EDITORIAL COMMENT

THE FINANCIAL MELTDOWN AND ITS INTERNATIONAL IMPLICATIONS

By Detlev F. Vagts

The worldwide economic downturn touched off by the meltdown of financial assets in the United States has been the center of attention in 2009 for individuals and governments alike. What caused the breakdown and what should be done about it preoccupy the media, the public, and the government. That this crisis is an international matter is shown by headlines about the meltdown that often concern transnational issues, such as unhappiness that government payments to American International Group were passed on to foreign banks that had been counterparties to credit insurance contracts with AIG. Foreign investors turned up among the many victims of Bernard Madoff's and R. Allen Stanford's schemes. Meetings of the Group of 20 have focused on meltdown issues.[1] Concerns were expressed that U.S. moves to stimulate economic activity might have protectionist results by excluding foreign firms as suppliers. Moreover, foreigners have tended to blame the United States for the mess.

The United States confronted the Great Depression of the 1930s with unilateral acts that also had repercussions abroad.[2] In 1971 the administration took action—the so-called Nixon Shock—without consultation with other states even though it arguably violated commitments under the Articles of Agreement of the International Monetary Fund (IMF) and the General Agreement on Tariffs and Trade (GATT).[3] That cannot happen this time. Reactions will have to be carefully coordinated among nations, and the United States will find that its elbow room

[1] Group of 20, *Declaration of the Summit on Financial Markets and the World Economy* (Nov. 15, 2008), *available at* http://www.un.org/ga/president/63/commission/declarationG20.pdf, *excerpted in* John R. Crook, Contemporary Practice of the United States, 103 AJIL 149 (2009). The Group of 20 consists of the nineteen major national economies and the European Union. The G-20 has established a Financial Stability Board.

[2] U.S. emergency action in 1933 to go off the gold standard and abrogate contractual gold clauses was upheld by a divided Supreme Court in the *"Gold Clause Cases."* Perry v. United States, 294 U.S. 330 (1935). The dissenters warned that "[l]oss of reputation for honorable dealing will bring us unending humiliation; the impending legal and moral chaos is appalling." *Id.* at 381 (McReynolds, van Devanter, Sutherland, & Butler, JJ., dissenting). Later there was a futile monetary and trade conference in London. Detlev F. Vagts, *International Economic Law and the* American Journal of International Law, 100 AJIL 769, 775 (2006).

[3] The original IMF Agreement committed the United States to maintain the dollar at a fixed rate in relation to gold; after the United States abandoned this commitment, *see* Vagts, *supra* note 2, at 779–80, the Agreement was amended in 1978. *Compare* Articles of Agreement of the International Monetary Fund, *opened for signature* Dec. 27, 1945, 60 Stat. 1401, 2 UNTS 39 (entered into force Dec. 27, 1945), *with* Amendment of Apr. 30, 1976, 29 UST 2203 (entered into force Apr. 1, 1978). It is questionable whether the accompanying tariff surcharge was compatible with the GATT provisions authorizing action in case of balance-of-payment problems. *See* Report of Working Party, GATT B.I.S.D. (18th Supp.) at 212–23 (1971). For one thing, the emergency balance-of-payments action authorized by GATT is a quota rather than a tariff surcharge. *See* JOHN H. JACKSON, WILLIAM J. DAVEY, & ALAN O. SYKES JR., LEGAL PROBLEMS OF INTERNATIONAL ECONOMIC RELATIONS 1100–03 (5th ed. 2008).

is restricted by the development of international rules and networks, and by the leverage of foreign governments.

This Comment attempts to sketch out the ways that this brave new world of international law and finance will hem in U.S. freedom to act. It is generally agreed that two tasks must be undertaken. One is to restart the economic system; bailouts, stimulus packages, and the like are the tools one looks to. The other is revising the regulation of financial markets. Regulatory failure alongside the recklessness of private actors bears some responsibility for the disaster. Many experts would also say—but not without dissenting voices, particularly abroad—that getting the world economy up and running again is the more urgent of the two tasks. Re-regulating is less urgent and requires more extended care and analysis.

The following discussion begins with an analysis of the regulatory issues since they are easier to fit into standard legal frameworks. Part I considers financial market regulation in general and then takes up accounting and financial reporting questions. The second part analyzes the constraints that foreign investments in the United States, both portfolio and direct, will impose on U.S. financial policy. The final part examines the relationship of these developments to fears already expressed about U.S. losses of freedom of choice (or of sovereignty) in other areas.

I. THE NEW FINANCIAL REGULATION

For many years the United States was regarded as setting the gold standard in securities regulation, just as New York was regarded as the capital of the financial world. In her study of the international networks, Anne-Marie Slaughter wrote only five years ago of "regulatory export" to denote the tendency of foreign governments to emulate U.S. supervision of the securities market.[4] She quoted a former SEC commissioner as saying, "The trick will be to encourage the securities regulators of the other major trading nations to develop systems that provide protections to investors substantially similar to those provided in this country."[5] Practitioners abroad imitated U.S. documentation for securities transactions, including by issuing prospectuses that looked American. They let U.S. lawyers take the lead in creating new forms of investment vehicles, particularly derivatives. Foreign enterprises subjected themselves to the jurisdiction of the Securities and Exchange Commission (SEC). In so doing, they believed that they were not only gaining access to the U.S. capital markets but also assuring investors in other countries that their integrity and transparency met U.S. standards.

The United States may now be in a state of "regulatory import." The loss of American primacy began with the Enron and Tyco corporate scandals and the consequent enactment in 2002 of the Sarbanes-Oxley statute on improving corporate governance under securities law.[6] Quite a few foreign corporations, conspicuously some in Germany, decided that the additional burdens of complying with that Act exceeded the advantages derived from having a presence

[4] ANNE-MARIE SLAUGHTER, A NEW WORLD ORDER 172–77 (2004).

[5] *Id.* at 172 (quoting Bevis Longstreth, *The SEC After Fifty Years: An Assessment of Its Past and Future,* 83 COLUM. L. REV. 1593, 1610 (1983)).

[6] Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (2002) (principally codified in 15 & 18 U.S.C.). For the Act's international implications, see Detlev F. Vagts, *Extraterritoriality and the Corporate Governance Law,* 97 AJIL 289 (2003). On the extent to which the relative decline of U.S. securities markets is due to the Act or to other factors such as the increasing efficiency of foreign markets, see Howell E. Jackson & Eric J. Pan, *Regulatory Competition in International Securities Markets: Evidence from Europe—Part II,* 3 VA. L. & BUS. REV. 207 (2008).

in the U.S. market. Accordingly, they sought to terminate their U.S. registration and lobbied to ease the rules for such withdrawals.[7]

The financial market crisis beginning in 2007 put a new edge on this negative judgment. Americans themselves were shocked at the outright dishonesty of schemes such as that captained by Madoff and the SEC's failure to prevent them despite warnings from whistleblowers. More pervasive was a sense that the SEC was too sympathetic to those it was supposed to be regulating and that its staff had not kept up with the new types of securities that had first fueled the exuberant boom and then generated the collapse. The creation and packaging of real estate mortgages largely escaped all forms of regulation. Although the Federal Reserve System had been given power to regulate these practices, it had deliberately refrained from doing so. State regulators who might have been willing to exercise oversight were bypassed by mortgage originators that were not banks. Meanwhile, certain types of derivatives such as credit default swaps were exempted from the jurisdiction of the Commodity Futures Trading Commission.

Criticism from abroad was sharp, particularly that of Peer Steinbrück, the German minister of finance.[8] Since European politicians nowadays have more of an urge to regulate and less willingness than Americans to trust the wisdom of the market, it seems likely that the end result will be more regulation than anticipated. In particular, the United States may be unable to maintain the traditional SEC style of regulation, which emphasizes compulsory full disclosure to investors by regulated companies rather than substantive controls involving bureaucratic judgments. How that power would be allocated among the present regulatory bodies—the SEC, the Commodities Futures Trading Commission, and the Federal Reserve—or some new agency remains to be seen.

The establishment of an international watchdog agency does not seem probable. However, the International Organisation of Securities Commissions (IOSCO) can be expected to play a larger role. IOSCO is in essence a network through which national bodies coordinate their work. It is not an intergovernmental organization and has no basis in treaty law. It cannot make decisions binding on its members; its stances do not become law in the United States unless the SEC, acting according to U.S. administrative law, adopts them. Nonetheless, IOSCO has significantly affected the activities of its members and exposed them to the collective reactions of their fellow regulators whose experiences and attitudes they share. It will be a conduit for exerting foreign pressures for change on the SEC.

A special and highly technical part of securities regulation consists of control over accounting and financial reporting standards. This is unfamiliar territory for international lawyers. Until recently, the United States was regarded as the source of the most advanced and admirable accounting practices. These are embodied in the Generally Accepted Accounting Practices (GAAP), which govern the way financial statements are presented, and the Standard Auditing Practices (SAP), which prescribe the investigations auditors must make before giving their opinion. That, too, has changed; it is an inconvenient truth that the world no longer looks to the U.S. GAAP as the global gold standard.

In recent years authority has been passing from the SEC and the relevant bodies of the U.S. accounting profession, such as the Financial Accounting Standards Board, to international

[7] Their efforts resulted in the promulgation in 2007 of Securities Exchange Act Rule 12h-6, 17 C.F.R. §240.12h-6 (2009).

[8] Eric Pfanner, *Germans Receive Bush Speech Coldly*, N.Y. TIMES ON THE WEB, Sept. 26, 2008, *available in* LEXIS, News Library, Individual Publications File.

entities.[9] The driving force has been the International Federation of Accountants, which has a membership of more than a hundred national accounting groups. It speaks authoritatively through the International Accounting Standards Committee, now the International Accounting Standards Board, a body in which U.S. parties have a significant, but by no means controlling, role. That body has been turning out International Financial Reporting Standards (IFRS), which have garnered increasing acceptance in Europe and other countries, and more recently in the United States.[10] They are not vastly different from U.S. rules, but gaps can be expected to open up as the years pass.

Some accounting rules are so technical that they receive little attention outside the profession, but others have stimulated political reactions. For example, Congress has threatened to intervene both in the reporting of executive stock options and in the maintenance of the mark-to-market requirement, which makes companies write down assets whose value has fallen below their price. Since 2007 the SEC has accepted filings by foreign issuers couched in IFRS without insisting that they be reconciled with the American GAAP.[11] International lawyers paid little attention when the SEC announced in 2007 that it was considering allowing U.S. issuers of securities to use IFRS rather than the good old GAAP in their filings.[12] This would represent a substantial international incursion into the way that the American accounting profession conducts its business. It has been termed "the most revolutionary development in securities regulation since the New Deal."[13]

II. REVIVING THE ECONOMY

As the new U.S. administration turns its attention to reviving a staggering economy, it finds its moves being carefully scrutinized and commented upon by the governments of other countries. Changes in interest rates, new tax rules, government expenditures, and other fiscal policy moves all have international implications. The foreign comments involve detailed questions, such as whether government money should be spent on buying tainted assets from threatened financial institutions or shares of stock in them. At some point the United States will encounter foreign elements that go further and inhibit actions the nation would like to take. This is not a matter of international law. The United States will not, for example, resort to the resources of the International Monetary Fund. The IMF simply does not operate on a scale to be very

[9] For background, see DAVID R. HERWITZ & MATTHEW J. BARRETT, MATERIALS ON ACCOUNTING FOR LAWYERS 174 (4th ed. 2006). For a comparative overview of accounting practices, see Detlev F. Vagts, *Law and Accounting in Business Associations, in* 13 INTERNATIONAL ENCYCLOPEDIA OF COMPARATIVE LAW, BUSINESS AND PRIVATE ORGANIZATIONS, ch. 12A (Alfred Conard & Detlev Vagts eds., 1998).

[10] Work is also being done to increase international uniformity in auditing practice. *See* HERWITZ & BARRETT, *supra* note 9, at 239.

[11] *Id.* at 8 (Supp. 2008).

[12] Allowing U.S. Issuers to Prepare Financial Statements in Accordance with International Financial Reporting Standards, Concept Release, 72 Fed. Reg. 45,600 (Aug. 14, 2007). The SEC has recently indicated that it may require use of IFRS by 2014. Roadmap for the Potential Use of Financial Statements Prepared in Accordance with International Financial Reporting Standards by U.S. Issuers; Proposed Rule, 73 Fed. Reg. 70,816 (Nov. 21, 2008).

[13] Lawrence A. Cunningham, *The SEC's Global Accounting Vision: A Realistic Appraisal of a Quixotic Quest,* 87 N.C. L. REV. 1, 3 (2008).

helpful to the United States and therefore cannot impose conditionality restraints on U.S. policies like the requirements of budget balancing, subsidy cutting, and bureaucracy pay limitations it has forced upon smaller economies.[14] The chief source of foreign leverage lies in the plain fact that each step taken by the United States affects the value of the dollar at a time when the nation is already heavily indebted to aliens.[15] Americans have to be concerned about the possibility not only that foreign treasuries and enterprises might withdraw dollar investments, but that they might be unwilling to make more investments. An official responsible for Chinese investments abroad has reminded the United States to "*be nice* to the countries that lend you money."[16]

One area in which U.S. action may be constrained is in resort to the Exon-Florio Act[17] to prevent foreign investments that might threaten national security. Two recent negative responses under these rules have caused concern among observers in the United States that such rejections might deter others contemplating investment in the United States. One was the opposition to the bid by the state-owned Chinese oil company CNOOC to buy Unocal Corporation. The second was the furor about the proposed takeover of P&O, a British firm that operated facilities at six U.S. seaports, by a company based in the United Arab Emirates.[18]

The current situation has recently been complicated by the emergence of foreign sovereign wealth funds,[19] agencies that manage the direct investments of foreign nations. As yet, we do not know a great deal about how they operate; for example, whether they will mix political considerations with their investment-value-maximizing tactics. How effectively the United States can regulate them is not clear, in particular if U.S. regulators would need access to files controlled by the foreign government. The agencies have adopted a code termed the Santiago Principles, which are very general and in any case not binding.[20]

Of somewhat longer standing are restrictions on U.S. freedom to regulate foreign investments under the North American Free Trade Agreement (NAFTA) and other international agreements. Americans had assumed that Mexico might inflict damage on foreign investors, as it had done in the decades after its 1910 revolution, and would be the target of proceedings. Americans were therefore startled when a substantial fraction of the claims filed by foreign investors under NAFTA were aimed at the United States. The case that brought this point home was initiated by Methanex, a Canadian firm that manufactured methyl tertiary butyl ether (MTBE), a chemical that when added to gasoline lessened the pollution emitted by the exhaust of motor vehicles. It turned out, however, that when MTBE leaked from storage tanks, it could impair the quality of groundwater. Accordingly, the state of California imposed severe restrictions on its use. Methanex's claim against the United States alleged denial of fair and equitable

[14] For a brief description of IMF conditionality, see FREDERIC L. KIRGIS JR., INTERNATIONAL ORGANIZATIONS IN THEIR LEGAL SETTING 565–69 (2d ed. 1993).

[15] The general impact on U.S. foreign policy of the nation's now being a "debtor empire" is explored in NIALL FERGUSON, COLOSSUS: THE PRICE OF AMERICAN EMPIRE 279 (2004).

[16] James Fallows, *Be Nice to the Countries That Lend You Money,* ATLANTIC, Jan. 2009, at 62, 65.

[17] 50 U.S.C. app. §2170 (2006).

[18] DETLEV F. VAGTS, WILLIAM S. DODGE, & HAROLD HONGJU KOH, TRANSNATIONAL BUSINESS PROBLEMS 489–93 (4th ed. 2008).

[19] Paul Rose, *Sovereigns as Shareholders,* 87 N.C. L. REV. 83 (2008).

[20] INTERNATIONAL WORKING GROUP OF SOVEREIGN WEALTH FUNDS, SOVEREIGN WEALTH FUNDS: GENERALLY ACCEPTED PRINCIPLES AND PRACTICES ("SANTIAGO PRINCIPLES") (Oct. 2008), *available at* http://www.iwg-swf.org/pubs/eng/santiagoprinciples.pdf.

treatment and de facto expropriation. The fact that Methanex lost its case before the arbitral panel only partially relieved anxieties about restraints on the U.S. freedom to regulate.[21]

The possible effect of the fair-and-equitable-treatment standard is magnified by the presence of similar—and even broader—investor-protecting clauses in bilateral investment treaties (BITs) with other countries that, it is now recognized, might have investments in the United States. While most U.S. BITs were concluded with states that only receive foreign investment, there are so many of these agreements that chances are good that some investor may rely on one to pursue a grievance against the United States.[22] Because of these concerns, the U.S. model bilateral investment treaty was modified and the negotiations on a multilateral investment agreement failed.[23]

III. DEMOCRATIC SOVEREIGNTY AND THE MELTDOWN

At first glance the constraints the United States is experiencing in dealing with the meltdown seem to resemble the constraints in other areas about which the so-called new sovereigntists have been complaining for some time.[24] They fear that the authority of elected U.S. political institutions will be undermined, undercutting American democratic sovereignty. On the whole, the new sovereigntists have focused on areas in which international law might interfere with U.S. practices with profound resonance in the American political arena, such as resort to the death penalty and the legalization of gay marriage. Noting that such issues are "tied to a particular culture, society, and history," Kenneth Anderson explains that "I stress values as distinguished from purely economic issues."[25] Thus, the new sovereigntists have tended to accept such international agreements as the GATT despite their imposition of important restrictions on U.S. freedom of action in the trade field, especially since the dispute resolution process involves a high level of legalism.[26]

In fact, the constraints dealt with here differ substantially in character from those that concern the sovereigntists. The latter restraints arise from the acceptance of international rules, either by treaty or by customary international law. They can be countered by legal reactions like attaching reservations to treaties, finding federalism restraints on the scope of treaties, and insisting on strict standards before a rule of customary international law can be established.

[21] Methanex Corp. v. United States, Final Award on Jurisdiction and Merits (NAFTA Ch. 11 Arb. Trib. Aug. 3, 2005), *discussed in* Sanford E. Gaines, Case Report: Methanex Corp. v. United States, *in* 100 AJIL 683 (2006).

[22] For a current listing of BITs, see the Department of State Web site at http://www.state.gov/e/eeb/ifd/bit/index.htm.

[23] On the 2004 revised model bilateral investment treaty, see Sean D. Murphy, Contemporary Practice of the United States, 98 AJIL 836 (2004), and John R. Crook, Contemporary Practice of the United States, 99 AJIL 259 (2005). On the ending of the negotiations for a multilateral treaty on investment, see LORI F. DAMROSCH ET AL., INTERNATIONAL LAW: CASES AND MATERIALS 1626–27 (4th ed. 2001). For an overall survey of the expropriation issue, see Steven R. Ratner, *Regulatory Takings in Institutional Context: Beyond the Fear of Fragmented International Law,* 102 AJIL 475 (2008).

[24] The label originated in Peter J. Spiro, *The New Sovereigntists: American Exceptionalism and Its False Prophets,* FOREIGN AFF., Nov.–Dec. 2000, at 9; *see also* Peter J. Spiro, *Globalization and the (Foreign Affairs) Constitution,* 63 OHIO STATE L.J. 649 (2002).

[25] Kenneth Anderson, *Squaring the Circle? Reconciling Sovereignty and Global Governance Through Global Government Networks,* 118 HARV. L. REV. 1266, 1286–87 & n.52 (2005) (reviewing ANNE-MARIE SLAUGHTER, A NEW WORLD ORDER (2004)).

[26] For an exception, see JEREMY A. RABKIN, THE CASE FOR SOVEREIGNTY: WHY THE WORLD SHOULD WELCOME AMERICAN INDEPENDENCE, ch. 5 (2004).

Although there are some possible exceptions to this generalization,[27] the limitations on U.S. actions in the financial crisis arise primarily from the basic economics, that is, the shift in the financial balance of power. The United States government cannot undo them.

An American nationalist, particularly one who came to maturity in a period of U.S. hegemony, will regret the relative loss of power regardless of its source. Perhaps reducing the level of U.S. indebtedness will restore some of that power. Similarly, improvements in the financial institutions of the United States and their regulation might rebuild some of its influence and prestige.

[27] Some U.S. stimulus actions might be thought to violate commitments under the GATT, specifically those concerning government procurement. Investment treaties may keep the United States from regulating foreign investments in this country the way the government might otherwise wish. In the future the United States may be drawn into treaty-based solutions for some aspects of the economic crisis such as an intergovernmental financial regulatory organization. To some extent, restraints are brought to bear through the medium of international networks or regimes. IOSCO, having once been a forum in which U.S. positions received widespread acknowledgment by other countries, has become a source of pressure on the United States to adapt its positions to international norms.