

A Public Choice Model of
International Economic Cooperation and
the Decline of the Nation State

Enrico Colombatto*, Jonathan R. Macey**

Abstract

The rate of formal and informal coordination of regulation among states has been increasing despite the fact that bureaucrats and politicians appear to value autonomy. The article builds on a model of international behavior where regulators would prefer to remain wholly autonomous, but are unable to because the firms that the regulators want to regulate are increasingly able to avoid domestic regulation. Bureaucrats who want a particular policy outcome, yet lack the political clout to obtain that outcome domestically can collude with regulators in other countries to achieve the policy outcome they prefer. Where the bureaucrats' desired policy outcome is enshrined in an international accord, then the bureaucrats' claim that the policy should be adopted has much more force. The value of international harmony and coordination is substituted for whatever substantive value is reflected in the regulations.

This article applies its theory to two case studies: the international coordination of capital adequacy requirements for banks, and the international coordination of insider trading regulation.

* Professor of Economics, University of Turin, and Director, International Centre for Economic Research, Turin, Italy.

** J. DuPratt White Professor of Law and Director, John M. Olin Program in Law & Economics, Cornell Law School.

The authors benefitted from comments and suggestions by Jack Barcelo, Ron Cass, David Gay, Steve Pejovich, and especially Raghuram G. Rajan and David Wippman, as well as from presentations made at the Cardozo Law School Conference on the Decline of the Nation State, and at the University of Chicago Law and Economics Workshop. Matthew Bibbens and Jeffrey R. Jewell provided valuable research assistance.

Forthcoming in the "Cardozo Law Review"

A Public Choice Model of International Economic Cooperation and the Decline of the Nation State

0. Introduction

The idea of the state lies at the core of international relations and international law. And the concept of sovereignty lies at the core of the notion of the state. Indeed, inherent in the existing system of states are the principles of political independence and sovereign equality that form the underpinnings of sovereignty.¹

Thus, it is unsurprising that the United Nations charter specifically declares that "[n]othing contained in the present Charter shall authorize the United Nations to intervene in matters which are essentially within the domestic jurisdiction of any state or shall require members to submit such matters to enforcement."²

The provision in the UN charter, which is similar to provisions found in many other international treaties,³ was necessary because without it sovereign states would have been reluctant to join the United Nations. Countries jealously protect their sovereignty, and even have the right under international law to use armed force to protect that sovereignty.

This devotion to sovereignty appears to be inconsistent with the increasing trend toward the establishment of international agreements and institutions, since, as a practical matter, such institutions and agreements involve a surrender of some degree of sovereignty. After all, "[s]ince governments put a high value on the maintenance of their own autonomy, it is usually impossible to establish international institutions that exercise authority over states."⁴ In other words, there appears to be an inconsistency

¹ Barry E. Carter & Phillip R. Trimble, *International Law* 1366 (2d edition 1995).

² U.N. Charter, Article 2(7).

³ Carter & Trimble, *supra* note 1 at 1366-67.

⁴ Robert O. Keohane, *After Hegemony: Cooperation and Discord*

between the basic desire for autonomy of nation-states and the trend towards the establishment of international agreements and institutions, which, by their very nature, entail a surrender of sovereignty.

This paper attempts to reconcile this apparent inconsistency by examining the trend toward international agreements from a public choice perspective. In order to provide focus and context to the inquiry, we concentrate on the areas of banking and securities law. The starting point for the analysis is that nations do not decide to cooperate or forge international agreements: rather the regulators, bureaucrats and politicians within nations do. And regulators will not agree to enter into international agreements unless it is in their (private) interest to do so. Furthermore, regulators are political support maximizing actors. They respond to political pressure and to self-interest. All else equal, regulators would prefer not to cede - or to share - regulatory authority with regulators from other countries. For this reason, regulators in a particular country generally do not want to coordinate their activities with regulators in other countries because such coordination forces the regulators to sacrifice autonomy. The thesis of this article, however, is that technological change, market processes and other exogenous variables can deprive the regulators in a particular country of the power to act unilaterally. Such change can cause regulators acting alone to become irrelevant. When this happens, the regulators in a particular country will have strong incentives to engage in activities such as international coordination in order to survive.

Viewed from this perspective, it becomes clear that the trend toward international agreements and the formation of international institutions are consistent with the basic desire of governmental actors to maintain their sovereignty. Such agreements and institutions ought to be viewed as attempts to preserve as much autonomy

as possible in the modern world.

In this Article, we apply our theory to the Basle Accords, the historic document which standardizes minimum capital requirements among the world's banks. In the context of the negotiations leading up to those agreements, our theory explains why agreement to coordinate capital levels was reached. Japanese regulators appeared to be reluctant to compromise with their bureaucratic colleagues from other nations, while the regulators from the United States were quite eager to reach an agreement about capital levels. Unlike their counterparts in the United States, the Japanese bureaucrats, who represented Japan's Ministry of Finance, were quite powerful. Their autonomy was not being threatened by internal or external sources, and therefore, the Japanese bureaucrats felt little need to reach an international accord in order to protect either their autonomy or their bureaucratic turf. By contrast, the U.S. banking regulators were faced with serious challenges to their own power at home, and therefore had strong private incentives to reach an agreement.

In addition, we also address the recent globalization of insider trading regulation. It was not long ago that insider trading was largely seen as a concern only within the United States. Today, with developments such as the European Community insider dealing directive and the criminalization of insider trading in Switzerland and most recently in Germany, we observe that most major financial center countries are adopting their own insider trading regulations. This trend reaches the same effective result as an international agreement such as the Basle Accords. Moreover, the individual adoption of similar domestic regulation is perhaps even more effective at "coordinating" on an international level due to the difficulties present in forcing a country to adhere to an international agreement.

Part I of this Article describes the public choice theory of international regulatory competition and coordination in more detail. It begins by briefly distinguishing two competing views of

government regulation, public-interest theory and public choice theory, in order to illustrate why public choice theory provides a useful perspective on recent international coordination in financial regulation. Next, the article lays out the framework of a public choice theory for financial regulation.⁵ In Part II, we apply the insights of public choice theory for financial regulation to the recent efforts to coordinate banking and securities law. First, we examine the Basle Accord on minimum capital requirements for financial institutions and demonstrate that coordination of such requirements makes little sense from a public interest perspective. However, we show that international coordination can easily be explained from a public choice view. Next, we turn to recent international agreements on insider trading regulations. In this area, where the United States also was facing serious threats to its autonomy, we will see that the United States successfully pressured other countries into adopting insider trading regulations that have helped the United States to maintain its autonomy in those areas. Again, public interest theory provides little use in explaining this activity, while a public choice provides a useful explanation.

I. Public Choice Theory and the Decline of the Nation-State

Political science and economics provide competing theories to explain the role of the government in regulating society. The traditional view of political scientists, formally known as the public-interest theory, generally posits that legal institutions and bureaucracies regulate in order to further the common good.⁶ Ad-

⁵ See also Edward J. Kane, "Tension Between Competition and Coordination in International Financial Regulation," in *Governing Banking's Future: Markets vs. Regulation* at 33-47 (Catherine England, ed. 1991) (applying public choice theory to international financial regulation).

⁶ A.C. Pigou, *The Economics of Welfare* (4th ed. 1932).

herents to the public-interest theory assert that a government seeks to achieve this basic goal of serving the public by solving collective action problems and intervening when private markets fail to allocate resources properly. "Public-interest theory maintains that government should correct these failures through regulation, for example, through taxes or subsidies designed to push markets toward a 'socially optimal' equilibrium."⁷

A. An Introduction to Public Choice Theory

To reach its conclusion about the role of government regulation, the public-interest theory makes some questionable assumptions about the abilities and nature of government. A major shortcoming of the theory is that it "assumes that government has the superhuman ability to both identify and correct market failures without cost."⁸ Moreover, as McCormick and Tollison note, "the [public-interest] approach assumes an all-knowing, benevolent government."⁹

Not surprisingly, the public-interest theory has been criticized as "not a very believable theory of government."¹⁰ Even more problematic, given its objective of explaining government regulation, is the fact that public-interest theory fails to explain much of what we observe in the real world. Contrary to the predictions of public-interest theory, we often observe regulation where there is little evidence, if any, of market failure. One also

⁷ Henry N. Butler and Jonathan R. Macey, "Health Care Reform: Perspectives from the Economic Theory of Regulation and the Economic Theory of Statutory Interpretation," 79 Cornell L. Rev. 1434, 1436 (1994); for a full description of the public-interest model, see Robert E. McCormick and Robert D. Tollison, *Politicians, Legislation and the Economy: An Inquiry Into the Interest Group Theory of the Government* 3 (1981).

⁸ McCormick and Tollison, at 3-4.

⁹ *Id.* at 4.

¹⁰ *Id.* at 3.

observes governmentally coerced wealth transfers that benefit powerful, discrete interest groups at the expense of the general public.¹¹

In contrast to the public-interest theory of political scientists, the public choice or "interest group" theory of regulation uses the standard assumptions about human nature routinely employed by economists. Public choice assumes that politicians, bureaucrats and other decision-makers in public life are rationally self-interested.¹² This means that, like individuals and firms in the private sector, politicians and bureaucrats attempt to maximize their personal power and wealth even when these selfish ends conflict with public-spirited goals.¹³ Applied to what bureaucrats and politicians do, the assumption of self-interest means that law is traded for political support, money, power, and other things that politicians and bureaucrats demand. As Judge Richard Posner explains, public choice theory "asserts that legislation is a good demanded and supplied much as other goods, so that legislative protection flows to those groups that derive the greatest value from it."¹⁴

The critical advantage of public choice theory over public-interest theory is its superior predictive powers. For example, as Kenneth Scott has noted, "[i]n [public choice theory's] light, much of banking regulation (such as restraints on entry or price fixing

¹¹ Kenneth E. Scott, Commentary on Edward J. Kane, "How Market Forces Influence the Structure of Financial Regulation," in *Restructuring Banking and Financial Services in America* at 387 (William S. Haraf and Rose Marie Kushmeider eds. 1988).

¹² "Thus, [public choice theory] analyzes decisions made by politicians, bureaucrats, and interest-groups in accordance with generally accepted principles of rational economic behavior." Macey and Butler, at 1437.

¹³ Butler and Macey at 1436.

¹⁴ Richard A. Posner, "Economics, Politics, and the Reading of Statutes and the Constitution," 49 *U. Chi. L. Rev.* 263, 265 (1982).

through the late and unlamented Regulation Q) can be explained as successful efforts by banks to obtain monopoly rents through a cartel administered by the government."¹⁵ Similarly, as one of us has demonstrated elsewhere (in joint work with Geoffrey Miller), the real beneficiaries of deposit insurance are financial institutions, because deposit insurance minimizes their cost of funds, and not the public, which pays for deposit insurance with foregone interest.

Regime theory is an important school of thought about international relations that can best be viewed as an application of the public interest theory that uses some aspects of public choice theory in its analysis.¹⁶ Because regime theory, like the theory presented here, generates predictions about the contours and timing of international cooperation based on certain tools of economics, the theory will be discussed here briefly.¹⁷

Although there is some ambiguity about the precise definition of a regime, regimes can be loosely defined as "sets of implicit or explicit principles, norms, rules and decision-making procedures around which actors' expectations converge in a given area of in-

¹⁵ Scott, at 387.

¹⁶ Two classic works in regime theory are Robert O. Keohane, *After Hegemony: Cooperation and Discord in the World Political Economy* 88 (1984) and *International Regimes* (Stephen Krasner, ed., 1983).

¹⁷ Realism, liberalism and Marxism generally are considered to be the three major contending schools of thought into which the competing theories of political scientists who focus on international relations can be divided. Robert Gilpin, *The Economy of International Relations* 24, 25 (1987). Jeffrey Frieden and David Lake (editors), *International Political Economy* 5 (2nd edition 1991). See generally Abla Amawi and G.T. Crand, *The Theoretical Evaluation of International Political Economy* (1991); David A. Lake, *The International Political Economy of Trade* (1993). However, the realist approach and the liberal approach are basically variants of the public interest approach. The Marxist approach is not worth discussing seriously.

ternational relations."¹⁸ Regimes are also "man-made arrangements for managing conflict in a setting of interdependence."¹⁹

B. Regime Theory and International Cooperation

Sophisticated regime theory, like public choice theory generally, begins with an assumption of rational self-interest. The critical difference between regime theory and public choice theory is that while public choice theory assumes rational self-interest on the part of individuals, regime theory assumes rational self-interest on the part of states. In other words, regime theory presumes that governments can have interests and preferences independent of the personal interests of the interest groups, politicians and bureaucrats who determine governmental policy. In contrast, public choice theory presumes that governmental policy reflects the equilibrium outcome of a rivalrous process among competing interest groups who try to cause governmental policy to further their own ends. In this respect, public choice theory reflects a similar view of State behavior to a school of thought called Liberalism, which, as Anne-Marie Slaughter explains, "assum[es] . . . that the primary actors in the international system are individuals and groups acting in domestic and transnational society."²⁰

Thus, for example, regime theory, like the public interest theory generally, predicts that "public goods problems affect the . . . demand for international regimes, which can ameliorate problems of transactions costs and information imperfections that hinder effective decentralized responses to problems of providing public

¹⁸ Stephen Krasner, *Structural Causes and Regime Consequences: Regimes as Intervening Variables*, in *International Regimes*, supra, at 23.

¹⁹ Ernest B. Haas, *Words Can Hurt You; or, Who Said What to Whom About Regimes* in *International Regimes*, supra note at 26.

²⁰ Anne-Marie Slaughter, "International Law in a World of Liberal States," 6 *European Journal of International Law* 503, 508 (1995).

goods."²¹ By contrast, public choice theory predicts that international regimes do not respond to public goods problems, but rather to the needs of politicians, bureaucrats and interest groups of the countries that constitute the relevant decision-makers within the regimes.

One critical prediction of regime theory that is in sharp contrast to the theory developed in this paper is that the pace of conflict will increase as markets develop and the world becomes more interdependent:

Interdependence in the world political economy generates conflict. People who are hurt by unexpected changes emanating from abroad, such as increases in the prices that producers charge for oil or that banks charge for the use of money, turn to their governments for aid. So do workers, unemployed because of competition from more efficient or lower-wage foreign production. Governments, in turn, seek to shift the costs of these adjustments onto others, or at least to avoid having them shifted onto themselves. This strategy leads them to pursue incompatible policies and creates discord.²²

There are several flaws with this analysis. First is the assumption that governments have preferences. Institutions in general and governments in particular do not have preferences, people do. Governmental policy reflects the preferences of powerful constituents, not some mystically determined set of preferences that might be described as the "national interest." Second, unlike public choice theory, regime theory presumes that governmental policy is made without regard to the preferences of the policy-makers who are

²¹ Robert O. Keohane, *The Demand for International Regimes*, in *International Regimes*, at 170.

²² Keohane, *supra* note at 243.

formulating and implementing that policy. This seems false and is inconsistent with the theory presented here. As is explained in the following section, it is hardly plausible that regulators and policy-makers will enact policies that threaten their own authority and autonomy, much less their very existence merely because such policies are consistent with the national interest.

This is not to say that the results generated by regime theory will always be inconsistent with the results generated by public choice theory. Sometimes the theories will generate the same predictions. Certainly, for example, where economic interdependence causes widespread unemployment among unionized workers who represent a powerful political constituency, it is likely that the political coalitions that represent these workers will mount a lobbying campaign that provides relief to these workers. This relief may manifest itself in international conflict, such as tariffs or other barriers to trade. A critical difference between public choice theory and regime theory is that regime theory posits that interdependence generates conflict, while public choice theory posits that interest groups generate conflict.

Thus under public choice theory, interest groups will, at times, galvanize into effective political coalitions which permit them to succeed in pressuring policy-makers to impose rules that provide such groups with private benefits but cause conflict internationally. The pressure for protectionist legislation that causes conflict exists independently of interdependencies. In contrast with regime theory, under public choice theory, interdependence is as likely to generate cooperation as conflict. In particular, interdependence will be observed where it is consistent with the interests of bureaucrats and interest groups.

In a nutshell, then, regime theory posits that international institutions (called "regimes") are vehicles through which states attempt to further their own interests.²³ Public choice theory

²³ Keohane at 246.

rejects the idea that states have interests, and instead posits that international institutions are vehicles through which politicians, bureaucrats, and interest groups reflect their own interests.

C. Public Choice Theory and Financial Regulation

Applying public-choice analysis to bureaucracies in general and to the promulgation of financial regulation by such bureaucracies in particular yields two insights. First, any given regulatory entity will engage in wealth-maximizing behavior. That is, they will attempt to maximize the rough "value of their (bureaucracies) subject to technological, market, and statutory restraints and principal-agent difficulties."²⁴ Second, any given regulatory authority competes with other regulatory authorities for whatever it is that they are attempting to maximize. This competitive behavior will occur on an international as well as an international level.

Thus, as Edward Kane has observed, "like dominant firms in any domestic market, a country's dominant financial regulator must worry about foreign competition."²⁵ Kane has offered an important explanation for changes in financial market regulation. Kane observes that, even where capital flight is easy and financial service firms can do business across borders with little difficulty, regulated entities cannot easily change regulators, because doing so is very costly, due to "substantial transition or switching costs."²⁶ Regulators employ exit fees, administrative delays, and outright prohibitions²⁷ to prevent the firms they regulate from

²⁴ Kane, "Tension Between Competition and Coordination," at 34 (citing Kenneth E. Scott, "The Dual-Banking System: A Model of Competition in Regulation," 30 Stanford L. Rev. 1 (1977)).

²⁵ Id. at 36.

²⁶ Id. at 37.

²⁷ Id at 37.

leaving the regulatory fold and to preserve their market shares.²⁸

However, "technological change and competition between foreign and state regulators"²⁹ has made it more difficult for regulators to protect their turf. Technological change and market developments have made it possible for banks and insurance firms and investment banks to compete directly, despite the fact that these firms traditionally have been regulated by rival regulators. Technology has increased competition, as travel and information costs have declined making international competition increasingly easy. These changes "have made it increasingly less costly for financial firms to penetrate U.S. and foreign regulators' administrative fences by cleverly adapting their institutional structures to squeeze through loopholes in the system of prohibited activities."³⁰ As Professor Kane observes:

The recent global acceleration of financial and regulatory change reflects the response of regulatees and regulators to exogenous and endogenous decreases in the costs of entry and exit from various financial product markets. The microeconomic view is that the product line and geographic market expansion by suppliers of financial regulatory services follow and support rivalry between client financial services firms within and across countries, regions, and various kinds of administrative boundaries. Supplementing strictly bureaucratic theories of regulatory behavior (e.g., Niskanen 1971), my conception is based on the premise that regulators attempt, subject to bureaucratic, market and technological constraints, to extend or defend their share

²⁸ Id.

²⁹ Id.

³⁰ Id. at 37.

of the market for regulatory services in the face of exogenous and endogenous disturbances in the economy.³¹

One of us has made an analogous argument to Kane's in a recent article discussing administrative agency obsolescence.³² In that Article, Macey applied principles of firm or industry failure in a market economy to administrative agencies. In a competitive market when a firm misuses limited resources by 'producing unwanted products, or overproducing, or using inefficient production techniques, at the extreme it will fail, and the resources will find more socially desirable resources.'³³ The argument there was that "just as technological innovations in markets often cause whole industries to become obsolete- for example, the introduction of the automobile had disastrous consequences for the buggy whip industry- so too can technological innovation render administrative agencies obsolete."³⁴ concluded that while a competitive market allows firm or industry failure so that resources will flow to more efficient uses, "when administrative agencies become obsolete, they are likely to respond to their obsolescence in ways that impose very heavy costs on the firms they are supposed to regulate, or on society generally, or both. As obsolescence sets in, administrative agencies are likely to replace the publicly articulated goals that provided the initial justification for the creation of the agency with self-serving goals designed to insure that the agency will

³¹ Id. at 37.

³² Jonathan R. Macey, "Administrative Agency Obsolescence and Interest Group Formation: A Case Study of the SEC at Sixty," 15 *Cardozo L. Rev.* 909 (1994).

³³ Macey, 15 *Cardozo L. Rev.* at 910 (quoting A. Dale Tussing, "The Case for Bank Failure," 10 *J.L. & Econ.* 129, 129 (1967)).

³⁴ Id. at 911.

remain a secure place for the officials who comprise its staff."³⁵

Applying these obsolescence principles to the recent international coordination of financial regulation produces conclusions consistent with Kane's. Specifically, when technological change, market processes or other exogenous variables threaten either to remove power from a nation's regulatory structure or cause it to become irrelevant, then the regulators in that nation will have strong incentives to engage in activities such as international coordination in order to protect their autonomy.

II. Applying Public Choice Theory in Specific Contexts: The Basle Capital Accords & Insider Trading

A. The Basle Capital Accords

1. Background

In theory, the purpose of capital adequacy rules is to protect depositors from the damage caused by excessive risk taking by financial institutions.³⁶ A bank's capital is, generally speaking, simply the difference between the banks' assets and its liabilities. This sum is often characterized as a bank's "cushion" against insolvency.³⁷ The higher a bank's level of capital, the larger the cushion that protects depositors in case of financial stress. Likewise, so long as a bank has a positive capital level, it is solvent: it has sufficient assets to pay all of its outstanding liabilities, and the risk of loss in case of failure falls solely on the shoulders of the shareholders.³⁸ Thus, the presence of adequate capital provides protection for depositors, or in the context of federal deposit insurance, for the federal deposit insurance

³⁵ Id. at 913.

³⁶ Jonathan R. Macey and Geoffrey P. Miller, *Banking Law and Regulation* at 284 (1992).

³⁷ Id.

³⁸ Id.

system.³⁹

While the theory of capital adequacy is relatively straightforward, implementation of a workable capital adequacy system is in reality quite difficult to achieve. First, there is the problem of quantifying a financial institution's base capital level in the first place. This process is made extremely difficult by the fact that capital takes many forms, ranging from more permanent and certain sources of value (e.g., common stock) to less certain and less permanent sources of value (e.g., subordinated debt).

Even more problematic is the problem of asset risk. Any rational system of capital adequacy rules must account in some meaningful way for the risk present in the financial institution's asset portfolio. This is because the riskier the firm's assets, the greater the risk of bankruptcy. For example, a bank that simply accepts time deposits and invests the proceeds in short-term government debt of matching maturities does not run any risk of insolvency (so long as the return on the notes can cover the interest on the deposits plus the bank's expenses). By contrast, a bank that takes deposits and invests the proceeds in speculative assets like real estate loans or derivatives presents a significantly higher risk of insolvency.

For these reasons, simple, bright-line capital rules are inappropriate and ineffective. Ironically, for a long time, such a crude, bright-line rule was exactly what financial institutions in the United States operated under. Known as leverage ratios, the original capital adequacy rules simply required that banks meet a gross ratio of capital to assets with no accounting for the risk of assets.⁴⁰ The implication of the leverage ratio structure, as in-

³⁹ Id.

⁴⁰ Id. at 285. While leverage ratios remain in place under United States banking regulation, their importance has effectively been trumped by the Basle Capital Accord guidelines.

licated above, was that banks could operate at widely disparate levels of risk while still be in compliance with the leverage ratio guidelines.

The inadequacy of the leverage ratio framework became increasingly apparent with the dramatic growth in banks' international and cross-border activities during 1970s. Because capital adequacy rules varied greatly across countries, major banking countries were concerned that countries with relatively strict capital guidelines were being placed at a competitive disadvantage with countries with more lenient guidelines.⁴¹

It was widely understood that the competitive advantage to be gained from more lenient capital standards was responsible for a reduction in the capital levels of international banks. The concerns about banks becoming increasingly risky as a result of dangerously low capital levels and off-balance sheet activities that made banks increasingly difficult to monitor led initially to a joint initiative between the United States and the United Kingdom, which was designed to achieve a common risk-weighted capital measuring system in 1986.⁴² This initiative was followed in December 1987 with the Basle Capital Adequacy Accords.⁴³ The Basle Accords are essentially a "gentleman's agreement" among central bankers in the countries that make up the Basle Supervisors Committee

⁴¹ Id. See, Risk-Based Capital Requirements for Banks and Bank Holding Companies: Hearing Before the Subcommittee on General Oversight and Investigations of the House Committee on Banking, Finance and Urban Affairs, 100th Congress, 2d Sess. 5 (1988)-(statement of William Taylor, Division of Banking Supervision and Regulation, Federal Reserve Board)("[W]e simply cannot ignore the impact of differing regulatory standards on U.S. banks' ability to compete worldwide. More consistent supervisory standards among countries can contribute to competitive equality and, in the long run, to a safer and more stable banking system."

⁴² Id.

⁴³ Ethan B. Kapstein, "Resolving the Regulator's Dilemma: International Coordination of Banking Regulations," 43 Int'l Org. 323, 323 (1989).

of the Bank for International Settlements (BIS).⁴⁴ In 1989, the Accord was extended to several European Union countries which are not among the G-10 countries when the European Union adopted its own capital guidelines based on the Basle structure.⁴⁵ In addition to these countries, many other nations have adopted the Basle Accord in order to enhance their international reputation, and to "enable them to operate in countries like the United States that require conformity with the Basle standards as a condition for entry."⁴⁶

2. The Basle Accords from the Public Interest Perspective

The public interest based explanation for the Basle Accords is easy to summarize. The globalization of financial markets that began in the 1970s brought a substantial increase in international competition. This increased competition combined with the explosion in banks' use of off-balance sheet activities to produce a need for international regulatory coordination in order to provide for the safety and soundness of the banking industry and to promote competitive equality within the banking industry.⁴⁷ Without the Basle accords, it is argued, banks operating in countries with weak capital requirements have a competitive advantage over banks operating in countries with stringent capital requirements. This competitive

⁴⁴ Hal S. Scott, "The Competitive Implications of the Basle Accords," 39 St. Louis U. L.J. 885 (1995). The BIS Committee includes the Group of Ten (G-10) countries (Belgium, Canada, France, Germany, Italy, Japan, Netherlands, Sweden, United Kingdom, and United States) plus Switzerland and Luxembourg.

⁴⁵ Id. This brought in Denmark, Greece, Ireland, Portugal and Spain.

⁴⁶ Id.

⁴⁷ See, e.g., Cooke, *supra* n ; Ethan Kapstein, "Resolving the Regulator's Dilemma, *supra* n ; Note, "The Proposed Risk-Based Capital Framework: A Model of International Banking Cooperation? 11 Fordham Int'l L.J. 777 (1988).

advantage puts pressure on bank regulators. A competition among regulators results that is best characterized as a "race to the bottom" in which regulators try to benefit their own constituents by lowering capital requirements. International coordination in the form of the Basle accords solves this problem. There are at least two problems with the public interest analysis. First, the Basle Accords did not improve the safety and soundness of the financial system. And they also have not "leveled the regulatory playing field" by eliminating the competitive inequities that can theoretically arise from differing capital guidelines. Second, the public interest approach presumes that such "harmonization" or "cooperation" is beneficial to the public without offering a believable explanation of why a country such as the United States would be so eager to sacrifice at least some of its national autonomy in the area of financial regulation.

Hal Scott and Shinsaku Iwahara have effectively demonstrated that the Basle Accords have not leveled the international playing field, and that they never even had a realistic chance of doing so.⁴⁸ Scott and Iwahara explain that "[c]ompetitive advantages between banks in two countries are caused primarily not by differences in capital ratios, but by differences in comparative advantage, the fundamentals of each economy, and governmental support in the form of safety net policies."⁴⁹

One of the principal reasons for Scott and Iwahara's conclusion arises from the existence of a "bailout differential" between nations.⁵⁰ In an efficient market, the risk of debtor default

⁴⁸ Hal S. Scott and Shinsaku Iwahara, "In Search of a Level Playing Field: The Implementation of the Basle Capital Accord in Japan and the United States", Occasional Paper 46 (Group of Thirty, 1994).

⁴⁹ Id.

⁵⁰ Hal S. Scott, "The Competitive Implications of the Basle Capital Accord," 39 St. Louis L.J. 885 (1995).

would lead creditors of highly leveraged firms to demand higher interest payments than creditors of less leveraged firms. This does not occur in the banking industry because of the presence of a governmental "safety net". All major banking countries have some form of implicit or explicit guarantee/deposit insurance that the depositors in financial institutions will be protected if the financial institution defaults.⁵¹ The presence of this guarantee generally makes creditors indifferent to a financial institution's leverage ratio.⁵²

However, the strength of this safety net varies from country to country. For example, there is strong evidence to support the fact that the Japanese and European safety nets are stronger than that of the United States.⁵³ The implication of this is that "creditors will demand higher interest rates from United States banks than they do from European or Japanese banks with the same leverage because the overall risk of lending to United States banks is higher. . . . United States banks must have more capital to make up for the weaker government guarantees."⁵⁴

The available data appear to confirm Scott and Iwahara's position. The average capital ratio for the ten largest United States banks in 1993 was 13.6%, as compared with 9.67% for the ten largest Japanese banks.⁵⁵ Similarly, the average capital ratio for the ten

⁵¹ Macey and Miller, *Banking Law & Regulation* at ?.

⁵² Scott, 39 St. Louis L.J. 885 (Westlaw copy; page references not available.)

⁵³ *Id.* Scott notes that no depositor in Japan has ever lost a single Yen as a result of a bank failure since the end of World War II, while U.S. depositors have often had to absorb significant losses. In addition, the safety net of European countries is also stronger than the that of the U.S. because the European countries have fewer, but larger, banks which makes them too big to fail, or have state-owned financial institutions.

⁵⁴ *Id.*

⁵⁵ *Id.* (citing Federal Reserve, *Japanese Securities Report*).

largest European banks in 1993 was 10.12%, also lower than the United States' 13.6%.⁵⁶ Moreover, neither the capital ratio differentials between the United States and Japan nor between the United States and Europe have narrowed since the inception of the Basle Accord.⁵⁷

Not only have the Basle Accords not leveled the international playing field with respect to capital, "it would be a total accident if it did so given the disparate effects of regulatory, market, accounting and tax differences among countries."⁵⁸ Moreover, Basle's risk-weight categories create competitive distortions based upon differences between domestic economies. Japanese banks typically have higher levels of private loans relative to the U.S., which are risk-weighted at 100%.⁵⁹ The U.S., in contrast, has relatively higher levels of residential mortgages, which carry a risk-weight of 50%.⁶⁰ Thus, the Basle standards themselves place Japan at a competitive disadvantage relative to the U.S. banks because residential mortgages, which are favored by the accords are a more important part of the U.S. banking market than the Japanese banking market, while private loans, which are disfavored are more important to Japanese banks.

What about safety and soundness? While no systematic analysis has yet to provide a clear answer as to whether the Basle Accords have achieved this objective, Robert Litan has shown the Basle framework can contribute to credit crunches in periods of economic downturn.⁶¹ Litan's analysis casts a strong shadow over any claim

⁵⁶ Id. (citing American Banker).

⁵⁷ Id.

⁵⁸ Id.

⁵⁹ Id.

⁶⁰ Id.

⁶¹ Robert E. Litan, "Nightmare in Basle," *The International Economy*, November/December 1992, at 7.

that the Accords have improved the safety and soundness of the banking system. The Basle Accords have this effect because the Basle "risk weights tilted the incentives of banks heavily toward investing in government bonds [risk-weight of 0%] rather than making loans [commercial/private loans risk-weight of 100%; residential mortgages' risk-weight of 50%].⁶² Assuming a bank must pay 3% to attract deposits and 10% for equity, the implication of these risk-weights is that a bank's cost of funding to invest in government bonds is 3%, while its cost of funding for a private loan is 3.56%⁶³

Thus, between December 1991 and July 1992, the volume of commercial bank loans in the United States fell by \$20 billion, while the total bank investments in government bonds rose by \$50 billion.⁶⁴ Litan concludes:

It is no doubt true that weak demand for commercial loans has contributed to this situation. But the undeniable fact remains that before the Basle Accord . . . the cost of funding both government bonds and loans were the same. . . . Moreover, by pushing banks into playing the government bond yield curve, the risk-weights are impelling banks to take on greater interest rate risk, which may come to haunt them when the yield flattens, as it eventually will.⁶⁵

Thus the public interest theory's safety and soundness and competitive equality arguments fall short. Moreover, public interest theory fails to offer any explanation of why a country would be willing to sacrifice its autonomy in order to take part in the Basle accords.

⁶² Id.

⁶³ Id.

⁶⁴ Id.

⁶⁵ Id.

3. The Basle Accord from Public Choice Perspective

The public choice model provides a much more useful perspective on the Basle Accord. Consistent with the public interest view, the public choice perspective traces the regulatory innovations that resulted in the Basle Accords to the market and technological innovations of the past twenty years. These exogenous market and technological forces posed a significant threat to the national regulatory structure of countries like the United States and the United Kingdom. In response to this threat, the bank regulators in those countries pushed the Basle agenda in an attempt to protect their own bureaucratic turf. On this view, the Basle Agreement is consistent with the desire of regulators and bureaucrats to protect their autonomy in the face of international competition. Indeed the Accords are entirely consistent with the desire on the part of regulators to avoid regulatory obsolescence.

The principal effect of the technological change and the globalization of markets over the past two decades has been to reduce the entry and exit barriers which had maintained financial institutions within domestic boundaries.⁶⁶ As barriers to competition have fallen and it has become easier for regulated firms to migrate to more sympathetic regulators, there has been increased competition among national regulatory authorities. In this competition, the United States has "been losing market share in securities and banking to foreign regulators, particularly to the Japanese."⁶⁷

This emerging loss of market share to the Japanese has forced nations such as the United States and the United Kingdom to respond with demands for "harmonization" in order to maintain some degree of autonomy. From their position of relative strength, regulators in Japan's Ministry of Finance saw little need to enter into an

⁶⁶ Edward Kane, "Tension Between Competition and Coordination in International Financial Regulation," at 44.

⁶⁷ Id.

international accord. Moreover, Japanese banks were not undercapitalized when the Basle accords were being discussed. Rather the reverse: Japanese banks were solidly capitalized.⁶⁸

But nonetheless, the Basle accords were unambiguously in the interests of Japanese regulators. For the Japanese regulators, the accords were a means of obtaining more power vis-a-vis the banks they were supposed to regulate. Japanese bureaucrats could not obtain the power unilaterally to impose minimum capital requirements on their own banks, because Japanese the banks were able to resist this attempt. But while the Japanese banks could constrain the regulators domestically, the agency costs between the banks and the regulators were too high in the international context. Thus, from the perspective of the Japanese, the Basle accords represented a kind of hands-tying strategy in which the bureaucrats were able to collude with bureaucrats in other countries in order to obtain more discretionary regulatory authority.

In this context it is important to note that it was only after United States regulators threatened to exclude Japanese banks from United States markets that the Japanese were drawn into the fold.⁶⁹

In other words, Japanese regulators could report back to their bank-clientele that they had no choice but to enter into the accords, or else the consequences for Japanese banks would be even worse. Probably the Japanese regulators at Basle could have resisted the threat to exclude them from U.S. markets by promising to protect depositors against loss. But they did not want to because signing the Basle accords increased the power and autonomy of Japanese regulators.

⁶⁸ I am grateful to Raghuram G. Rajan of the University of Chicago reminding me of this historical fact.

⁶⁹ Ethan Kapstein, "Resolving the Regulator's Dilemma," *supra* n.

B. Insider Trading Regulation

1. Background

The recent trend toward international regulation of insider trading provides another example of how the trend in internationalization is consistent with the desire of the nation to maintain its autonomy.⁷⁰ As recently as the mid-1980s, actual enforcement of insider trading regulations was largely confined to the United States. Most other major financial center nations either did not have insider trading regulation (e.g., Germany) or, if they did, did not actively enforce the regulations (e.g., Japan).⁷¹ Today, "[v]irtually every country with a major stock market has adopted, or is actively considering, provisions outlawing insider trading."⁷² For example, in 1989 the European Community adopted a directive calling for the coordination of regulations on insider trading.⁷³ Even more striking is the fact that in June 1994 the German Parliament authorized legislation making insider trading a crime for the first time in that country's history.⁷⁴

Given the fact that many of these nations, especially Germany, historically failed, and even still fail, to view insider trading with the same approbation that Americans do, this recent global regulation appears to contradict the theory that the nation state would act to maintain its autonomy. However, as was the case with the Basle Accords, this recent trend reflects the response of a

⁷⁰ See, Harvey Pitt & David B. Hardison, "Games Without Frontiers: Trends in the International Response to Insider Trading," 55 *Law and Contemporary Problems* 199 (Autumn 1992).

⁷¹ *Id.*

⁷² *Id.*

⁷³ Council Directive 89/592 on Regulations on Insider Dealing, 1898 O.J.K. (L 334) 30 [hereinafter "Council Directive"].

⁷⁴ Daniel James Standen, "Insider Trading Reforms Sweep Across Germany: Bracing for Cold Winds of Change," 36 *Harv. Int'l. L.J.* 177.

nation faced with obsolescence in a regulatory arena in the face of technological change, market processes and exogenous variables. In particular, the recent trend toward globalization of insider trading regulations represents a response by the Securities and Exchange Commission (SEC) to protect its own power through international accords, and through pressuring other nations to adopt an insider trading framework analogous to the one in the United States.

a. The United States' Insider Trading Framework

The SEC's power to regulate insider trading derives from the existence of domestic federal statutes prohibiting insider trading and allocating the power to enforce the prohibition to the Commission. Current insider trading laws forbid the purchase or sale of corporate stock by employees or other closely associated individuals when done on the basis of information that is not publicly available.⁷⁵ The source of these laws derives primarily from Section 16(b) of the Securities and Exchange Act of 1934,⁷⁶ and judicial interpretation of both Section 10(b) of the Exchange Act and Rule 10b-5⁷⁷ promulgated by the SEC under authority granted to it by Section 10(b).⁷⁸ Section 16(b) of the Securities Exchange Act of 1934 requires corporate officers, directors and other statutorily defined insiders to disgorge profits made from the purchase and sale of equity in their firm within any six month period.⁷⁹ This statute, however, is limited in its effectiveness against insider trading since penalties can be avoided simply by holding onto securities for longer than the required six months.⁸⁰

⁷⁵ David D. Haddock and Jonathan R. Macey, Controlling Insider Trading in Europe and America: The Economics of the Politics, 149.

⁷⁶ 15 U.S.C. Section 78 et seq. (1995) (herein referred to as "Exchange Act").

⁷⁷ 17 C.F.R. Section 240.10b-5.

⁷⁸ Michael Mann and Lise A. Lustgarten, Internationalization of Insider Trading Enforcement: A Guide to Regulation and Coopera-

Section 10(b) of the Exchange Act, however, is far broader than Section 16. It prohibits ". . . any deceptive or manipulative device or contrivance in contravention of such rules and regulations as the Commission may prescribe" relating to securities trading.⁸¹ By way of this congressional grant of authority, the SEC crafted Rule 10b-5, which requires an individual who possesses material inside information to either refrain from trading, or publicly disclose that information well before trading in the relevant stock.⁸² Specifically, Rule 10b-5 makes it unlawful: "(a) to employ any device, scheme, or artifice to defraud; (b) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading; or (c) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security."⁸³ This regulation serves as the basis for the prohibition against insider trading.

The language of Section 10(b) and Rule 10b-5, however, is not facially limited to insiders.⁸⁴ In fact, the term "insider" is not

tion, Practising Law Institute, Corporate Law and Practice Course Handbook Series, January 1993 at 3 (available on Westlaw as cite 798 PLI/Corp 7).

⁷⁹ 15 U.S.C. Section 78p(b) (1995).

⁸⁰ Jennings & Marsh, Securities Regulation: Cases and Materials, (fifth ed. 1982) at 1315-16.

⁸¹ Mann and Lustgarten, supra note ___ at 3.

⁸² SEC v. Texas Gulf Sulphur Co., 401 F. 2d 833, 848, 856-7, (1968), cert. denied, 394 U.S. 976 (1969).

⁸³ 17 C.F.R. Section 240.10b-5.

⁸⁴ Brudney, Insiders, Outsiders, and Informational Advantages Under the Federal Securities Laws, 93 Harv. L. Rev. 322, 329 (1979-).

defined in statutes pertaining to insider trading.⁸⁵ The scope of the regulations in effect today was narrowed considerably by the Supreme Court in Chiarella v. United States,⁸⁶ and Dirks v. SEC,⁸⁷ two opinions that dealt considerable blows to the SEC's power and prestige.

In Chiarella, a financial printer made stock purchases based on confidential information regarding client companies obtained through his employment with Pandick Press.⁸⁸ The printing company produced mandatory filings for tender offers on target company securities.⁸⁹ Chiarella used the information submitted to Pandick to purchase stock in the target companies prior to public disclosure of the offers.⁹⁰ The defendant was subsequently charged with violating Section 10(b) of the Exchange Act in lieu of SEC Rule 10b-5.⁹¹ The Court found that Chiarella did not violate the statute, stating that simple possession of non-public information does not alone establish an affirmative duty to either disclose or refrain from trading the pertinent security.⁹² The Court held that a fiduciary duty, arising from a contractual or quasi-contractual relationship, must be present to establish liability under Rule 10b-5.⁹³ Since Chiarella had neither a contractual relationship nor a position of trust with the client companies, he did not have

⁸⁵ Mann and Lustgarten, supra note ___ at 4.

⁸⁶ 445 U.S. 222 (1980).

⁸⁷ 463 U.S. 646 (1983).

⁸⁸ 445 U.S. at 224.

⁸⁹ Mann and Lustgarten, supra note ___ at 4.

⁹⁰ Id.

⁹¹ Haddock and Macey, supra note ___ at 157.

⁹² 445 U.S. at 235.

⁹³ 445 U.S. at 228.

a fiduciary duty to disclose.⁹⁴ The Court's ruling in Chiarella was reaffirmed several years later in Dirks v. SEC, another landmark insider trading decision.

In this case, Raymond Dirks, an investment analyst sold insider tips received from an employee of Equity Funding Corporation about a massive fraud within the company to his investment banking clients.⁹⁵ He advised his clients to sell stock in Equity Funding based upon the damaging information he received directly from the corporation.⁹⁶ The Court held that since Dirks did not have any connection with Equity Funding, he could not possibly owe a fiduciary duty to the corporation. Absent a fiduciary duty, there could be no liability under SEC Rule 10b-5.⁹⁷

These cases rejected an equal information requirement for all traders that had been the prevailing interpretation of Rule 10b-5, and the interpretation favored by the SEC for decades.⁹⁸ The "equal access to information" doctrine declared that "all members of the investing public should be subject to identical market risks, - which market risks include . . . the risk that one's capital available to put at risk may exceed another's capacity or capital . . . inequalities based upon unequal access to knowledge should not be shrugged off as inevitable in our way of life."⁹⁹

Following Chiarella and Dirks, the SEC's rejected equal access theory was replaced by a duty to disclose only "where the person who has traded on inside information was not [the corporation's] agent . . . was not a fiduciary, [or] was not a person in whom the

⁹⁴ 445 U.S. at ____.

⁹⁵ Haddock and Macey, supra note ____ at 158.

⁹⁶ 463 U.S. 646.

⁹⁷ Id.

⁹⁸ Haddock and Macey, supra note ____ at 155.

⁹⁹ SEC v. Texas Gulf Sulfur Co., 401 F.2d 833, 852 (1968).

sellers [of the securities] had placed their trust and confidence."¹⁰⁰ The duty to disclose is, therefore, now limited solely to true insiders.¹⁰¹

2. International Insider Trading Regulation from a Public Interest Perspective

According to the public interest theory of insider trading, insider trading laws were enacted to protect investors from unfair competition in financial markets.¹⁰² Unfortunately for the SEC, for years, although insider trading was prohibited in the United States, it has long been legal in most other countries around the world.¹⁰³ This immediately calls into question the legitimacy of the often summarily accepted proposition that insider trading is, in fact, bad for both markets and investors in light of the robust capital markets that exist in trading forums like Japan, Honk Kong, Singapore, and Germany, where insider trading has long been either *de facto* or *de jure* legal.

To determine whether the SEC's pursuit of international insider trading agreements is explained by the public interest theory, some insight is required into the benefit accorded to the public by the promulgation of regulations against insider trading.

Investors in capital markets can earn significant returns by obtaining information relating to a firm's future prospect that is not already reflected in the firm's share price.¹⁰⁴ Those investors who are more capable of obtaining information about a firm's future

¹⁰⁰ Chiarella v. United States, 445 U.S. at 232; quoted with approval in Dirks v. SEC 463 U.S. at 464.

¹⁰¹ Haddock and Macey, *supra* note ___ at 155.

¹⁰² find authority

¹⁰³ David D. Haddock & Jonathan R. Macey, Controlling Insider Trading in Europe and America: The Economics of the Politics, 149.

¹⁰⁴ Haddock and Macey, *supra* note ___ at 151.

prospects are more likely to profit from their investments.¹⁰⁵ Profiting from investments requires two things: first, the ability to acquire information not already reflected in the share price and, second, the ability to access the market with this information through the purchase or sale of shares.¹⁰⁶ To determine whether insider trading laws truly serve the public interest, their effect on various types of investors must be examined.

There are basically three primary groups of stock market investors: (1) true insiders, (2) quasi-insiders, and (3) outsiders.¹⁰⁷ True insiders are individuals who are closely associated to a particular firm and have instant access to firm-specific information not readily available to others.¹⁰⁸ This group includes corporate officers and directors, legal counsel, employees, and others who may reasonably be expected to have privileged access to information about the future value of the firm by reason of their employment status.¹⁰⁹ In light of existing insider trading laws in the United States, which prevent true insiders from trading in firms with which they have a professional affiliation, the next best information processors permitted to trade (quasi-insiders) will benefit from the insider trading laws because they will be able to take advantage of new-found information about the share values and translate that information into an effective trading strategy.¹¹⁰ Even in the absence of trading by true insiders, by the time the true outsiders get new information that will affect share prices it will be too late for them to profit from it because

¹⁰⁵ Id.

¹⁰⁶ Id.

¹⁰⁷ Id.

¹⁰⁸ Id. at 151-152.

¹⁰⁹ Id. at 152.

¹¹⁰ Id.

market professionals already will have caused share prices to adjust to their correct levels.

Market professionals, or "quasi-insiders" are people and firms who specialize in acquiring information about publicly traded companies or industries and have expertise in evaluating that information as it applies to financial markets.¹¹¹ This group is primarily composed of stock brokers, investment bankers, portfolio managers, and similar professionals who work on Wall Street. They differ from true insiders in that they do not owe a fiduciary duty to the firms they research.¹¹² While true insiders have better access to information, quasi-insiders have better access to markets. By the nature of their profession, they can execute trades more rapidly than true insiders.¹¹³ Quasi-insiders also invest heavily in methods to acquire, evaluate, and apply firm-specific information, which mitigates against the natural advantage enjoyed by true insiders.¹¹⁴

Outsiders comprise the third group of market investors. Members of this group include ordinary shareholders and the general public.¹¹⁵ Outsiders are at a tremendous competitive disadvantage in acquiring new information *vis à vis* true insiders and quasi-insiders since they do not have a personal connection to the firm like true insiders.¹¹⁶ Moreover, they lack the ability to analyze and utilize firm-specific information as quickly as quasi-in-

¹¹¹ Id.

¹¹² Id.

¹¹³ Id.

¹¹⁴ Id. True insiders, by contrast, do not have an equal incentive to invest resources in applying information to trading markets.

¹¹⁵ Id.

¹¹⁶ Id.

siders.¹¹⁷ Outsiders are, therefore, the least likely group to profit from new information.

Current insider trading laws in the United States apply only to true insiders.¹¹⁸ In the absence of these restrictions, true insiders would have a clear advantage over the remaining two groups. Insider trading laws, however, tip the balance in favor of quasi-insiders, who are the next best information processors.¹¹⁹ The legal system, therefore, does not benefit outsiders. Rather, insider trading laws work to the advantage of quasi-insiders, like Chiarella and Dirks, at the expense of true insiders.¹²⁰ The vast majority of the American public, however, are not quasi-insiders. It is, therefore, not necessarily true that these regulations benefit most Americans. Moreover, it has been argued that insider trading is not necessarily bad for markets.¹²¹ At a minimum, no one has clearly articulated why firms should not be allowed to voluntarily exempt themselves from insider trading laws if the shareholders deem it to be in the best interests of the corporation.¹²²

And, of course, if domestic insider trading laws do not benefit the general public, then expanding the ban on insider trading internationally cannot be consistent with public interest theory, either. Public interest theory, therefore, does not accurately explain the motivation behind the SEC's pursuit of international agreements in this area of the law. Moreover, even if insider trading were found to be harmful to the capital markets in a par-

¹¹⁷ Id.

¹¹⁸ Id.

¹¹⁹ Id. at 152-153.

¹²⁰ Id. at 153.

¹²¹ Henry Manne, *Insider Trading and the Stock Market* at 166 (1966). Haddock and Macey, *supra* note ___ at 154.

¹²² Dennis Carlton and Daniel R. Fischel, *Insider Trading* article, *Stanford Law Review*;

ticular nature, it is by no means clear why a government would want to export insider trading prohibitions to other countries. Why would any rational country want to help rival nations develop competing capital markets in light of the global competition for capital?

3. International Insider Trading Regulation from a Public Choice Perspective

Public choice theory provides a more persuasive explanation of the SEC's pursuit of international insider trading agreements. The problem for the SEC is that few states had similar laws.¹²³ This created an incentive for insider traders to simply conduct their transactions in any one of the numerous countries that are not subject to similar prohibitions. This exogenous factor undermines the power of the SEC's enforcement authority, threatening to make the agency irrelevant in this area. The battle for self-preservation, however, cannot be won in the domestic arena. Thus, barring the opportunity to exercise preferred autonomous measures at home, the agency is forced to engage in the second best alternative, which involves cooperation and assistance from abroad. Thus the agency's willingness to enter into international agreements is consistent with its desire to consolidate its own power.¹²⁴

Within the insider trading context, the SEC's power to enforce its regulations will become meaningless if the Commission cannot successfully prevent insider trading abroad. As capital markets become more global, people with inside information can easily use that information in trading markets outside of the United States. Within these foreign meaningful insider trading regulations may simply not exist. Where regulations do exist, there often will be an unwillingness to enforce the regulations that do exist. And the

¹²³ Haddock and Macey, *supra* note ___ at 149.

¹²⁴ Cardozo article on SECs' obsolescence.

bank secrecy laws of several European countries make it even more difficult to enforce local rules in the United States.¹²⁵ These aspects of overseas markets may be used by non-residents to circumvent domestic insider-trading laws here in the United States.¹²⁶

To respond these threats, the SEC has not only expended significant resources in investigating and prosecuting transnational insider trading cases, but has also "exerted pressure on countries to prohibit insider dealing and to provide the Commission with information on insider trading cases."¹²⁷

For example, Switzerland enacted article 161 of its Penal Code in 1988 criminalizing insider trading largely in response to pressure from the United States.¹²⁸ Likewise, Japan stepped up enforcement of its previously ignored insider trading regulations due to United States pressure.¹²⁹ The SEC's influence can also be seen behind the European Community's 1989 Council Directive obligating member nations of the EC to adopt insider trading regulations by 1992.¹³⁰

¹²⁵ Id. at 150.

¹²⁶ C. Edward Fletcher, *Materials on the Law of Insider Trading* (1991) at 554.

¹²⁷ Pitt and Hardison, *supra* n at 204 (citing Reauthorization for the Securities and Exchange Commission, 1992-94, Hearing before the Subcommittee on Securities and Senate Committee on Banking, Housing and Urban Affairs, 102d Congress 1st Sess 22 (July 25, 1991)(testimony of Richard Breeden, Chairman of the United States Securities and Exchange Commission, requesting further increases in resources available to the SEC for international enforcement and assistance initiatives).

¹²⁸ Pitt and Hardison, *supra* n at 204.

¹²⁹ Id. (citing, Michael Hughes, "Insider Trading Like Polygamy-- Depends Where You Do It," *Reuters Bus Rep* (March 27, 1989)-(quoting Japanese broker as stating that Japan upgraded criminal penalties for insider trading in response to pressure from the United States).

¹³⁰ Council Directive 89/592 on Regulations on Insider Dealing, 1989 O.J. (L 334) 30 [hereinafter "Council Directive"].

Perhaps the most telling example of the SEC's influence came from Germany's recent adoption of insider trading legislation in July of 1994, making insider trading a crime in Germany for the first time in that country's history.¹³¹ Obviously, "the SEC cannot dictate Germany's insider trading rules . . . nonetheless [the SEC] made its disapproval of [Germany's] current system known both directly and indirectly through the prosecution of high-profile cases involving transactions originating in Germany that violate United States insider trading laws."¹³²

It is important to note that the SEC's "lobbying" to get other nations to adopt insider trading regulations is an even more powerful form of "coordination" than merely working to obtain an international agreement relating to insider trading. This is because an international agreement lacks of enforcement authority of domestic regulation. Thus, international agreements can be more easily side-stepped and ignored.

In addition to lobbying for other countries to adopt their own insider trading regulations, the SEC uses its membership in the International Organization of Securities Commissions (IOSCO) in order to promote stronger international coordination of rules against insider trading.¹³³ The SEC's involvement with this international regulatory body facilitates its ability to protect itself by providing an international forum within which to discuss the implementation of insider trading laws around the globe.

Finally, the SEC has negotiated bilateral agreements, treaties, or memoranda of understanding with its counterparts in other

¹³¹ Standen, *supra* n at 177.

¹³² Standen, *supra* n at 200. Notably, by focusing on the possession of inside information as opposed to the existence of a fiduciary duty, the Council Directive and German regulations have a much broader scope than their United States counterparts.

¹³³ *Id.*

nations.¹³⁴ These negotiations have resulted in enhanced procedures to access international information pertaining to SEC investigations.¹³⁵ The SEC has successfully reached accords to deal with the problem of insider trading through secret bank accounts with several nations, including Switzerland, the Cayman Islands, Brazil, the United Kingdom, Canada, Japan, France and the Netherlands.¹³⁶ In 1988, Congress supplemented existing SEC authority to reciprocate exchanges of information by providing that:

On request from a foreign securities authority, the Commission [SEC] may provide assistance in accordance with this paragraph if the requesting authority states that the requesting authority is conducting an investigation which it deems necessary to determine whether any person has violated, is violating, or is about to violate any laws or rules relating to securities matters that the requesting authority administers or enforces. The Commission may, in its discretion, conduct such investigation as the Commission deems necessary to collect information and evidence pertinent to the request for assistance. Such assistance may be provided without regard to whether the facts stated in the request would also constitute a violation of the laws of the United States. In deciding whether to provide such assistance, the Commission shall consider whether (A) the requesting authority has agreed to provide reciprocal assistance in securities matters to the Commission; and (B) compliance with the request would prejudice the public interest of the United States.¹³⁷

¹³⁴ Id. at 554-5.

¹³⁵ Id. at 555.

¹³⁶ Id;

¹³⁷ Id; Insider Trading and Securities Fraud Enforcement Act of 1988 amending section 21(a) of the 1934 Securities and Exchange Act.

Congress thereby strengthened the SEC's ability to extend its influence, and consequently protect its autonomy, by expanding the agency's discretion and providing a vehicle for reciprocity at the international level.

Thus, much of the recent trend towards the globalization of insider trading regulations can be viewed as a response by the SEC to protect its autonomy in the face of technological and market forces which threatened that autonomy.

Conclusion

It is clearly the case that nations try to maintain their sovereignty, and that bureaucracies try to protect their turf. We observe this on many levels, but it is certainly apparent at the limits. Countries fight to protect their borders, even when the odds of victory appear slight. The recent trend in international agreements is consistent with this view. As international borders have become virtually irrelevant in global capital markets, regulators have been forced to enter international agreements in order to remain relevant.

Over time, all bureaucracies will substitute private, bureaucratic objectives for the public objectives that characterized their origination. But it seems clear that this general problem becomes worse in the case of agencies facing obsolescence, since obsolescence makes the problem of bureaucratic self-interest far more immediate. Thus, it stands to reason that agency officials faced with the prospect of losing their ability to control the actions of the firms they are supposed to regulate will fight hard to find some way to retain their power.

Local bureaucracies will enter international agreements that sacrifice some of their national sovereignty in order to avoid the specter of becoming irrelevant. This thesis, as exemplified in both the Basle Accords and efforts by the SEC to internationalize insider trading laws provides a new way to explain international

economic coordination in an era of increasing global competition.

In sum, the purpose this article has been to view international cooperation from a public choice perspective. The hypothesis is that the behavior of politicians, interest groups and bureaucrats in the international arena is no different than their behavior elsewhere. We live in a rent-seeking society and international agreements reflect this. This article has applied this perspective to two important sources of international cooperation: insider trading on securities markets and capital requirements for banks. In these settings international cooperation was driven by concerns on the part of regulators about the effect of the increasingly internationalization of capital markets on their ability to regulate. Financial market regulators are concerned about their ability to regulate in a world in which capital can be transferred around the world quickly, business can be conducted across borders at very low cost, and institutional structures can be changed in order to avoid regulation.

From the regulators perspective, reaching international accords have two effects, one positive, the other negative. The positive effect is that such accords, by homogenizing regulation across borders, regulators in one country can effectively collude with their colleagues in other countries, and reduce the demand of the domestic firms they regulated to move their operations to more congenial jurisdictions. The negative effect of international accords is that they require compromise because regulators in different countries reflect different domestic interests (although we have argued here that they do not reflect "the national interest" in large part because that term has no real meaning). The process of compromise requires the bureaucrats to give up power and autonomy, which they would prefer not to do.

We can expect an international accord among financial regulators whenever an international agreement involves a smaller sacrifice of autonomy than the autonomy that would be lost by normal market processes as firms migrated to the most liberal regulatory

environment. A major point of this article is that the increasing globalization of markets, brought about largely through exogenous technological developments, has increased the incentives of regulators to enter into international accords by raising the loss of power to bureaucrats who do not enter into such accords.

Finally, there is no claim in this article that all international accords are fueled by concerns about losing regulatory turf.

In many contexts regulators, politicians and interest groups have other concerns. The point here is simply that technological change has made concerns about relevance of great importance at the moment in the area of global corporate finance. In other areas where international accords are discussed, such as the environment, national security, aid to developing nations, and monetary policy, other concerns are likely to dominate (however the particular analysis used here would seem to apply with particular force to the desire of European countries to bind themselves together more closely into the European Union, in order to avoid irrelevance on the world state -- but that broad topic should be the subject of future research).

The broader point of this article is that regulators and politicians must maximize political support in order to survive. This political support comes from interest groups. The international agreements, accords, structures, frameworks and regimes negotiated by politicians and bureaucrats are going to reflect the preferences of these groups. In the end, all politics is local.