ctr. for Bioethics & Human Dignity, New Embryonic Stem Cell Study Smoke and Mirrors Says Bioethicist (Aug. 24, 2006), http://www.cbhd.org/media/pr/2006-08-24.htm. *See generally* Moore v. Regents of Univ. of Cal., 793 P.2d 479, 491 (Cal. 1990) ("Nor is it necessary to force the round pegs of 'privacy' and 'dignity' into the square hole of 'property' in order to protect the patient, since the fiduciary-duty and informed-consent theories protect these interests directly by requiring full disclosure.").

59. *See* Nicholas Wade, *Concerns of Dashed Hopes from Promised Miracles*, N.Y. TIMES, Jan. 12, 2007, at A19. *See also* Letters to the Editor, *No Taxation If There Is Fertilization*, WALL ST. J., Aug. 4, 2006, at A17.

moral devaluation of the human body.[60] Many believe financial profit from the human body or its element is impermissible.[61] Some opponents of hESC research worry that increased research will lead to a black market for human embryos.[62] Another fear is the creation of human embryos purely for research purposes, which is widely viewed as unethical and is outlawed in most countries.[63] Still, pursuant to the Human Fertilisation and Embryology Act ("HFEA"), the United Kingdom permits the creation of human embryos for research purposes as long as the researcher first obtains a license from the relevant government authority.[64]

II. EUROPEAN PATENT LAW: THE MORALITY EXCEPTION TO PATENTABILITY

A. Article 27 of TRIPs

The Agreement on Trade-Related Aspects of Intellectual Property Rights[65] ("TRIPs") set forth powerful international standards for intellectual property. Article 27(1) of TRIPs provides that "patents shall be

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60. *See* CEC REPORT, *supra* note 32, at 9. *Cf.* U.S. CONGRESS, OFFICE OF TECH. ASSESSMENT, NEW DEVELOPMENTS IN BIOTECHNOLOGY: OWNERSHIP OF HUMAN TISSUES AND CELLS, 33–35, 46 (1987), *available at* http://www.fas.org/ota/reports/8719.pdf ("The ease of application of biotechnology processes has allowed researchers to turn undeveloped human tissues and cells into human biological products with significant therapeutic promise and commercial potential. Yet the ultimate value of these technologies may not be simply their end products; their greater value may be the insights they provide about disease processes.").

61. EGE OPINION, *supra* note 14, at 2. *See also* CEC REPORT, *supra* note 32, at 66–69 (providing examples of national regulatory regimes with varying levels of prohibition on embryonic research and commercialization of embryos). *See generally* Gloria G. Banks, *Legal and Ethical Safeguards: Protection of Society's Most Vulnerable Participants in a Commercialized Organ Transplantation System*, 21 AM. J.L. & MED. 45 (2005); Jonathan G. Stein, *A Call to End Baby Selling: Why the Hague Convention on Intercountry Adoption Should Be Modified to Include the Consent Provisions of the Uniform Adoption Act*, 24 T. JEFFERSON L. REV. 39 (2001).

62. *See, e.g.*, Daniel McConchie, *Using Stem Cells from Embryos Will Make Human Flesh Profitable*, CTR. FOR BIOETHICS & HUMAN DIGNITY, June 29, 2001, http://www.cbhd.org/resources/stemcells/mcconchie_2001-06-29.htm.

63. *See* CEC REPORT, *supra* note 32, at 9, 66–69; *Survey of European Scientists on Ethics of Scientific Advancements*, GENETIC ENGINEERING & BIOTECH. NEWS, Jun. 15, 2005, http://www.genengnews.com/articles/chitem.aspx?aid=502&chid=0.

64. Human Fertilisation and Embryology Act (HFEA), 1990, c. 37, §§ 3, 9–15, *available at* http://www.opsi.gov.uk/Acts/acts1990/pdf/ukpga_19900037_en.pdf.

65. Agreement on Trade-Related Aspects of Intellectual Property Rights, Apr. 15, 1994, Marrakesh Agreement Establishing the World Trade Organization, Annex 1C, Legal Instruments—Results of the Uruguay Round, 33 I.L.M. 81 (1994) [hereinafter TRIPs].

available for any inventions, whether products or processes, in all fields of technology, provided that they are new, involve an inventive step[,] and are capable of industrial application."[66] But under Article 27(2), Member States may enact laws to exclude inventions from patentability where necessary to protect ordre public or morality.[67] The morality exclusion from patentability is optional. For example, the United States has not enacted a statute prohibiting patents directed for "immoral" subject matter. Europe, on the other hand, has implemented a morality exclusion to patentability in its laws.[68]

B. Directive 98/44/EC on the Legal Protection of Biotechnological Inventions

In July 1998, the European Union adopted Directive 98/44/EC ("Directive") on the legal protection of biotechnological inventions.[69] The purpose of passing the Directive was to harmonize the patent laws of EU Member States[70] in order to give Europe "a competitive advantage in biotechnology innovation."[71] Article 1 of the Directive provides that each Member State must protect biotechnogical inventions under its national patent laws and in accordance with the Directive, and, if necessary, adjust its laws to conform to the Directive.[72] The Directive goes on to define biotechnological terms, patentable biotech inventions, and patentability requirements.[73] Article 6(1), however, specifically excludes from patentability inventions whose "commercial exploitation would be contrary to ordre public or morality."[74] Subsection (2)(c) further states that "uses of

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66. *Id*. art. 27(1).

67. *Id*. art. 27(2) ("Members may exclude from patentability inventions, the prevention within their territory of the commercial exploitation of which is necessary to protect ordre public or morality, including to protect human, animal or plant life or health or to avoid serious prejudice to the environment, provided that such exclusion is not made merely because the exploitation is prohibited by their law.").

68. Council Directive 98/44/EC, 1998 O.J. (L 213) 13 [hereinafter Directive].

69. *Id*.

70. The current EU Member States are Austria, Belgium, Bulgaria, Cyprus, Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Ireland, Italy, Latvia, Lithuania, Luxembourg, Malta, the Netherlands, Poland, Portugal, Romania, Slovakia, Slovenia, Spain, Sweden, and the United Kingdom. European Union, Offices, http://www.eurunion.org/states/offices.htm (last visited Mar. 4, 2009).

71. Jasemine Chambers, *Patent Eligibility of Biotechnological Inventions in the United States, Europe, and Japan: How Much Patent Policy Is Public Policy?*, 34 GEO. WASH. INT'L L. REV. 223, 237 (2002).

72. Directive, *supra* note 68, art. 1.

73. *Id*. art. 2, 3.

74. *Id*. art. 6 (italics omitted).

human embryos for industrial or commercial purposes" are explicitly unpatentable inventions.[75]

Article 7 of the Directive provides that the Commission's European Group on Ethics in Science and New Technologies ("EGE") shall evaluate all ethical aspects of biotechnology.[76] In a May 2002 opinion on the ethics of patenting human stem cell inventions, the EGE stated that it believed that it was ethically acceptable to permit patenting inventions involving the transformation of unmodified hESCs into genetically modified stem cell lines or specific differentiated stem cell lines for specific therapeutic or other uses, provided that the inventions meet the standard patentability requirements and would not lead to uses of human embryos for industrial or commercial purposes.[77]

Although most EU Member States have transposed the Directive into their national laws, not all the Member States have done so completely voluntarily.[78] Notably, the Swedish National Council on Medical Ethics ("SMER")[79] strongly opposed the Swedish government making such

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75. Article 6(2) specifically excludes from patentability

> (a) processes for cloning human beings; (b) processes for modifying the germ line genetic identity of human beings; (c) uses of human embryos for industrial or commercial purposes; [and] (d) processes for modifying the genetic identity of animals which are likely to cause them suffering without any substantial medical benefit to man or animal, and also animals resulting from such processes.

Id.

76. *Id*. art. 7.

77. EGE OPINION, *supra* note 14, at 16.

78. Article 15 of the Directive requires that each of the Member States comply with, or adjust its law to comply with, the Directive by July 30, 2000. Directive, *supra* note 68, art. 15. As of June 29, 2005, twenty Member States (Belgium, Cyprus, Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Ireland, Malta, the Netherlands, Poland, Portugal, Slovakia, Slovenia, Spain, Sweden, and the United Kingdom) had complied with Article 15, while the remaining Member States were at various stages in the process of transposing the Directive. *See Report from the Commission to the European Parliament, the Council, the Committee of the Regions and the European Economic and Social Committee—Life Sciences and Biotechnology—A Strategy for Europe—Third Progress Report and Future Orientations*, COM(2005) 286 final (June 29, 2005). Over the last several years, the European Commission has instituted various infringement actions to encourage the noncomplying States to transpose the Directive into their national laws. *Id*.

79. "The Swedish National Council on Medical Ethics is an advisory board to the Swedish government on ethical issues raised by scientific and technological advances in biomedicine." Swedish National Council on Medical Ethics (SMER), http://www.smer.se/Bazment/2.aspx (last visited Mar. 4, 2009).

changes to its patent laws.[80] The SMER objected to, *inter alia*, the Directive's branding of certain aspects of ESC research as contrary to ordre public and morality, even though ESCs constitute a highly progressive and promising field of research; the SMER argued that this fact was completely unknown at the time the Directive was formulated, but that —had it been known—ESC research would not be considered contrary to ordre public and morality.[81] Yet Sweden yielded to European pressure and implemented the Directive into its national laws.[82]

In a case decided in 2001 by the Court of Justice of the European Communities, the Netherlands, supported by Italy and Norway, sought to enjoin implementation of the Directive on six separate grounds.[83] One such ground was that Article 6 would allow Member States to refuse to provide patent protection for a controversial biotechnological invention simply by asserting that it was contrary to ordre public or morality.[84] Although the court rejected all of the Netherlands' arguments, the fact that the case even exists supports the proposition that the morality provision was not universally popular among European States.[85]

C. Article 53(a) and Rule 28 of the European Patent Convention

The European Patent Convention has contained a morality provision in Article 53(a) since its inception in 1973.[86] Article 53(a)—its language mirroring that of Article 6(1) of the Directive—prohibits the granting of patents for inventions "the commercial exploitation of which would be contrary to 'ordre public' or morality."[87] In September 1999, the Euro-

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80. SMER, Opinion on Directive 98/44/EC on the Legal Protection of Biotechnical Inventions, and Its Implementation in Sweden (Feb. 25, 2002), *available at* http://www.smer.gov.se/english/opinion/patent.eng.htm.

81. *Id*.

82. *See* THE SWEDISH GROUP OF AIPPI, REPORT Q166: INTELLECTUAL PROPERTY AND GENETIC RESOURCES, TRADITIONAL KNOWLEDGE AND FOLKLORE (July 2006), *available at* http://www.aippi.org/reports/q166/quest06/q166_sweden06.pdf.

83. Case C-377/98, Kingdom of the Netherlands v. Eur. Parliament & Council of the Eur. Union, 2001 E.C.R. I-7079

84. *Id.*

85. *Id*. For a thorough overview of this case, see Juliane Kokott & Thomas Diehn, Kingdom of the Netherlands v. European Parliament & Council of the European Union*, Case C-377/98. 2001 ECR I-7079*, 96 AM. J. INT'L L. 950 (2002).

86. EPC 1973, *supra* note 20, art. 53(a).

87. Article 53 provides in full:

> European patents shall not be granted in respect of: (a) inventions the commercial exploitation of which would be contrary to 'ordre public' or morality; such exploitation shall not be deemed to be so contrary merely because it is prohibited by law or regulation in some or all of the Contracting States; (b) plant or

pean Patent Organization followed in the EU's footsteps and adopted the language of Article 6(2) of the Directive.[88] Consequently, Rule 28 of the EPC, in providing specific examples of inventions that fit the patentability exclusion of Article 53(a), states that "European patents shall not be granted in respect of biotechnological inventions which, in particular, concern . . . uses of human embryos for industrial or commercial purposes."[89]

III. PATENTING EMBRYONIC STEM CELL LINES IN EUROPE

A. The WARF Stem Cell Case: EPO's Refusal of WARF's European Patent Application

WARF's European patent application contained ten claims.[90] Claim 1 was directed to primate embryonic stem cell cultures.[91] Specifically, claim 1 provided:

> A cell culture comprising primate embryonic stem cells which (i) are capable of proliferation in vitro culture for over one year, (ii) maintain a karyotype in which all chromosomes normally characteristic of the primate species are present and are not noticeably altered through culture for over one year, (iii) maintain the potential to differentiate to derivatives of endoderm, mesoderm, and ectoderm tissues throughout the culture, and (iv) are prevented from differentiating when cultured on a fibroblast feeded layer.[92]

> animal varieties or essentially biological processes for the production of plants or animals; this provision shall not apply to microbiological processes or the products thereof; (c) methods for treatment of the human or animal body by surgery or therapy and diagnostic methods practised on the human or animal body; this provision shall not apply to products, in particular substances or compositions, for use in any of these methods.

EPC 2000, *supra* note 20, art. 53(a).

88. Press Release, EPO, The EPO Follows the EU's Directive on Biotechnology Patents, Oct. 27, 2005, *available at* http://www.epo.org/about-us/press/releases/archive/2005/27102005.html.

89. EPC Regs., *supra* note 27, R. 28.

90. As amended by WARF on June 18, 2003. Reply to Examination Report, T.J. Duckworth on behalf of WARF (June 18, 2003) (on file with the EPO). *See also* Case T-1374/04, [2007] E.P.O. O.J. at 314.

91. Reply to Examination Report, *supra* note 90. *See also* Case T-1374/04, [2007] E.P.O. O.J. at 314.

92. Reply to Examination Report, *supra* note 90, at claim 1 (emphasis omitted). *See* Case T-1374/04, [2007] E.P.O. O.J. at 314.

WARF acknowledged that "primate embryonic stem cells," as recited in claim 1, included *human* embryonic stem cells.[93] Claims 2–8 were directed to further embodiments of the cell culture of claim 1.[94] Claim 9 was directed to a method of maintaining such a cell culture, and claim 10 to a method of obtaining differentiated primate cells from such a cell culture.[95]

The EPO Examining Division refused WARF's European application for the failure of claims 1–7, 9, and 10 to comply with Article 53(a) in conjunction with Rule 28(c).[96] WARF appealed to the EPO Technical Board of Appeal, challenging the Examining Division's interpretation of Article 53(a) and Rule 28(c).[97] Because of the potential impact of the EPO's interpretation of the EPC provisions on future patentees and stem cell research in general, the Technical Board of Appeal referred the case to the Enlarged Board of Appeal posing the following questions:

> 1. Does Rule [28](c) EPC apply to an application filed before the entry into force of the rule?
>
> 2. If the answer to question 1 is yes, does Rule [28](c) EPC forbid the patenting of claims directed to products (here: human embryonic stem cell cultures) which—as described in the application—at the filing date could be prepared exclusively by a method which necessarily involved the destruction of the human embryos from which the said products are derived, if the said method is not part of the claims?
>
> 3. If the answer to question 1 or 2 is no, does Article 53(a) EPC forbid patenting such claims?
>
> 4. In the context of questions 2 and 3, is it of relevance that after the filing date the same products could be obtained without having to recur to a method necessarily involving the destruction of human embryos (here: eg derivation from available human embryonic cell lines)? [98]

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93. Case T-1374/04, [2007] E.P.O. O.J. at 328.

94. Reply to Examination Report, *supra* note 90, at claims 2–8. *See also* Case T-1374/04, [2007] E.P.O. O.J. at 314.

95. Reply to Examination Report, *supra* note 90, at claims 9–10. *See also* Case T-1374/04, [2007] E.P.O. O.J. at 314–15.

96. Case T-1374/04, [2007] E.P.O. O.J. at 315. Claim 8 was directed to a cell culture of any of claims 1–7 wherein the cells were *non-human* primate cells; accordingly, claim 8 was not refused as contrary to morality. Reply to Examination Report, *supra* note 90, at claim 8. However, because claim 8 depended on claims 1–7, it was unpatentable on its own. *Id*.

97. Case T-1374/04, [2007] E.P.O. O.J. at 340.

98. *Id*. The purpose of the Enlarged Board of Appeal is to ensure uniform application and to resolve important questions of European patent law. EPC 2000, *supra* note 20, art 112.

Question 1, pertaining to the retroactivity of Rule 28, would not have any bearing on future ESC patent applications because these applications would presumably be filed after Rule 28 was already in force.[99] In addition, Question 4 was quite specific to the WARF patent application, so the Question's solution is unlikely to significantly affect future ESC cases.[100] Accordingly, this Note largely ignores Questions 1 and 4.[101]

The crux of the case rested in the answers to Questions 2 and 3. The Technical Board noted that the main issue was whether Rule 28(c) should be construed narrowly or broadly.[102] If construed narrowly, according to WARF, Rule 28(c) would exclude from patentability "only applications whose claims were directed to the use of human embryos"; a broad interpretation would likely exclude patents claiming products "whose isolation necessitated the direct and unavoidable use of human embryos."[103] As a general principle, exceptions to patentability, such as

99. In referring Question 1 to the Enlarged Board, the Technical Board cited two Technical Board decisions that ostensibly answer the question. In Case T-272/95, unpublished op. at 9 (Technical Bd. App. Oct. 23, 2002), *available at* http://legal.european-patent-office.org/dg3/pdf/t950272eu2.pdf, the Technical Board concluded that Rules 23b–e (now Rules 26–29) were merely interpretive of Article 53(a) and therefore went into force on September 1, 1999. Case T-1374/04, [2007] E.P.O. O.J. at 329. Similarly, in Case T-315/03, [2006] E.P.O. O.J. 15 (Technical Bd. App. 2004), the Technical Board held that Rule 23d (now Rule 28) applied to cases pending on September 1, 1999, because this Rule was merely interpretive of Article 53(a) and did not previously cause an unpredictable change in its interpretation. Case T-1374/04, [2007] E.P.O. O.J. at 330. Accordingly, the EPO may not grant a patent for any application that was pending on September 1, 1999, if the application claims an invention that concerns uses of human embryos for industrial or commercial purposes. *Id*. at 331.

100. First, the Enlarged Board would only need to address Question 4 if it concluded in response to Questions 2 or 3 that Rule 28(c) and/or Article 53(a) rendered WARF's invention unpatentable. Furthermore, future ESC inventions are unlikely to necessitate the destruction of human embryos, but will instead rely upon available hESC lines.

101. Nevertheless, in discussing Question 4, the Technical Board did raise an interesting issue of whether a law enforcing moral attitudes should be based on the state of public opinion at a patent application's priority date or based on the *current* state of public opinion. Case T-1374/04, [2007] E.P.O. O.J. at 339. On the one hand, the attitude toward ESC research has become more favorable since the inception of the Directive. On the other hand, the Technical Board decided in Case T-315/03, [2006] E.P.O. O.J. 15, that a "Rule 23d type" or Article 53(a) assessment should be made based on the state of affairs at the filing or priority date. *Id*. at 51–56.

102. Case T-1374/04, [2007] E.P.O. O.J. at 317.

103. *Id*. at 317. The Technical Board cited several of WARF's arguments in favor of a narrow construction: First, Rule 28 refers to the unpatentability of certain "inventions," which is arguably a reference only to the claimed subject matter, not the indirect and unclaimed use of human embryos. Second, Rule 28(d) explicitly specifies that the product of "processes for modifying the genetic identity of animals" (i.e., genetically modified animals) is unpatentable, whereas Rule 28(c) clearly omits any reference to the

those provided in Rule 28(c) and Article 53(a), should be interpreted narrowly.[104] While the Enlarged Board once stated that this narrow construction rule "did not apply without exception," the Enlarged Board never clarified exactly what would constitute an exception to the general rule.[105]

In the opinion, the Technical Board also reasserted the Examining Division's position that Rule 28(c) excludes the WARF application for patentability, even under a narrow construction.[106] According to the EPO, Directive 98/44/EC, from which Rule 28(c) was derived, was drafted with an aim of emphasizing that technologies using human embryos for an "ethically unacceptable" purpose should be barred from patenting.[107] Although Article 6(2) was amended just prior to the Directive's adoption to replace the phrase "methods in which human embryos are used" with "uses of human embryos,"[108] the Examining Division concluded that the incorporation of the new language was not made with the intent to allow patenting of products derived from such uses of human embryos.[109] The Examining Division reasoned that the European Commission was not necessarily aware of the establishment of the hESC lines at the time of the Directive's adoption, and therefore could not have deliberately allowed patenting of inventions involving hESCs.[110]

With regard to Question 3, WARF argued that the Board should apply a balancing test in deciding whether patent application claims violate

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product of using human embryos; therefore Rule 28(c) should not exclude the WARF application from patentability. Another argument supporting a narrow construction is that prior to its enactment, the Directive was amended to replace the phrase "methods in which human embryos are used" with "uses of human embryos." As amended, the Directive's prohibition seems to be limited to direct uses of human embryos, rather than any invention in which human embryos are used even indirectly. *Id*. at 318–19.

104. *Id*. at 332–33.

105. *Id*. (citing Case G-1/04, [2006] E.P.O. O.J. 334, 350 (Enlarged Bd. App. 2005)) ("It is also true that the frequently cited principle, according to which exclusion clauses from patentability laid down in the EPC are to be construed in a restrictive manner, does not apply without exception. However, the Enlarged Board of Appeal considers that the principle of a narrow interpretation of such exclusion clauses is to apply in respect of the scope of the exclusion from patentability under Article 52(4) EPC concerning diagnostic methods.").

106. Case T-1374/04, [2007] E.P.O. O.J. at 335–36.

107. *Id*.

108. *Id*. at 319–20.

109. *Id*. at 335–38.

110. Although the WARF application was published in 1996, the first scientific journal article reporting on WARF's discovery was not published until November 1998, after the Directive had already been adopted. *Id*. at 337. *See* Thomson et al., *supra* note 16.

Article 53(a).[111] However, the Technical Board expressed doubts over the ethics of balancing the interests of patients who could potentially benefit from the exploitation of ESCs against the rights of human embryos.[112]

The Enlarged Board, recognizing the prevalent public and governmental interest in the case, invited third parties to file amici curiae with the court.[113] The Enlarged Board received over 160 submissions from a wide variety of individuals, organizations, and special interest groups.[114] Notably, the United Kindom Intellectual Property Office ("UKIPO") filed an amicus brief in strong support of WARF's interpretation of the EPC provisions.[115] The United Kingdom heavily promotes hESC research and has arguably the most relaxed embryonic research regulations of any Western nation.[116] The United Kingdom adopted the language of the Directive into its national laws because it considered the Directive to restrict only the granting of patents for processing stem cells from human embryos or totipotent stem cells, but not from pluripotent hESCs.[117] Applying a balancing test, the UKIPO reasoned that the danger of commercial exploitation of pluripotent hESCs was outweighed by the "enormous potential of stem cell research, including embryonic stem cell research, to deliver new treatments for a wide range of serious diseases."[118] Consequently,

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111. Case T-1374/04, [2007] E.P.O. O.J. at 338.

112. *Id*. ("The Board has doubts whether, when it comes to human life, it would be ethically acceptable to make a decision by weighing the interests of human beings who could potentially benefit from the exploitation of the technology against a right, if any, of human embryos (whether or not they can already be qualified as human beings), to get to life and of not being destroyed for the benefit of others. The Board will not add more on this matter than just voicing its doubts on the position advocated by the appellant.").

113. Communication from the Enlarged Board of Appeal Concerning Case G 2/06, [2006] E.P.O. O.J. 393.

114. *See* Amici Curiae in EP0770125, http://www.epoline.org/portal/public/registerplus (search "Publication No." for "EP0770125"; then follow "All Documents" hyperlink) (last visited Mar. 4, 2009).

115. UKIPO, Patentability of Human Embryonic Stem Cells: WARF's European Patent Application, http://www.ipo.gov.uk/p-policy-biotech-stemcell.htm (last visisted Mar. 4, 2009).

116. *See* CEC REPORT, *supra* note 32, at 11.

117. UKIPO, PRACTICE NOTICE ON INVENTIONS INVOLVING HUMAN EMBRYONIC STEM CELLS (Apr. 2003), *available at* http://www.ipo.gov.uk/p-pn-stemcells.htm [hereinafter 2003 PRACTICE NOTICE] ("[T]he Office is ready to grant patents for inventions involving such [human embryonic pluripotent stem] cells provided they satisfy the normal requirements for patentability."). However, the 2003 Practice Notice was superseded in 2009 after the Enlarged Board's decision on the patentability of hESC lines. UKIPO, PRACTICE NOTICE ON INVENTIONS INVOLVING HUMAN EMBRYONIC STEM CELLS (Feb. 3, 2009), *available at* http://www.ipo.gov.uk/pro-types/pro-patent/p-law/p-pn/p-pn-stemcells-20090203.htm.

118. 2003 PRACTICE NOTICE, *supra* note 117.

the UKIPO's amicus brief stressed that the Examining Division's restrictive interpretations of Rule 28(c) and Article 53(a) were contrary to the United Kingdom's goals of encouraging investment in stem cell research.[119]

As a matter of universal patent law, an invention is only as broad as its patented claims.[120] According to the UKIPO, Article 53(a) is only concerned with whether exploitation of the claimed invention would be contrary to morality, "not with whether other acts, preparatory, ancillary or subsequent thereto may be morally objectionable."[121] The main invention claimed in WARF's European patent application was stem cell lines originally derived from primate (including human) ESCs.[122] Therefore, the United Kingdom concluded, WARF's invention involved only a product of a primate embryo, not the primate blastocystic inner cell mass itself.[123]

The UKIPO further contended that, "in order for exploitation of an invention to be contrary to morality within the meaning of Art. 53(a), it must offend against common European standards of morality."[124] The specific exceptions to patentability set forth in Rule 28(c) were derived from the Directive, and there was a "limited consensus" among European States that exploitation by destruction of human embryos for industrial or commercial purposes was contrary to morality.[125] Exceptions to patenta-

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119. Amicus Curiae Submission of the United Kingdom (Oct. 26, 2006), at 8–9 (on file with the EPO), *available at* http://www.ipo.gov.uk/warf.pdf. *See also* James Randerson, *Warning for UK Stem Cell Research If US Relaxes Rules*, GUARDIAN, Sep. 28, 2007, at 6.

120. *See, e.g.*, EPC 2000, *supra* note 20, art. 84 ("The claims shall define the matter for which protection is sought."); Markman v. Westview Instruments, Inc., 517 U.S. 370, 373 (1996) ("The claim defines the scope of a patent grant.") (internal quotations omitted).

121. Amicus Curiae Submission of the United Kingdom, *supra* note 119, at 2.

122. *Id*. at 12.

123. *Id*. at 3 ("There are certain matters which are regarded across the EPC area as being immoral, for example the use of anti-personnel mines. Patents for anti-personnel mines would rightly be rejected under Art. 53(a). But there are other matters on which differing strands of respectable opinion exist within the EPC area. In some cases the divergence of opinion will exist within each Contracting State. In other cases the opinions will differ between Contracting States, so that in one Contracting State something is generally regarded as immoral, whereas in other Contracting States it is generally regarded as being acceptable. . . . It is submitted that if exploitation of an invention would be regarded as moral in (at least) a major Contracting State, then a patent should not be refused under Art. 53(a).").

124. *Id*. at 10–11.

125. *Id*. at 6, 14 ("It cannot be said that it would generally be regarded as immoral to use the claimed stem cells. The only circumstance in which an issue arises is if the applicant (or his licensee) wishes to prepare further stem cell cultures with additional proper-

bility must be construed narrowly; the consensus cannot be extended beyond what was actually agreed upon by the European Community.[126]

Still further, the UKIPO argued that the purpose of WARF's use of human embryos was neither industrial nor commercial, but solely to "carry[] out precursor research activities."[127] Therefore, the UKIPO concluded, the WARF patent application did not meet the specific, narrow exception to patentability of Rule 28(c), nor would use of WARF's claimed invention be contrary to the general consensus of morality.[128]

B. The Enlarged Board's Decision

WARF's arguments on appeal were similar to those in the UKIPO's amicus brief.[129] At the June 24, 2008, oral proceedings before the Enlarged Board, WARF prefaced its arguments with the following comments:

> In 1998[,] the named inventor using the methods suggested in the application was the first to successfully isolate and culture human embryonic stem cells that can grow *in vitro*. The provision of these is a major scientific breakthrough and pioneering invention opening up a new and very exciting field of research having great potential for promising medical therapies and other applications, and worthy of patent protection.[130]

The basis of WARF's main argument was that under Article 27(2) of TRIPs and Article 53(a) of the EPC, the EPO can only exclude an invention from patentability if the "claimed monopoly . . . embraces the use of an embryo for an industrial or commercial purpose."[131] The claimed mo-

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ties to those of the one already prepared. This would require research using another spare embryo—an activity which also cannot be said to be generally regarded as immoral.").

126. Thus, the UKIPO concluded:

> (1) Article 53(a) does not prevent the patenting of claims to human embryonic stem cells where the claimed stem cells can be made by the skilled person without the use or destruction of human embryos. (2) Article 53(a) does not prevent the patenting of claims to human embryonic stem cells where the applicant or his licensee can make the claimed stem cells without the use of human embryos for industrial or commercial purposes.

Id. at 14.

127. *Id*.

128. *Id*.

129. Reply to May 11, 2006 Communication from the Enlarged Board, T.J. Duckworth on behalf of WARF (Oct. 31, 2006) (on file with the EPO).

130. Case G-2/06, unpublished op. at 4 (Enlarged Bd. App. Nov. 25, 2008), *available at* http://legal.european-patent-office.org/dg3/pdf/g060002ex1.pdf.

131. *Id*. at 6.

nopoly of WARF's application, WARF asserted, was not to the "use of an embryo" and not "for an industrial or commercial purpose"; rather, the monopoly was to the use of an ESC, which "at most . . . is a product [that] ultimately was derived from an embryo."[132] WARF noted that there was neither treaty nor common tradition among the European Member States banning human embryos under fourteen-days-old[133] from being used in hESC research.[134] WARF reasoned that the Directive's specific prohibition on the patenting of uses of embryos should not be interpreted broadly to prohibit uses of anything outside of the definitional embryo, because otherwise the Directive would have explicitly provided as such.[135] Furthermore, the purpose of the morality exception to patentability was to prevent industrial or commercial exploitation of human embryos. The preparatory extraction of cells from the blastocyst for the purpose of starting an hESC line in no way constituted an industrial or commercial act.[136]

The Enlarged Board disagreed, however.[137] The Enlarged Board stated that the purpose of enacting Rule 28 was to align the EPC with Article 6(2) of the Directive.[138] Therefore, the Directive constituted a "supplementary means of interpretation" of Rule 28.[139] Looking at the history of Article 6(2) of the Directive, the Enlarged Board noted that the European Council's first drafts of the Directive in 1996 did not contain specific prohibitions on patenting uses of human embryos.[140] In 1997, it was first proposed that Article 6(2) should place limits on the patentability of human embryos by specifically excluding "methods in which human embryos are used."[141] The European Council amended Article 6(2) in February 1998, to exclude "uses of human embryos for industrial or commercial purposes"; this was the text officially adopted by the EU in the final version of the Directive in July 1998.[142]

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132. *Id*.
133. According to WARF, in the medical field, an embryo is by definition an "embryo" only once it is fourteen-days-old. *Id*. at 22.
134. *Id*. at 6.
135. *Id*. at 6–7.
136. *Id*.
137. The Enlarged Board answered "yes" to Question 1, meaning Rule 28 applied retroactively. *Id*. at 17.
138. *Id*. at 20.
139. *Id*.
140. *Id*. at 21.
141. *Id*.
142. The Enlarged Board also rejected WARF's argument that the European Community funds hESC research because the European Community actually used a selective funding regime under which (i) the European Community chose not to seek funding for

The Enlarged Board then moved on to address WARF's specific argument. First, the Enlarged Board rejected WARF's definition of "embryo" as an embryo at least fourteen-days-old.[143] The Enlarged Board noted that German law defined "embryo" as including a fertilized egg;[144] and the U.K. HFEA defined "embryo" to encompass "an egg in the process of fertilisation," after "the appearance of a two cell zygote."[145] In light of the purpose of Article 6(2) of the Directive and Rule 28 of the EPC "to protect human dignity and prevent the commercialization of embryos," the Enlarged Board inferred that the legislatures left the term "embryo" undefined in the Directive and EPC in order to adopt the nonrestrictive meanings used in national laws.[146]

The Enlarged Board further rejected WARF's argument that Rule 28(c) was only triggered if the application specifically claimed "the use of human embryos."[147] The Enlarged Board reasoned that Rule 28's exclusion of an "invention," rather than a "claim," required it to look at "the technical teaching of the application as a whole" to determine if human embryos were used.[148] Because at the time of the filing, the only known method of acquiring hESCs required the destruction of a human embryo, WARF's invention fell within Rule 28(c)'s meaning of "use of human embryos."[149]

Furthermore, the Enlarged Board found that WARF's use of human embryos was for "industrial or commercial purposes."[150] The Enlarged Board reasoned that the steps involved in making an industrial or commercial product (such as WARF's ESC lines) are themselves industrial or commercial exploitations of the product.[151] Thus, the required preliminary destruction of the human embryo was "an integral and essential

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"research activities [that] destroy human embryos, including for the procurement of stem cells"; and (ii) "the exclusion of funding for this step of research will not prevent the Community funding of subsequent steps involving human embryonic stem cells." *Id*. at 22.

143. *Id*. at 22–23.

144. Gesetz zum Schutz von Embryonen [Embryo Protection Act], Dec. 13, 1990, BGBl. I at 2746, § 8, *available at* http://www.bmj.bund.de/files/-/1147/ESchG%20englisch.pdf.

145. HFEA, 1990, c. 37, § 1(1).

146. Case G-2/06, unpublished op. at 23 (Enlarged Bd. App. Nov. 25, 2008), *available at* http://legal.european-patent-office.org/dg3/pdf/g060002ex1.pdf.

147. *Id*.

148. *Id*. at 23–24.

149. *Id*. at 24 ("To restrict the application of Rule 28(c) . . . to what an applicant chooses explicitly to put in his claim would have the undesirable consequence of making avoidance of the patenting prohibition merely a matter of clever and skilful drafting of such claim.").

150. *Id*. at 24–26.

151. *Id*.

part of the industrial or commercial exploitation of the claimed invention."[152] The Enlarged Board further rejected WARF's assertion that the Directive's legislative history (i.e., the change of "methods in which human embryos are used" to "uses of human embryos for industrial or commercial purposes") indicated a narrowing of the scope of Rule 28(c).[153] Instead, the Enlarged Board inferred a legislative intent to differentiate between commercially exploitative uses of human embryos (excluded from patentability) and "therapeutic or diagnostic purposes applied to the human embryo and useful to it" (patentable).[154]

Finally, the Enlarged Board rejected any notion that its interpretation of Rule 28(c) rendered Rule 28(c) *ultra vires* to Article 53(a) of the EPC and Article 27(2) of TRIPs.[155] WARF argued that the Enlarged Board's broad construction went beyond the scope of these two Articles, which only permit excluding from patentability inventions that themselves are "against ordre public or morality."[156] However, the Enlarged Board emphasized,

> [i]n this context, . . . it is not the fact of the patenting itself that is considered to be against ordre public or morality, but it is the performing of the invention, which includes a step (the use involving its destruction of a human embryo) that has to be considered to contravene those concepts.[157]

The European patent community understood the Enlarged Board's decision to mean that claims directed to processes of obtaining stem cells from human embryos could not receive patent protection through the EPO, but supposedly could still receive protection directly through the national patent offices of the Member States whose laws did not exclude such inventions from patentability.[158] On a grander scale, some experts believe that the Enlarged Board's decision will bolster the stem cell re-

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152. *Id*. at 25.

153. *Id*. at 25–26.

154. *Id*.

155. *Id*. at 26–28.

156. *Id*. at 26 (emphasis omitted).

157. *Id*. (italics omitted). Having already answered Question 2 in the affirmative, the Enlarged Board declined to address Question 3 because Rule 28 (the specific exclusion) fell within the scope of Article 53(a) (the general exclusion). *Id*. at 28. *See also id*. at 29 ("Thus question 4 must be answered to the effect that it is not of relevance that after the filing date the same products could be obtained without having to recur to a method necessarily involving the destruction of human embryos.").

158. James Randerson, *Europe Rejects Patent Governing Use of Embryonic Stem Cells*, GUARDIAN, Nov. 27, 2008, *available at* http://www.guardian.co.uk/science/2008/nov/27/embryonic-stem-cells-patent.

search market in Europe, because European biotech companies will be able to conduct hESC research without having to pay costly patent licensing fees.[159]

IV. COMPARING THE U.S. AND EUROPEAN PATENT SYSTEMS: RAMIFICATIONS

The moral boundaries of hESC research are difficult to draw. Still, most countries allow hESC research within their borders in at least some limited capacity.[160] However, the morality of patenting inventions based on derivatives of human embryos is a separate issue. The difference in treatment of Dr. Thomson's invention by the USPTO and the EPO underscores a divergence in policies between two of the world's principal patent systems.

In the WARF stem cell case, the Enlarged Board adopted the legislature's determination under Rule 28(c) that industrial or commercial exploitation of WARF's invention would be "contrary to morality."[161] By specifically addressing only Question 2, and not Question 3, the Enlarged Board did not take the opportunity to perform a cost-benefit analysis to ascertain the net morality of WARF's invention.[162] After all, hESCs were not specifically contemplated when the European Council drafted Article 6(2) of the Directive.[163] Had the EPO never adopted Rule 28(c) (i.e., never specifically excluded "uses of human embryos for industrial or commercial purposes"), it is not clear that WARF's invention would have been excluded from patentability as "contrary to morality" under Article 53(a) alone. The EPO's Technical Board of Appeal has performed such a case-by-case morality analysis and allowed the application to undergo patent examination after finding that the harm the invention caused to animals was outweighed by the potential benefits to human health (as discussed below in the Oncomouse case[164]). A factual "morality" analysis in the WARF stem cell case would have been far more difficult than a straightforward legal determination of the scope of Rule 28(c), especially because the morality and efficacy of hESC research is still hotly debated across Europe.[165]

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159. *Id*.

160. *See* William Hoffman, Stem Cell Policy: World Stem Cell Map, http://www.mbbnet.umn.edu/scmap.html (last visited Mar. 4, 2009).

161. Case G-2/06, at 27–28.

162. *Id*. at 28.

163. Case T-1374/04, [2007] E.P.O. O.J. 313, 337 (Technical Bd. App. 2006).

164. Case T-19/90, [1990] E.P.O. O.J. 476 (Technical Bd. App. 1990).

165. For examples of conflicting European views on the morality, therapeutic potential, and legal position of hESCs, see Amici Curiae in EP0770125, *supra* note 114.

Similarly, the United States has not reached a consensus on the morality of hESC research. Yet the USPTO would not even consider addressing this morality issue.[166] To better understand this discrepancy, an overview of U.S. stem cell law and policy is necessary.

In 1996, the U.S. Congress passed legislation (known as the "Dickey Amendment"), which prohibited the National Institutes of Health ("NIH") from funding research (1) involving the creation of human embryos for research purposes; or (2) in which human embryos are destroyed.[167] Congress has renewed the provisions of the Dickey Amendment every year since.[168]

On August 9, 2001, then-President George W. Bush announced that federal funds would be available only for ESC research utilizing one of the seventy-eight ESC lines then in existence.[169] The Bush administration had concluded that the value of human life—even embryonic human life—outweighed the benefits of speeding up hESC research by deriving new stem cell lines from new embryos.[170]

The U.S. Congress reached a different conclusion than the executive branch, twice passing legislation (entitled Stem Cell Research Enhancement Act of 2005 and 2007, respectively) that would have eased ESC research funding restrictions by permitting federal funds to be allocated for the creation of new ESC lines derived from excess embryos that were created for the purpose of fertility treatments and that would otherwise be discarded.[171] However, President Bush vetoed both bills, and issued a June 20, 2007 Executive Order that further enforced his August 9, 2007 Presidential Statement.[172]

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166. *See generally* Margo A. Bagley, *Patent First, Ask Questions Later: Morality and Biotechnology in Patent Law*, 45 WM. & MARY L. REV. 469 (2003).

167. Balanced Budget Downpayment Act, Pub. L. No. 104-99, 110 Stat. 34 (1996). *See* WHITE PAPER, *supra* note 46, at 1.

168. *E.g.*, Consolidated Appropriations Act, Pub. L. No. 110-161, 121 Stat. 2209 (2008); Consolidated Appropriations Act, Pub. L. No. 106-554, 114 Stat. 2763A-71 (2001); Omnibus Consolidated and Emergency Supplemental Appropriations Act, Pub. L. No. 106-554, 112 Stat. 2681-386 (1999). *See* Sheryl Gay Stolberg, *New Stem Cell Policy to Leave Thorniest Issue to Congress*, N.Y. TIMES, Mar. 9, 2009, at A1.

169. As it turned out, only about twenty of these stem cell lines were viable for research purposes. *See* Leshner & Thomson, *supra* note 53. For a concise, yet broad, overview of patenting and regulatory issues facing stem cell research in the United States, see Raymond R. Mandra & Alicia A. Russo, *Stem Cells and Patenting and Related Regulatory Issues: A United States Perspective*, 7 BIO-SCI. L. REV. 143, 146 (2005).

170. *See* Editorial Desk, *Downside of the Stem Cell Policy*, N.Y. TIMES, Aug. 31, 2001, at A18.

171. *See* Zeleny, *supra* note 13.

172. Exec. Order No. 13,435, 72 Fed. Reg. 34,589 (June 22, 2007), *available at* http://edocket.access.gpo.gov/2007/pdf/07-3112.pdf. *See* Sheryl Gay Stolberg, *First Bush*

While ESC research struggled politically to gain federal support during the Bush-era, some states passed laws promoting ESC research.[173] Additionally, President Bush's limits on federal funding did not prevent the biotech sector from using private, nonfederal funds to conduct hESC research.[174] Still, the 2001 federal funding ban slowed the pace of hESC research.

But the future for federally funded hESC research suddenly looked brighter during the 2008 presidential campaign. Both then-Senator Barack Obama and Senator John McCain had voted in favor of the Stem Cell Research Enhancement Act of 2007.[175] Senator McCain's stance with respect to hESC research was quite liberal compared to that of the Republican Party which, in August 2008, adopted a party platform of a "ban on the creation of or experimentation on human embryos for research purposes" and "ban on all embryonic stem-cell research, public or private."[176] Then-Senator Obama had vowed, once elected, to reverse about 200 of President Bush's executive orders and policies, including the limits on federally funded hESC research.[177]

On March 9, 2009, newly elected President Obama followed through on his promise and set aside the Bush-era funding restrictions. President Obama's Executive Order explicitly revoked President Bush's August 9, 2001 Presidential Statement and June 20, 2007 Executive Order.[178] The

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Veto Maintains Limits on Stem Cell Use, N.Y. TIMES, July 20, 2006, at A1; Stolberg, *supra* note 41.

173. *See* Mandra & Russo, *supra* note 169, at 149. *See also* Andrew Pollack, *California Stem Cell Research Is Upheld by Appeals Court*, N.Y. TIMES, Feb. 27, 2007, at A11. *But see* Monica Davey, *For Missouri, Stem Cell Act Changes Little*, N.Y. TIMES, Aug. 10, 2007, at A12.

174. *See* Mandra & Russo, *supra* note 169, at 147.

175. U.S. Senate Roll Call Votes, 110th Congress, 1st Session, http://www.senate.gov/legislative/LIS/roll_call_lists/roll_call_vote_cfm.cfm?congress=110&session=1&vote=00127 (last visited May 16, 2009).

176. Larry Rohter, *Back and Forth on Stem-Cell Research Energizes Race*, N.Y. TIMES, Sep. 10, 2008, at A22; Republican National Committee, 2008 Republican Platform, http://www.gop.com/2008Platform/HealthCare.htm (last visited Mar. 4, 2009).

177. Ceci Connolly & R. Jeffrey Smith, *Obama Positioned to Quickly Reverse Bush Actions: Stem Cell, Climate Rules Among Targets of President-Elect's Team*, WASH. POST, Nov. 9, 2008, at A16.

178. Exec. Order No. 13,505, 74 Fed. Reg. 10,665 (Mar. 11, 2009), *available at* http://edocket.access.gpo.gov/2009/pdf/E9-5441.pdf. Many believed President Obama would lift the federal funding ban in his first week in office, stem cell scientists were left waiting for several weeks for President Obama to follow through on his promise. *See* Gardiner Harris & William J. Broad, *Scientists Welcome Administration's Words but Must Wait for Action*, N.Y. TIMES, Jan. 22, 2009, at A23; Carle Hulse, *Democrats Weigh Methods For Ending Stem Cell Ban*, N.Y. TIMES, Jan. 3, 2009, at A11; Jacqueline L. Salmon & Michelle Boorstein, *Progressive Faith Groups Now Trying to Shift Debate: Activists Opti-*

Executive Order specifically permitted the NIH to fund "responsible, scientifically worthy human stem cell research, including human embryonic stem cell research"; and it directed the Secretary of Health and Human Services to draft within 120 days new NIH guidelines and safeguards consistent with the decree.[179] Still, the President did not seek to annul the Dickey Amendment; the Executive Order left up to the U.S. Congress the question of whether the federal government should fund experiments on embryos themselves.[180]

Despite Europe's adoption of Rule 28, the moral debate surrounding hESC research is far from settled.[181] The eastern, more conservative European States generally oppose hESC research funding, while the western half of Europe largely favors it.[182] At one extreme, Germany prohibits the procurement of hESCs, but allows importation of hESC lines for research purposes.[183] At the opposite end of the regulatory spectrum, the United Kingdom permits the procurement of hESCs even from human embryos created solely for research purposes.[184] Nearly half of the EU Member States have passed legislation allowing the procurement of hESCs from supernumerary embryos, "leftover" embryos that would otherwise be discarded after fertilization treatments.[185] Still other Euro-

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mistic That Obama Will Back Causes, WASH. POST, Jan. 31, 2009, at A4; Rob Stein, *Scientists Await Action on Stem Cells: Some Proponents Had Expected Obama to Immediately Reverse Bush Policies*, WASH. POST, Feb. 19, 2009, at A2.

179. Exec. Order No. 13,505, 74 Fed. Reg. 10,665.

180. *Id*. *See* Stolberg, *supra* note 167.

181. *See* Samantha Halliday, *A Comparative Approach to the Regulation of Human Embryonic Stem Cell Research in Europe*, 12 MED. L. REV. 40 (2004) (comparing the various hESC research regulatory schemes of Europe).

182. *See* Nicholas Watt, *US Faces Science Brain Drain After Europe Backs Stem Cell Funding*, GUARDIAN, July 25, 2006, at 17 ("But deep European divisions were exposed at yesterday's ministerial meeting in Brussels. Poland, Austria, Malta, Slovakia and Lithuania voted against stem cell research. They were opposed yesterday by France, Britain, the Netherlands, Spain and Portugal, showing that the divisions were not simply between Catholic and non-Catholic countries.").

183. *See* Halliday, *supra* note 181, at 43.

184. *Id*.

185. European Consortium for Stem Cell Research, Regulations in EU Member States Regarding hES Cell Research (Feb. 2007), http://archive.eurostemcell.org/Documents/Outreach/stemcell_hesc_regulations_2007FEB.pdf [hereinafter EuroStemCell]. *See also* Int'l Consortium of Stem Cell Networks, Global Regulation of Human Embryonic Stem Cell Research and Oocyte Donation, http://icscn.files.wordpress.com/2008/09/global-regulation-hesc-research-oocyte-donation-sep-08.pdf [hereinafter ICSCN]. In order to compete effectively with States like the United Kingdom, in 2004 Swiss voters overwhelming approved a law allowing experimentation on stem cells derived from human embryos. *See* Luke Harding, *Swiss Voters Back Stem Cell Research*, GUARDIAN, Nov. 29, 2004, at 3.

pean States have not regulated ESCs at all.[186] The European scientific community is similarly divided.[187]

Yet even with the back-and-forth political debate in the United States, the USPTO has never rejected an ESC patent on the ground of it being immoral. An invention is patentable in the United States if it meets the requirements of utility, novelty, and nonobviousness, and is adequately described in the patent specification.[188] While permitted by TRIPs to impose a morality exception to patentability, the United States does not have a statute on the books that excludes "immoral" inventions from patentability. In fact, the USPTO may not make moral judgments about an invention disclosed in a patent application.[189] As the U.S. Supreme Court has stated, "Congress never intended that the patent laws should displace the police powers of the States, meaning by that term those powers by which the health, good order, peace, and general welfare of the community are promoted."[190]

In truth, the early view in the United States was that patent law's utility requirement[191] contained a morality element.[192] In the 1817 circuit court case of *Lowell v. Lewis*, Justice Story established what came to be known as the "moral utility" doctrine,[193] under which inventions "frivolous or injurious to the well-being, good policy, or sound morals of society" were unpatentable.[194] Courts applied the moral utility doctrine for over a

186. EuroStemCell, *supra* note 185.

187. *Survey of European Scientists on Ethics of Scientific Advancements*, *supra* note 63.

188. 35 U.S.C. §§ 101–03, 112 (2007).

189. *See* Juicy Whip, Inc. v. Orange Bang, Inc., 185 F.3d 1364, 1368 (Fed. Cir. 1999).

190. Webber v. Virginia, 103 U.S. 344, 347–48 (1880).

191. The utility requirement is found in 35 U.S.C. § 101 (2009) ("Whoever invents or discovers any new and *useful* process, machine, manufacture, or composition of matter, or any new and *useful* improvement thereof, may obtain a patent therefor, subject to the conditions and requirements of this title.") (emphasis added). *See also* Diamond v. Chakrabarty, 447 U.S. 303, 308 (1980) ("The Patent Act of 1793, authored by Thomas Jefferson, defined statutory subject matter as 'any new and useful art, machine, manufacture, or composition of matter, or any new or useful improvement [thereof].'").

192. *See* 1 DONALD S. CHISUM, CHISUM ON PATENTS § 4.03 (2007).

193. *See* Bagley, *supra* note 166, at 476.

194. Lowell v. Lewis, 15 F. Cas. 1018 (C.C.D. Mass 1817) ("The word 'useful,' therefore, is incorporated into the act in contradistinction to mischievous or immoral. For instance, a new invention to poison people, or to promote debauchery, or to facilitate private assassination, is not a patentable invention. But if the invention steers wide of these objections, whether it be more or less useful is a circumstance very material to the interests of the patentee, but of no importance to the public.").

hundred years, particularly to invalidate patents on gambling devices.[195] The moral utility doctrine prevented inventions that facilitated consumer fraud or deception from receiving patent protection.[196]

In 1980, the U.S. Supreme Court held in *Diamond v. Chakrabarty* that a genetically modified bacterium constituted patentable subject matter under Section 101, based on the legislative intent that patentable subject matter include "anything under the sun that is made by man."[197] While *Chakrabarty* is famous for paving the path for future biotech patents, by declaring the breadth of patentable subject matter, it essentially marked the death knell for the moral utility doctrine.[198] In April 1987, the USPTO, relying on the Supreme Court's holding in *Chakrabarty*, announced that it considered "nonnaturally occurring, non-human multicellular living organisms, including animals, to be patentable subject matter."[199] About a year later, the USPTO issued to Harvard the first U.S. patent for a genetically modified animal: a transgenic mouse genetically engineered to carry an activated gene (specifically, an oncogene) that greatly increased the mouse's susceptibility to cancer, making the mouse a prime specimen for cancer research and the development of cancer treatments ("Oncomouse").[200]

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195. *E.g.,* Brewer v. Lichtenstein, 278 F. 512 (7th Cir. 1922); Meyer v. Buckley Mfg. Co., 15 F. Supp. 640 (N.D. Ill. 1936); Nat'l Automatic Device Co. v. Lloyd, 40 F. 89 (N.D. Ill. 1889); Schultze v. Holtz, 82 F. 448 (N.D. Cal 1897). *But see* Chicago Patent Corp. v. Genco, Inc., 124 F.2d 725, 727–28 (7th Cir. 1941) (finding that a pinball machine is not inherently a gambling device).

196. Rickard v. Du Bon, 103 F. 868, 873 (2d Cir. 1900) (When determining that the claimed process for producing counterfeit tobacco leaves lacked utility, the court found that "[i]n authorizing patents to the authors of new and useful discoveries and inventions, congress did not intend to extend protection to those which confer no other benefit upon the public than the opportunity of profiting by deception and fraud. To warrant a patent, the invention must be useful; that is, capable of some beneficial use as distinguished from a pernicious use."). *See also* Scott & Williams, Inc. v. Aristo Hosiery Co., 7 F.2d 1003 (2d Cir. 1925) (concluding that a patent in seamless stocking designed to trick consumers into thinking it was of higher quality was invalid for lack of utility).

197. Diamond v. Chakrabarty, 447 U.S. 303, 309 (1980).

198. *See* Bagley, *supra* note 166, at 476–77, 495 ("For many years a judicially created 'moral utility' doctrine served as a type of gatekeeper of patent-eligible subject matter. . . The gate, however, is currently untended, as a result of judicial decisions . . . [b]eginning in 1980 with [*Diamond v. Chakrabarty*], ... [which] flung open the doors of the USPTO to biotech subject matter.").

199. Commissioner of Patents and Trademarks, *Animals—Patentability*, 1077 OFFICIAL GAZ. PAT. OFF. 24 (Apr. 21, 1987).

200. U.S. Patent No. 4,736,866 (issued Apr. 12, 1988). Claim 1 provides: "A transgenic non-human mammal all of whose germ cells and somatic cells contain a recombinant activated oncogene sequence introduced into said mammal, or an ancestor of said mammal, at an embryonic stage." *Id*.

In 1999, the Federal Circuit declared in *Juicy Whip, Inc. v. Orange Bang, Inc.*, that although "years ago courts invalidated patents on gambling devices on the ground that they were immoral[;] . . . that is no longer the law."[201] The court continued:

> Of course, Congress is free to declare particular types of inventions unpatentable for a variety of reasons, including deceptiveness. Until such time as Congress does so, however, we find no basis in section 101 to hold that inventions can be ruled unpatentable for lack of utility simply because they have the capacity to fool some members of the public.[202]

The *Juicy Whip* court also noted that the utility requirement was not a directive to the USPTO or the courts "to serve as arbiters of deceptive trade practices" and that there are other federal agencies, such as the Food and Drug Administration and Federal Trade Commission, that are responsible for protecting consumers from fraud and deception.[203]

Over the last few decades, the U.S. legal system has limited the USPTO's power of discretion to its area of expertise: patentability requirements. This policy shift has taken the morality "ax" out of the hands of the USPTO and the courts, a shift that is in line with the fundamental purposes of U.S. patent law "to encourage inventions, their disclosure, and their commercialization."[204] Innovation in technology should be driven by investment in scientists and engineers instead of an arbitrary or unpredictable moral compass. "A patent is a creature of statute,"[205] so only Congress should have the power to declare certain inventions unpatentable.

Patent law is supposed to strike a balanced bargain between the inventor and the public. The public encourages industry to invest in technological research and development with the promise of a set number of years of exclusive rights over commercial exploitation of the claimed invention. In return, the public benefits from the use of the new technology. The new knowledge the patent brings about enables further investment in technology, which is again fueled by the incentives of the patent system.

The purpose of European patent law is the same as that of U.S. patent law: "to promote technical innovation and the dissemination of its

201. Juicy Whip, Inc. v. Orange Bang, Inc., 185 F.3d 1364, 1367 (Fed. Cir. 1999).

202. *Id*. at 1368 (citation omitted).

203. *Id*. *See also* Whistler Corp. v. Autotronics, Inc., 14 U.S.P.Q.2D 1885 (N.D. Tex. 1988) (upholding radar detector patent); Murphy, 200 U.S.P.Q. 801 (Pat. & Trademark Off. Bd. App. 1977) (upholding slot machine patent).

204. In re Sarkar, 588 F.2d 1330, 1332 (C.C.P.A. 1978).

205. Arachnid, Inc. v. Merit Indus., Inc., 939 F.2d 1574, 1578 (Fed. Cir. 1991).

fruits."[206] Theoretically, inventions whose monopolized exploitation would promote that purpose should qualify for patent protection in both the United States and Europe. Yet the hESC controversy is not the first time that the EPO has deviated from the USPTO on the basis on morality. The USPTO granted Harvard a U.S. patent in 1988 for its Oncomouse invention.[207] But the Oncomouse European application, filed in June 1985, faced troubles similar to those of WARF's European patent application.[208] On July 14, 1989, the Examining Division initially refused the application on the ground that the invention violated Article 53(b) of the EPC,[209] which excludes from patentability "plant or animal varieties or essentially biological processes for the production of plants or animals."[210] While the United States had already affirmed the patentability of transgenic species in *Chakrabarty*,[211] the EPO had never addressed the issue of whether Article 53(b) prohibits patents in transgenic animals.[212] On appeal, the Technical Board concluded that Article 53(b) excluded animal varieties, but not animals in general.[213] On remand, the Examining Division granted the patent after concluding that Oncomouse did not constitute an animal variety,[214] nor did Oncomouse violate the morality provision of Article 53(a).[215] In reaching its conclusion on the morality issue, the Examining Division found that the potential benefit to humanity (i.e., cancer prevention) outweighed the detriment to animals.[216] Al-

206. *See* EGE OPINION, *supra* note 14, at 6 ("The inventor gets exclusive rights to control commercial exploitation of his invention for some years and in return, he discloses detailed description of his invention, making the new knowledge available to all. This disclosure enables others[, e.g.,] researchers[,] . . . to build on the achieved knowledge.") (internal punctuation omitted).

207. U.S. Patent No. 4,736,866 (issued Apr. 12, 1988).

208. Press Release, EPO, "Oncomouse" Opposition Proceedings Resume at EPO (Nov. 5, 2001), http://www.epo.org/about-us/press/releases/archive/2001/05112001.html [hereinafter 2001 EPO Press Release].

209. EPC 1973, *supra* note 20, art. 53(b).

210. *See* 2001 EPO Press Release, *supra* note 208.

211. Diamond v. Chakrabarty, 447 U.S. 303 (1980).

212. *See* 2001 EPO Press Release, *supra* note 208.

213. Case T-19/90, [1990] E.P.O. O.J. 476 (Technical Bd. App. 1990).

214. Grant of European Patent No. 0 169 672 (Onco-mouse/Harvard), [1992] E.P.O. O.J. 588, 590 (Examining Div. 1992).

215. *Id.* at 593.

216. *Id.* ("In the overall balance the Examining Division concludes that the present invention cannot be considered immoral or contrary to public order. The provision of a type of test animal useful in cancer research and giving rise to a reduction in the amount of testing on animals together with a low risk connected with the handling of the animals by qualified staff can generally be regarded as beneficial to mankind. A patent should therefore not be denied for the present invention on the grounds of Article 53(a) EPC.").

though the EPO eventually granted the Oncomouse patent,[217] the case exemplifies the uncertain status of a patent system with an ambiguous morality exception to patentability.

The problem with excluding hESC inventions is that the benefits of stem cell research are hugely in the public interest.[218] Innovation in hESC, as evidenced by the global research effort, is a reward for which the public should be willing to pay handsomely. Rejecting an invention for being "against morality" unjustifiably shifts the balance of the patent system by eliminating the inventor's most valuable incentive, exclusive rights, while simultaneously expropriating for public use the new knowledge disclosed in the patent. This shift in balance upsets the equilibrium of the patent system and is an impediment to innovation.

Morality itself is a public interest factor. If a patent office is required to factor morality into the patentability equation, it should consider morality in light of all other public interest factors, especially human health benefits. Whereas morality is largely a subjective category, subject to substantial public deviation and change over time, human health benefits are objectively and universally in the public interest. While some may oppose the use of such a cost-benefit analysis because it involves putting a price on human life, these kinds of valuations are done all the time. Courts award damages in wrongful death suits. People purchase health and life insurance policies. Actuaries assess the costs and risks of death.

The scientific community has demonstrated a significant reason to pursue hESC technology. Despite the moral haziness presented by hESCs, most countries allow hESC research to some extent.[219] The scientific promise and potential health benefits of hESC research cannot be ignored. The world is craving a breakthrough in hESC technology. The patent system should not stand in the way.

CONCLUSION: SUGGESTED ALTERNATIVE PRACTICES

The Directive was originally adopted in order to establish "legal certainty" among the Member States in the area of biotechnological innovation.[220] Theoretically, this legal certainty was supposed to make Europe a better landscape for attracting investment in biotechnology.[221] But not all the Member States can agree on what constitutes an "immoral" invention.[222]

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217. European Patent No. EP 0169672 (published May 13, 1992).
218. *See* NIH, *supra* note 42.
219. ICSCN, *supra* note 185. *See generally* Hoffman, *supra* note 139.
220. *See* EGE OPINION, *supra* note 14, at 6.
221. *Id*.
222. *See, e.g.*, Amicus Curiae Submission of the United Kingdom, *supra* note 119.

The EPO has a few alternatives to its current practice of blackballing "immoral" inventions. As a first alternative, the EPO could still resolve whether an invention is contrary to morality, but—instead of refusing to examine the application—the EPO could "yellow-flag" it for having a "contrary-to-morality" status and continue with standard examination procedures. The EPO could then notify the national ethics committee of each Member State so that each could make a determination of patentability based solely on domestic norms. After each national ethics committee notified the EPO of its conclusion, the EPO could advise the applicant which States refused to grant patent protection. The applicant could then make an informed decision whether to proceed further with examination, while simultaneously avoiding the lengthy delays and heavy costs associated with appealing a decision of the Examining Division.

The EPO could supplement the yellow-flag system by requiring applicants of yellow-flagged applications to post a significant bond in order to keep the application in examination. If the applicant posted the bond and the application was green-lighted by a certain proportion of Member States, the EPO would return the bond to the applicant. If too many Member States found the invention to be "contrary to morality," the applicant would forfeit the bond. The bond system would avoid an influx of applications that disclose clearly "immoral" subject matter, or at least compensate the EPO for wasting its time on meritless cases.

Europe also has the option of granting a reduced patent term to inventions deemed to be morally reprehensible, instead of refusing to examine the application.[223] Although this alternative would not satisfy people who believe that granting property rights in "immoral" inventions is never permissible,[224] it would constitute a fair compromise on the difficult issue and still promote the purposes of patent law. The EPC could also establish statutory licensing fees for patents for immoral inventions; this would minimize the ethical costs of the commercial exploitation of the "immoral" invention by limiting the economic power of the patentee's exclusive rights.

Another alternative is to repeal Article 53(a), but preserve Rule 28. The adoption of Rule 28 has arguably rendered Article 53(a) obsolete. Rule 28 is a declaration of a consensus among the Member States of what specifically constitutes an invention unpatentable for being contrary

223. EPC 2000, *supra* note 20, art. 63(1) provides: "The term of the European patent shall be [twenty] years as from the date of filing of the application." *Id.*

224. *See, e.g.*, Ronald L. Conte Jr., *Against Embryonic Stem*, CATHOLIC PLANET, Dec. 2, 2004, http://www.catholicplanet.com/articles/article95.htm.

to ordre public or morality. The Enlarged Board in the WARF stem cell case found it unnecessary to address Article 53(a) after concluding WARF's invention was unpatentable under the specific exclusion of Rule 28(c).[225] The Enlarged Board found that the legislature had predetermined that the invention was contrary to morality.[226] This is essentially how the U.S. system works; any invention meeting all the Title 35 patentability requirements is patentable in the United States[227] unless it is specifically excluded by statute. For example, Congress explicitly used its powers to promote public health and welfare to exclude the patenting of nuclear weapons.[228]

A judicial finding of "contrary to morality" under Article 53(a) would require the EPO to make a much broader determination than under any of the specific, legislatively mandated exceptions to patentability under Rules 28 and 29(1).[229] If an invention does not explicitly fall within one of the unpatentable categories elucidated in Rules 28 or 29(1), an established European social norm that the invention's exploitation is immoral likely does not exist. Otherwise, the legislature would have explicitly guarded against such a patent. Instead of relying on Article 53(a) as a backstop to Rule 28, the legislature could build upon Rule 28 to include any other categories of invention whose exploitation is commonly deemed immoral across Europe. In order to prevent the patenting of breakthrough technology that falls outside of the explicitly prohibited categories but whose exploitation would be contrary to morality, the legislature would have to keep up with the latest advances in science and technology, especially those relating to human health.

It is surprising that Europe has decided to burden its patent office with understanding categories and degrees of morality, rather than leaving the EPO to exercise its expertise in determining novelty, industrial applicability, and inventive step.[230] Morality has no place as a tool in the hands of a patent office,[231] especially a regional patent office such as the EPO, which controls whether the various national patent offices of Europe even lay eyes on an application. While it might feel good to prohibit pa-

225. Case G-2/06, unpublished op. at 28 (Enlarged Bd. App. Nov. 25, 2008), *available at* http://legal.european-patent-office.org/dg3/pdf/g060002ex1.pdf.

226. *Id*.

227. 35 U.S.C. § 101–03, 112 (2009).

228. 42 U.S.C. § 2181 (2009).

229. EPC Regs., *supra* note 27, R. 29(1) provides: "The human body, at the various stages of its formation and development, and the simple discovery of one of its elements, including the sequence or partial sequence of a gene, cannot constitute patentable inventions." *Id*.

230. EPC 2000, *supra* note 20, art. 52(1).

231. *See* Juicy Whip, Inc. v. Orange Bang, Inc., 185 F.3d 1364, 1368 (Fed. Cir. 1999).

tents for inventions in morally dubious areas of science, in the end, morality restrictions on patentability only slow the pace of technology and frustrate the purposes and effectiveness of patent law.

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SOVEREIGN WEALTH FUNDS AND THE PROBLEM OF ASYMMETRIC INFORMATION: THE SANTIAGO PRINCIPLES AND INTERNATIONAL REGULATIONS

INTRODUCTION

In 2008 and 2009, Sovereign Wealth Funds ("SWF") appeared almost daily in financial news and had risen in significance in international capital markets and policy circles. Having grown in number and size, SWFs are now the second largest class of investors in the international capital market.[1] In general terms, SWFs are private equity funds run by governments to manage their excess foreign reserves. They are among a range of investment vehicles that governments can employ to manage excess revenues or foreign reserves.[2] One of the key differences between SWFs and other investment vehicles is that SWFs typically have higher risk preferences and return expectations.[3]

SWFs, however, are not a new phenomenon in the international capital market. One of the oldest SWFs dates back to 1953, when Kuwait established the Kuwait Investment Authority ("KIA"),[4] and, as Dr. Lyons[5]

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1. Ronald J. Gilson & Curtis J. Milhaupt, *Sovereign Wealth Funds and Corporate Governance: A Minimalist Response to the New Mercantilism*, 60 STAN. L. REV. 1345, 1356 (2008). SWFs lag only behind large institutional asset managers such as Fidelity and Barclays. François Bujon de l'Estang, Chairman, Citi France, presentation at Tables rondes finance islamique et fonds souverains des 14 et 15 mai 2008: Sovereign Wealth Funds: Growing Global Force 3 (May 15, 2008), *available at* http://www.senat.fr/commission/fin/actualites/fs_bujon.ppt.

2. Gilson & Milhaupt, *supra* note 1, at 1354 ("Sovereign wealth funds belong to a continuum of sovereign investment vehicles. At one end of the spectrum are central banks. At the other end are state-owned enterprises such as Russia's Gazprom or China's National Offshore Oil Corp. In between are sovereign stabilization funds, sovereign saving funds, and government investment corporations. Thus one way to define sovereign wealth funds is by exclusion: SWFs are sovereign investment vehicles that are not central banks, monetary authorities in charge of foreign reserves, or national pension funds, unless they are financed by commodities exports."); Edward F. Greene & Brian A. Yeager, *Sovereign Wealth Funds—A Measured Assessment*, 3 CAPITAL MARKETS L.J. 247, 249 (2008). *See also* Citigroup Global Markets Inc., Sovereign Wealth Funds: A Growing Global Force 11 (2008).

3. Robert M. Kimmitt, *Public Footprints in Private Markets: Sovereign Wealth Funds and the World Economy*, FOREIGN AFF., Jan/Feb 2008, at 119

4. Kimmitt, *supra* note 3, at 120. *See also* GERARD LYONS, STANDARD CHARTERED BANK, STATE CAPITALISM: THE RISE OF SOVEREIGN WEALTH FUNDS 5, 22 (2007); *Testimony Before the Comm. on Foreign Affairs, U.S. H.R.: The Rise of Sovereign Wealth Funds: Impacts on US Foreign Policy and Economic Interests*, at 8 (May 21, 2008) (tes-

noted, "Of the twenty two largest SWFs . . . seven were in existence before 1990, six started in the 90s and nine since the millennium."[6]

Despite the number of years SWFs have existed, their sheer number and size have recently raised a number of concerns.[7] Among these are that "SWFs are a threat to the sovereignty of the nations in whose corporation they invest" and that "the nations whose corporations are targets of investments are said to be threatened with becoming 'sharecropper' states if ownership of industry moves to foreign-government absentee holders."[8] The biggest concern, however, is that SWFs will make decisions for political or strategic reasons rather than economic and commercial ones.[9] In fact, the increasing number of SWFs and the ownership stakes they are taking have led to an outcry for regulatory control and for opposition to SWF investment in recipient countries.[10]

In this Note, I will discuss the various concerns surrounding SWFs, the need for international regulation, and possible solutions to some of the problems SWFs raise. The focus of this discussion is on the problem of asymmetric information. Asymmetric information occurs when one party has better information than the counterparty.[11] SWFs are not in the same position as typical private parties in business relationships, which might have superior information. First, unlike private parties, SWFs might have interests that are not economic or commercial in nature.[12] Second, SWFs

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timony of Edwin M. Truman, Senior Fellow, Peterson Inst.), *available at* http://www.petersoninstitute.org/publications/papers/truman0508.pdf [hereinafter *Truman Testimony*].

5. Dr. Gerard Lyons is Chief Economist and Group Head of Global Research at Standard Chartered. Lyons, Chief Economist and Group Head of Global Research, Standard Chartered, Speech at the Institute for International Bankers Annual Washington Conference: Two Hot Topics: Sovereign Wealth Funds and China 3 (Mar. 3, 2008), *available at* http://wholesalebanking.standardchartered.com/en/capabilities/financialmarkets/research/Documents/thoughtleadershpspeeches.pdf.

6. *Id.* at 5.

7. *Id.* at 3.

8. Gilson & Milhaupt, *supra* note 1, at 1345–46.

9. *Id.* at 1346.

10. *See* Katrin Bennhold, *Sovereign Wealth Funds Seek Balance Against Western Regulation*, INT'L HERALD TRIB., Jan. 24, 2008, http://www.iht.com/articles/2008/01/23/business/fund.php; *US Treasury Cautions China over Sovereign Wealth Fund*, CHANNEL NEWSASIA, Feb. 8, 2008, http://www.channelnewsasia.com/stories/afp_asiapacific_business/view/327561/1/.html; Cathy Mputhia, *Sovereign Funds Rub Governments the Wrong Way*, BUS. DAILY (Africa), Sept. 10, 2008, http://www.bdafrica.com/index.php?option=com_content&task=view&id=9923&Itemid=5848.

11. Press Release, The Royal Swedish Acad. of Sci., Advance Information for Award of the Bank of Sweden Prize in Economic Sciences in Memory of Alfred Nobel 1–2 (Oct. 10, 2001), http://nobelprize.org/nobel_prizes/economics/laureates/2001/ecoadv.pdf.

12. Lyons, *supra* note 5, at 5.

introduce state capitalism to the market.[13] The problem of asymmetric information is the source of the problems surrounding SWFs and that any regulation of SWFs must address this issue.

Part I will provide a background discussion on SWFs. Particularly, I will focus on their significance to the global capital market, the current global market's effect on SWFs, and how the United States currently regulates SWF investments. Part II discusses the need for regulations, while Part III addresses why SWFs must be regulated internationally. Part IV discusses the newly adopted Santiago Principles created by the International Monetary Fund ("IMF") to govern SWF conducts.

I. BACKGROUND ON SWFS

A. What Are SWFs?

As the Acting Under Secretary for International Affairs in the U.S. Treasury Department, Clay Lowery, noted in his remarks concerning SWFs, "There is no universal, agreed definition [of SWFs]."[14] However, because SWFs are only one of several ways a government can manage and invest in the global capital market,[15] "[d]ifferentiation between different types of sovereign-controlled entities is integral to identifying policy issues raised by their activities, and in crafting appropriate policies to address such issues."[16]

The definitions offered by the U.S. Treasury Department ("Treasury Department") and the IMF are helpful for discussion purposes. The Treasury Department defines an SWF as "a government investment vehicle which is funded by foreign exchange assets, and which manages those assets separately from official reserves."[17] The IMF adopted a similar definition: a "government-owned investment [fund], set up for a variety of macroeconomic purposes. They are commonly funded by the transfer of foreign exchange assets that are invested long term, overseas."[18]

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13. Gilson & Milhaupt, *supra* note 1, at 1346.

14. Clay Lowery, Acting Under Sec'y for Int'l Affairs, U.S. Treasury Dep't, Remarks on Sovereign Wealth Funds and the International Financial System (June 21, 2007), http://www.treas.gov/press/release/hp471.htm.

15. Kimmitt, *supra* note 3, at 120. *See also* Lyons, *supra* note 5, at 5.

16. Greene & Yeager, *supra* note 2, at 249. Even within the realm of SWFs, there are different ways to organize and structure an SWF. *See* INT'L WORKING GROUP OF SOVEREIGN WEALTH FUNDS, INT'L MONETARY FUND, SOVEREIGN WEALTH FUNDS: GENERALLY ACCEPTED PRINCIPLES AND PRACTICES "SANTIAGO PRINCIPLES" 11 (2008).

17. Lowery, *supra* note 14.

18. INT'L MONETARY FUND, MONETARY AND CAPITAL MARKETS AND POLICY DEVELOPMENT AND REVIEW DEPARTMENTS, SOVEREIGN WEALTH FUNDS—A WORK AGENDA 4 (Mark Allen & Jaime Caruana eds., 2008).

Dr. Lyons offers a slightly more specific and detailed definition. He limits it to four features: (i) the organization is owned by a sovereign nation state, but, as an exception, includes five subnational-level funds "that are financed by foreign exchange assets resulting from commodities exports, and that are large enough to rank within [the] top [twenty-two SWFs]";[19] (ii) the organization is "[n]ot a national pension fund, unless [it is] financed directly by foreign exchange assets generated by commodity exports"; (iii) the organization is "not [a] central bank[] or [authority] that perform[s] roles typical of a central bank"; and (iv) the organization is a "investment fund[] rather than producer[] of goods or services."[20]

Finally, in the recently published Santiago Principles, the IMF's International Working Group of Sovereign Wealth Funds defined SWFs as "special-purpose investment funds or arrangements that are owned by the general government."[21] The term "general government" includes "both central government and subnational government."[22] The definition excludes, "*inter alia*, foreign currency reserve assets held by monetary authorities for the traditional balance of payments or monetary policy purposes, state-owned enterprises . . . in the traditional sense, government-employee pension funds, or assets managed for the benefit of individuals."[23]

While these definitions are useful in defining the limits of SWF, it is important to recognize that they are both over-inclusive and under-inclusive.[24] However, this Note will be using the International Working Group's definition for SWFs because it is sufficiently broad to include most of the entities affected by the Santiago Principles.

B. Who Has SWFs?

As of 2009, there are over twenty-two entities widely accepted as SWFs.[25] The seven largest are known as the "Super Seven," and each has

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19. The five subnational-level funds large enough to be ranked with the top twenty-two SWFs are ADIA (Abu Dhabi), Istihmar (Dubai), Dubai International Capital, Alberta Heritage Savings Trust Fund (Canada), and Alaska's Permanent Reserve Fund. Lyons, *supra* note 5, at 23–24.

20. *Id*.

21. *See* INT'L WORKING GROUP OF SOVEREIGN WEALTH FUNDS, *supra* note 16, at 3.

22. *See id.* at 3 n.5.

23. *See id.* at 3 n.6.

24. *See* Lyons, *supra* note 5, at 23. For example, the IMF definition does not explicitly exclude noncommodity-based national pension funds. The Treasury definition does not include central banks that perform management functions for foreign investments such as the Saudi Arabia Monetary Authority.

25. *Id.* at 23.

over $100 billion in assets.[26] The Super Seven includes Abu Dhabi Investment Authority, the Government of Singapore Investment Corporation, the Government Pension Fund of Norway, KIA, China Investment Corporation, Russia National Wealth Fund, and Temasek Holdings.[27] Of the listed owners, United Arab Emirates' Abu Dhabi Investment Authority possesses the largest SWF, with assets estimated to be somewhere between $250 billion and $1 trillion.[28] Another player of note in this league of large SWFs is the China Investment Corporation ("CIC"), which has an initial endowment of $200 billion.[29] While not as large as the Super Seven, the holdings of other SWFs are still quite substantial.[30]

C. Why Create SWFs?

The goals of SWFs, unsurprisingly, depend on to whom they belong and the source of their endowments.[31] Apart from potential political and strategic motivations, SWFs are typically created in order to achieve any combination of the following goals: macroeconomic stabilization, intergeneration transfers, higher returns, and domestic industrial developments.[32]

Countries that establish SWFs for macroeconomic stabilization purposes are usually "highly dependent on commodity exports" because they are "exposed to swings in global prices."[33] For countries like Russia,[34] the macroeconomic stabilization component functions (i) by supplementing government revenues when there is a decrease in global pric-

26. *Id.* at 7.

27. *Id. See generally Truman Testimony*, *supra* note 4, at 8 (providing a more complete list of SWFs).

28. Bujon de l'Estang, *supra* note 1, at 4; Lyons, *supra* note 5, at 32. Standard Charter estimates Abu Dhabi's assets to be approximately $600 billion, but Citigroup estimates the assets to be closer to $875 billion. Bujon de l'Estang, *supra* note 1, at 4; Lyons, *supra* note 5, at 32. The results of the estimates vary significantly due to the lack of transparency of Abu Dhabi's fund.

29. Bujon de l'Estang, *supra* note 1, at 9; Lyons, *supra* note 5, at 36.

30. *See generally* Lyons, *supra* note 5, at 32–62 (providing a list and features of the twenty-two largest SWFs).

31. *See id.* at 29.

32. *Id.*

33. *Id.*

34. Russia is exposed to global swings in commodity prices because its exports are concentrated in a few commodities (i.e., oil, natural gas, metals, and timber). These exports account for over eighty percent of Russia's exports and thirty percent of government revenues. CENT. INTELLIGENCE AGENCY, WORLD FACT BOOK (2008). *See also* Lyons, *supra* note 5, at 37. Countries that also depend on a few commodities good for their economies are similarly situated, since their economies are not sufficiently diversified.

es, and (ii) by absorbing excess revenues when there is an increase in global prices, thereby preventing inflation.[35] An SWF with macroeconomic stabilizing goals can helps minimize "short- and medium-term fluctuations."[36] Similarly, countries dependent on finite commodity resources (e.g., oil and coal) may create SWFs to preserve the wealth of these national resources for future generations by converting them into financial resources.[37] This wealth could be used to finance pension funds, such as Norway's Government Pension Fund,[38] or be used as an "alternative to oil reserves for . . . future generations," such as Kuwait's KIA.[39]

Higher returns are also a common objective of SWFs.[40] Traditionally, foreign reserves are kept and maintained by the country's central bank.[41] Due to the goals[42] and roles that central banks serve, their assets tend to be held in lower risk and lower-yielding financial vehicles.[43] With the build up of reserves,[44] these countries are motivated by the "opportunity cost associated with funds being invested in risk free assets" to seek

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35. Kimmitt, *supra* note 3, at 120; Y.V. Reddy, Governor, Reserve Bank of India, Address at the Golden Jubilee Celebrations of the Foreign Exchange Dealers' Association of India, Mumbai: Forex Reserves, Stabilization Funds, and Sovereign Wealth Funds: Indian Perspective 3 (Oct. 8, 2007).

36. Lyons, *supra* note 5, at 29.

37. *Id.*

38. *Id.* at 33.

39. *Id.* at 35.

40. *Id.* at 29.

41. Kimmitt, *supra* note 3, at 120.

42. The IMF lists six major objectives for central banks:

> support and maintain confidence in the policies for monetary and exchange rate management . . . ; limit external vulnerability by maintaining foreign currency liquidity to absorb shocks during times of crisis or when access to borrowing is curtailed . . . ; provide a level of confidence to markets that a country can meet its external obligations; demonstrate the backing of domestic currency by external assets; assist the government in meeting its foreign exchange needs and external debt obligations; and maintain a reserve for national disasters or emergencies.

INT'L MONETARY FUND, GUIDELINES FOR FOREIGN EXCHANGE RESERVE MANAGEMENT (2001), *available at* http://www.imf.org/external/np/mae/ferm/eng/index.htm#I.

43. *See* John Nugée, *Foreign Exchange Reserves Management*, *in* CTR. FOR CENT. BANKING STUDIES BANK OF ENG. 26–29 (Handbooks in Central Banking No. 19, 2000).

44. By 2006, Asian central banks, at $3.1 trillion, held over sixty percent of the global foreign reserves. *See* MCKINSEY GLOBAL INST., THE NEW POWER BROKERS: HOW OIL, ASIA, HEDGE FUNDS, AND PRIVATE EQUITY ARE SHAPING GLOBAL CAPITAL MARKETS 73 (2007), http://www.mckinsey.com/mgi/publications/The_New_Power_Brokers/.

higher returns for their money.[45] Finally, some countries utilize SWFs to "restructure and encourage domestic industries."[46]

D. Why Are SWFs Significant?

SWFs are significant for a variety of reasons. Primary among these are the size of their asset holdings and their investment strategies. Already holding an estimated $2–3 trillion in assets,[47] SWFs are projected by various commentators to grow rapidly during the next decade and reach an estimated value of somewhere between $7 trillion and $13.4 trillion in assets.[48] However, even when we use the upper estimated aggregate size of SWFs, $3 trillion, the amount of assets held by SWFs is small when compared to the amount of global financial assets or U.S. denominated assets in existence. As a point of reference, in 2006, global financial assets were estimated to be about $164 trillion, and U.S. denominated assets about $56.1 trillion.[49] This means that SWFs are only 1.8% and 6%, respectively, of these markets. Nonetheless, even though SWFs hold a small share of the global capital markets, they should not be ignored. At $3 trillion, they have more assets than both hedge funds[50] and private equities[51] combined.[52] Even individually, the six largest SWFs are comparable to the largest institutional investors in the world.[53] Regardless of what metric of reference we use to assess the size of their holdings, SWFs are large enough to affect market prices.[54]

Besides their size, another important concern is their investment strategy. As noted above, traditionally, countries manage their foreign reserves

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45. Lyons, *supra* note 5, at 29.

46. *Id.*

47. Simon Johnson, *The Rise of Sovereign Wealth Funds*, 44 FIN. & DEV. (Sept. 2007), *available at* http://www.imf.org/external/pubs/ft/fandd/2007/09/straight.htm.

48. *See* STEPHEN JEN, MORGAN STANLEY, HOW BIG COULD SOVEREIGN WEALTH FUNDS BE BY 2015? at 2 (2007) (projecting SWF assets to reach $12 tirllion by 2015); John Lipsky, First Deputy Managing Dir. of the Int'l Monetary Fund, Speech at the Seminar: Sovereign Funds: Responsibility with Our Future 2 (Sept. 3, 2008), *available at* http://www.imf.org/external/np/speeches/2008/090308.htm (projecting SWF assets to reach $7-13 trillion by 2013); Lyons, *supra* note 5, at 9 (projecting SWF assets to reach $13.4 trillion over the next decade).

49. MCKINSEY GLOBAL INST., MAPPING GLOBAL CAPITAL MARKETS FOURTH ANNUAL REPORT 10–11 (2008), *available at* http://www.mckinsey.com/mgi/publications/mapping_global/.

50. Hedge funds are estimated to have approximately $1–1.5 trillion in assets. Lyons, *supra* note 5, at 11.

51. Private equities are estimated to have $0.7–1.1 trillion in assets. *Id.*

52. *Id.*

53. Bujon de l'Estang, *supra* note 1, at 3.

54. Kimmitt, *supra* note 3, at 122.

with their central banks or financial ministries that perform central bank functions.[55] Central banks and their equivalents have typically focused their investment in low-risk and low-yield assets (e.g., U.S. treasury bonds) to preserve liquidity.[56] With the significant accumulation of foreign reserves, preservation of liquidity becomes less important and countries shift their asset allocation to include more higher-risk and higher-yield assets (e.g., equity, real estates, and hedge funds).[57]

While SWFs do raise policy concerns, they can also be very beneficial to the global capital market if managed properly. SWFs are "in principle long-term investors, which typically do not deviate from their strategic asset allocations in the face of short-term volatility."[58] By shifting away from debt assets, SWFs are actually promoting a more stable financial market by reducing the effects of entry and withdrawal that would otherwise occur in the debt market.[59] They also allow the reserve-rich countries to "recycle trade surpluses and to increase the supply of funds to the equity market," thereby "reducing the cost of capital."[60] SWFs are particularly attractive for this function because they are not highly leveraged and can provide liquidity to the capital market.[61]

E. How Does the United States Regulate SWF Investments?

In the United States, since 1988, foreign directed investments ("FDIs") were subject to the Exon-Florio Amendment. [62] After the controversial attempt by China National Offshore Oil Company and Dubai Ports World to acquire Unocal, and Peninsular and Oriental Steam Navigation Company, respectively, Congress passed the Foreign Investment and National Security Act of 2007 ("FINSA") to amend the Exon-Florio Amendment.[63] FINSA confers on the president the power to "suspend or prohibit any covered transaction that threatens to impair the national se-

55. *Id.* at 120.

56. *See* Nugée, *supra* note 43, at 26–29.

57. *See id*. Acting Under Secretary for International Affairs Clay Lowery explains that "force diversification" is occurring because the amount of assets held by SWFs have outgrown the amount of debt assets in the world. Lowery, *supra* note 14.

58. Kimmitt, *supra* note 3, at 122.

59. Gilson & Milhaupt, *supra* note 1, at 1360.

60. *Id.* at 1360.

61. *Id.* at 1360; Kimmitt, *supra* note 3, at 122.

62. "Exon-Florio amend[ed] Title VII of the Defense Production Act of 1950." W. Robert Shearer, *The Exon-Florio Amendment: Protectionist Legislation Susceptible to Abuse*, 30 HOUS. L. REV. 1729, 1731 n.12 (1993). *See also* 50 U.S.C. app. § 2170 (1988) (amended 2007); Gilson & Milhaupt, *supra* note 1, at 1349; Greene & Yeager, *supra* note 2, at 261.

63. Gilson & Milhaupt, *supra* note 1, at 1349; Greene & Yeager, *supra* note 2, at 261.

curity of the United States."[64] Further, the statute makes the Committee on Foreign Investment in the United States ("CFIUS") responsible for

> (i) review[ing] acquisitions by foreign persons of control of US businesses in the interest of US national security during a [thirty] day period after notice or its own initiation of the review, (ii) [investigating] such acquisitions during an additional [forty-five] day period if the transaction threatens the national security of the US, is by a foreign government controlled entity, would result in critical infrastructure coming under control of a foreign person or the government agency leading the review so recommends and (iii) report[ing] its findings to Congress.[65]

Since its inception in 1975, by March 2006, CFIUS had reviewed over 1600 cases of foreign acquisitions.[66] In 2006, "of approximately 10,000 [mergers and acquisitions] transactions [in the United States], 1,730 were cross-border."[67] During that year, 113 of the cross-border transactions were subject to CFIUS review but none were blocked.[68] Despite the number of cases it reviewed, however, the Committee has investigated only twenty-five and submitted twelve of them to the president for decision.[69] Of the twelve cases, the president elected to allow eleven of the transactions to proceed.[70] The only occurrence of a presidential divestment of FDI occurred in 1990 when President George H.W. Bush ordered China National Aero-Technology Import and Export Corporation to divest its interest in MAMCO, an aircraft parts company.[71]

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64. 50 U.S.C. app. § 2170(d) (2007).

65. Greene & Yeager, *supra* note 2, at 261 (citation omitted). *See also* 50 U.S.C. app. § 2170 (2007).

66. *Testimony Before the S. Comm. on Banking, Housing, and Urban Affairs* (Mar. 2, 2006) (testimony by Robert Kimmitt, Deputy Sec'y U.S. Dep't of the Treasury), *available at* http://www.ustreas.gov/press/releases/js4086.htm [hereinafter *Kimmitt Testimony*].

67. Greene & Yeager, *supra* note 2, at 262; Kimmitt, *supra* note 3, at 123.

68. Greene & Yeager, *supra* note 2, at 262; Kimmitt, *supra* note 3, at 123.

69. *Kimmitt Testimony*, *supra* note 66.

70. *Id.*

71. *See id.* (indicating that since 1988, the president only ordered one forced divestiture out of the twelve cases submitted for decision after investigation); Message from George H.W. Bush, President of the U.S., to U.S. Congress on the China National Aero-Technology Import and Export Corporation Divestiture of MAMCO Manufacturing, Incorporated (Feb. 1, 1990), *available at* http://www.presidency.ucsb.edu/ws/index.php?pid=18109); ANN M. CALVARESI-BARR, DIR., U.S. GOV'T ACCOUNTABILITY OFFICE, REPORT TO CONGRESSIONAL REQUESTERS, DEFENSE TRADE: ENHANCEMENTS TO THE IMPLEMENTATION OF EXON-FLORIO COULD STRENGTHEN THE LAW'S EFFECTIVENESS, GAO Doc. No. 05-686, at 10 (2005); KATHERINE V. SCHINASI, ASSOC. DIR., U.S. GEN. ACCOUNTING OFFICE, REPORT TO CHUCK HAGEL, U.S. SENATE, DEFENSE TRADE:

As Edward Greene and Brian Yeager[72] noted, "despite the small number of final negative determinations by CFIUS, CFIUS review can have an *in terrorem* effect that discourages transactions."[73] In addition to FINSA, SWFs are also subject to various traditional regulations such as the Securities Exchange Act of 1934, the Hart-Scott-Rodino Act, and the Bank Holding Company Act of 1956.[74]

II. CONCERNS INVOLVING SWFS

The growing importance of SWFs raises various policy issues and concerns for host countries, recipient countries, and the international capital market in general. Of these concerns, lack of transparency, economic protectionism, market distortions, conflicts of interest, strategic positioning, and national security are at the forefront of the debate. Each of these issues must be addressed carefully in order to ensure that SWFs are not unduly restricted when providing necessary protection to all parties.

A. Lack of Transparency

One of recipient countries' largest complaints is the lack of transparency of some SWFs.[75] While some hedge funds and private equity funds are equally, if not more, secretive about their investments, recipient countries have found the opaqueness of SWFs much more alarming.[76] As one commentator suggests, this is not because SWFs are nontransparent about their investments, but because they are government owned.[77] Also,

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IDENTIFYING FOREIGN ACQUISITIONS AFFECTING NATIONAL SECURITY CAN BE IMPROVED, GAO/NSIAD Doc. No. 00-144, at 9 (2000).

72. Greene & Yeager, *supra* note 2, at 247 n*.

73. *Id.* at 262; Kimmitt, *supra* note 3, at 123. The authors give the example of a CIC official's statement that "[CIC] will not consider investments in the USA that may be subject to CFIUS review," after the failure of Bain Capital and Huawei Technologies's bid to acquire 3Com. Greene & Yeager, *supra* note 2, at 262.

74. Greene & Yeager, *supra* note 2, at 264–66. *See generally* 12 U.S.C. §§ 1841–50; 15 U.S.C. § 18a; 15 U.S.C. §§ 78a–78lll.

75. Gilson & Milhaupt, *supra* note 1, at 1360; Greene & Yeager, *supra* note 2, at 268; Lowery, *supra* note 14; Lyons, *supra* note 5, at 12–14.

76. *See* Lyons, *supra* note 5, at 6. As Deputy Secretary Kimmitt stated, the framework for market discipline applicable to hedge funds to mitigate systematic risk is not applicable to SWFs. Kimmitt, *supra* note 3, at 128. This is because "SWFs are public-sector entities managing public funds, and profit maximization may not be considered the primary objective." *Id.* Unlike hedge funds, the key avenues for transparency between the fund and counterparties, and among counterparties, creditors, and regulators are not applicable, and counterparties may rely on sovereign guarantees to ensure payment rather than practice market discipline. *Id.*

77. Lyons, *supra* note 7.

the opaqueness of SWFs has the potential of affecting private investors due to uncertainties involving the funds' behavior.[78]

In regards to transparency concerns, one commentator has noted that SWFs have never conducted themselves in any way to warrant the suspicion placed on them.[79] The lack of evidence of wrongful conduct, however, is largely irrelevant. This commentator failed to recognize that what is perceived to be true can be far more important than what is actually true. If an SWF is perceived to be acting with ulterior motives, a country will most likely take action against the perceived threat. The mere fact that the perception is wrong or that there is no evidence to support that perception will therefore not make much of a difference. While some might argue that States should not act in such a manner, this is the only rational decision. In terms of game theory, countries are in a non-cooperative game environment and have an asymmetry of information problem.[80] While countries often do cooperate with each other, they are still in such an environment because there is no way to form binding and enforceable agreements.[81] It is important to remember that countries cooperate with each other voluntarily and there is no meaningful way to force compliance short of going to war.[82]

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78. Lowery, *supra* note 14. *See also* Truman, *supra* note 4, at 3.

79. Bader M. Al Sa'ad, Kuwait Inv. Auth., Key Note Speech at the First Luxembourg Foreign Trade Conference: Overview on the Kuwait Investment Authority and Issues Related to Sovereign Wealth Funds 6 (Apr. 9, 2008), *available at* http://www.kia.gov.kw/NR/rdonlyres/67D2B0DD-450D-4B51-B522-C2BE1C00F12D/916/FINA_SPCH_LUXEMBORG_APR_9_092.pdf.

80. *See generally* 1 THE NEW PALGRAVE A DICTIONARY OF ECONOMICS 133–35 (John Eatwell et al. eds., 1987); 3 THE NEW PALGRAVE A DICTIONARY OF ECONOMICS 661–63 (John Eatwell et al. eds., 1987). In a non-cooperative game setting, there exists no institution that can make binding any agreement among players. 3 THE NEW PALGRAVE A DICTIONARY OF ECONOMICS, *supra*, at 661. Asymmetric information occurs when players of a particular game are not privy to the same information. 1 THE NEW PALGRAVE A DICTIONARY OF ECONOMICS, *supra*, at 133.

81. It could be argued that countries will comply with international agreements and treaties because noncompliance would be too costly and even as "soft law," these rules can still have practical effects. Francis Snyder, *The Effectiveness of European Community Law: Institutions, Processes, Tools and Techniques*, *in* IMPLEMENTING EC LAW IN THE UNITED KINGDOM: STRUCTURES FOR INDIRECT RULE 64 (Terence Daintith ed., 1995). However, because compliance of international law in general is voluntary, there is always a risk that a country will decide that the benefit of noncompliance outweighs the cost of compliance. Thomas M. Franck, *Legitimacy in the International System*, 82 AM. J. INT'L L. 705, 705 (1988). In such a non-cooperative environment, one cannot assume that the mere fact that a party is complying with international agreements or treaties now means there will be compliance in the future.

82. *See* Alex Glashausser, *What We Must Never Forget When It Is a Treaty We Are Expounding*, 73 U. CIN. L. REV. 1243, 1285 n.264 (2005) (citing Patricia McGowan

Countries are also plagued with the problem of asymmetry of information. There is simply no way for a country to predict how counterparties will behave, and there is always a risk that they will guess wrong. Therefore, countries can only act on the information that they perceive to be true, and depending on the urgency of the situation, there may not be an opportunity to ascertain the accuracy of the information before taking adverse action.

Furthermore, even though some SWFs have existed for a long time, their opaqueness also creates concerns about their potential impact on market stability.[83] Markets and investors do not have extensive experience dealing with SWFs or similar entities because countries tended to prefer debt assets in the past and held little, if any, equity assets.[84] Therefore, because SWF investment policies are poorly understood, markets will experience greater volatility when they have, or are suspected to have, SWF participation.[85] With no information or experience to guide them, market participants have no way to distinguish mere rumors from actual facts, or minor comments from significant ones.[86] This increases the level of uncertainty and risk associated with participating in the market. Elevated risk levels will increase the cost of capital because a higher risk premium will be needed to compensate parties for the amplified risk.

With that said, however, it is important to bear in mind that mere formal disclosure would not resolve any of the transparency concerns.[87] Disclosures are only as meaningful as the creditability of the disclosing party. A party's denials and disclosures have little creditability when the party is already suspected or accused of misconduct. Similarly, if a host government lacks creditability, any statements made or disclosures published are unlikely to be taken at face value. This illustrates that the real concern regarding transparency is the problem of asymmetric information and underscores the need for a credible method to ascertain the truth. This problem places SWFs that lack creditability but are innocent of any misconduct at risk of unwarranted adverse actions. Any regulation of SWFs must address these transparency and creditability concerns.

Wald, *Judging at the Hague*, JUD. DIVISION REC., Summer 2002, at 19–20) (noting that international law has been enforced "only by voluntary compliance, diplomacy, threats of war or war itself").

83. Lowery, *supra* note 14.

84. *See id.*

85. *Id.*

86. *See id*.

87. Gilson & Milhaupt, *supra* note 1, at 1362 (discussing the problem of voluntary disclosures).

B. Economic Nationalism and Protectionism

Another concern raised by the increased globalization of the financial market is the growing sentiments of economic nationalism and protectionism that FDIs have sparked. Despite the benefits that globalization can bring, this is a sensitive issue that is not just limited to industrialized countries, but is also prevalent in emerging market economies.[88] China's and Dubai's attempted acquisition of major U.S. assets caused such a political outcry in the United States that the parties withdrew their bid for acquisition.[89] Similarly, Germany recently proposed new legislation to allow the Economy Minister to scrutinize purchases of stakes of twenty-five percent or more in German firms by buyers from outside the European Union and its four partners in the European Free Trade Association and, if necessary, to block the transaction.[90] Even African countries, which were initially enthusiastic about Chinese investments, are experiencing backlash due to concerns over "China's intentions and . . . whether its investment was in the Continent's best interests."[91]

The real fear for the recipient countries is that if they sell off more and more of their economy and country each year, they will be subjugating themselves to a "sharecropper economy."[92] While this would be undesirable, economic protectionism or nationalism is not the answer. Globalization of the financial capital market has many benefits.[93] For example, businesses are no longer tied to their own domestic capital market and can obtain capital at a lower cost[94] by tapping into international capital.[95]

88. Lowery, *supra* note 14.

89. Lyons, *supra* note 5, at 16–17.

90. Jonathan Braude, *New German Foreign Investment Law Faces Challenges*, LAW.COM, Sept. 8, 2008, http://www.law.com/jsp/article.jsp?id=1202424321685.

91. Lyons, *supra* note 5, at 16.

92. David R. Francis, *Will Sovereign Wealth Funds Rule the World?: These Enormous Government-owned Funds May Turn Their Economic Clout into Political Gain*, CHRISTIAN SCI. MONITOR, Nov. 26, 2007, *available at* http://www.csmonitor.com/2007/1126/p16s01-wmgn.html.

93. Kimmitt, *supra* note 3, at 124–26.

94. To illustrate the benefits of and differences between a purely domestic ("closed") capital market and an international ("open") capital market, we can look at the cost of capital. N. GREGORY MANKIW, MACROECONOMICS 53, 115 (4th ed. 2003). The cost of capital is really the cost of borrowing or the interest rate. *Id.* at 54–55. The interest rate is determined by the supply of capital and the demand for capital, and is inexplicably tied to a country's economic output. *Id.* at 59–61. One measure of the output of a country's economy is the gross domestic product ("GDP"). *Id.* at 15–16. Under the expenditure method of measuring GDP in a closed economy, GDP = Consumption (C) + Investment (I) + Government Spending (G). *Id.* at 53. A simple reorganization of this equation shows that I = GDP – C – G – net exports (NE); in other words, investment is always equal to the national savings in a purely domestic market. *Id.* at 59–61. As we can see, the nation-

It also helps countries finance current account deficits.[96] Among these benefits is the increased ability of investors to spread risk by diversification into different markets, contributing to the stability of the global financial market.[97] The biggest threat to maximizing the benefits of a global capital market, as Deputy Secretary Kimmitt noted, is "investment protectionism," the erection of barriers to foreign investment.[98] To reduce the risk that countries will engage in protectionist conduct, regulations need to encourage SWFs to behave in a purely commercial manner.

C. Market Distortions

SWFs have the potential of creating market distortion because of their size and their governmental connections.[99] SWFs are "already large enough to be systemically significant," and if they are imprudently managed and misguidedly take risk, there will be broad consequences for the whole market.[100] For example, there is a danger that SWFs might not perceive risk correctly. Unlike traditional financial institutions, SWFs are accountable only to their respective governments because they are their only principal. This feature is a benefit for the financial market because capital requirements or investor withdrawals cannot force SWFs to liquidate their holdings;[101] however, this very feature also creates the risk of

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al savings limits the supply of capital, and simple logic tells us that cost increases when demand increases against a limited supply. *Id.*

Now suppose we move to an open capital market system. In such a system, GDP = C + I + G + NE, and thus, investment = national savings + net foreign investment. *Id.* at 24–26, 117–18. This means that if this type of economy has more investment opportunities than national savings, foreign investment can be used to supplement the deficit. *Id.* at 121–24. Alternatively, if there is more savings than good investment opportunities, investors can invest in foreign markets. *Id*. This leads to a more efficient allocation of capital because in this case, excess capital can be directed to more profitable ventures. This also benefits businesses that have great ideas, but would have been foreclosed from pursuing them because the cost of capital is too high.

95. Kimmitt, *supra* note 3, at 124; Gen. Atl.: Global Growth Investors, *Thought Leadership: Accessing Global Capital Markets: Benefits and Challenges*, Mar. 8, 2007, http://www.generalatlantic.com/en/news/article/53 (General Atlantic is a global private equity fund.).

96. Kimmitt, *supra* note 3, at 124.

97. *See generally* René M. Stulz, *Globalization of Equity Markets and the Cost of Capital*, (Dice Ctr., Working Paper No. 99-1, 1999) (providing a more detailed discussion of the effects of globalization of capital markets on cost of capital and effects of risk).

98. Kimmitt, *supra* note 3, at 126.

99. *See generally Truman Testimony*, *supra* note 4, at 3.

100. Kimmitt, *supra* note 2, at 122; Lowery, *supra* note 14.

101. Kimmitt, *supra* note 2, at 122; Lowery, *supra* note 14.

low accountability.[102] SWFs typically have no clearly defined liabilities like pension funds or other institutional investors; instead, they tend to have broadly defined goals and are rarely earmarked for specific government expenditures.[103] With essentially no liabilities,[104] there is a danger that fund managers may take excessive risks and treat losses as irrelevant so long as there is no strong domestic accountability.

Unfortunately, there is usually little, if any, regulation governing SWF behavior either directly or indirectly.[105] Therefore, investor discipline will depend on citizen monitoring because there is no market discipline through institutional investors.[106] The problem with this reliance is that there is no incentive for individual citizens to monitor the performance of the SWF. There is also a free-rider problem with citizen monitoring. Even one of the smaller SWFs has a value of $400 million, assuming the information is available, any monitoring of the fund will require significant time, effort, and expense. Furthermore, a party that monitors the SWF will not be able to capture all of the benefits because other parties will benefit from the monitoring without incurring the expense. [107] Therefore, parties will have no incentive to do anything more than the average citizen, which, in this case, will be nothing.

Due to the fact that "SWFs represent large, concentrated, and often opaque positions in financial markets," if the funds have distorted risk preferences, it will have the potential of influencing the market.[108] This is because investment prices may be artificially inflated and misrepresent the true relative market value.[109] There is also a danger that parties will not practice market discipline in assessing the risk of a particular transaction, but instead rely on the notion of "sovereign guarantee."[110] With the

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102. *See* Lowery, *supra* note 14.

103. Adrian Blundell-Wignall et. al., *Sovereign Wealth and Pension Fund Issues*, 94 FIN. MARKET TRENDS 117, 124 (2008).

104. This, of course, does not include SWFs that also serve as a pension fund such as Norway's SWF.

105. Lowery, *supra* note 14.

106. *Id.* Accountability of SWFs will depend on "what their citizens know and how active they are in monitoring fund activities." *Id.*

107. It is unclear whether there are actual benefits for citizens to monitor their country's sovereign wealth fund; however, any hypothetical benefits that may or may not exist will just have a free-rider problem. Furthermore, if no benefits exist, there would be no incentive to expend the necessary resources to conduct such monitoring.

108. Kimmitt, *supra* note 3, at 122–23.

109. It is conceivable that if a large SWF fails to assess risk properly, it can influence the market price for that asset by purchasing more of the asset than is prudent. This price, which is driven up, will not reflect the value of the asset relative to other alternative investments.

110. Lowery, *supra* note 14.

threat of parties not practicing market discipline, a substantial risk to market stability arises if SWFs are not regulated because there is typically limited disclosure of their investment policies, and the private sector may react to speculation and rumors of potential SWF shifts.[111] Therefore, SWFs and the capital market would benefit from regulations that impose greater transparency, improve the governing and monitoring structure, and further accountability of the funds.

D. National Security

One of the most critical concerns regarding foreign acquisitions is national security. When dealing with foreign investment, countries need to be able to "ensure that national security concerns are addressed, without unnecessarily limiting the benefits of an open economy."[112]

The problem with national security issues is that there is no way to clearly define what types of investment invoke these concerns and what types of investments do not.[113] While it may be clear that foreign investment in a country's defense industries would raise national security concerns, there are many other industries that do not fall within the traditional notion of defense but are nonetheless essential to a country's security.[114] Furthermore, something short of acquisition of de jure control, such as when "an investor seeks board seats or outsized voting rights," could still trigger national security concerns.[115] Accordingly, anything but purely passive investment by SWFs has the potential of raising these issues.[116] Moreover, as much as FDI may trigger national security concerns, there is also a risk that recipient countries will use national security as a guise for protectionism policies.[117] This risk creates a twin tension that any governing policy and principle must balance with care.

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111. Kimmitt, *supra* note 3, at 122–23.
112. *Id.* at 123.
113. *See* Lyons, *supra* note 5, at 17.
114. For example, the media, the communication, and the energy industries are essential infrastructures for a country's national security. *Id.* at 15. There are also companies that supply essential war-making materials, e.g., ball bearing manufacturers, but FDI would only raise national security concerns during a war. The difficulty in determining which industries raise legitimate national security concerns makes determinations by organizations such as CFIUS highly subjective and could be used as a guise for protectionism. *See id.* at 17; Kimmitt, *supra* note 3, at 126.
115. Kimmitt, *supra* note 3, at 123.
116. *Id.*
117. *Id.* at 126.

E. Strategic Positioning

There is also a fear that SWFs will invest for strategic positioning purposes.[118] These purposes may motivate the funds to make investments with the objective of acquiring intellectual property, skills, and other advantages, and transferring these assets to domestic companies.[119]

On a macro level, strategic acquisitions may not seem like a problem because the party that values those assets the most is making use of them; however, on a micro level, this creates a conflict of interest problem between the SWFs and other investors. Objectives other than maximization of share values conflict with the interest other investors because transferring technology or other expertise from a portfolio company to a domestic company will reduce the value of the portfolio company. [120] All owners share in this reduction in value, while only the SWF and its government will benefit from the transfer.[121] Thus, the fund is essentially stealing from the portfolio company when it induces these kinds of transfers.

Not only is strategic acquisition fundamentally unfair to the company and other investors it will also have detrimental effects on the market.[122] If investors come to believe that they are at a disadvantage in relation to the publicly backed entity, it could damage the stability and confidence in the market.[123] After all, who would want to play when the other party always has an Ace up its sleeve? Therefore, any regulation of SWFs must address the problem of strategic acquisitions.

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118. *See* Greene & Yeager, *supra* note 5, at 259; Lyons, *supra* note 2, at 15.

119. *See* Lyons, *supra* note 5, at 15. *See also* Gilson & Milhaupt, *supra* note 1, at 1361–62 ("SWFs may wish to help domestic companies secure technology or other expertise."). *Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions: A Common European Approach to Sovereign Wealth Funds*, at 5, COM(2008) 115 provisional (Feb. 27, 2008), *available at* http://ec.europa.eu/internal_market/finances/docs/sovereign_en.pdf ("SWF investment in certain sectors could be used for ends other than for maximi[z]ing return. For example, investment targets may reflect a desire to obtain technology and expertise to benefit national strategic interests, rather than being driven by normal commercial interests in expansion to new products and markets. By the same token, holdings could influence decisions by companies operating in area of strategic interest or governing distribution channels of interest to the sponsor countries. More generally, business and investment decisions could be influenced in the political interest of the SWFs owners."). Governments as investors may pursue interests other than economic ones, such as "technology transfer, access to raw materials, access to buyers or even larger political or social purposes." Greene & Yeager, *supra* note 2, at 259.

120. Gilson & Milhaupt, *supra* note 1, at 1361.

121. *Id.* at 1362.

122. *See* Greene & Yeager, *supra* note 2, at 259.

123. *See id.*

F. The Real Problem: Asymmetric Information

At the root of these concerns is the problem of asymmetric information. The outcries for more transparency on the part of SWFs arise out of insufficient or unreliable information. The asymmetric problem can be due to the inability to ascertain the accuracy of information, the lack of incentives to acquire information, or the inability to acquire the information. While they cannot be attributed to insufficient information per se, the problems associated with nationalism or protectionism are still based on the fear and misunderstanding of SWFs.[124] So, too, is the problem of market distortion, which occurs when other parties cannot understand an SWF's market behavior and objectives because of insufficient information. Finally, lessening the informational disadvantage of recipient countries can mitigate the dangers of strategic positioning and national security problems. This is because the recipient country will be able to make decisions on how to respond to foreign acquisitions with accurate information rather than on mere speculation. Also, by strengthening the informational position, host countries have an incentive to limit, if not eliminate, strategic motives from their investments since they do not want their opportunities limited by restrictive pressures.[125] Thus, creating a method of disclosures that is credible and reliable can decrease most of these concerns.

III. SWFS SHOULD BE REGULATED IN AN INTERNATIONAL FORUM

International regulation and monitoring of SWFs is preferable to domestic regulations and monitoring. In particular, such a forum is attractive because of its ability to alleviate many of the concerns discussed above. Furthermore, while it is true that even without an international regime a country can still impose disclosure requirements and other forms of protections on SWFs, international regulation provides several additional benefits. Beyond the ability to address the concerns surrounding SWFs, an international forum would protect the host and recipient countries' interests, create a level playing field and avoid over-regulation due to nationalist and protectionist pressures.

First, drafting and implementing regulations internationally protects both the host countries' and recipient countries' interests. It would do this by creating an opportunity for these countries to have a meaningful dialog over how SWFs should be regulated. If left solely to domestic regulations, there is a risk that only recipient countries' concerns will be

124. *See* Lyons, *supra* note 5, at 16.

125. While there are a lot of opportunities available to SWFs, all else equal, I believe any investor will prefer having more opportunities than less.

addressed, as SWFs and their host countries will not have an opportunity to voice their concerns. The ability to express different opinions is essential because SWFs and recipient countries have competing interests. On the one hand, SWFs want to have unlimited freedom to invest however they want. On the other hand, recipient countries may want to limit what SWFs can invest in. Recipient countries have an incentive to enact, and do enact, legislation and policies that restrict SWFs' activities to protect domestic industries from foreign acquisitions.[126] Such unilateral development of regulation has the potential of placing SWFs in an unduly disadvantageous position, and even if SWFs are not disadvantaged by the legislation, a perception that SWFs are being discriminated against may still result and harm the capital market.

Second, international regulation could create a level playing field and prevent a race to the bottom. Preventing harmful investments and encouraging beneficial ones should be a major goal of regulating SWFs. Domestic regulations, however, cannot adequately serve this mission because recipient countries have two opposing interests in regards to SWFs. On the one hand, they would like to prevent harmful investments and even prevent foreign acquisition of domestic interests by imposing regulations. On the other hand, they want to attract foreign investment to fund other investments by lowering the barriers to investment.[127] This could lead to under regulation of SWFs by recipient countries, which creates its own problems.

There is also a genuine risk that underregulation will occur because countries are in constant competition for investment and capital. Since the credit crisis began in 2007, the competition for foreign capital has

126. Motivated by the interest in "defending French companies from unwanted predators," France has proposed to create its own SWF and encouraged other EU countries to do so. Emma Vandore, *France to Create Sovereign Fund*, AP NEWS (Paris), Oct. 23, 2008, http://www.blnz.com/news/2008/10/23/France_create_sovereign_fund_4890.html. This kind of response to the growing acquisition and diversification by SWFs is a great example of how countries may and do act to resist foreign acquisitions. While the French response is not using legislative restrictions to prevent foreign acquisitions, this type of response is still a hostile move towards the free flow of capital and should not be encouraged.

127. *See* Ralph Gowling, *France Invites Overseas Wealth Funds*, REUTERS (London), Nov. 3, 2008, http://uk.reuters.com/article/businessNews/idUKTRE4A206I20081103; Ben Hall & Scheherazade Daneshku, *France's Invitation to Overseas Wealth Funds*, FIN. TIMES, Nov. 3, 2008, http://www.ft.com/cms/s/0/232fa6a4-a92f-11dd-a19a-000077b07658.html?nclick_check=1; Michael R. Sesit, *Sarkozy Turns Sovereign Fund Idea Upside Down: Michael R. Sesit*, BLOOMBERG, Nov. 7, 2008, http://www.bloomberg.com/apps/news?pid=20601039&refer=columnist_sesit&sid=aiq0GQVKxg_Q.

become even greater.[128] Some countries have not only been open to SWF investments but also actively sought them.[129] They accomplish this by lowering transaction costs or giving preferred treatment to certain investors, which can be done by offering preferential tax treatments, such as deferred taxes or lower tax rates,[130] or by having favorable regulations. In an environment where countries are in desperate need of capital, countries may decide that the benefit of more capital outweighs the cost of bad investments and lower their regulations to attract more investments. Market forces will then force other countries to lower their regulations or miss out on the benefits of investments by SWFs.[131] Eventually, if the need for competition is strong enough, market forces will cause countries to reduce their regulation to the minimum level and, perhaps, to no regulation at all.

Because of the macroeconomic impact that SWFs can have on the global economy, it is undesirable for countries to decide that capital is more important than a safe and stable investing environment. Not only will competition for capital create incentive problems on the regulation of SWFs; it will also create global and regional systemic problems.[132] Any regional market has a certain level of liquidity and shock absorbent abilities.[133] Because SWFs control a significant block of wealth, any sudden movement by them will have significant impacts on the local markets.[134] Take Romania, for example, one of the newest members of the European Union. Its annual nominal GDP in 2007 was $166 billion, and

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128. *See, e.g.*, Andrew Hay & Manuel Maria, *Spain Wants Sovereign Wealth Funds to Help Cover Its Debt*, INT'L HERALD TRIB., Oct. 20, 2008, http://www.iht.com/articles/2008/10/20/business/peseta.php.

129. *See id.*

130. In a personal income context, we can see tax deferred and tax exempted savings plans performing a similar function to incentivize individuals to allocate their wealth to a particular area. These plans encourage deferring consumption to a later time by saving for retirement.

131. The country that has the least amount of regulation (let us call it "Country A") receives two benefits. First, the potential pool of investors has just increased because more of the SWFs are able to meet their regulations, of course, assuming that not all SWFs are already able to meet the regulatory requirements. Second, the cost of investing is lower since the component cost of compliance is lower. Because the cost of investing is less, SWFs, both good and bad, will flock to Country A because they are able to retain more profits. However, once other countries observe that Country A is receiving these benefits, they too will likely want a piece of the pie and also lower their regulation, even though these benefits would not exist if all States had the same regulations.

132. *See* Lyons, *supra* note 5, at 18–19.

133. *See id.* at 19.

134. Kimmitt, *supra* note 3, at 122–23. *See also* Lyons, *supra* note 5, at 19.

it had approximately $46 billion in investments that year.[135] Compared to the United States, which has $13.84 trillion in GDP with $2.1 trillion in investments, Romania's market is relatively small, and an influx of capital or sudden decrease in capital availability will have significantly greater effects on its economy.[136] Furthermore, there is a chance that any capital market regardless of size could experience a total collapse given a sufficiently large market shock. In addition to the risk of market shock and stability, the risk of sudden movement by SWFs will cause a rise in interest rates, because an interest rate is an aggregate of the real interest rate, inflation expectation, risk premium, and liquidity preference.[137] An increase in risk will require borrowers to offer additional risk premiums to compensate the investors.[138] Therefore, *ceteris paribus*, an increase in risk will cause an increase in interest rates.[139]

Above all else, a level playing field will ensure that investments and allocation of capital will be made on the basis of risk and reward, rather than on the cost of compliance with regulatory requirements. If we accept that the principle goal of international finance is to place capital in the hands of those who can use it best, a system that allocates resources based on compliance cost is untenable. In such a system, compliance cost operates as a tax on SWFs. While it is not entirely clear who will ultimately bear the cost of the tax, companies that depend on SWF investments are the most likely candidates. This is because no one market dominates the international capital market to such a degree that there are no alternative venues for SWFs to invest.[140]

A uniform, or even a mostly uniform, regulatory system will have the additional benefit of lower compliance cost and redundancy.[141] The banking privacy regulation in the United States demonstrates these benefits in a domestic context. In the United States, banks are subject to a situation similar to what SWFs experience. They are subject to regula-

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135. CENT. INTELLIGENCE AGENCY, *supra* note 34.

136. *Id*.

137. *See* Mankiw, *supra* note 94, at 57, 89–95, 271–73.

138. *See id.* at 57.

139. *See id.*

140. With $164 trillion in global financial assets, it will not be difficult for SWFs to find opportunities all over the world to invest their 1.8% worth of global financial assets. *See* MCKINSEY GLOBAL INST., *supra* note 49, at 10–11 (indicating the amount of global financial assets). Even if SWFs are foreclosed from investing in U.S. denominated assets, there still remains almost $100 trillion worth of other financial assets in which SWFs can invest. *See id.*

141. Elizabeth K. Brill, *Privacy and Financial Institutions: Current Developments Concerning the Gramm-Leach-Bliley Act of 1999*, 21 ANN. REV. BANKING L. 167, 216–17 (2002).

tions by multiple jurisdictions and benefit from a uniform system. With varying privacy regulations among states, and between state and federal requirements, large financial services organizations will likely face overlapping and conflicting privacy regulations.[142] Financial services will also "be vulnerable to more stringent, and inevitably conflicting, state regulation."[143] Uniform regulation is necessary for maximum efficiency and equity[144]: "[c]ompanies benefit from decreased compliance cost . . . . Consumers benefit from a more consistent and comprehensible regulatory system."[145]

Using the same logic, these benefits of uniform regulations also extend to SWFs. By adopting uniform international regulations to govern SWF behavior, the funds only have to comply with one set of regulatory requirements, rather than comply with requirements of each individual country. The recipient countries also benefit because they are able to pool the cost of monitoring compliance, rather than having to individually monitor each and every potential SWF investor. Finally, this approach discharges the problem and possibility of conflicting regulations.

The danger also remains that certain countries will take a protectionist position and overregulate SWF investments.[146] One of the major goals of regulating SWFs is to prevent harmful investments and encourage beneficial ones, and overregulation has the potential of driving away foreign investment.[147] While international regulations are unlikely to eliminate all protectionist problems, they do have the potential to reduce protectionist pressures.[148]

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142. *Id.*

143. *Id.*

144. *Id.*

145. *Id.*

146. This is particularly evident when we consider the fact that French President Nicolas Sarkozy "called on European nations to create sovereign wealth funds" to protect national industries. Simon Kennedy, *Sarkozy Proposes European Sovereign Wealth Funds: Wealth Funds Could Prevent Foreign Buyers Getting European Firms Cheaply*, MARKETWATCH (London), Oct. 21, 2008, http://www.marketwatch.com/news/story/french-president-proposes-european-sovereign/story.aspx?guid={A1273F1E-E0A6-40FB-B4D1-CC8105234E73}&dist=msr_1; Erik Kirschbaum, *Several German Leaders Reject Sarkozy's Economic Proposals*, REUTERS (Berlin), Oct. 21, 2008, http://www.reuters.com/article/usDollarRpt/idUSLL47443420081021?pageNumber=1&virtualBrandChannel=0.

147. *See* Henny Sender & Mure Dickie, *China Fears Scupper $2bn Deal for 3Com*, FIN. TIMES, Feb. 20, 2008, http://www.ft.com/cms/s/0/0b3e3988-dfe6-11dc-8073-0000779fd2ac.html.

148. *See* INT'L WORKING GROUP OF SOVEREIGN WEALTH FUNDS, *supra* note 16, at 4.

IV. THE SANTIAGO PRINCIPLES

A. What Are the Santiago Principles?

In October 2007, the International Monetary and Financial Committee[149] expressed the need for "further analysis of key issues for investors and recipients of SWF flows, including a dialogue on identifying best practices."[150] Based on this need, the International Working Group of Sovereign Wealth Funds ("IWG") was founded April 30—May 1, 2008.[151] With Hamad Al Hurr Al Suwaidi[152] and Jaime Caruana[153] as co-chairs, the IWF consists of twenty-six IMF members with SWFs.[154] Using results from an IMF-commissioned voluntary survey on current structures and practices, drawing from widely-accepted international principles and practices, and taking input from a number of recipient countries, the IWG developed a set of Generally Accepted Principles and Practices ("GAPP"), also known as the "Santiago Principles."[155] Underlying the different principles of the GAPP are four foundational objectives:

> i) To help maintain a stable global financial system and free flow of capital and investment;
>
> ii) To comply with all applicable regulatory and disclosure requirements in the countries in which they invest;
>
> iii) To invest on the basis of economic and financial risk and return-related considerations; and
>
> iv) To have in place a transparent and sound governance structure that provides for adequate operational controls, risk management, and accountability.[156]

The IWG identified several purposes for the development of the GAPP: (1) increase countries' and the financial markets' understanding of SWFs; (2) ensure that the international financial market continues to benefit from SWF participation in the financial market; (3) support the "institutional framework, governance, and investment operations of SWFs

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149. The International Monetary and Financial Committee is a committee of the Board of Governors of the IMF. *Id.* at 1.
150. *Id.*
151. *Id.*
152. Hamad Al Hurr Al Suwaidi is the Undersecretary of the Abu Dhabi Finance Department. *Id.*
153. Jaime Caruana is the Director of the Monetary and Capital Markets Department of the IMF. *Id.*
154. *Id.* at 1 n.2.
155. *Id.* at 1–2.
156. *Id.* at 4.

that are guided by their policy purpose and objectives and consistent with a sound macroeconomic policy framework"; and (4) "improve understanding of SWFs as economically and financially oriented entities in both the home and recipient countries" for the "stability of the global financial system, reduc[tion of] protectionist pressures, and . . . maint[enance] of an open and stable investment climate."[157] To achieve these goals, the IWG is relying on cooperation from recipient countries and the Organisation for Economic Co-operation and Development ("OECD").[158]

Comprised of twenty-four rules, the Santiago Principles are a voluntary set of criteria "that the members of the IWG support and either have implemented or aspire to implement."[159] These principles are subject to applicable laws of the home country and any intergovernmental agreements.[160] The IWG expects that the GAPP will guide SWF activities so that the funds will invest professionally and help institute-related reforms.[161] Finally, the IWG assumes that all SWFs will operate on a good faith basis and comply with all applicable regulatory and disclosure requirements.[162]

The Santiago Principles are divided into three groups: "(i) legal framework, objectives, and coordination with macroeconomic policies; (ii) institutional framework and governance structure; and (iii) investment and risk management framework."[163] The IWG explains that the principles in the first area "underpin a robust institutional framework and governance structure of the SWF, and facilitate formulation of appropriate investment strategies consistent with the SWF's stated policy objectives."[164] The second area ensures that SWF investments are free from political influences by separating the owner, the government, and the management to create operational independence.[165] The third area promotes sound investment operation and accountability as well as demonstrates operational discipline.[166] The IWG expects that different SWFs will have different time frames for adopting the GAPP because of the evolving nature of SWFs, the different maturity levels of the funds, as well as their different investment objectives, horizons, and strategies.[167]

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157. *Id*.
158. *Id.*
159. *Id.* at 5.
160. *Id.*
161. *Id.*
162. *Id.*
163. *Id.*
164. *Id.*
165. *Id.*
166. *Id.*
167. *Id.*

Finally, the IWG considers the GAPP to be a minimum standard for SWFs, but recognizes that not all principles will be applicable to every SWF.[168]

B. Criticisms of the Santiago Principles

The Santiago Principles offer important guidelines for the structure, governance, and management of SWFs; however, they have several flaws that will constrain their effectiveness in achieving their stated objectives. First, the GAPP is too focused on SWFs as entities and not enough on their relationship with recipient countries. Second, there are no standards to measure compliance with or achievement of the Principles. Third, the Santiago Principles do not address the asymmetric information problems faced by recipient countries. Finally, there are no sanctions or rewards available to ensure compliance.

Rather than balancing the interests and concerns of both host and recipient countries, the Santiago Principles focus exclusively on what SWFs and the host countries should do. While principles concerning the proper structuring, governance, and management of SWFs are important, the relationship among the funds, the host countries, and the recipient countries is far more important. As demonstrated above, the problems surrounding SWFs or foreign investments in general are not one-sided. Instead, it is the tension among the competing interests of parties that is the source of the problems and deserves the attention of the international community.

For instance, it is not necessary for SWFs to disclose every piece of financial data or every strategy; however, it would be insufficient for the funds to merely release a statement containing only publicly available information. Excessive disclosure requirements are also problematic, because they would inhibit the SWFs' daily management and goal of maximizing returns, since every strategy decision would be public information. Additionally, disclosures for the sake of formality alone would not create a more stable global capital market since they do not actually ease the informational barrier. Simply repackaging publicly available information is convenient for other parties, but it does not improve their informational position in the least.

A similar situation exists for asset allocation. SWFs should not be required to provide the world with a detailed list of which companies they have invested in and the size of their investment. This would simply impose an unnecessary cost because whether or not an SWF invested in a paper towel company does not matter to recipient countries or the finan-

168. *Id.* at 6.

cial market. However, a system could be created that requires disclosures when an SWF invests in a particular list of companies or industries. This kind of scheme would put SWFs on notice that recipient countries are concerned about these companies and industries for either strategic or national security purposes, and would also limit potential protectionist regulations. As the above two examples illustrate, the international community needs to focus not on SWFs and recipient countries separately, but as one problem. By dealing solely with the SWFs' side of the problem, the Santiago Principles are essentially putting a Band-Aid over a gaping wound.

The GAPP lacks measurable standards that an SWF, host country, recipient country, counterparty, or third-party can use to determine to what extent and how effectively a particular SWF has achieved these minimum principles. It is important to remember that these Principles should not be adopted simply for the sake of having basic principles. Instead, constructive feedback is essential for the continued development of international norms governing SWFs in this ever-changing financial market landscape.[169] Constructive feedback requires that there is some method of measuring success. How can one know whether SWFs and recipient countries can work together to increase the stability of the financial market, avoid protectionism, etc., without knowing whether the measures implemented thus far are effective or even serving the purposes that they are suppose to serve? By not creating a standard to measure whether the Santiago Principles are a success, the IWG deprived the GAPP of an essential tool to improve the Principles' effectiveness and make them a success.

Furthermore, the Santiago Principles do not address the asymmetric information problems faced by recipient countries. The GAPP in a number of sections and subsections calls for various public disclosures.[170] This movement towards transparency is an important step in dealing with the asymmetric information problem, because the adoption of these Principles demonstrates that SWFs and the IWG recognize the importance of transparency. However, the asymmetric information problem does not lie solely with the lack of information, but with the lack of *credible* information. By failing to create a method to ascertain this, the effectiveness of any disclosure will be limited.[171] This cripples the Santiago Principles in

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169. The IWG noted in the introduction that "constructive and collaborative response from the recipient countries will be essential" to ensure the success of the GAPP. *Id.* at 4.

170. *See id.* at 7–9. (Articles 2, 4, 15–19, and 21–22 of the GAPP are particularly relevant.)

171. *See supra* Part II. This would be similar to the former USSR claiming to be destroying its nuclear arsenal but not allowing inspectors to verify the claim. Setting aside

the area where they are most needed. When countries trust each other and have a good relationship, they do not need to rely on the Principles because they have no reason to suspect foul play. National security and strategic acquisition concerns are not a concern.[172] In contrast, when countries do not trust each other, disclosures that comply with the GAPP would not ease the concerns of recipient countries because they will consider the disclosures unreliable. If the Santiago Principles are only effective when they are not needed and are ineffective when they are actually needed, what possible benefit will they provide besides recognizing that there is a problem?

Finally, because the GAPP is a voluntary set of principles subject to the laws of host countries, there are no rewards or sanctions available to encourage or force compliance. Given the recognized importance of sound regulation of SWFs, ideally there should be a mechanism that will ensure that parties comply with the Principles and will encourage the adoption of the GAPP. It is foreseeable that counterparties could require the adoption of the GAPP through contract; however, the adoption of the GAPP by SWFs, limited as it is, should not be left to private dealings. Instead, it should be required as a systemic control for the stability of the world's financial market.[173]

C. How to Improve the Santiago Principles

Given the limitations of the Santiago Principles, there are several devices that could improve their operation and effectiveness. Crippled by the failure to address the relational element between SWFs and other market participants, the lack of standards, and the asymmetric information problem, I propose four changes to the structure and elements that I believe will improve the Santiago Principles' chance of success.

First, the IWG and OECD should collaborate and create an expanded list of guiding principles to address not only what SWFs should do as best practices, but also the relationship and competing interests of parties. A collaborative approach would allow both sides to voice various

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the dissimilarity of any relationship between an SWF or its host country and a recipient country, and the relationship between the United States and the former USSR, this example illustrates that a mechanism to ascertain creditability is essential for any long-term monitoring arrangements.

172. *See* Lyons, *supra* note 5, at 16–17 (demonstrating that the cases towards which there was strong political opposition involved SWFs whose host countries were considered unfriendly to the recipient countries).

173. Parties can require compliance with the Santiago Principles as a condition to doing business, but this assumes that any counterparty will have the leverage necessary to force SWFs to accept these kinds of restrictions.

concerns, and identify a balanced approach to deal with the problems surrounding SWFs. As discussed above, it would be ideal if the IWG and OECD developed a single system of regulation.[174] Furthermore, the collaboration between the two needs to deal with SWFs' relationships with third-parties because recipient countries are not the only interested participants. Unlike the current Santiago Principles, this method would address a fuller spectrum of concerns that are raised in the international capital market.[175]

Second, this collaborative group should create more specific guidelines for disclosure requirements and create standard disclosures. The development of specific disclosure requirements would benefit the market by creating a more level playing field[176] and address the information imbalance among the parties. Standard disclosures reduce the informational imbalance by creating reasonable expectations of what will be disclosed and establishing a minimum standard of transparency. This method would protect SWFs from having unreasonable disclosure requirements imposed on them[177] and would also ensure that recipient countries have the information necessary to protect their national security and other domesticinterests.[178] Standardized disclosure requirements, by avoiding duplication, would also benefit SWFs by lowering costs associated with their production.

Third, the GAPP should create a standard that permits the IWG and its corollary to measure how successful the Santiago Principles are in accomplishing their objectives. It would aid them in developing a plan for improving the effectiveness of the Principles. More importantly, such standards would enable the parties to monitor the actions of both SWFs and recipient countries, which would help ensure fair play and minimize systematic risk.

Finally, an independent audit committee should be created. This committee should be composed of individuals appointed from an equal number

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174. *See supra* Part IV.A.

175. *See supra* Part IV.C.

176. *See supra* Part IV.A (discussing the benefits of a level playing field).

177. The drive towards transparency will probably lessen with increased disclosure, and the adoption of disclosures similar to those of Norway's SWF will help alleviate the fear of SWF activities. As discussed above, disclosure of reliable information is essential not only for the protection of national security interests, but also to the stability of the international capital market. Standard disclosure, however, will not eliminate the threat of overregulation until the GAPP or its successor evolves from a voluntary set of principles to a binding treaty that controls both SWFs and recipient countries.

178. By using a collaborative approach, recipient countries can seek to integrate into the standard disclosure the information necessary for the protection of their national security and domestic interests.

of members from SWFs and recipient countries, and one member nominated by the IMF. It should be granted access to all relevant materials to ensure compliance with the GAPP and the validity of disclosures, and be required to publish its findings. By using an independent committee to verify information, parties could be assured that the information disclosed by the SWFs is indeed credible. Furthermore, this approach would recognize the risk of unlimited access to confidential information. In exchange for unlimited access to the SWFs' information, the committee should be required to sign nondisclosure agreements that would limit the use of the information for the sole purpose of verifying the disclosures. By addressing both what should be disclosed and the creditability issue, the GAPP could significantly reduce the asymmetric information problem.

CONCLUSION

While there are severe limitations to the Santiago Principles, they still remain an important first step in the creation of a new international norm. The GAPP outlined the various concerns relating to SWFs and created a forum for addressing how SWFs should behave and how other parties should treat them. However, despite these advances, the Santiago Principles will eventually need to address the asymmetric information problem as well as the relational element between SWFs and recipient countries in order to more fully address the concerns connected to state capitalism and the use of SWFs. The development of standardized disclosures, benchmarks of success, and an independent audit committee would be a beneficial step for the future of regulating and monitoring SWFs' activities and their evolution as financial instruments.

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