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The Standardization of Law and Its Effect on Developing Economies

I. INTRODUCTION

The integration of markets has gone hand in hand with a proliferation of efforts to harmonize key aspects of the law relating to finance and trade. Following the recent financial crises in Asia, Russia, and parts of Latin America, the International Monetary Fund (IMF) has embarked on improving the international financial architecture with special emphasis on the legal framework for corporate finance and corporate governance.

The vehicle for building the legal architecture for global markets is the harmonization of law around the globe by way of developing legal standards.[1] These standards may be incorporated into international conventions, bilateral treaties, or retain the nonbinding form of recommendations. The expectation is that standardization will accelerate the process of legal convergence with the double benefit of reducing transaction costs for transnational investors and increasing the quality of legal institutions in countries whose institutions are less developed. This expectation is based on the assumption that convergence towards international legal standards will improve the institutional environment in the receiving country. The standards proposed have a clear normative agenda. At least at face value,[2] their purpose is not simply to harmonize in order to reduce transaction

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1. The use of the term "standards" should not be confused with quality and product standards. This paper uses this term to refer to the level of specificity of law. While standards embody only the legal principles, legal rules are much more specific not only about their goals of that rules but also, for example as to the type of behavior they address. For details see below under section IV. For a discussion of the cost and benefits of law development using legal standards vs. legal rules see Kaplow, "Rules versus Standards: An Economic Analysis," 42 *Duke L.J.* 557-629 (1992).

2. One may, of course, take the view that the standards are an insurance device for foreign investors. If high-risk countries can be forced to adopt internationally accepted legal rules, foreign investors cannot be blamed anymore for misguided investment decisions. I would like to thank David Woodruff for this point.

costs and to benefit from economies of scale, but to improve domestic legal institutions.[3]

This paper takes issue with this approach to reforming domestic legal systems. It will not only argue that proposed standards often do not hold what they promise, as will be further discussed in section VI, but more importantly, it questions the assumption that legal harmonization will result automatically in improvement of legal institutions. The paper suggests that the quest for developing an optimal set of legal rules ignores a central feature of successful economic development, namely the constant change, innovation, and adaptation of institutions and organizations in a competitive environment. The standardization of "best practice" or "efficient" law replaces the Schumpeterian process of "creative destruction" with the ideal of the "perfect construction" of law. Instead of improving domestic legal systems, standardization or harmonization may, in fact, undermine the development of effective legal systems. The reason for this can be found in two essential features of legal systems: First, the interdependence of legal rules and concepts that comprise a legal system, and second, the fact that law is a cognitive institution. The interdependence of legal rules means that there are only a few rules that can be understood and applied without reference to other legal rules or concepts. This implies that standardized rules can be realized and enforced only if other bodies of law already exist in the standard receiving legal system, otherwise additional law reform efforts must be pursued. Without ensuring complementarities between the new law and preexisting legal institutions, harmonization may distort rather than improve the domestic legal framework.

The notion that law is a cognitive institution means that for law to be effective and actually change behavior, it must be fully understood and embraced not only by law enforcers, but also by those using the law, i.e., its "customers" or by legal intermediaries including courts, judges, etc. The external supply of best practice law—while facilitating more radical change than might be feasible without external pressure—sterilizes the process of lawmaking from political and socioeconomic development. It thereby distances it from the process of continuous adaptation and innovation. The process of legal innovation depends on the availability of information not only about the contents of legal rules—something international legal standards do

3. On the distinction between normative and non-normative harmonization quests, see Leebron, "Lying Down with Procrustes: An Analysis of Harmonization Claims," in 1 *Fair Trade and Harmonization* 41-118, at 50 (Jagdish Bhagwati & Robert E. Hudec eds. 1996) 41-118, pp. 50. He distinguishes between pure "non-normative harmonization claims", which are "neutral with regard to which rule should be chosen as the basis of harmonized rule", and "pure harmonization claims" that aim at implementing the same policies or rules in all countries. Most harmonization claims according to Leebron contain non-normative and normative claims, i.e., they can be referred to as mixed claims.

provide—but also about their functioning in the context of a living legal system. The perfect construction of law by legal experts for wide dissemination can deprive lawmakers and law enforcers in the receiving countries of the knowledge of living law, which is context specific. Moreover, the imposition of rules from the outside—not a new experience for most developing countries as the history of colonization exemplifies—may also lead to domestic resistance. Thus, irrespective of the quality of the supplied legal standards, this paper questions the feasibility of using this approach for developing *effective* legal systems, i.e., legal systems that are capable of effectively enforcing laws and adapting them to a changing domestic and international environment.[4]

The development of effective domestic institutions is crucial for the governance of global markets, because absent a supranational enforcement system, law enforcement is dependent on local institutions. Even in cases where disputes are settled by international arbitration tribunals in accordance with international arbitration standards, domestic courts will need to recognize the award. Domestic bailiffs, court enforcers, sheriffs, etc., will need to seize assets, freeze bank accounts, or take other actions to execute the award should the parties fail to comply voluntarily. Thus, the standardization of law does not solve the problem that transnational transactions are governed by multiple jurisdictions. At best, it may reduce the uncertainty about the contents of the applicable law. Standardization, however, is not a guarantee for uniform interpretation and enforcement of set standards.[5]

A more fundamental issue that is not addressed in this paper is whether the areas of the law currently targeted by IMF standardization claims are in fact the most relevant area for legal reforms for developing countries. While there is some empirical evidence that equity markets are important determinants of economic growth,[6] comparative data also suggest that countries need to cross a certain threshold in their income levels before viable securities markets will take off. More importantly from the point of view of legal develop-

4. The importance of effective legal institutions, i.e. those that are capable of enforcing existing rules and actually do this, has also been stressed by Andrew Cornford, *Risks and Derivatives Markets: Selected Issues* (Geneva: United Nations Conference on Trade and Development)(1995).

5. On the need to ensure receptivity at the law receiving end, see also Buxbaum, "Modernization, Codification, and Harmonization: The Influence of the Economic Law of the European Union on Law Reform in the Former Socialist Block," in *European Economic and Business Law* 125-35 at p. 127 (Richard Buxbuam, Gérard Hertig, Alain Hirsch, & Klaus J. Hopt eds., 1996).

6. See for example, Ross Levine & Sara Zervos, *Stock Markets, Banks, and Economic Growth* (1996); Levine, "The Legal Environment, Banks, and Long-Run Economic Growth," 30 *Journal of Money, Credit, and Banking* 596-613 (1998); and Goldsmith, "Financial Structure and Development," in *Studies in Comparative Economics* 561 (1969).

ment, most of the proposed reforms depend on the existence of a fairly developed and well functioning legal infrastructure. Absent this infrastructure, reforms in the areas of accounting standards, securities legislation, insurance regulation, and even corporate governance will remain at the surface. For most of this paper, however, we will not question the relevance of reforms in these areas of the law, but focus on whether the desired improvements in domestic legal institutions can be achieved by adopting international legal standards.

This paper is organized as follows: Section II gives an overview of the most important standardization efforts for the international financial architecture that are currently under way, assesses the justification for harmonizing law in these areas, and reviews the debate about the costs and benefits of harmonization versus regulatory competition. Section III discusses the problem of the interdependence of standardized rules with the preexisting legal order. Section IV introduces the concept of law as a cognitive institution. Section V discusses the propensity of newly-introduced standards to affect behavior, i.e., the problem of law enforcement. Section VI applies this framework to the legal rules that form the core of the international financial architecture. Section VII discusses the possible implications for attracting foreign investments by countries that subscribe to standardized rules and develops some policy proposals for improving the effectiveness of legal institutions as an alternative or complement to adopting standardized rules.

II. THE PERFECT CONSTRUCTION OF LAW THROUGH INTERNATIONAL STANDARDIZATION

The current trend towards globalization of markets has not invented, but reinforced the idea of defining a common core of legal standards. The most prominent example of legal harmonization of financial market regulations is the Basle Capital Accord of 1988, which established capital adequacy rules for banking engaging in cross-border activities.[7] The integration of financial markets, in particular the massive flow of international capital to emerging markets, has exposed the legal and institutional environment of these countries to pressures they were often not able to withstand.[8] In response to the recent financial crises in emerging markets, the governance of

7. For a discussion of the 1988 standards and the proposals for their revision see Andrew Cornford, *The Basle Committee's Proposals for Revised Capital Standards: Rationale, Design, and Possible Indicende* (Lima, Peru: Intergovernmental Group of 24 on International Monetary Affairs)(2000).

8. This has become apparent in particular in the Asian Financial Crisis. An analysis of the quality of the legal framework as an explanatory variable for the extent to which different countries have been affected by the crisis is given by Johnson, Boone, Breach, et al., "Corporate Governance in the Asian Financial Crisis 1997-98," 58 *Journal of Financial Economics* 141 (2000).

markets, firms, and intermediaries has become the focal point of attention.

In addition to banking regulation, the legal standardization efforts identified by the IMF to be of primary importance for the international financial architecture include accounting, auditing, bankruptcy, corporate governance, insurance regulation, and securities market regulation.[9] Various entities are involved in developing legal standards for these areas of the law. Some are professional interest groups whose members come primarily from the private sector. An example is the International Federation of Accountants (IFAC). Others recruit their members from national regulatory agencies. Both the International Association of Insurance Supervisors (IAIS) and the International Organization of Securities Commissions (IOSCO) represent this category of international standard setters. In addition, several multilateral organizations are involved in building the legal architecture for global markets. The United Nations Commission on International Trade Law (UNCITRAL) has a long record of developing model laws and international conventions[10] and has recently adopted a Model Law on cross-border insolvency. UNCITRAL collaborates with the World Bank and the International Bar Association (IBA) in developing a model law for domestic bankruptcy law. The Organization for Economic Cooperation and Development (OECD) has recently adopted standards for corporate governance, the so-called "Principles of Corporate Governance." In addition, the OECD has developed a separate set of corporate governance principles for transition economies. Finally, the World Bank is also engaged in improving the framework for corporate governance in many of its lending countries.

A common feature of the above-listed standardization efforts is their nonbinding nature. All take the form of recommendations addressed at the members of their organizations. In case sovereign states are members, the addressees of the standards are lawmakers. Where members are primarily private parties, as is the case with the International Accounting Standards Committee (IASC), the standards pursue at least implicitly a dual goal: a bottom up dissemina-

9. For an overview of the IMF's activities in unplugging the standards, see www.ijuaj/external/standards&wdes (last visited 6 May 2002).

10. The Conventions include, among others, the Convention on the Limitation Period in the International Sale of Goods (New York, 1974/1980); on the Carriage of Goods by Sea (Hamburg, 1978); on Contracts for the International Sale of Goods (Vienna, 1980); on International Bills of Exchange and International Promissory Notes (New York, 1988); and on the Recognition and Enforcement of Foreign Arbitral Awards (New York, 1958). The Model laws include the UNCITRAL Model Law on International Commercial Arbitration (1985); on International Credit Transfers (1992); on Procurement of Goods, Construction and Services (1994); and on Electronic Commerce (1996). For a detailed status report of the signature and ratification of the various conventions see http://www.uncitral.org/english/texts/index.htm (last visited 6 May 2002).

tion of standards through their adoption by individual companies and firms, and a lobbying effort for legislative change to incorporate the organization's standards into domestic law.[11]

Another feature of the financial law standards is that they tend to be general in nature rather than specific, and leave ample scope for their interpretation to lawmakers and law enforcers. Rather than harmonizing highly-specified rules, the standards aim only at establishing the principles for such rules. This means that there is no attempt to force a single set of rules—the perfect law—upon sovereign lawmakers around the world. In principle, countries can therefore choose not to adopt these standards and are free to modify them where appropriate. Yet the aim of standardization is to minimize deviations from the standards, lest the very purpose of standardization is undermined. Most standard setters are therefore quite explicit about the need to stay as closely as possible to the standards.[12] Moreover, the endorsement legal standardization has received from the IMF strongly suggests that these standards may serve to assess the quality of domestic laws in the future. It also leaves open the possibility that they will be used as conditionalities in loan agreements.

The voluntary and nonbinding nature of legal standards reduces the degree to which law will actually be harmonized across jurisdictions, and by implication, it reduces the possible savings for transnational investors as a result of the standardization effort. However, it gives countries greater scope for taking an active role in the reception of these standards and their transformation into domestic law. This requires that domestic lawmakers have a good sense of the purpose of the proposed rules and the alternative choices for detailed rule making they may entail, which in turn presupposes familiarity with living legal systems. The supply of ready-made standards to domestic lawmakers does not facilitate, and may actually impede, the acquisition of this knowledge. Legal standards developed at the supranational level are typically distilled from legal practice in individual countries, without their merits having been tested in a functioning legal system. The generality of standards may also disguise the fact that they often entail a substantial reallocation of rights with important implications for the political economy of enforcing them within a domestic setting. At the same time, their generality opens the possi-

11. The IACS, for example, stresses the need for international harmonization in light of the huge costs the current multiplicity of accounting standards creates and advocates the adoption of IACs for developed as well as developing countries. See http://iasc.org.uk (last visited 6 May 2002).

12. Art. 12 of the "Guide to Enactment" of the UNICITRAL Model Law on Cross-Border Insolvency, for example, explicitly states that while countries are free to make any changes they see fit, ". . . in order to achieve a satisfactory degree of harmonization and certainty, it is recommended that States make as few changes as possible in incorporating the model law into their legal systems."

bility to subscribe to them without necessarily implementing them.[13] This makes not only monitoring of compliance difficult, but misguides investors, who may take the fact that a country has formally subscribed to a standard as evidence that the law is in fact used and enforced in a certain way. Alternatively, investors may take the signals for what they are – formal or creative compliance with international standards. While they may perfectly understand that this does not necessarily increase the security of their investments in the long term, they have at least covered their back vis-à-vis their own superiors and ultimately their investors. However, if subsequent experience reveals that these assumptions are wrong, this may increase rather than reduce uncertainty about how to assess the investment environment of a given country. Conversely, countries that are actually complying in practice with these standards may experience problems relating their superior performance to the outside world, as the law on the books will lose its signaling power.

Developing international legal standards, and adapting legal systems around the world to these standards is a costly undertaking, and thus requires some justification. The harmonization or standardization of law can be questioned on the grounds of principle irrespective of the area of the law in question and the quality of the standards that may emerge from the effort. This is the topic of debate about whether harmonization or regulatory competition produces better rules from an economic efficiency point of view.[14] This debate has long focused on law development within domestic legal systems, in particular federal systems, but has more recently embraced the topic

13. Subscribing to legal standards as used in this paper does not imply any formal process of ratification. As noted above, most of the standards discussed are not mandatory. The term "subscribing" is used loosely to refer to any type of commitment a country makes to these standards, including public statements that international standards guide law reform efforts.

14. The literature is voluminous and can only partially referenced. In the area of corporate law *Legal Harmonization and the Business Enterprise* (Richard M. Buxbaum & Klaus J. Hopt eds. 1988). The contributions in *European Business Law* (Richard M. Buxbaum, Gerard Hertig, Alain Hirsch, et al. eds., 1991) give an overview over the main arguments pro and contra harmonization. See also Roberta Romano, *The Genius of American Corporate Law* (1993); Bebchuk, "Federalism and the Corporation: The Desireable Limits on State Competition and the Corporation," *Harv. L. Rev.* 1437-1510 (1992) A similar debate is currently under way for securities legislation. Romano, "Empowering Investors: A Market Approach to Securities Regulation," 107 *Yale L.J.* 2359-2430 (1998) with further references; and the contributions in Claude E. Barfield, *International Financial Markets—Harmonization versus Competition* (1996), especially White, "Competition versus Harmonization—An Overview of International Regulation of Financial Services," in *International Financial Markets—Harmonization versus Competition* 5-48 (Claude E. Barfield ed., 1996) An endorsement of the European harmonization strategy can be found in Warren, "Global Harmonization of Securities Laws—the Achievements of the European Communities," *Harv. Int'l L. J.* 185 (1990) More cautious based on an analysis of the achievements of harmonization are the contributions in Guido Ferrarini, *European Securities Markets—The Investment Services Directive and Beyond* (1998).

of law development in a global economy. Advocates of harmonization claim that minimum standards are needed to prevent a race to the bottom between different jurisdictions. Countries around the world compete for capital and in order to attract foreign capital they will tend to offer lax rules in the relevant areas of the law, including tax, torts, environmental protection, and financial market regulation. Moreover, harmonized legal rules will lower transaction costs and therefore foster international trade and commerce. Proponents of regulatory competition argue that harmonization will result in suboptimal rules. Different reasons are put forward to support this point. The process of selecting legal standards that shall be harmonized may lead to the choice of the lowest common denominator instead of the most efficient rule. Where there is little certainty about the right choice, as in most cases, harmonization will lock a large number of jurisdictions into suboptimal rules and prevent flexible adaptation to better rules and changing circumstances. Instead, competition between regulators will lead to a race to the top and bring about efficient rules, because experience will teach regulators that in the long term they will benefit from adequate protection of investors and a high-quality legal system.

Some authors have developed a more attenuated assessment of the relative costs and benefits of harmonization versus regulatory competition.[15] They argue that both harmonization and regulatory competition tend to lead to indeterminacies and thus to suboptimal legal rules, albeit for different reasons. In the case of legal harmonization, the diversity of opinions and the necessity to compromise leads to indeterminacy. In case experts are in charge of developing legal standards, they may have incentives to ensure the need for their services in the future. The use of open-ended terms typically requires further expert consultation and indeed can be found frequently in private law making activities.[16] But regulatory competition may also lead to indeterminacies.[17] Once a regulatory system has established a head start over others, it benefits from rules that can be interpreted and applied only within that regulatory regime. Superior legal expertise of attorneys and judges is an important asset that is not easily emulated by other jurisdictions.[18] Developing rules

15. Compare Kamar, "A Regulatory Competition Theory of Indeterminacy in Corporate Law," 98 *Colum. L. Rev.* 1908 (1998), who focuses on the purported superiority of the Delaware corporate law. For a more general argument see Gillette, "Lock-In Effects in Law and Norms," 78 *B.U. L. Rev.* 813-842 (1998).

16. See Schwartz & Scott, "The Political Economy of Private Legislatures," 143 *U. Pa. L. Rev.* 595-654 (1995) for a detailed analysis of private law making involving legal experts.

17. This is exemplified with the case of the Delaware corporate law by Kamar ob cit. at 15.

18. A good example is the case of Nebraska, which copied the Delaware corporate statutes word by word, but was not able to attract corporations. This has been attrib-

that require their expertise can reinforce this advantage. An important implication of this debate is that the outcome of the lawmaking process is not independent of that process.

But the quality of the law that results from decentralized or centralized lawmaking may not be the only reason for or against harmonizing law, or developing international standards for certain areas of the law.

An important justification for harmonization is the interface of different jurisdictions in cases that involve more than one jurisdiction and the difficulty in reconciling different legal regimes.[19] The UNCITRAL Model law on transnational bankruptcy is a case of interface harmonization of legal rules. No attempt is made to standardize domestic rules for all bankruptcy cases. The goal is to reduce transaction costs and increase certainty only for those cases that are at the interface between different jurisdictions without necessitating far reaching domestic change.

The international accounting standards (IAS) pursue a dual role. They seek to establish a common set of accounting standards independent of domestic legislation, and to convince domestic lawmakers to adopt these standards. The latter goal is intended to improve local institutions, but it is not a necessary condition for achieving the first goal. This goal can be justified primarily on grounds of economies of scale and transparency. If all companies on the international market disclose their financial information according to the same standards, transparency will be greatly increased and transaction costs reduced for investors as well as for firms monitoring each other's activities.

The other standardization efforts listed above target primarily domestic legal institutions, even though the standards of IOSCO and IAIS also aim at improving collaboration between national supervisors in coping with cross-border transactions. The standardization of domestic securities market regulation could be justified on the grounds that negative externalities of movements in stock market in one country or region of the world shall be avoided. The 1997-98 financial crisis in Asia had a strong contagion effect on other emerging markets. Studies have shown that the quality of domestic law has played an important role in buffering the effect of the crisis. Countries with better laws on the books *and* more effective legal institutions were more likely to weather the storms of the crisis than countries where shareholder protection was only weak on the books as well as in practice.[20] Another justification would be that the fungi-

uted to positive network externality of the Delaware system, which could not be easily replicated in a different state. See Kamar supra n.15.

19. See Leebron op. cit. at supra n. 3. pp. 51-66.

20. Johnson et al. op. cit. at supra n. 8. The level of legal protection in this context refers to the quality of shareholder and creditor rights as measured by La Porta, Lopez-de-Silanes, Shleifer, et al., "Law and Finance," 106 *Journal of Political Economy*

bility of securities makes it difficult for each country to unilaterally enforce its laws.[21] Thus, there is a strong theoretical possibility of a race to the bottom, as issuers may prefer countries with loose regulations to countries with stricter ones. Available evidence, however, does not support this proposition. On the contrary, there seems to be strong trend of migrating to stricter regimes.[22] As far as the insurance industry is concerned, interface jurisdiction makes a strong case for harmonization. In both cases, however, the efficacy of the harmonized rules will depend to a large extent on the ability of different countries to enforce these rules. To the extent issuers wish to migrate to weak regulatory regimes, weaknesses in enforcement can create similar incentives for migration, as do weak laws on the books.

The development of best principles for corporate governance could be justified on the same grounds that political economies of scale can be used to justify legal harmonization in this area of the law.[23] Changes in the existing corporate governance regime may be difficult due to a political stalemate. This problem could be solved by shifting jurisdiction to a supranational body, or by providing principles from the outside. However, the enforcement of legal standards thus introduced depends on substantial domestic support as well as additional institutional change, and the supply of legal standards may not be sufficient to accomplish this. A second argument in favor of standardizing principles of corporate governance could be that they prevent governments from adopting rules that clearly serve only some interests and thus make these rules more transparent.[24] On the downside, however, standardization reduces the choices for domestic lawmakers in developing their own legal solutions, which might be a better fit for the problems they face, or for the institutional capacities they have. Moreover, the harmonization of standards still leaves ample room for ambiguity when translating them into specific domestic rules, and is no guarantee for the standards being enforced in practice.

Thus, although there are good justifications for harmonization at least in some of the areas of the law mentioned, the test for the success of harmonization efforts will be the enforcement of the new laws.

1113-55 (1998). Measure of the effectiveness of legal institutions include perception data on the functioning of the judiciary, the ability to enforce contracts, and the likelihood that governments will uphold contracts and not expropriate property, as well as the absence of corruption. See id.

21. For a detailed discussion of externalities and nonefficiency of unilateral rules, see Leebron, supra n. 3, at 54, 55. The arguments against harmonization of securities legislation are summarized below, footnotes 43 following and accompanying text.

22. Coffee, Jr., "The Future As History: The Prospects for Global Convergence in Corporate Governance and Its Implications," 93 *NW. L. Rev.* 631-707 (1999); see also Romano, "Empowering," supra n.14, at 2359-2430.

23. Leebron, supra n. 3, at 63.

24. Id., at 65.

This leads us to the basic proposition of this paper: Even if it were possible to design the perfect law or to develop the best standards for a particular area of the law, the incorporation of this law into a domestic legal system is per se not a guarantee for it to become effective. For the latter, the process of lawmaking, the compatibility of the new rules with preexisting ones as well as with given economic and political conditions, and the existence of constituencies with a demand for these rules is more important than the contents of the supplied rules.

In the end, this argument favors decentralized lawmaking and by implication, regulatory competition over harmonization. But the point is not that regulatory competition consistently produces superior law, but that it produces law in a way that its relevance will be understood domestically and that innovations and adaptations will take place endogenously through the process of socioeconomic and political change.

III. The Interdependence of Rules

The purpose of standardizing legal rules is to achieve conformity in the contents and quality of law across different countries. Additional expectations are usually associated with the standardization of law, including lowering transaction costs for market participants, improving the quality of legal institutions in some countries, and ensuring consistency in the application, interpretation and enforcement of the law. This section demonstrates that even the primary purpose of standardizing legal rules—conformity in the contents of law across countries—is difficult to achieve. The reason is that only very few rules are freestanding and do not require further explanation in the form of explicit or implicit references to other rules, legal terms or concepts. In principle, the more explanations or cross-references a rule requires, the more difficult it is to achieve conformity.

Good examples of freestanding rules are most, although not all, traffic rules. The rule that a car shall come to a stop at an intersection does not require further explanation. The use of traffic signs is a means to facilitate the recognition of this rule in different countries, but adds nothing to the rule itself. We will ignore the possibility that this rule will be enforced differently in different countries (i.e., in some, the police may not intervene when cars slow down rather than bring the vehicle to a complete stop, while in others they may insist on a full stop). The point is that no further references to other legal rules or concepts are needed to convey the full contents and meaning of the rule (although different enforcement practices may change its meaning over time). Some traffic rules require, if not a reference to other legal concepts, at least clarification. An example is speed limits that apply only under certain conditions (i.e., when the road is wet or

in foggy weather). Courts in most countries had to clarify the threshold for "wetness" or "fog." This creates the possibility for diverging contents of seemingly identical rules. In some countries, a road is said to be wet only once a seamless layer of water has formed, while in others a few drops of rain may suffice.

More complexity is added when a rule is not freestanding, but its meaning can be understood only in conjunction with other legal concepts. We call these rules dependent rules. A simple example of a dependent rule is the rule "do not steal." The critical term is stealing. An example of defining stealing taken from the German criminal code is "the taking of an alien object by breaching someone else's possession." A host of further questions arises from this definition, and real world cases demonstrate that the application of the very simple rule "do not steal" does in fact raise questions, such as what is an object? Does it include electricity or gas (i.e., is it "stealing" if somebody hooks his home to an electricity line without contract and payment)? What is alien? Only objects that are clearly owned by somebody else, or also those the "offender" co-owns, or that are part of a common pool? What is a breach of possession? What happens if the original owner has "lost" his property?

If we want to standardize the rule "do not steal" as a legal rule that will be consistently applied across different jurisdictions, we need to agree on some of the basic concepts behind this rule. Otherwise standardization will remain at the surface of very diverse legal concepts that give a different meaning to identical rules when applied in different contexts. This suggests that the standardized rule must include the referenced legal concepts. There are several possibilities to go about this. First, one can use the concepts of a particular national legal order. Second, one can try to find the lowest common denominator of the diverse legal concepts that are in use in the jurisdictions that participate in the standardization effort. And third, one can try to create new concepts that synthesize different legal concepts. The three approaches have different trade-offs, which are discussed below.

National Model

The choice of a particular national legal order may reduce the costs of adaptation, as at least one country already complies with the new standards. However, this approach smells of domination or legal imperialism. Political reasons therefore make it unlikely that this approach is taken openly, although the search for common denominators or a new synthesis often disguises the influence of a particular national legal order. Political factors should be taken seriously not only because they may delay or dwarf the standardization effort, but because they will have a strong impact on the reception of the stan-

dardized rule. If a legal standard is rejected for political reasons, it is unlikely that substantial efforts will be made to enforce it. But there are also other reasons for questioning the efficacy of this approach for legal standardization. Most importantly, foreign national concepts may be inconsistent with the preexisting legal and social concepts in the law-receiving country. Several outcomes may result from this mismatch of new and old concepts. First, the new concept may come to dominate over time and replace preexisting ones. This would lead to convergence of law as a result of standardization. Second, new and old concepts may coexist with each other. This leads to a segmentation of the legal order and reduces rather than increases certainty, because the jurisdiction of different bodies of case law, their relation to other legal rules, as well as their contents will need to be determined on a case-by-case basis. Third, the new legal concept might be ignored and leave no traces on the domestic legal order, even though it is on the books. Only in the first case can it be expected that the introduction of standardization will generate the desired effects, but ex ante this outcome is undetermined. A different question is whether companies opt into foreign legal systems for individual transactions. Choice of law as well as choice of forum (the place where disputes should be adjudicated) clauses are common in transnational contracts, and frequently parties choose a jurisdiction that is not the home jurisdiction of either party. The choice of a particular legal system may entail additional costs, as transactions have to be tailor-made to that system, and lawyers with specific knowledge of that system need to be hired. However, having a fallback option for issues the contract does not cover, and referring to a system that is known to be highly developed and fairly consistent, may well be worth the price.

Lowest Cost Denominator

The lowest common denominator (LCD) approach is frequently used for standardizing the law. It avoids some of the problems of choosing a particular legal order, because at least in theory the lowest common denominator should be compatible with preexisting concepts and rules. However, this approach limits the scope of standardization. The minimum standards that are established do not preclude diversity in different jurisdictions. On the positive side, they may raise the level of legal rules in countries whose pre-standardization laws did not meet the minimum standard. On the negative, they may lower the level of legal standards in jurisdictions that had already developed higher standards. This does not necessarily prevent a country from raising its national standards, but market forces may force regulators to stick to the common denominator. Moreover, raising standards may be prevented by other rules of international or

regional trade as they could be interpreted as entry barriers in disguise, which violate the principle of free trade. Recent trade disputes between the European Union and the U.S. about, for example, the export of beef that was treated with hormones exemplify different priorities concerning consumer protection versus free trade. European Union case law is full of examples that show the difficulties in balancing the goal of creating a common legal framework for the European market on the one hand, and national governments seeking to ascertain their prerogative over areas of the law that for various reasons are deemed to be of "national interest," on the other. Similar conflicts can be expected for other standardization efforts and should be taken into consideration when determining the areas and scope of standardized law.[25]

Synthetic Concept

A compromise between these two approaches is to create a new legal concept based on comparative research and incorporating it into the standardized rule. This approach is appealing because it avoids, or at least mitigates some of the political problems of using a particular national legal order. It can also be regarded as an improvement to the LCD-approach, because it raises the level of the standardized rule beyond this minimum level and thus reduces the likelihood that some countries will see the need for more stringent national regulation. Yet, as with all compromises, some of the problems outlined for the national model and the LCD-approaches remain. For example, there is little guarantee that the synthesis will be a better match for preexisting legal institutions rather than a foreign national solution. Moreover, the coalition of countries that pushes through the synthesis may be met with similar political resistance as the choice of a national model. In comparison to the LCD approach, the level of the standardized rule may be higher, but not substantially, as a synthesis is based on a compromise. In addition, new problems arise. Most importantly, the new synthetic concept is, as the name implies, an artificial product that has not been tested in any legal system. The new concepts will need to be clarified in future case law. Judges and other law enforcers in the different jurisdictions lack a common point of reference to interpret these concepts, and this increases uncertainty for the endusers of the law. It is therefore not surprising to find that they frequently opt out of internationally standardized rules and prefer choosing a specific legal order to govern their transactions. An example is the Vienna Convention on the International Sale of

25. It is interesting to note that the EU, after first having attempted to harmonize law in detail, has increasingly reverted to establishing minimum standards only and to support law making and law enforcement at the lowest appropriate level (principle of subsidiarity).

Goods (CISG). Available evidence suggests that in the few cases where courts have applied the convention, both parties were apparently unaware that this Convention governed their transaction.[26] Parties realizing that they might be subjected to it frequently opt out of it by including a provision in the contract that explicitly denies the application of the CISG.[27] The reason for opting out is that the uncertainties involved in interpretation of the new terms and concepts included in the convention are deemed to be too high.[28] By contrast, where standardization is based on an existing national model, that national legal system may be used as a reference point for further clarifications. And where the LCD-approach is used, judges may use comparative research to identify and interpret legal concepts referenced in the law. Newly-created synthetic concepts, by contrast, need to be interpreted from scratch. Legal experts that designed them may help in this process, but this raises the specter of making future legal development dependent on a small group of more or less arbitrarily-chosen experts. It may also create moral hazard problems, as experts, when designing the standardized rules, may try to ensure that their services will be needed in the future.[29]

IV. Law as a Cognitive Institution

The interdependence of legal rules and the characteristic of law as a "cognitive institution" are closely related.[30] Because most rules are not freestanding, they can be understood only in the context of a given legal order. Information about the existence of a norm and its contents is a prerequisite for any impact of the law beyond a shelf life. This problem can be overcome by improving legal information systems. An additional requirement is that legal rules are understood. This is a serious constraint for legal transplantation because – as Sunstein put it -- "the meaning of legal statements is a function of social norms, not of the speaker's intentions."[31] In other words, how-

26. Walt, "Novelty and the Risks of Uniform Sales Law," 39 *Va. J. Int'l L.* 671-706 (1999) at p. 688.

27. Since upon ratification of the Convention, it becomes part of the domestic law of a given country, which applies even without specific reference to it, an explicit statement of this sort is required to opt out of it. See id.

28. Walt, id. A clarification of these terms and concepts requires that many parties opt into the convention. Therefore, this practice might well render CISG ineffective, even though all parties may benefit in the longterm form a uniform sales law for transnational transactions.

29. Schwartz & Scott, supra n.16, at 595-654.

30. This term was coined by Means in his study of law in nineteenth century Columbia. See Robert Charles Means, *Underdevelopment and the Development of Law* (1980).

31. Sunstein, "On the Expressive Function of Law," 144 *U. Pa. L. Rev.* 2021-53 (1996) at p. 2050. For a more elaborate statement of this point see also Sunstein, "Social Norms and Social Roles," 96 *Colum. L. Rev.* 903-68 (1996) at pp. 925. While his argument deals primarily with social norms, the point is also applicable to formal law. See also Buxbaum op. cit. at fn. 5.

ever perfectly designed a law that is supplied from the outside may be, its impact is ultimately determined by how it is understood by lawmakers, law enforcers, and law users at the receiving end.

Assuming that a cognitive gap exists between any rule that is supplied and the understanding of that rule by its end-users, and that this gap impedes the effectiveness of transplanted rules, the question arises, how this gap could be closed. One approach taken in the literature is to make appropriate changes at the supply side, for example by supplying simple, bright-line rules rather than detailed, complex ones.[32] An alternative approach is for the law to spell out in detail the rights and responsibilities of the relevant parties. This is supposed to have beneficial educative effects on the recipients of the law.[33] A bright line approach could be sufficient, if the problem was merely an intellectual, not a cognitive problem. It is possible to argue that in many countries the legal profession is not sufficiently trained, and highly sophisticated rules may not be understood for this reason. However, it is also true that even the simplest rule acquires different meanings in different contexts. Take, for example, the simple rule "do not steal," discussed above. How shall this rule be applied in relation to communal property? Is overgrazing of the commons captured? Where shall the line between normal use and overgrazing be drawn? What about takings by people who are not members of the social group which shares the commons? As discussed in the previous section, it is possible to define the concepts that the rule "do not steal" refers to in more detail. This will certainly clarify the scope of application of this rule, but it may also render the rule useless in contexts that are outside its scope.

V. Law Enforcement

The idea behind the standardization of law is that well-designed legal standards once adopted by domestic governments will change the behavior of individuals and entities and thereby influence the path of future economic development. The adoption of a law, however, is not a guarantee that it will indeed affect behavior, or that it will affect behavior in the intended fashion. While informal rules of behavior or norms survive only if a sufficiently large number of people comply with them, formal law may remain on the books, even if ignored or contradicted by actual behavior.

32. See Hay, Shleifer & Vishny, "Toward a Theory of Legal Reform," 40 *European Economic Review* 559-67 (1996). This approach is developed from experience with legal reforms in Russia.

33. See Black, Kraakman & Hay, "Corporate Law from Scratch," 2 *Corporate Governance in Eastern Europe and Russia* 245-302 (Roman Frydman, Cheryl Gray, & Andrzej Rapaczynski, 1996) and Black & Kraakman, "A Self-Enforcing Model of Corporate Law," 109 *Harv. L. Rev.* 1911-82 (1996) for a discussion of the educative function of law.

The enactment of a new law that is designed to change behavior can have essentially four outcomes. First, the law may be ignored. Existing behavioral patterns are not changed and, as a result, the law does not have any impact. Second, the law may be observed formally, but be circumvented in practice. This has been aptly called "creative compliance."[34] Creative compliance is relatively easy, where the new law is ill specified and general terms leave much room to interpretation. The scope of behavior that can be subsumed under such a law is broad. Courts typically try to define the limits of such expansive interpretation by taking recourse to the spirit of the law or the intention of the lawmakers. These concepts, however, are themselves unspecified and subject to varying interpretations. Creative compliance is also possible when rules are highly specified. In fact, McBarnet and Whelan who have coined this term have defined it as "the use of formalism to avoid legal control."[35] Formalistic application of the law often contradicts its spirit. Examples include the holding of elections to buttress the claim that a country is a democracy, even though only incumbents may stand for office; the convocation of a shareholder meeting at a remote place which only preinformed shareholders are able to reach on time; or the exclusion of critical shareholders under the guise of formalistic violations of the law.[36] Third, law may be designed so that it applies only selectively. Examples of explicit exemptions include a waiver of strict liability rules, and the implementation of safety or environmental standards for certain sectors. Frequently, however, exemptions are implicit. An exemption from the application of an otherwise general rule can be granted by defining the scope of its application in a fashion that excludes potential target groups, which may render the entire rule ineffective. An example is a provision in the German corporate law that denies liability of management for wrongful conduct, if the conduct was approved by a majority vote taken at the shareholder meeting. Since German companies are often controlled by friendly blockholders, such a vote may not be difficult to come by. The provision in essence exempts management from liability vis-à-vis minority shareholders.[37] Even when a law applies universally, enforcement may be selective. In tax matters states may wish to spare sectors that are key to the economy and/or have good political connections. Finally, the fourth and from the standpoint of lawmakers, the most de-

34. Belcher, "Regulation by the Market: The Case of the Cadbury Code and Compliance Statement," *J. Bus. L.* 321-42 (1995) quoting McBarnet and Whelan who coined this term.

35. Id.

36. For a selection of cases that violate shareholder rights by using and misusing provisions of the corporate law see Black, Kraakman & Tarassova, "Russian Privatization and Corporate Governance: What Went Wrong?," 52 *Stan. L. Rev.* 1731-1803 (2000).

37. See § 117 section 7 of the German joint stock company law (AktG).

sirable outcome is that the new law may be used and applied indiscriminately in the intended fashion.

The propensity of the law to affect behavior differs in the four scenarios. An ignored law has no impact on actual behavior. A law that leads to creative compliance has an impact on behavior, but not the intended one. The expected effect of the law is typically not achieved. Instead, economic agents device schemes to neutralize its impact. The net result may well be a welfare loss, as the circumvention strategies may create additional costs. The selective application of law does change the behavior of those who either voluntarily comply with, or are subjected to (selective) enforcement. The selectivity of law enforcement may, over time, erode the force of the law and lead to widespread creative, rather than true, compliance. This will be the case when those who bear the costs of compliance cannot reap its benefits, because they will accrue only if a sufficiently large number of other agents comply as well. An example is compliance with disclosure requirements. Even though this is costly for firms, they may benefit from comparing their information with that of other market participants, and from reading the market responses of the disclosed information. However, these benefits materialize only, if a firm is not alone in disclosing its information.

When voluntary compliance cannot be ensured, the law has to be enforced by the state in order to be effective. One may regard voluntary compliance and state enforcement as substitutes. In fact, they are complements. State enforcement, to be effective, depends on high levels of voluntary compliance. Only in this case can resources be bundled to enforce the law against deviant behavior. If deviant behavior is widespread, law enforcement will be ineffective. The reverse is also true. Thus, the fact that most disputes in everyday life are solved without reverting to state enforcement agencies is at least in part dependent on the belief that, if this failed, state enforcement would in fact be available.

VI. Standardizing Law for the International Financial Architecture

In this section, we apply the above analysis to those legal rules that currently form the core of the standardization efforts endorsed by the IMF.[38] We will exclude the UNCITRAL Model law on cross-border insolvency, because the target of this model law is limited to transnational cases and the improvement of domestic legal institutions is not a primarily purpose of this harmonization effort.

The purpose of this analysis is to establish whether the incorporation of the standardized rules is likely to lead to an improvement of

38. See Section II above.

the domestic legal system or not. This would require first, that the standards could be used for assessing the quality of the domestic legal framework. In other words, the standards should offer independent guidance, which implies that key concepts are included in the standards themselves. Second, we will check the extent to which the major standardized rules are freestanding, or else, whether they are dependent on domestic or synthetic legal concepts. Freestanding rules will be the easiest to incorporate, as they do not require extensive additional reform efforts to make preexisting rules compatible with them. Reference to domestic systems may increase the likelihood that a standard will be used and applied in the future, but also questions whether the overall goal of the standardization effort can be achieved. References to synthetic concepts incorporated in the standards (or related documents) will achieve the harmonization of the law on the books, but as discussed above, they may be difficult to interpret and enforce.

International Accounting Standards (IAS)[39]

Of the different legal standards discussed in this paper, only the IAS are freestanding. The immediate objective of these standards is to formulate an independent set of accounting standards for worldwide use by companies.[40] The harmonization of accounting standards around the world is a second objective, but this is not a prerequisite for the first objective to be realized. In essence, IAS can be compared to the artificial language Esperanto. Esperanto does not replace local languages, but functions as an independent medium for communication. While Esperanto has not been a success, there is evidence that firms in many jurisdictions have decided to disclose their financial data both according to domestic standards and according to IAS. This is costly for companies and a good reason to harmonize the rules over time. In order to create a freestanding body of rules, the IAS include principles of accounting, its purposes, as well as detailed rules about how to enter information for specific items, including inventories, costs for research and development, employee benefits, and the like. It is certainly possible (and indeed quite likely) that not everything of relevance is included, i.e., that IAS have gaps. But this feature they share with any domestic legal rule. The difference to dependent rules is that the meaning of the IAS can be derived from reading the IAS alone and no further reference to other rules, legal concepts, or entire bodies of law needs to be made. In light of our above analysis this bodes well for harmonization. Although domestic lawmakers may for whatever reasons stick to their own accounting standards, firms have

39. IASC, *International Accounting Standards 1999* (London: International Accounting Standards Committee)(1999).

40. IASC, id., at 29.

at least the option to use IAS in addition to the local ones. This might be costly, but the rewards in the form of greater recognition on the international market may well be worth it.

IOSCO Objectives and Principles of Securities Legislation (IOSCO Principles)[41]

The IOSCO Principles include only the basic principles of securities legislation and refer to a host of other guidelines and recommendations that were developed by IOSCO. We will ignore most of these other guidelines for the purpose of this analysis, although it should be noted that they often provide the concepts the general guidelines discussed here refer to.

The IOSCO Principles explicitly state that the efficacy of the proposed rules will depend on the scope and quality of the general framework for commercial law. Thus, they are making these rules dependent not only on specific rules included in other statutes, but also on the broader legal framework. Annexure 3 to the IOSCO Principles lists those parts of the legal framework, which according to IOSCO, are of special importance. The list includes company, commercial, and contract law; tax laws, bankruptcy and insolvency laws, competition law, banking law, and the entire system for dispute resolution. For each area of the law, IOSCO lists those aspects that are of particular relevance for securities regulation. With respect to company law, special company formation, the duties of directors and officers, regulations of takeover bids, and other transactions intended to effect a change in control, laws governing the issue and offer for sale of securities, disclosure of information to security holders to enable informed voting decisions, disclosure of material shareholders, are listed. For commercial and contract law, the IOSCO Principles include private rights of contract, facilitation of securities lending and hypothecation, property rights, including rights attaching to securities, and the rules governing the transfer of those rights. For other areas, the reference is more opaque. With respect to tax laws, the Principles note the importance of clarity and consistency, "including, but not limited to, the treatment of investments and investment products." And for dispute resolution systems, "a fair and efficient judicial system (including the alternative of arbitration or other alternative dispute resolution mechanisms)" as well as the "enforceability of court orders and arbitration awards, including foreign orders and awards" is noted as prerequisites for effective securities regulation. In sum, securities legislation rests on the existence of a comprehensive and effective legal system.

41. September 1998. The Securities Principles can be found on IOSCO's home page (www.iosco.org).

Without questioning the interdependence of securities legislation with other parts of the legal system, it is at least worth considering, whether effective securities legislation could serve as a functional substitute to other legal provisions that may not be working quite as well. The concept of a functional substitute is well known in comparative law, where scholars have long asserted that identical legal problems may be solved by different legal rules and/or institutions.[42] A simple example is the treatment of trusts as a contract or a property right. Economic analysis of the details of these legal concepts in civil and common law systems reveals that irrespective of this fundamental difference, they perform essentially similar functions.[43] One proposition made in the comparative corporate governance literature, which is of particular relevance for the questions addressed in this paper, is that weak enforcement of minority shareholder rights in the general court system could be substituted with effective securities market legislation.[44] The successful migration of firms from home markets that protect shareholder rights only weakly to markets with strong securities regulations is taken as an indication for the host jurisdiction offering substitute legal protection. The interesting point about this example is that migrating companies take the home corporate law with them, but subject themselves to more stringent securities regulations. Observers of capital market development in transition economies have found that effective securities market regulation has been more important in promoting market development than minority shareholder protection.[45] Results from a study using data from twenty-four transition economies confirm these findings.[46] In fact, the quality of securities market legislation is the only law on the books variable that has a (marginally) significant impact on securities market development in these countries.

The major lesson from these findings is that despite the fact that IOSCO itself draws attention to other parts of the legal system as a prerequisite for the efficacy of the proposed standards, strong securities market regulations may also substitute for weaknesses in other areas. Yet, it is important to consider the tradeoffs of investing in one

42. Konrad Zweigert & Hein Kötz, *Introduction to Comparative Law* (1998) develop a functional approach to comparative law in general. For a critical assessment of this approach see Frankenberg, "Critical Comparisons: Re-thinking Comparative Law," 26 *Harv. Int'l L. J.* 411-55 (1985).

43. Henry Hansmann & Ugo Mattei, *Comparative Law and Economics of Trust* (1995).

44. On this point see especially Coffee, supra n. 22, 631-707.

45. Coffee, "Privatization and Corporate Governance: The Lessons from Securities Market Failure," 25 *J. Corp. L.* 1-39 (1999). Pistor, "Law as Determinant for Stock Market Development in Transition Economies," in *The Value of Law in Transition Economies* 249-87 (Peter Murrell ed., 2001); and Johnson, Glaeser & Shleifer, "Coase vs. Coasians," 116 *Quarterly Journal of Economics* 3, 853-99 (2001).

46. For a discussion of these results see infra n. 67 and accompanying text.

part of the legal system with limited impact on others, when resources for legal reform are limited.

Beyond the general reference to other areas of the domestic legal system, the IOSCO Principles explicitly reference three types of rules: (1) specific domestic legislation, (2) domestic politics and the accountability of government agents, (3) synthetic legal concepts developed in other IOSCO regulations. The very fact that they are doing this demonstrates the breadth and complexity of legal reform that will be necessary to make securities legislation work. In addition, the examples show that in the end domestic lawmakers are in many cases left to decide the appropriate level of regulations themselves.

References to domestic legislation include the use of legal concepts that imply further definitions. An example is the problem of conflict of interests that according to IOSCO Principles is relevant, in particular, for self-governing organizations and managers of collective investment schemes (CIS).[47] Where the boundaries shall be drawn between permissible actions and those that are clearly considered conflict of interests is up to each legal system. In most countries, the final demarcation of this line is left to the courts, as it is difficult to come up with a definition for codifying a rule that is both sufficiently abstract to include a range of potential cases, and still specific enough to be enforceable. Other examples include more general references to regulations, including accounting standards, the regulation of CIS, intermediaries, or banks.[48] Further guidance is given in some additional IOSCO guidelines. However, in several instances, regulators are warned that a particular issue needs to be regulated, but no guidance as to the possible contents is given. The IOSCO Principles state, for example, that the level of disclosure required for corporate control differs from jurisdiction to jurisdiction.[49] While this statement is certainly true, it is of little guidance for lawmakers in developing countries for deciding what the appropriate level of disclosure for their country might be.[50]

In several instances, the IOSCO Principles go far beyond references to specific parts of the domestic legal system, but stress the quality of the overall legal system or the legal and political governance system. In an attempt to define the meaning of 'accountability of the regulator,' the Principles state that this implies

- "a regulator that operates independently of sectoral interests;
- a system of public accountability of the regulator;

47. As will be further discussed below, CIS refer to mutual funds and other types of investment funds.

48. See pp. 26 of the IOSCO Principles for these examples.

49. 10.5 at p. 25 IOSCO Principles.

50. The Principles mention that the said rules typically set the threshold well below a controlling interest. This is certainly of some help, but the content of the final rule obviously depends on how a controlling interest is defined.

- a system permitting judicial review of decisions of the regulator."

These are important conditions, which point directly at the political structure and the realization of the rule of law in a given country. A system permitting judicial review of decisions of the regulator does not imply that *all* acts of the state need to be subject to judicial review, but certainly those of the securities market regulator. The issue of public accountability of the regulator raises a host of questions about the effectiveness of legal constraints and other mechanisms of accountability, including appointment, dismissal and disciplinary procedures. Taken seriously, making the securities market regulator accountable would require far-reaching political reforms in many countries.

Finally, in a few cases, the IOSCO Principles reference synthetic legal concepts. An example is the reference to regulation of collective investment schemes (CIS).[51] IOSCO has adopted separate guidelines for CIS, which includes a definition of this term. It is quite comprehensive and tries to include the variance of investment funds that deal in securities found in a large number of countries (or at least those that were most influential in drafting the guideline). At the same time, it is limited by excluding closed-end funds and "schemes investing in property/real estate, mortgages or venture capital."[52] There are two problems with this approach. First, the definition of what comprises a collective investment scheme is based on partial empirical observation. It is derived from investment schemes common in developed markets, but is likely to exclude many other structures that already exist or may arise in other markets. Second, the regulation of one class of investment (open-end funds that invest in securities), but not others, can create distortions. Promoters of schemes that fall under the definition of the guideline will certainly try to find ways around them when confronted with adjustment and compliance costs.

To summarize, the IOSCO Principles cannot be characterized as freestanding rules. They reference other laws and legal concepts, including domestic laws and synthetic concepts found in other IOSCO Principles. In addition, they call attention to how closely related a well-functioning regime for regulating securities market is to the political system. A general agreement to adopt these standards and comply with them can therefore be hardly more than a memorandum

51. IOSCO Principles for the Regulation of Collective Investment Schemes, October 1994. Available on the IOSCO.org webpage under publicdocuments . . . (last visited 6 May 2002).

52. The definition of CIS is "an open and collective investment scheme that issues redeemable units and invests primarily in transferable securities or money market instruments."

of understanding. Without additional reforms, including reforms aimed at enhancing the accountability of state agents, change will not be achieved.

IAIS Insurance Principles, Standards and Guidance Papers (IAIS Principles)[53]

The most striking aspect about the IAIS Principles is that they fail to define what constitutes an insurance business. The introduction to the Principles explicitly refers this to future work. In lieu of a common definition of insurance business, the Principles leave the definition of insurance business entirely to domestic law. This, of course, is not only an open invitation to creative compliance, but defeats the very purpose of legal harmonization. Thus, the IAIS Principles fail to meet the first criterion we established at the outset of this analysis, namely that that standard can be used to assess the quality of the domestic legal framework.

The inability to find a common definition can, in part, be attributed to the wide variety of risks that it may be insured against, which distinguishes this sector from other financial industries. It certainly reflects the diversity of insurance activities in member countries of IAIS and the difficulties in reconciling differences in commercial practice and regulatory activities of different countries. This of course raises the more fundamental question, whether standardization in such a diverse sector is at all meaningful. It is probably safe to say that until a common definition of what constitutes an insurance business is agreed upon, the Principles are unlikely to have any serious impact. Take, for example, the general licensing principles established by IAIS. The basic notion is that companies wishing to underwrite insurance in the domestic insurance market should be licensed.[54] However, absent a definition of what an insurance business means, it is impossible to determine whether or not countries comply with the licensing requirement. A provision that states, "license refers to the authority to operate business in the domestic market, which under domestic law is defined as insurance business"[55] is as meaningless as a provision that would allocate the right to define the scope of legal protection of trademarks to their users. The Principles recognize that differences in the definition of insurance business can lead to supervisory problems, especially where cross-border operations are concerned.[56] Yet, they contemplate excluding certain activities from the application of the IAIS Principles – without having

53. December 1999. The Insurance Principles can be found on the webpage of IAIS (www.iaisweb.org).
54. IAIS Principles, p. 5.
55. IAIS Principles, p. 30 (5).
56. IAIS principles p. 31 (13).

established the scope of their applicability in the first place. Thus, insurance activities that are limited as to the possible number of policyholders or to a geographical area shall be exempted from the application of the Principles. The phrasing of the exemption suggests that the drafters of the Principles had to bow to pressure from members in whose countries nonlicensed insurance activities proliferate: "The reason for this fact [the exclusion] could be that the insured sums do not exceed certain amounts, or that losses are compensated by payments in kind, and that the activities are pursued following the idea of solidarity." It is not difficult to imagine how nonlicensed insurance activities could mushroom under the pretext that they follow the idea of solidarity. More importantly, however, including exemptions in regulations that do not define the scope of the regulation is a meaningless exercise. Without clear statements as to whether the criteria used to justify the exclusions (number of policy holders, sums involved, purpose or motivation of activity) are relevant criteria for defining the scope of insurance business regulations, they can hardly be used for justifying an exemption from their application.

Given that the IAIS Principles fail to provide even a common lowest denominator for the type of activities that shall be governed by these principles, what can be possibly accomplished by the new standards? They establish a number of procedural requirements for establishing and licensing insurance businesses and for the withdrawal of the license. These include provisions on the type of information that should be submitted when applying for a license; an *ultra vires* provision that activities outside the approved scope of business are not permissible; minimum capital requirements; the submission of a business plan; as well as detailed information about the members of the board of directors, including professional education, training, and past employment.[57] But absent a clear demarcation of the types of activities that should be subject to these requirements, they are only checklists for the possible scope of regulation, which can be determined only once we know what an insurance business is.

OECD Principles on Corporate Governance (OECD CG-Principles)[58]

Whereas the IOSCO and IAIS Principles can be characterized as a combination of LCD-approaches to legal reform with some attempts to establish synthetic concepts, the OECD CG Principles take a more radical approach. They use economic rationales as a normative agenda and deduce specific rules for shareholder protection.[59] The

57. IAIS Principles, pp. 33.

58. Available from the OECD webpage at http://www.oecd.org under "corporate governance" (last visited 6 May 2002).

59. The approach is not consistently followed, but is combined with observations from actual rules in different jurisdictions. In the Annotation to the "basic shareholder rights", the CG-Principles state: "This Section can be seen as a statement of

principles establish the concept of "basic shareholder rights" and explain this with the statement that "equity investors have certain property rights."[60] In other words, the essence of equity investment is the acquisition of property rights, and the OECD CG Principles derive the basic shareholder rights from applying the property rights concept to a publicly-traded firm. Yet, the CG-Principles raise similar questions as to their precise meaning and the scope of their application as do the IOSCO or IAIS Principles. The CG-Principles state that "basic" shareholder rights include the right to

- secure methods of ownership registration
- convey or transfer shares
- obtain relevant information on the corporation on a timely and regular basis
- participate and vote in general shareholder meetings
- elect members of the board
- share in the profits of the corporation

Each of these rights requires further explanation. I.e., when are methods of ownership registration secured? Is the right to convey or transfer shares violated, if the transfer is subjected to approval by other shareholders and/or the board of directors? What is relevant information? Some guidance is given in the Annotations to the CG-Principles for answering these questions, but the task of translating the principles into specific laws and interpreting their meaning is left to domestic lawmakers and law enforcers.

The advantage of standards derived from abstract principles rather than consisting merely of a synthesis of existing legislation is that they offer a benchmark for assessing the quality of the law in different countries. The disadvantage, however, is that the principles from which they are derived may have little to do with existing practice and the remedies they offer could therefore be quite ineffective. In particular, the CG-Principles "focus on governance problems that result from the separation of ownership and control."[61] This certainly reflects the classic paradigm within the corporate governance literature.[62] Yet, an increasing number of empirical studies suggest that in most countries the separation of ownership and control is not the key issue. Concentrated ownership is much more common than had ear-

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the most basic rights of shareholders, which are recognized by law in virtually all OECD countries." (CG-Principles at p. 12).

60. OECD CG-Principles, p. 12.

61. OECD CG-Principles, p. 2.

62. This literature was greatly influenced by Adolf Augustus Berle & Gardiner Means, *The Modern Corporation and Private Property* (1932) For a critique of this paradigm and suggestions on how to expand the research on corporate governance, see Berglöf & von Thadden, "The Changing Corporate Governance Paradigm: Implications for Transition and Developing Countries," *Proceedings of the Annual Bank Conference on Development Economics* (1999).

lier been assumed.[63] Where a controlling shareholder is present, however, ownership and control is not separated. Different problems may arise in this situation, which may require a different legal solution. The protection of minority shareholders against block holders, for example, will be more important than protecting minority shareholders against management, as management is effectively controlled by a block holder. Even if the block holder is only a disguise for de factor managerial control, the target of the rules should probably be the block holder, rather than management.

An example for how misleading the CG-Principles may be when analyzed in the light of real world corporate governance problems particularly in emerging markets is their treatment of "stakeholders." This term loosely refers to all parties with a stake in the firm who are not shareholders and includes investors, employees, creditors, and suppliers.[64] The only guidance as to how to handle the interests of these various stakeholders is that "where stakeholder interests are protected by law, stakeholders should have the opportunity to obtain effective redress for violation of their rights." And the annotations add, "The legal framework and process should be transparent and not impede the ability of stakeholders to communicate and to obtain redress for the violation of rights."

The most straightforward application of this principle is employee codetermination. Where the law gives employees the right to participate in the company's board and to vote on issues of business strategy, these rights should be enforced. Interestingly, the OECD CG-Principles are silent on whether codetermination is desirable and fail to address the potential conflict between shareholder property rights and the legal rights allocated to employees under such a scheme. For all other stakeholders, the rights that could possibly be protected by law and should therefore be enforced are ambiguous.

Take, for example, the family-controlled foundation, which is only a subsidiary of, say, a Korean chaebol, and holds only a minority stake in the parent company. Yet, this foundation controls key business decisions and, in particular, the process of nominating and electing the chief executive officer of the parent company, who may, but does not need to be, a member of the family.[65] Is this foundation a "stakeholder"? What legally-protected rights does it have, and what is the meaning of an unrestricted right to communicate among stake-

63. La Porta, supra n.20, at 1113; and La Porta, Lopez-de-Silanes and Shleifer, "Corporate Ownership Around the World," LIV *Journal of Finance* 471-517 (1999).

64. CG-Principles, Annotations p. 18.

65. On corporate governance problems in Korea see Kon Sik Kim, "Chaebol and Corporate Governance in Korea," *Korean Law in the Global Economy* 598-677 (Sang-Hyun Song ed., 1996) A description of the pyramid structure that can be found in Korea chaebols is included in La Porta, Lopez-de-Silanes & Shleifer, "Corporate Ownership," supra n.63.

holders in an environment where deals among different members of the controlling family are commonplace? Another example is the influential role a local government might have on corporations that are located within its jurisdiction. Is the government a stakeholder? If yes, the wording of the OECD Principles could be interpreted restrictively to mean that *only* those rights that are protected by law should be respected. A corporation could use this to defend its interests against political interference. But certainly, there will be provisions in the local constitution that gives the government the right to take appropriate measures to enhance the public good. Are these legally-protected rights?

These examples demonstrate that the attempt to derive specific rules from economic "truths" is not without flaws. The solutions thus arrived at are meaningful only if the theoretical assumptions about the main corporate governance problems are consistent with reality. To the extent this is not the case, they offer little guidance to lawmakers for solving real world problems.

VII. Implications for Developing Countries

This section addresses the questions and implications the adoption of the above legal standards may have for the propensity of countries, in particular developing countries, to attract foreign investors and to participate in global markets. At the outset, three points are worth stating. First, harmonization or standardization of law is not necessary for international trade and investment to take place. Most transactions today take place using law that has not been harmonized or standardized. Second, the areas of the law that are at the core of the IMF standardization claims are important for attracting financial investors, in particular, portfolio investors. Their relevance for foreign direct investment (FDI), however, is less evident. Analyses of the flow of foreign investments and data from surveys of investors around the world clearly show that a functioning legal system for contract enforcement and effective legal constraints that limit arbitrary state power are important determinants for investment decisions.[66] While this does not mean that improvements in financial market legislation are not important, countries with limited resources available for law reform clearly need to make a choice and target their reform efforts to areas that will bring the highest returns in the long term. Third, the adoption of legal standards in any area of the law, including financial law, is not sufficient for creating an effective institutional framework that will enhance a country's likelihood to attract foreign investment, or create effective buffers against con-

66. See *Competitiveness Report* (2000), Economic Forum and Center for International Development.

tagion effects of future crises. The third point requires further explanation.

The underwriting of international standards for the said areas of the law may serve as a signal to foreign investors that a country is indeed complying with these standards. Past experience shows that once a crisis hits, investors will pull out where they might have serious doubts about the effectiveness of legal institutions and their ability to protect their claims. At this point, they will not be misled by formal indicators, but take a closer look at the ability of the country in question to actually enforce these rules. Improvements in the legal infrastructure can serve as a buffer against such swings, but only if this infrastructure is perceived to be effective.

The signaling function of internationally-agreed legal standards is likely to erode, if too many countries practice formal compliance rather than real compliance. The question is not whether or not foreign investors will find out how effective legal institutions are, but only when. This creates a dilemma for countries intending not only to adopt international standards, but also to engage in further reforms. Because institutional reforms are generally slow, the payoffs of these reforms will take some time to materialize. In the meantime, the positive signal the adoption of the standard may send originally is likely to be undermined by crises in economies that pursued merely a formal compliance strategy. Investments in extended legal reforms may be lost. Indeed the credibility of international legal standards could well be undermined.

The best strategy to counter this downward slope seems to be for countries not only to signal the adoption of formal legal standards, but to ensure that they have the capacity to enforce the newly-adopted laws and in fact to demonstrate this capacity. A selective approach to legal reforms tied in with institutional reforms and the allocation of sufficient resources to ensure their success would be a more promising strategy. Successful reforms will reinforce each other. Effective enforcement of new laws will enhance the credibility of legal institutions and raise investors' confidence in financial markets. This will also attract investors willing to make long-term commitments. By contrast, the best laws on the books may have little impact on the development of financial markets and their credibility in the eyes of domestic or foreign investors. A recent study that investigates the relation between legal reforms and financial market development in transition economies demonstrates this point. The substantial improvements in the law on the books as measured by a variety of legal indicators by and large had little impact on the development of capital markets. By contrast, the effectiveness of legal institutions was

much higher correlated with increases in market capitalization and improvements in liquidity.[67]

Thus, the key to success for any given country will be the establishment of effective legal institutions. In part, this depends on the resources that are available, including financial and human resources. Where these resources are not available, or other obstacles stand in the way of effectuating financial law, a country should consider whether it is ready to expose itself fully to the winds of international financial markets.[68] Resources, however, are not the only consideration. In addition, the process of legal reform needs to ensure that a sufficiently large domestic constituency is engaged in the reform process. As was pointed out in the section above, the efficacy of law enforcement depends on the level of voluntary compliance, and this in turn depends on the support for law reform by local constituencies. Research on the propensity of countries to develop effective legal institutions suggests that a strong demand for law reform is more important for the long-term development of effective legal institutions than the quality of the laws on the books.[69] These results hold when controlling for today's levels of GDP per capita, suggesting that the effectiveness of legal institutions is not only determined by a country's wealth.

A key element for successful reforms is access to information about the scope of legal solutions that exist to tackle a particular problem, and the conditions under which these solutions may or may not be enforceable. This information is not easily available. The proposed standards for reforming the financial architecture certainly do not provide it. Instead they rely on ambiguous guidelines and extensive references to synthetic concepts that are in need of further clarification.

In light of these considerations, this paper argues that a new approach to reforming legal systems in developing countries and emerging markets is warranted. Instead of developing legal standards by legal experts or professional interest groups, lawmakers around the

67. Pistor, Raiser & Gelfer, "Law and Finance in Transition Economies," 8 *Economic of Transition* 325-68 (2000). The various legal indicators used in this study and the variance of these indicators across different transition economies is discussed in Pistor, "Patterns of Legal Change: Shareholder and Creditor Rights in Transition Economies," 1 *European Business Organization Law Review* 59-110 (2000).

68. In the aftermath of the Asian financial crisis, the restriction of portfolio capital inflows has been discussed as a possible policy option.

69. Berkowitz, Pistor & Richard, "Economic Development, Legality, and the Transplant Effect," in *European Economic Review* (2002) (forthcoming). The authors focus on the introduction of formal legal systems in the 19th century and distinguish between origin countries, i.e., countries that developed their formal legal systems internally, and transplant countries. The latter are further divided into transplants with (receptive) and without (unreceptive) a demand for the new law. Origins and receptive transplants today have more effective legal institutions than unreceptive transplant countries.

world should be given access to alternative legal solutions found in living legal systems. This would enable domestic agents to identify problems and find solutions that are adequate and potentially effective given the institutional constraints their country faces.

Lawmakers in Korea, for example, will want to know how other countries with large business groups solve the problem of protecting minority shareholders in these groups. Different jurisdictions have experimented with different approaches. Some countries use takeover codes to protect shareholders in transactions that could dilute their previous holdings. They are less concerned with minority shareholders that have decided to keep their stakes, unless block holders misuse their dominant role. Germany, by contrast, has developed a complex legal regime for business groups in an attempt to protect minority shareholders in companies that belong to business groups. The reason for these different approaches can be found in diverging policy choices in the process of company formation during industrialization. In the United States, strong antitrust rules prevented close contractual or equity relations between independent firms and thereby promoted either full integration or separation. Germany by contrast, allowed the formation of cartels and thus saw the emergence of groups of companies that are interconnected by equity holdings, explicit or implicit contractual arrangements.[70] Countries that have business groups may want to consider legal systems that have developed ex post controls, because they have already foregone preventing the emergence of such groups ex ante. By contrast, the OECD CG Principles focus on ex ante, rather than ex post controls.[71]

Irrespective of their initial conditions, all countries should have access to information on how different legal systems create mechanisms of accountability for common problems. A case in point is board members failing to comply with their obligations. The OECD CG Principles include a list of responsibilities of the board. However, they do not offer solutions to the vexing question as to how members of the boards shall be incentivized to take these responsibilities seriously, and what redress shareholders should have against members who fail to live up to their legal duties. Legal solutions found in different countries range from dismissal with or without cause, compensation plans as incentive devices, rules on frequency of board meetings, all the way to direct or derivative shareholder suits. Lawmakers in the receiving country will need to address these issues

70. For a historical analysis of the development of firms and legal responses between 1870 and 1933 see Gerald Spindler, *Recht und Konzern—Interdependenzen der Rechts- und Unternehmensentwicklung in Deutschland und den USA* (1993).

71. Art. 1 D OECD CG Principles.

in order to design procedural devices, without which the law cannot be enforced.[72]

Similar points can be made for the other areas of the law discussed in this paper. In the absence of a common definition of insurance business under the IAIS Guidelines, it is crucial that countries obtain access to information as to what constitutes insurance businesses in different countries, and why some activities are included, and others excluded. It is commonly known that in legal matters 'the devil lies in the details.' These details are not included in the discussed standards. In fact, by definition, broad legal standards avoid these details. The laws to be enacted by different countries, however, will need to be much more specific.

What is needed, therefore, is a market for information on the scope of legal solutions to solve comparable problems, including information about how these solutions are tied into the general legal framework and the enforcement institutions. This would allow lawmakers, say from Vietnam, to consult not only the laws from developed market economies, but also those of neighboring countries, or other transition economies. They could identify elements from different systems and use this to develop a legal product they understand, and can afford. Moreover, other constituencies—professional organizations, self-governing bodies—should have similar access to information, which would put them into a position to participate in the debate of which solution could be the best fit for their country. Access to different domestic legal systems is currently impeded not only by language barriers, but also by the idiosyncrasies of different legal systems. This often makes it difficult to locate the legal rules that address a particular problem, and to understand their links to other parts of the legal system. These problems are exacerbated by legal terminology, which differs from jurisdiction to jurisdiction.

Yet, it is not impossible to overcome these barriers. Japanese lawmakers in the late 19th century were able to debate in detail, whether the French, German, or English common law system would be more appropriate for them.[73] They received experts from Europe and sent delegations to various countries to learn about their economic and legal systems. Today, lawmakers throughout the world should have an easier task to obtain relevant information. Travel certainly has become more convenient. More important, information technology offers opportunities for making legal information available around the globe that has previously been nonexistent. In fact, a wealth of legal information is already available on the Web. The

72. The design of such rules does not guarantee that the law will be enforced, but is still an important prerequisite.

73. See John Owen Haley, *Authority Without Powe* 67 (1991) for a discussion of Western legal transplants to Japan during the Meiji restoration.

greatest obstacle for accessing and using this information are language barriers, and perhaps even more importantly, differences in the structure of legal systems which makes it difficult to locate the rules or relevant case laws that deal with a particular problem. Different legal systems use different grammar for organizing their laws. However, these problems are not insurmountable, at least not if resources were made available for new legal information systems rather than used for creating general standards.

VIII. Conclusion

The objective of this paper was to assess the standardization efforts of financial laws that are currently under way. Because standardization is costly, the paper first analyzes the possible justifications for standardizing different areas of the law, including cross-border insolvency cases, accounting standards, securities regulation, insurance regulations, and principles of corporate governance. While good arguments can be found to justify these standardization efforts, the likelihood for them to have any beneficial impact hinges on additional factors. The new standards need to be fitted into domestic legal systems. Most of them are not freestanding, but their meaning and interpretation depends on preexisting rules or rules that will still need to be established. As discussed above, the IOSCO principles are quite explicit about the interdependence of the proposed rules with domestic ones. In addition, the effectiveness of these rules will depend on the efficacy of enforcement institutions. Given this close relationship between most standardization efforts – the IAS being the only exception to this – and the comprehensiveness and effectiveness of the domestic legal system, this paper asks, whether standardization is the best strategy for improving domestic legal institutions. It suggests that this is not the case. The reason is that the process of standardizing rules makes it necessary to either develop synthetic concepts to bridge differences between different legal cultures, or to agree to the lowest common denominator. Neither result offers clear-cut solutions for domestic lawmakers, economic agents as the consumers of the laws, or law enforcers. Instead, they need to give meaning to these concepts by relating them to preexisting legal concepts or interpreting them from scratch. In some cases, the process of standardization defeats its very purpose. An example is the IAIS, which include a comprehensive reference to domestic legal systems for defining the object ("insurance activity") for which standardized rules shall be developed. On a more theoretical level, this paper argues that laws, to be effective, need to have local constituencies with a strong interest and understanding of the laws. This is the prerequisite for the new laws to become part of the continuous process of legal change, without which the formal legal system will remain largely irrelevant. It is

also important for ensuring high levels of voluntary compliance with the law, and thus for its effectiveness. In sum, the paper warns against viewing legal standards as a panacea for building effective legal systems around the world.