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EXPORTING RISK: GLOBAL IMPLICATIONS OF THE SECURITIZATION OF U.S. HOUSING DEBT

Aaron Unterman*

INTRODUCTION

The development of the global capital market is a tale of two systems. While these systems should in principle reflect one another, their development has in fact diverged considerably. The international capital market has thrived and grown to unimaginable levels, however its regulation has stagnated and remains trapped in a different era.

Globalization has brought with it a flourishing of the international capital market which has fundamentally changed the global economy. The magnitude and variety of international debt transactions that occur daily is truly astounding. However, the regulatory regime governing this market has lagged severely behind its economic growth, leaving both investors and the global economy vulnerable to manipulation and potential economic disaster. This paper will examine the proliferation of the global debt market in a relatively unregulated climate, highlighting the disjunction between governance and the actual state of the market.

This paper will begin by exploring the operation of the international

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capital market focusing on the specific issue of securitization. To illustrate the operation of this market instrument, we will examine a peculiar relationship between a grandmother living in Japan and her grandson living in the United States. This peculiarity—unbeknownst to either of them—operates within the complex, opaque realms of the global capital market. Through the medium of the grandmother-grandson relationship, this paper will explore the process of securitization, and demonstrate the chain linking one grandmother's pension savings to her grandson's first home purchase. And, in telling this tale, we will discuss the possible legal and economic dangers inherent in this relationship.

This portion of the paper will then move on to focus on U.S. mortgage backed securities as an illustration of the implications of securitization to the global market. This discourse is particularly important, as at the time this paper was being written, the dangers of securitization were exposed in the U.S. mortgage-backed securities market, and an important segment of the industry was reduced to rubble. This industry demolition—that is, this market failure—demonstrates a serious deficiency in the operation and regulation of the international capital market. Part one of this paper will therefore conclude by introducing the need for international action to prevent recurring market abuses and potential economic disaster.

Part two of this paper examines the regulation, or lack thereof, of the international capital market. Worldwide, regulation occurs predominantly at the domestic level and this section will explore this approach by focusing on the US domestic securities regime's effect on the international market. It will be argued that the international debt market has outgrown the national approach to governing securities transactions and that it is now time for greater coordination at the international level. In that vein, the achievements and failings in attempts at international securities regulation to date will be examined. This section will explore intergovernmental initiatives, agreements between domestic regulators, and the role of credit rating agencies as de facto market gatekeepers. This paper will conclude by making recommendations to improve the current international framework and, more importantly, will call for the creation of an international credit organization to regulate and guide the operation of the global capital market.

The economic tie between a grandmother and grandson half a world apart demonstrates the international integration of the capital market. It is also representative of millions of ungoverned relationships which characterize the current operation of the global capital market. The rise and fall of the U.S. mortgage backed securities market is a demonstration of the risks associated with the unregulated capital market growth of international capital. At this moment there is a very real threat that the U.S. mortgage crisis could contribute to a sustained recession, if not an international financial crisis. The time has come for the global community to focus its attention on improving the regulation of international debt.
PART I: SECURITIZATION AND THE GLOBAL CAPITAL MARKET

A. SECURITIZATION OF DEBT

The international debt market allows states and private enterprises to attract capital from all corners of the globe. It gives national, institutional, and individual investors seemingly limitless opportunities to invest money in a borderless market. Capital markets transcend domestic borders and new investment instruments are continuously being created in an effort to capitalize on the international flow of debt. This paper will focus on one such instrument which is rapidly becoming a major shaping force in the global capital market. Asset securitization has emerged as a primary means of capital formation and attracts trillions of dollars in investments. Its use has proliferated internationally and plays a vital role in the flow of global capital as it is considered the fastest growing sector of credit markets.

Securitization is a means of dispersing risk amongst a wide group of investors and reducing risk exposures of financial institutions. It involves assets which generate cash flows such as mortgages, credit card receivables and equipment leases. The primary form of securitization is that of mortgages, however, any asset which generates regular cash payments can be securitized. Securitized assets are a more specific assumption of investment risk than typical securities because they essentially transfer the risk of debt obligations and their fulfillment, to the investor. In exchange for assuming the risks of default on the underlying asset, investors receive

2. J. Deacon, Global Securitization and CDOs xi (John Wiley and Sons Ltd. 2004)
4. Examples include automobile, aircraft, equipment and municipal leases, credit card receivables, retail and trade receivables, purchase contracts for natural resource assets, non-performing student and home loans, for a complete list please see Id. at 205.
5. The process of securitization pools together cash flow generating assets and creates contractual rights over these cash flows through a process called optimization. The benefits and risks of this pool are transferred to investors through the sale of securities. Investors inherit the risk that this regular cash flow will not materialize if the pool of debtors is unable or unwilling to make their payments The value of the security is dependent on the value and performance of the underlying assets. For additional information see Glukhovsky, supra note 1, at 653.
6. A distinction between traditional securities and asset-back securities is that investing in traditional shares of a company is an equity investment by which the investor assumes a bundle of ownership rights in a company. Equity investors assume a share of the financial gain of a company's success and a share of loss in case of failure which is reflected in the stock price. Asset-Backed Securities involve assets which generate regular and predictable cash flows. The purchaser of an asset-backed security does not have a stake in the underlying asset but rather an interest in the cash flow generated by that asset. Essentially, the rate of return is offered to compensate for the risk of default by the debtor.
higher rates of return than more secure investments like Government bonds. Unlike corporate investments, these fixed income assets do not have the potential to exceed expectations.\textsuperscript{7} Fixed income assets can either meet expectations through repayment of the principle and interest according to schedule, or suffer a loss. In other words the only way to go is down. Although securitized assets typically offer higher yields than government issued securities there was confidence that certain types, such as those created by pools of mortgages, were of low risk and therefore suitable alternatives to investment in government treasury bonds (such faith no longer exists). Securitized assets are attractive to large institutional investors because they represent a huge market for investment which offers relatively high yields. It is these large scale investors, often referred to as “sophisticated,” which have provided a great deal of capital investment in securitization markets. They also bear a great deal of the corresponding risk.

Securitization involves separating the credit or bankruptcy risk from an asset.\textsuperscript{8} By selling loans in the secondary market other institutions provide funding and credit risk management.\textsuperscript{9} This detachment allows risk to be dispersed amongst a wide group of investors and potentially increases the stability of the finance industry. Securitization has been praised with reducing the potential of financial shocks and increasing the efficiency and health of financial markets. According to the IMF Global Financial Stability report:

There is a growing recognition that the dispersion of credit risk by banks to a broader and more diverse group of investors, rather than warehousing such risk on their balance sheets, has helped to make the banking and overall financial system more resilient. Credit risk transfer markets tend to shift credit exposures from banks to investors with liability structures and investment horizons that make them better suited to hold or trade these risks such as insurance companies, regional banks, pension funds, mutual funds and increasingly hedge funds. [\ldots]

\textsuperscript{7} Fixed income assets cannot outperform expectations because they are limited to income which is owed from debtors. The best case scenario for these securities is that cash flows are received according to schedule.

\textsuperscript{8} From a technical perspective this legal separation occurs through the creation of a “Special Purpose Vehicle” (SPV) or “Special Purpose Entity” (SPE) which assumes legal ownership of the asset to be securitized. A securitisation SPE is defined by the Bank for International Settlements as: \ldots a corporation trust or other entity, other than a credit institution, organised for carrying on a securitisation or securitisations, the activities of which are limited to those appropriate to accomplishing that objective, the structure of which is intended to isolate the obligations of the SSPE from those of the originator credit institutions, and the holders of the beneficial interests in which have the right to pledge or exchange those interests without restriction.” Avail at http://www.bis.org/. When these assets have been transferred to the SPV, it issues securities which represent an entitlement to the benefit of the cash flows associated with the underlying assets. In exchange for transferring these cash flow rights the originator receives cash. For a complete description please see Glukhovsky, supra note 1, 654 and 658.

Transferring credit risk from banks via the capital markets helps to make the banking system, including smaller banks, less vulnerable to credit shocks.\textsuperscript{10}

Securitization is a huge player in the international debt market, both as a source of capital and by improving the financial position of institutions due to their "off-balance sheet treatment."\textsuperscript{11} The risks of default are not be borne by the financial institution because the assets and liabilities have been exchanged for cash,\textsuperscript{12} improving the firm's balance sheet and reducing capital reserve requirements. However, there is a growing skepticism towards these alleged benefits with some arguing that "the benefits of securitization to date have rested primarily upon a chance combination of a lengthy economic expansion coupled with asset price increases."\textsuperscript{13}

1. Dangers of Securitization

While the benefits of securitization have been carefully analyzed, the corresponding risks have not received the same consideration. Until recently, few studies have been conducted regarding the effects transferring credit risk may have on regional and global financial stability.\textsuperscript{14} Securitized assets are often pooled into Collateralized Debt Obligations (CDOs)\textsuperscript{15} which balance underlying assets of various credit qualities. These instruments are extremely complex and even the savviest of investors may fail to appreciate their risks. There has been little international development in the standardization of securitization transactions or their regulation.\textsuperscript{16} This void has allowed the investment industry to thrive in an unregulated climate.

Investment banks and other private enterprises currently shape the structure and rules of these instruments and the only true monitors at the international level are rating agencies who price these securities. The wisdom of allowing private enterprises, driven by profit, a free reign to

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\textsuperscript{11} Provided that the securitization process complies with relevant national requirements and international standards. See Glukhovsky, \textit{supra note 1}, at 658.
\textsuperscript{12} \textit{Id} at 655.
\textsuperscript{14} IMF, \textit{Supra note 10}, at 52.
\textsuperscript{15} Collateralized Debt Obligations are securities backed by a pool of mortgages and other fixed income securities. They may contain as few as twenty underlying assets but often contain hundreds.
\textsuperscript{16} Glukhovsky, \textit{Supra note 1}, at 652.
\end{flushright}
create and distribute instruments of debt comprehensible to a select few (most of whom are the individuals creating the securities) is questionable at best. The risks of CDOs are described by Glukhovsky as follows:

What little marketing literature we have on CDOs does not focus on "accelerated concentration risk", probably because CDOs would then sound more like Russian roulette than the grand triumphant inventions of off-balance sheet financial engineering.\(^{17}\)

The complexity of CDOs mask and misrepresent risk transfers through an opaque grading system which combines investment pools with different risk exposures. However, credit risks do not disappear and are simply shifted to other areas of the market. There is increasing concern that investors may be unaware of the risks associated with these investments and find themselves incurring losses based on representations made by securities issuers. The complexity and lack of transparency of securitized assets has allowed investor ignorance to be manipulated for profit and this will likely be reflected in widespread securities litigation.

The U.S. has been the global leader in the development of the securitization industry. According to a recent study by Fitch ratings they are also the undisputed leader in defaulting on these instruments with the US accounting for 97% of structured finance defaults worldwide from 1991-2005.\(^ {18}\) The creation of the global debt market allows institutions to shift credit risks outside of the domestic market. Credit risk is now spread across the global economy and therefore negative credit cycles can be more easily absorbed. Unfortunately, the explosion of such a large unregulated market has led to irresponsible behaviors within the finance industry.

The ability to transfer risk may create incentives for banks to overextend credit and assume excessive credit risk. Others have raised questions about the potential for risk transfer to adversely affect financial stability by reducing incentives for banks to screen and monitor borrowers.\(^ {19}\)

Securitization has altered the risk paradigm in the U.S. mortgage market, thus leading to widespread and systemic improprieties.

B. MORTGAGE-BACKED SECURITIES

Keeping this technical background in mind it is now time to breathe life into this concept of securitization and demonstrate how it can link an

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17. Id. at 655.
American homeowner to a foreign investor. This section will explore the diversification and exportation of US mortgage risk through securitized real estate loans, known as Mortgage Backed Securities (MBS)\(^{20}\) and how this perpetuated the U.S. housing boom and created rife conditions for malfeasance. Let us examine a peculiar relationship between Hiro, an American of Japanese decent and his grandmother Kayori who lives in Japan. Hiro lives in California; although intelligent, he has not found his passion in life and has been content to drift between jobs. Hiro has had occasional problems making credit card payments and has a limited credit history. He is a member of a credit class known as sub-prime. Unlike Hiro, his grandmother did not take long to settle into her career. At twenty-one Kayori became a nurse and remained so until she retired at sixty. Although very cautious with her savings a portion of her paycheck was regularly invested into a joint fund for all nurses, known as a pension fund.

**Mortgage Securitization**

1. Mortgage Originators

Hiro has just found his dream home, but to buy it he must borrow money from a lending institution known as a mortgage originator. The originator assesses the creditworthiness of mortgage applicants to determine whether to lend and under what terms or conditions. They are

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20. Mortgage-backed securities are instruments which are created and backed by pooling together mortgages. The basic form of MBS is known as the “pass-through security” which entitles investors to receive a proportional share of cash flow from the pool of mortgages. This cash flow is the regular payments of principle and interest paid by mortgage holders. It is the SPV which maintains ownership of the underlying asset and issues securities which are sold. For definition please see the U.S. Securities Exchange Commission website avail at http://www.sec.gov/answers/mortgagesecurities.htm-Mortgage.
usually responsible for servicing the mortgages and collect payments at regular intervals.

Traditionally mortgage originators bore the risks of their loans and therefore had incentive to ensure loan security and repayment. Therefore an individual like Hiro, with a checkered credit history, could have had a difficult time obtaining a loan. However, the dynamics of mortgage lending have been substantially altered with the proliferation of the MBS market significantly increasing Hiro’s chances. As a result of securitization the mortgage lending business has many participants: “In systems dominated by the secondary market, mortgage origination tends to have low barriers to entry and thus is highly competitive and has many players.” The incentive and risk structure of mortgage lending has fundamentally changed. Mortgage originators receive income for lending and their revenues correspond with the quantity and size of mortgages they lend. Today most mortgages are sold and packaged into MBS and therefore mortgage risk is assumed by investors, not the originators. Secondary mortgage markets increase the flow of capital to housing “by developing new instruments and institutions that can lower the risks of mortgage lending for originators and provide them with new funding outlets.” This transfer of risk and influx of capital has lowered lending standards and as a result sub-prime mortgage lending has increased dramatically in the US market. Hiro can now afford his dream home.

The sub-prime industry benefited from lax lending standards and the willingness of MBS originators to accept loans indiscriminately. This facilitated the development of “exotic loan products” which made home ownership accessible to individuals of varying credit positions. These products vary, but generally they either require very low initial investment by the homebuyer, pay very little regard to credit history, or both. In the first category adjustable rate mortgages (ARMs) have become a major form of lending at the sub-prime level. These loans provide short term benefits to encourage borrowing by offering initially low rates of interest which eventually reset to significantly higher levels. Other examples include: interest only mortgages which do not require principle payments in the initial period of the mortgage and piggyback mortgages, where borrowers receive a mortgage plus a line of credit to cover the mortgage

21. Lea, supra note 9, at 17.
22. Id. at 14.
24. Some these loans do not even require interest payments in the initial period.
These mortgages allow buyers to purchase more expensive homes because they are not required to make full payments on their loans in the initial period. However, these rates are only temporary and are usually followed by substantially higher rates of interest and repayment requirements. As these rates begin to reset at the sub-prime level, there is potential for a huge wave of defaults. The second category of loan products requires little, or no, documentation of the mortgage applicant’s credit position. These include stated income or no doc loans, which do not require proof or verification of the borrower’s income. Such loan products demonstrate negligence, as well as a lack of accountability and financial incentive to screen borrowers.

These “exotic loans” present Hiro with what he believes to be a once in a lifetime opportunity. He has a poor credit history and no funds for a down payment on his dream home, yet is still eligible to receive a loan. Customers with low credit ratings are the most profitable borrowers as they pay the highest rates. They also carry the greatest risk of default. However, this only matters if originators held the risk, which often they do not. The development of MBS has fundamentally altered the nature of mortgage lending because it has created an influx of capital and changed the matrix of risk. Mortgage originators were able to engage in negligent lending practices, confident there would be a buyer to for the mortgages. Issuers of MBS bought all the mortgages they could get their hands on, recognizing their huge global demand. In fact, many mortgage originators bear no financial risk of potential loan defaults because they are compensated by banks and brokerages who act as their creditors. Furthermore, mortgage originators often received incentives from banks and brokerages to market the instruments those lenders wished to sell or hold.

The creation of MBS has allowed mortgage originators to make negligent loans with the confidence they could be sold to investment banks or government sponsored agencies and packaged into mortgage-backed securities. As a result, although Hiro was not in the financial position to buy a home he was lent the money to do so. Furthermore, the mortgage originator who lent him the money loses nothing if (or when) Hiro defaults on his loan.

27. Id.
28. Id.
2. Securitizers

After Hiro is granted a loan, it is bought along with thousands of others by the investment industry. His mortgage joins a pool and at this point the process of securitization occurs. MBS are created by amalgamating mortgages and issuing securities which are claims to the expected interest and principle payments owed by the mortgagees. Because of the volume, Hiro’s ability to make payments becomes of marginal significance to the pools performance. However, when low quality mortgages like Hiro’s are prevalent, obviously the risks increase. The balancing of mortgages of various qualities through the creation of MBS and CDOs, is the business of the securitization industry. In return billions of dollars in commissions are received.

The two most significant purchasers of mortgages in the U.S. market are investment banks and the Government Sponsored Enterprises (GSEs) Fannie May and Freddie Mac. These purchasers pool and securitize mortgages for sale to investors and their own holdings. The simplest form of a MBS is known as the pass-through participation certificate which entitles the investor to a share of all the principle and interest payments made on the pool of mortgages. However, MBS often adopt more complicated schemes and incorporate instruments such as derivatives to balance risk levels. The business of securitizing mortgages is vast and lucrative. With a seemingly limitless supply, and huge global demand, billions of dollars have been made. MBS are often sold to large scale investors such as pension funds and insurance companies. By selling loans in the secondary market other institutions provide the funding and credit risk management. Securitizers, therefore, do not bear the risk of default on mortgage payments.

MBS enjoyed a great deal of market confidence during the U.S. housing boom, with some even thought of as an alternative to the security of U.S. Government Treasury Bonds. However, recent events in the U.S. housing market have shattered this confidence and exposed widespread misunderstanding of the risks associated with MBS. The most fundamental misconception relating to MBS is the belief that the pooling of mortgage loans automatically reduces risk through diversification. The risks of a

29. MBS are usually divided into tranches based upon credit quality and sold to investors offering different rates of return.
30. Derivatives are used to protect against negative credit events and will be discussed in the following section.
31. Lea, supra note 9, at 16.
32. Please note that there are some repurchase agreements in the industry which oblige issuers of MBS to buy back non-performing loans.
MBS are determined by the quality of mortgage loans which are accumulated. While adding high quality mortgages reduces risk, obviously the credit quality of a sub-prime mortgage pool does not improve through the acquisition of more low quality loans. Furthermore, the state of the real estate market influences the performance of mortgage-backed assets. Clearly, securities composed of assets all from one sector are not truly diversified and their performance is significantly dependant on the health of the housing market. Members of the securitization industry are guilty of inspiring false confidence in the MBS market. The industry marketed MBS as stable instruments insulated from the risks of a housing downturn. These factors worked in unison to artificially inflate the MBS market by fooling investors to believe that bad loans could be transformed through the sophistication of the investment industry. Predictably, this was not the case.

i. Government Sponsored Enterprises (GSEs)

Fannie Mae and Freddie Mac create mortgage backed securities. Both companies pool non-government insured mortgages and rely on private mortgage insurance. Fannie Mae and Freddie Mac are not government institutions but rather private corporations. However, they are government sponsored enterprises with a widely referred to implicit government guarantee against failure. However, it is essential to realize that MBS issued from these companies are not guaranteed by the US government. Low quality housing debt is perpetuated by these GSEs who buy this debt and package it into MBS. Although the fundamental quality of the debt remains unchanged, it is magically transformed into debt regarded by the market as high quality, low risk.

By 2003, the portfolio of the two GSEs stood at $1.5 trillion in assets, or 23% of the home-mortgage market. Fannie May and Freddie Mac have an unclear relationship with the U.S. government. While the prospectus of both companies indicate that the U.S. government does not insure or otherwise protect these companies from failure, it is widely believed they are too important to the U.S. economy for the government to let them fail. This implicit guarantee allows mortgage-backed securities to be regarded as secure investments even though the assets which underlie them may not be.

Alan Greenspan, former chairman of the U.S. Federal Reserve, has openly criticized these government sponsored entities for exploiting this implicit guarantee. In a speech delivered to the Federal Reserve Bank of Atlanta he stated:

33 Both have a $1-billion credit line from the U.S. Treasury and one-third of their boards of directors are appointed by the president. Please see the Office of Federal Housing Enterprise Oversight available at http://www.ofheo.gov/.

The Federal Reserve has been unable to find any credible purpose for the huge balance sheets built by Fannie and Freddie other than the creation of profit through the exploitation of the market-granted subsidy.\textsuperscript{35}

He suggested that these enterprises increased profit through highly risky investments like sub-prime MBS, stating that:

Because the many counterparties in GSE transactions assess risk based mainly on the GSE’s perceived special relationship to the government, rather than on the underlying soundness of the institutions, regulators cannot rely on market discipline to contain systemic risk.\textsuperscript{36}

This so-called “implicit guarantee,” resulted in their MBS being assigned artificially low risk valuations.\textsuperscript{37}

These companies share responsibility for the housing boom and misrepresentation of the underlying value of MBS.\textsuperscript{38} Furthermore, these quasi-governmental entities have not operated accountably and both have been rocked by large accounting scandals.\textsuperscript{39}

ii. Investment Banks

Investment banks marketed MBS as the answer to achieving high investment yields accompanied by low risk levels. MBS are often combined into instruments holding mortgages of ranging quality known as CDOs. These complex structures often utilize derivatives as an insurance policy for their assets. The premise was that these structures were insulated from market risk because of their diverse composition. These instruments received sanction from ratings agencies that were complacent in designing the securities.

The role of the investment banks in misrepresenting MBS will be more fully examined when we explore the state of the U.S. housing market today.

\textsuperscript{36} Id.
\textsuperscript{37} Jaffe, supra note 34.
\textsuperscript{38} Id.
\textsuperscript{39} In May 2006, the Securities and Exchange Commission and the Office of Federal Housing Enterprise Oversight, the GSEs top regulator, fined Fannie Mae $400 million for its accounting misdeeds. Among other things, the regulators alleged Fannie Mae executives manipulated accounting in order to trigger millions in bonuses for executives.
iii. Derivatives

Securitization spawned the credit derivatives market which exploded to unprecedented levels and may have severe implications for the global debt market. These instruments balance credit risks associated with securitized assets. Derivatives such as credit default swaps (CDS) are often incorporated into securitized assets to hedge, or provide protection in case of failure of the underlying assets. These instruments are very complicated but in principle they are designed to act as insurance policies against negative credit events. They are frequently used to offset the risk of mortgage defaults within a mortgage pool.

While it is beyond this paper’s scope to detail the magnifying effect derivatives can have on debt markets, a brief introduction is necessary to understand their role in the sale of securitized assets and the overall risk they pose to global economic stability. Credit default swaps are basic derivatives that act as insurance to credit defaults. They operate as an insurance policy by triggering a payment in the case of a credit event often defined by a percentage of default on the underlying assets. A seller of a credit default swap provides protection against negative credit events in exchange for payment of a premium. If the specific credit event occurs the seller is obliged to provide compensation to the buyer according to the terms of the swap agreement. If not, the seller keeps the premium.

The derivatives market has increased confidence in MBS, and is promoted as a safety net to protect against negative credit cycles or widespread defaults within a MBS. However, the derivatives industry has taken on a life of its own and they are vigorously traded by financial institutions in an effort to tailor risk exposures. Credit default swaps are rarely discussed, and even more infrequently understood. Despite this the current notional amount of credit default swaps is estimated at $26 trillion. Unbelievably, this vast industry is almost entirely unregulated.

The complexity of derivatives raises questions regarding whether investors fully comprehend their underlying risks. Timothy Geithner,

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40. For example, in order to protect against the risk of mortgage defaults in an investment portfolio a protection buyer could make bi-annual premium payments to a protection seller. In return for these payments the seller would pledge to make payment in the event of a specific credit event. A CDS could be structured so that the insurance payment would be made if 20% of the underlying mortgages went into default. This is a simplified example and the range of products is only limited by the imaginations of investment bankers who issue them.

41. According to The International Swaps and Derivatives Association Notional amount of credit default swaps grew by 52% in the first six months of 2006 to $26.0 trillion from $171 trillion. The annual growth rate for credit derivatives is 109% from $12.4 trillion at mid-year 2005. Eighty-eight firms provided credit default swap data which is available at http://isda.org/statistics/recent.html#2006mid (ISDA). This figure is all the more staggering if we consider that the values of such instruments were $536 billion in 2001 according to the Bank for International Settlements avail at http://www.bis.org/.

42. IMF, supra note 10, at 61.
president of the Federal Reserve Bank of New York, has warned that the magnitude of debt and derivatives markets poses a significant threat to the global financial system. In a recent speech he stated:

The same factors that may have reduced the probability of future systemic events, however, may amplify the damage caused by, and complicate the management of, very severe financial shocks. The changes that may have reduced the vulnerability of the system to smaller shocks may have increased the severity of larger ones.43

If deteriorating credit conditions in the U.S. housing market lead to significant levels of credit events triggering swap payouts a liquidity crisis could ensue.

The global derivatives market exemplifies the proliferation of financial instruments in an unregulated climate. A staggering amount of global capital is linked to this market and directly tied to the MBS market. The derivatives market allowed investors and financial institutions to balance credit risks and protect themselves against negative credit events. These instruments have grown exponentially in conjunction with the rise of securitization and play an important role in the MBS industry. However, they have not been tested in a negative economic cycle and could exacerbate an economic downswing. As the US housing slump worsens we may have an opportunity to test the resilience of the derivatives market.

iv. Credit Agencies and CDOs

Although credit rating agencies are not securitizers, they play an integral role in the sale of MBS and the securitization industry. These agencies are extremely powerful and are arguably the most influential market regulators.44 In many ways their ratings created the market confidence in MBS. In the largely ungoverned realm of MBS and CDOs, rating agencies are often the only entities which act as a monitor and evaluator of the performance and value of these securities. Whether a security is rated as investment grade45 can determine the success of a MBS structure and whether they can be held by institutional investors.

Credit rating agencies are often active participants in structuring


44. Thomas L. Friedman has commented that there are two world powers the U.S. and Moody’s credit rating agency. Please see Frank Partnoy, *The Siskel and Ebert of Financial Markets?: Two Thumbs Down For Credit Rating Agencies*, Washington University Law Quarterly, v. 77 No. 3 (1999). ("Partnoy").

45. Investment grade securities are those which receive a credit rating of BBB or higher.
CDOs.\textsuperscript{46} Issuers of CDOs refer to rating agency models in the creation of these instruments and receive input on how to achieve desired ratings.\textsuperscript{47} These models allow issuers to adapt their structures in response to direction from the rating agency. Creative structuring and rating agency compliance allowed billions of sub-prime debt to become investment grade. Ratings agencies go as far as offering CDO risk management services, allowing them to judge their own creation.\textsuperscript{48} This obvious conflict of interest is currently unregulated and contributes to the lack of appreciation of the hazards of CDOs.

The majority of the riskiest MBS are held by CDOs with sub-prime exposures averaging around 45%.\textsuperscript{49} Structured products like CDOs lack transparency and do not allow investors to examine the credit quality of the underlying borrowers who are relied upon for cash flows. The magic of CDOs has been their ability to transform sub investment grade MBS into investment grade assets. This has made fortunes for the credit rating industry and not surprisingly mis-priced securities.\textsuperscript{50} However, risk does not disappear and the combined credit risk of each mortgage comprising the pool is the actual risk of that security. In other words, the sum cannot be less than the parts. Credit agencies are behind this phony transformation and their ratings provide quasi-official sanction of these securities.

A series of recent reports attack the methodology used by these agencies to rate CDOs, exposing severe flaws in their rating systems as well as fundamental conflicts of interest.\textsuperscript{51} The role of rating agencies in the operation of the international capital market will be more fully explored in part two of this paper.

3. The Investors

At the last link of the chain is Hiro’s grandmother, unaware has played an integral role in funding the US housing boom and perhaps Hiro’s very own home purchase. Kayori, like millions of others worldwide, has had a portion of her employment earnings invested in a pension fund. It is these

\textsuperscript{46} Partnoy, supra note 44, at 17.
\textsuperscript{47} Id. at 13.
\textsuperscript{48} Id.
\textsuperscript{49} Rosner, Supra note 13, at 16. Mortgage debt is usually divided into “tranches” according to credit risk. The top tranches are the first to receive cash flows and therefore most secure. The bottom tranches are the last to receive cash flow and are contingent on all the higher tranches receiving payment first. Therefore, the lowest tranche will be the first to be effected by non-payment or mortgage defaults.
\textsuperscript{50} Unbelievably, 75% of CDOs are rated as AAA, the highest credit rating. Whereas only six corporations in the entire US receive this rating. Please see Mark Pittman, Moody’s May cut $5 Billion of Subprime-Backed CDO’s, (July 11, 2007), Bloomberg Online, http://www.bloomberg.com.
\textsuperscript{51} Please see Rosner, supra note 13, and Partnoy, supra note 44.
funds in, addition to other large investors such as insurance companies and hedge funds, which provided the bulk of capital to the MBS market. Even foreign governments, especially those from Asia, have invested in these instruments in an attempt to garner higher investment yields. A number of factors make MBS attractive to large scale investors. First, they represent a near limitless market for investment. Real estate is one of the largest global stores of wealth and mortgage markets provide the funding for asset purchases. Second, they offer higher yields than Government Treasury Bonds and provide investors with an opportunity to increase their returns. Third, they were regarded as stable low risk investment and received high ratings from credit agencies. Large scale demand for investment grade securities with higher yields fuelled the growth of the MBS industry and encouraged the development of various creative financial products.

These investors, known as "institutional" or "sophisticated", operate in an unregulated atmosphere as it is assumed they have the knowledge and market power to protect themselves. According to Green:

Most, if not all, developed markets have a private, largely unregulated market for certain investors (variously characterized as institutional, sophisticated or professional) that is an integral part of the capital raising process.

The lion's share of investment in the MBS industry came from large investors. Therefore a high proportion of these securities were unregulated and not required to meet public disclosure standards. So, although the underlying investor in a security may be a pension fund contributor like Kayori there is no obligation for issuers to provide information regarding their securities to the public. As we shall see many of these professional investors may not have been as sophisticated as regulators assumed.

III. MORTGAGE-BACKED SECURITIES AND THE U.S. HOUSING MARKET

Housing is of fundamental importance to individuals and nations alike. Politically, a strong housing market can create support for the government in power. Economically, it means greater national wealth (at least in monetary terms) and this increases domestic consumption.

52. The MBS market has recently attracted large state investments particularly from Asia. China's Central Bank is thought to be moving large holdings from US Treasury Bonds to American Mortgage-Backed Securities and Corporate bonds in an attempt to earn higher yields. Please see China's Foreign Reserves: Who Wants to be a Trillionaire, (October 28, 2006), The Economist, http://www.economist.com/finance/displaystory.cfm?story_id=8083036.


54. Some commentators point to the US Housing bubbles as the reason behind President Bush's re-election. See Hale Supra note 23.
Securitization of mortgage assets helped to drive growth of the U.S. housing market to unprecedented levels. It has also been credited with reducing financial instability through diversification of risk. According to the IMF Global Financial Stability Report, the securitization of mortgage assets has had the following effects:

Market liquidity and funding have increased with the greater use of securitization and, more recently, a variety of advanced credit derivative products. Securitization of this sector has helped to secure a steadier supply of mortgage finance over time, reducing the volatility of the provision of housing credit, and possibly contributed to moderating credit cycle dynamics and output loss.\(^{55}\)

However, as securitization has radically changed the dynamics of the housing industry, it may contribute to the demise of the U.S. real estate market. The altered risk matrix and complexity of secondary market instruments has facilitated widespread malfeasance and artificially inflated asset prices. As the global market realizes this, there will certainly be a different attitude toward the U.S. market, and it is likely that domestic and international investment in MBS will begin to dry up.

The U.S.'s real estate market enjoyed a prolonged expansionary period where house prices rose by 50% in the five-year period leading up to 2005.\(^{56}\) The low costs of financing home ownership increased demand, driving house prices to staggering levels, creating what is popularly known as the U.S. housing bubble. The secondary mortgage market increased the flow of capital funding into housing and also reduced the risks for mortgage originators.\(^{57}\) This phenomenon fuelled a rise in American home ownership from 64% to 69%.\(^{58}\) MBS were an important source of capital and an instigator in the housing boom. According to the U.S. Federal Reserve Board, the residential MBS market reached $5.139 trillion last year.\(^{59}\)

The U.S. housing boom was unique in a number of ways. First, although the increased value of real estate led to greater domestic wealth, the housing boom was accompanied by a decreased level of domestic savings,\(^{60}\) with the U.S. experiencing persistent negative savings rates.\(^{61}\) A major reason for this decline in savings was the increase in credit available to the private sector.\(^{62}\) Why save to buy a home when you can have one now by

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55. IMF, supra note 10, at 75.
57. Lea, supra note 9, at 19.
60. Id.
61. The US savings rate is -0.6 percent according to Hale, Supra note 23, at 30.
62. Marco Terrones et al., Chapter II: Global Imbalances. A Savings and Investment and
The prolonged housing boom in America increased the asset value of American households, which led to decreased savings, as home equity replaced savings and personal investments as a store of wealth. The reduction in American savings reflects the country's weakened fiscal position and its reliance on foreign borrowing.

In 2005 foreign investors held an estimated $550 billion of Residential MBS, representing a 10.7% share of the overall market. This massive global influx of investment in MBS contributed to the seemingly endless supply of capital for mortgage financing and reduced the risks of lending. Therefore, the relative cost of purchasing a home in the U.S. was lower due to international investment.

This investment also signified an enormous transfer of housing credit risk from the domestic market to the international market. With an increasingly high proportion of default risk absorbed by foreign investors, lenders increased lending levels and risk exposures. The huge demand for MBS papers and influx of capital also created conditions susceptible to questionable practices within the mortgage-backed security industry.

These factors increased mortgage lending from a nominal perspective as well as from an increased borrowing base. As mentioned previously, the proliferation of the MBS market facilitated the growth of the sub-prime mortgage lending industry. The sub-prime MBS market nearly doubled in 2004 and represented 21% of MBSs issued. Sub-prime loans in 2005 equaled $625 billion in 2005. Essentially, many individuals previously unable to purchase homes entered the market because of increased lending and reduced standards. As we shall see it is this sub-prime mortgage industry which has been the first casualty of the declining U.S. real estate market.

IV. THE U.S. HOUSING BUST

The U.S. housing market has been described as the economic "global wildcard". During the housing boom all levels of the market benefited from the growth of MBS. Individuals purchased homes beyond their means. Mortgage originators were able to proliferate lending through 

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Investment Perspective, in IMF World Economic Outlook 105, (September 2005). ("IMF 1").
63. Inside MBS & ABS, supra note 59.
65. Sub-Prime loans have a higher risk of default because the borrower is in a poor financial position relative to the size of the loan.
68. Hale, supra note 23, at 29.
indiscriminate screening processes, confident that even the most high risk mortgages could be sold. MBS issuers became part of one of the greatest investment sector booms in history and the housing boom was an impetus for the recent economic success of the U.S.

Everybody wins? Not likely. The U.S. housing boom is over. Prices across the country have stagnated and in many areas begun to drop. The U.S. is bracing for its first annual decline in median housing prices since the Great Depression. Strong home-price appreciation since 1998 prevented mortgage delinquencies and defaults from developing into losses. However, with the softening of real estate prices mortgage foreclosures in the U.S. have increased by 35% with almost 437,500 filings reported in the first quarter of 2007. The MBS market, once credited with providing both liquidity and stability is now accused of “providing liquidity without responsibility.” Homeowners, like Hiro, who received loans beyond their means, are being subjected to increasing repayment obligations, and losing their homes and entire neighborhoods are being affected.

The hardest hit sector of the market has been the sub-prime level. During the housing boom sub-prime lenders benefited from huge housing demand and were able to achieve high lending volumes and profit margins. However, it has come to light that; “sub-prime lenders tried to maintain volume as the housing market was faltering in late 2005 and 2006 by making riskier loans.” Sub-prime mortgages now account for $1.28 trillion and the current past due rate on these mortgages is 13.33%.

Since the beginning of 2006, twenty-three sub-prime lenders have filed for bankruptcy, including the nation’s second largest lender, First National. Over the past twelve months over sixty sub-prime lenders have ceased operations or solicited buyers. This meltdown has resulted from financing cuts by the banks and brokerages, which previously had securitized their sub-prime mortgages. This has also coincided with a

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70. Rosner, supra note 13, at 7.
73. Rosner, supra note 13, at 76.
76. Rosner, supra note 13, at 28.
dramatic increase in risk premiums demanded by investors for sub-prime mortgages and a significant decrease in market liquidity. What was once a thriving industry has been destroyed.

CDOs, which supplied so much liquidity to the sub-prime market, could be the next casualty of the sub-prime crisis. The recent downgrading of $5.2 billion of MBS debt by Moody's rating agency and proposed downgrade of $12 billion by S&P will have widespread implications for the CDOs created from these securities. Rating downgrades could pose a dire threat to the U.S. housing market if it forces institutional investors to sell their holdings. Not only would insurance and pension funds suffer significant losses but it could spur a severe liquidity crisis in the U.S. housing market.

1. Litigation

As the mortgage industry continues its plunge, litigation is underway and will surely increase in the months and years to come. Wrongdoings of the sub-prime lenders have been exposed in the U.S. market. That members of the sub-prime industry engaged in unethical, fraudulent lending practices and will be found liable to investors and mortgagees is beyond doubt. However, the recent wave of bankruptcies of the industry's major lenders raises questions regarding whether there will be any lenders left to sue once the housing downturn has run its course.

The role of investment banks who package these sub-prime mortgages into mortgage backed securities has not been similarly examined and the relationship of the investment industry to illegal sub-prime lending is now of tremendous interest to potential plaintiffs worldwide. It is estimated that in 2006 alone the New York-based securities industry earned $540 billion turning sub-prime home loans into securities. Issuers of mortgage-backed securities managed to earn huge commissions while detaching themselves from the risks of the underlying assets. The same cannot be said for investors who stand to lose up to $100 billion according to Federal Reserve Chairman Ben Bernanke. Mortgage securitizer's were instrumental in the rise of the sub-prime industry and in the booming MBS market there was ample opportunity for negligent loan packaging and misrepresentation of underlying assets. Finally, the role of credit agencies in evaluating MBS

77. Blair, supra note 26.
79. Rosner, supra note 13, at 75.
80. Richard, supra note 75.
mislead investors is the subject of recent scathing reports which calls their evaluation techniques and impartiality into doubt. Both Moody’s and S&P rating agencies recently reported that they underestimated the levels of losses that will be suffered in 2006 sub-prime loan pools. It is clear the underlying risks of MBS were not adequately disclosed to investors and that significant losses will continue to be suffered. What remains to be seen is if, and to what extent the securitization industry, which profited so greatly will be forced to compensate losses.

A booming market can mask improprieties but when the market begins to fail these behaviors can no longer be concealed. There are a number of class action lawsuits that have been initiated against sub-prime lenders, which will undoubtedly add to the line of creditors looking to collect through bankruptcy proceedings in this doomed industry. However, securitizers were integral to the operation of mortgage originators and lawsuits are beginning to surface against investment banks that packaged and sold MBS.

In this regard the recent upholding of a jury finding of liability in a class action suit against Lehman Brothers Inc., a major American investment bank is extremely significant. First Alliance Mortgage Company, a sub-prime lender now bankrupt, was found liable for committing a host of fraudulent and unethical lending practices. Lehman Brothers Inc.'s relation to First Alliance was that of credit provider for the issuance of sub-prime loans and underwriter of the company’s mortgage-backed securitizations. A federal jury found that Lehman Brothers provided financing for First Alliance’s mortgage business with the knowledge that the mortgage lender was involved in fraudulent sales practices and that the extension of such credit facilitated this fraud. The jury held Lehman Brothers liable in tort under the California law for aiding and abetting this fraudulent lending scheme. The Court of Appeals affirmation of this jury finding is a significant step towards imposing liability against investment banks that were instrumental to the rise of the secondary mortgage market. While this verdict is specific to fraudulent lending practices, it has important implications to the overall industry.
because it represents a link in the chain of liability between mortgage originators and the firms responsible for their securitization.

On one level this provides defrauded parties potential for financial redress where a sub-prime originator is insolvent. However, it also raises questions regarding the integrity of the securitization industry as a whole. Where liability is found based on knowledge of fraudulent lending practices it follows that the complacent party should have also been aware of the risks associated with these assets. If securitizers knew that sub-prime lenders were making bad loans, they must have known that the securities created from these loans were not stable investments.

The parties involved in the securitization of mortgage loans include all major American investment banks, as well as government sponsored Fannie May and Freddie Mac. With the demise of a major proportion of sub-prime mortgage originators and the spate of allegations against their negligent and fraudulent lending practices, the potential exists for an explosion in litigation. Predatory lending and the use of so-called exotic loan products, such as option ARMs, were widely known and reported throughout the finance industry. It is difficult to believe that within this industry, composed of the world's leading financial minds, participants were unable to comprehend that mortgage securities are not worth more than the assets that underlie them.

Legal action is commencing against the investment industry. Bear Stearns, a leading U.S. investment bank, is currently under investigation for its March 1, 2007, ratings upgrade of New Century Financial. This upgrade came only eight days before the Company's stock declined 94%. Furthermore, it has recently been reported that Credit Suisse Group, an investment bank who sold bonds backed by sub-prime mortgages, has been sued by a Florida insurer named Banker's Life Insurance Co. According to the plaintiff's law firm, a number of other similar claims are in progress. The claims against Credit Suisse include: accepting inferior loans, understating losses, and covering up delinquencies. It is more than likely that these and other illegal practices were widespread throughout the securitization industry.

There is widespread speculation that pension funds and insurance companies are holding a high proportion of the risk associated with the

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88. Bankers Life v. Credit Suisse, 07-cv-00690, U.S. District Middle Court, Middle District of Florida.
90. Id.
U.S. sub-prime market.\textsuperscript{91} If conditions continue to deteriorate and losses begin spreading to higher rated mortgage debt there may be severe consequences to the health of these institutions and the millions of individual investors worldwide they represent. Furthermore, the timing of large foreign investments in MBS is such that issuers were likely aware of the impending crisis in the market. It is extremely difficult to accept that the investment industry was unaware of the true value (or lack thereof) of the assets underlying these investments.

V. CONCLUSION

Securitization perpetuated the U.S. housing bubble and resulting malfeasance within the mortgage finance industry. The harm created by irresponsible and fraudulent actions will be felt by the U.S. housing industry, its economy, and foreign investors. The downturn of the U.S. housing market will expose the need for greater regulation and oversight of global debt markets. This is crucial to protect investors from potential abuse and to ensure the stability of international economy.

The MBS industry has demonstrated how capital markets can be abused at each level of operation. From the consumer who purchases an unaffordable house, to the mortgage lender who makes a bad loan, to the government-sponsored agency which implicitly guarantees this loan, to the investment bank which misrepresents these securities domestically and internationally to garner enormous commissions, the market was systematically manipulated. This harmed millions of people across the U.S. whose financial positions are in jeopardy due to their mortgage obligations. Many home purchasers like our hypothetical protagonist Hiro will lose their homes. As for Hiro’s grandmother Kayori, if her pension fund invested heavily in MBS she may be in for a shock when she goes to collect. If, and to what extent losses will be felt by pension holders will not be fully understood in the near future. U.S. MBS attracted a great deal of foreign investment and this has transferred domestic housing market risks outside the country’s borders. The Japanese nurse whose pension contributions, indirectly funded an American’s home purchase, may suffer losses if the loan fails. There is no question that people’s savings have been put at risk by the MBS industry and its shady operations. Disturbingly, there are many questions regarding who has suffered losses due to the sub-prime market meltdown.\textsuperscript{92} Clearly a system unequipped to

\textsuperscript{91} Rosner, \textit{Supra} note 13, at 75.

\textsuperscript{92} Alistair Barr, \textit{Mortgage crisis to hit holders of risky derivatives Most hedge funds made money, but some lost; Asian investors fingered}, (April 2, 2007), Market Watch, http://www.marketwatch.com/news.
track the losses of such a significant market failure is inadequate to provide protection to that market.

Investors and mortgagees are not the only parties at risk from the bursting of the U.S. housing bubble. The failures of the MBS industry pose a threat to the economy of the U.S. and are already being reflected in the country's fiscal position. The U.S. dollar is down 3% from last year and there is concern the US may be headed towards a recession. Fundamental fiscal weaknesses in the U.S., like the debt imbalance, have been masked by the country's economic success. However, this success has been largely fuelled by asset bubbles which artificially inflated the wealth of the country. As the value of U.S. real estate declines it may become apparent that they mortgaged their future to maintain domestic consumption. From a global economic point the MBS market is an example of an inefficient use of global capital, instead of contributing to building productive capacities, such as research and development, international financial resources were used to sustain consumption and the U.S. housing boom. This is indicative of the failure of the international capital market to efficiently allocate capital. The following statement illustrates the current state of affairs:

[A] more efficient international capital market is supposed to ensure that capital is allocated to the most productive use. Yet much of the recent inflow of foreign money into America is not financing productive investment, but a housing bubble and a consumer binge.

The U.S. housing market helped to sustain a high level of domestic consumption but failed to generate true growth.

The securitization of assets also created an unregulated market which proliferated without any true understanding of the potential consequences to the global economy. How the derivatives market will respond to an economic contraction remains to be seen but it could increase and prolong the severity.

The fate of the international economy lies in capital markets, but their regulation remains in an infantile state. The second part of this paper describes the international legal regime and its influence, or lack thereof, on the global capital market. It will become clear that although the global capital market drives the world's economy, no one is behind the wheel. The continued neglect of the international securities market by the global community creates tremendous risks and raises important questions which

93. Rosner, Supra note 13, at 80.
94. Former Federal Reserve Chairman Edward Greenspan has suggested there is a 1/3 probability of an economic recession other commentators suggest higher. Please see Howley, Supra note 69
will be addressed in the following section. What has become starkly obvious is that international capital markets need better regulation and far greater transparency. It would be truly unfortunate if it took an economic catastrophe to mobilize the world into action.

**PART II: THE INTERNATIONAL SECURITIES FRAMEWORK**

The global capital market is vast, complex, and has re-shaped the world’s economy. International debt transactions are commonplace and domestic borders have lost their meaning. The globalization of debt markets has created tremendous potential for the efficient allocation of capital and a huge market for investment. However, these opportunities are accompanied by dangers to market participants and the international economy. The operation of the U.S. MBS market is an example of the integration of financial markets and some of the dangers which arise as a result. The unprecedented levels of domestic and foreign investment into U.S. mortgage debt perpetuated systemic industry-wide abuses which temporarily enriched the U.S. housing market while simultaneously spreading risk to investors worldwide. Although this created a thriving real estate market will ultimately injure market participants such as investors and mortgagees.

These risks may have been avoided through stronger regulation, greater transparency, and better international coordination. The increasing integration and complexity of the international capital market necessitates the creation of an international regulatory body. The aims of such a framework should achieve two objectives. The first is to protect market participants. In our example we discovered how both Hiro and his grandmother were victims of a debt market dominated by private industry. Hiro may lose his home and go bankrupt and Kayori’s pension fund may suffer losses (or worse), leaving her less money with which to enjoy her retirement. However, the current regulatory system does not recognize these unfortunate circumstances or effectively govern international debt relationships.

A second major objective is to ensure the health of the international economy. The U.S. housing market has entered a period of decline. Just as the MBS industry contributed to the housing boom it will likely perpetuate the downturn of the U.S. market and could lead to a recession felt worldwide. The dangers of securitization arose due to a lack of information and understanding of these instruments. The international capital market must develop in a way that is transparent and allows regulators and market participants to understand the nature of investments. The global economy cannot afford to have trillions of dollars moving through murky international networks of investment, controlled by private industry.
The flow of capital transcends national borders and creates strong interdependence of world markets. However, advancements in the fields of international oversight and regulation have not accompanied capital market development. The following passage co-written by former Director of International Affairs of the U.S. Securities and Exchange Commission, Michael D. Mann, describes the necessity of international initiatives aimed at regulating the market:

The globalization of the securities market and the growing interdependence of the world’s economies have fostered a need for the international community to be able to respond to prevent potential cross market disruption.\(^9\)

Currently, international securities laws deal with the coordination and application of domestic law, neglecting the greater realities of an international capital market. Furthermore, large segments of this market remain ungoverned. Both the derivatives market and sophisticated investors are largely unregulated by either domestic or international legislation. Lack of international oversight and regulation has left the global capital market vulnerable and allowed private enterprises to flourish in the void.

Part two of this paper examines the current legal framework which governs the international securities trade. Securities regulation remains largely a domestic enterprise and the first section will focus on domestic legislation of the U.S. and how this regulatory scheme applies to international securities transactions. The U.S. was chosen as a representative system because it is arguably the most sophisticated and is actively involved in international matters. The second section describes existing securities law initiatives at the international level including state, industry, and private regulation. This paper will conclude by examining how to remedy the current system so that regulation is more reflective of the realities of the global capital market.

A. The National Approach

Regulation of the international capital market occurs predominately at the domestic level. National security regimes attempt to affect the international market by regulating their respective domestic domains and the international transactions connected to these markets. The starting point for examining the legal infrastructure of the international capital market are the traditional rules of conflict of law found in the principles of

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private international law. These laws, as they relate to securities, generally focus on conflicts of law between jurisdictions and the appropriate law to apply in a dispute.

The general position with regards to securities is that *lex situs*, the law of where a thing is situated, governs choice of law. However, this application is artificial when dealing with securities which are more akin to intangible assets than physical property and therefore less amenable to occupying a physical location. As a result uncertainties can arise as to what constitutes the *lex situs* of a security. There is debate as to whether this should be where the issuer is incorporated, or where the share certificates are registered. The leading texts dealing with conflict of laws assert that the location of shares is the register at which they reside. However, merely identifying which national law applies to securities transactions does little to improve protection for market participants and the health of the overall market. Furthermore, there remains uncertainty within the private international law approach to securities law and this highlights one basic difficulty of applying conventional laws to an evolving market. It is argued, "The preoccupation with seeking the *situs* for shares is an impediment to the development of rational choice of law rules in this growing area." It also demonstrates the futility of attempting to regulate an international market through domestic regimes that possess very different securities laws and regulations. Current international initiatives focus largely on clarifying conflict of law rules while neglecting the reality that an international integration of securities frameworks is the true way forward for capital market regulation.

To this point domestic regulation has facilitated the development of the international market and international securities law remains primarily concerned with the interaction of domestic regimes. While it is clear this

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98. Dicey & Morris the authoritative text on conflicts of law states that, questions regarding title to shares are governed by the law of *Situs*, at 983 Please also see .Maisie Ooi, Shares and other Securities in the Conflict of Laws, (2003) ("Ooi").

99. The Privy Council has commented that “There are […] so many qualities of a share which are attributable to different places it would seem to follow that there cannot be a proper local habitation for a share at all.” Brassard v. Smith, AC 371, (1925).

100. The case of *Macmillan Inc v. Bishopsgate Investment Trust plc and others* (no.3) confirmed that the law of *situs* applied to shares, however the court was divided as to whether this should be the location where the shares are registered or the place of incorporation of the issuer. *Macmillan Inc v. Bishopsgate Investment Trust plc and others* (no 3) 1 WLR 387, (1996).

101. The reasoning behind this assertion is that the court where the register is located maintains jurisdiction over the register. The location of the register of non-negotiable shares is usually where the issuing company resides and therefore possesses the most substantial connection to the securities transaction. Chesire & North, *supra note* 97 at 823.

system is inadequate to regulate the global capital market, it is important to understand how domestic securities regimes have nonetheless managed to facilitate capital transactions extending far beyond their borders. To illustrate this phenomenon the following section will focus on the most influential regulator of capital in the world, the United States.

1. U.S. CAPITAL MARKET REGULATION

Governance and regulation of the international capital market remains severely underdeveloped and this has led to domestic regimes to become active at the international level. The U.S. long-arm approach to securities regulation and enforcement has expanded to the regulatory void and plays an important role in the international securities market. The U.S. securities market encourages foreign investment because it is regarded as stable, profitable and the most vigilant guardian of investor rights. It has set the standard simultaneously for liberalization and regulation and as a result is the largest recipient of global capital. Their securities regime is of importance to international securities law for a number of reasons. First, as it is considered a world leader in regulation, it is extremely influential in the global convergence of domestic security regimes. The implied strength and comprehensive nature of the U.S. securities regime is an important reason for its dominant role in the global capital market. Second, as Greene states, "[h]istorically, the United States has been the most open of all markets," attracting a great deal foreign investment. Third, American courts and legislatures have not hesitated to apply their laws to international securities matters. Fourth, U.S. courts are regarded as very hospitable venues to commence litigation because of their tendency to make large rulings and availability of plaintiff-friendly legal conditions. The combined result is the U.S. legal system has transcended the role of a traditional state and reached the level of an international entity. However, the failure of the U.S. securities regime to prevent massive securities fraud in their market has demonstrated that this pillar of regulation cannot effectively govern its own market let alone an international one. Furthermore, developments in the world of finance have made it increasingly unrealistic for domestic regulators to govern international transactions.

The following section deals with U.S. judicial and legislative activism at the international level and its role in the international market. The second section focuses on why the U.S. is so attractive to foreign litigants. The third section will analyzes the limitations of the national approach considering the U.S.'s failure to protect foreign investors from misfeasance in the MBS market.

103. Greene, supra note 57, at 16.
A. U.S. Securities Regime

U.S. regulation and enforcement has emerged in the void of an international framework with the U.S. judicial system often behaving as a court of international jurisdiction in matters of securities law. The American securities regime is governed by the Securities Act of 1933 (Securities Act) and the Securities Exchange Act of 1934 (Exchange Act), legislation passed in the wake of the 1929 stock market crash. These Acts provide the structure for securities regulation and enforcement domestically and are also applied to international transactions connected to the U.S.

The application of the U.S. legislation has tremendous implications for the international securities market. A body of U.S. case law has established the courts broad jurisdiction over securities transactions. U.S. courts have extended their jurisdiction to international matters to protect its citizens from fraud committed abroad and to protect foreigners from fraud committed in the U.S. Famously, the court in Schoenbaum stated that:

We believe that Congress intended the exchange act to have extraterritorial application in order to protect domestic investors who have purchased foreign securities on American exchanges and to protect the domestic securities market from the effect of improper foreign transactions in American securities.

The Exchange Act has been interpreted to extend U.S. jurisdiction beyond domestic borders. A key provision in section 10(b) prohibits fraud by the “use of any means or instrumentality of interstate commerce or of the mails in connection with the purchase of sale of any security.” This seemingly innocuous provision apparently did not envision interstate commerce as domestic transactions which cross U.S. state borders. Rather the Act defines interstate commerce to include “trade, commerce, transportation, or communication . . . between any foreign country and any state.” Based on this the judiciary has enforced U.S. securities laws in a broad range of cases. Furthermore, the Securities Act provides that: “Any condition, stipulation, or provision binding any person acquiring any security to waive compliance with any provision of this subchapter or of the rules and regulations of the Commission shall be void.”

106 Schoenbaum v. Firstbrook, 405 F. 2d 200 at 206 (2nd Cir. 1968).
107. Id.
109 Id., Definitions.
110 Securities Act 14, supra note 107.
indicates that compliance with U.S. securities regulation is a condition for the validity of any securities transactions and encourages securities law convergence on U.S. terms.

U.S. jurisdiction in cases of international securities law has been applied extraterritorially based on two distinct principles. The "effects approach" allows U.S. jurisdiction to be applied to cases where American investors are harmed by actions committed in another country. This encompasses acts which affect the U.S. investment market, so any fraud committed in a foreign country that causes a loss to American citizens could qualify as within U.S. court jurisdiction.

The second approach, known as the "conduct approach," provides protection to foreign investors against conduct occurring in the U.S. which contributes to securities fraud. The justification for asserting this jurisdiction is that congress would not want the U.S. used as a base of operations from which to "defraud foreign securities purchasers or sellers." The court in Kauthar went so far as to say that jurisdiction could be asserted even if fraud was not committed in the U.S. The court stated that if activities in furtherance of such fraud were undertaken, "this conduct must be more than merely preparatory in nature; however, we do not go so far as to require that the conduct occurring domestically must itself satisfy the elements of a securities violation."

Under this interpretation the U.S. courts can exercise jurisdiction over an act of securities fraud affecting a foreign claimant even if it was not committed in the U.S. Based on this jurisprudence it is evident that U.S. courts have accepted the role of policing international securities fraud committed domestically, or abroad, so long as there is a connection between the activity and the U.S. By extending jurisdiction to international matters, the U.S. judiciary has signaled to foreign investors that their rights will be protected. The extension of domestic jurisdiction to international transactions has perpetuated the national approach to securities regulation. This is augmented by the fact that many domestic and foreign claimants are attracted to the U.S. court system for resolution of international disputes.

B. Attractiveness of U.S. Courts

The American judiciary has not shied from protecting domestic interests from foreign malfeasance. Furthermore, the scope of jurisdiction
applied by the U.S. judiciary extends to cover harms which originate or contributed to by activity on U.S. soil. The motivation for this application raises questions; however, the result is clear: foreign claimants can use the U.S. court system to make securities claims. Both U.S. and foreign claimants recognize the advantages of litigating international matters in U.S. courts. With his usual panache Lord Denning describes this phenomenon: "As a moth is drawn to light, so is a litigant drawn to the United States." A host of reasons can be advanced for this magnetism, the foremost of which is the U.S. courts' worldwide reputation for generosity. The U.S. also possesses stringent securities regulations increasing the chances that marginal practices would constitute a violation. Jack B. Weinstein, a senior district Judge, attributes the attraction of global disputes to U.S. jurisdiction to four factors. First, U.S. procedural and jurisdictional rules are generally helpful to plaintiffs. One such rule which is highly relevant to securities litigation is 23(a) of the Federal Rules of Civil Procedure which permits class action lawsuits. Securities litigation is very amenable to class actions because shares are often held amongst large numbers of investors who hold similar interests and are subject to common harm. Class actions allow individual investors to pursue compensation with minimal effort and often do not require a contribution of resources. The availability of class action lawsuits represents an opportunity for large groups to litigate, unavailable in many foreign jurisdictions. The wave of class action suits filed in the wake of the tech bubble burst is a good example of class action suits in securities litigation. Second, U.S. courts tend to award high monetary judgments. This factor obviously offers great incentive to litigate and can inspire claimants to file suit even if a different jurisdiction bears a more significant connection. Third, substantive law tends to favor plaintiffs and there is the possibility of almost limitless punitive damages. Punitive damages seek to punish wrongdoers and focus on applying an appropriate punishment based on the resources of the liable party. The securities

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117. Id.
118. The Federal Rules of Civil Procedure (1998), rule 23 states that: One or more members of a class may sue or be sued as representative parties on behalf of all only if (1) the class is so numerous that joinder of all the members is impracticable, (2) there are questions of law or fact common to the class, (3) the claims or defenses of the representative parties are typical of the claims or defenses of the class, and (4) the representative parties will fairly and adequately protect the interests of the class.
120. See for example Kauhar, Supra note 119, Richards v Lloyds of London, 135 F.3d 1289 (9th Cir. 1998).
121. Weinstein, supra note 116, at 167.
industry is composed of parties with very deep pockets representing the potential for huge punitive damages. Fourth, there is a powerful plaintiffs' bar capable of financing and prosecuting cases. This is particularly relevant to class action suits because plaintiffs are able to file suit without advancing any resources. The U.S. judiciary's liberal approach to international enforcement of securities issues and the attractiveness of its courts have combined to make the U.S. a major center of securities litigation.

C. Limitations of the Domestic Approach

The U.S. capital market is regarded as one of the most regulated and transparent in the world. By enforcing some of the world's strictest securities regulations and offering the largest verdicts, the U.S. is in effect inviting foreign claimants to use its court system. As a result the U.S. market attracts a great deal of foreign capital allowing the country to sustain high levels of domestic spending. However, although U.S. law and policy extends its influence to international markets it is becoming increasingly ineffective. Capital markets operate without regard for national borders and it is unrealistic to rely on national regulation to limit international activities.

Recently, the reputation of the U.S. securities framework as world leader was severely damaged. The failure of the U.S. capital market to detect and prevent the massive frauds and eventual collapse of Enron and WorldCom demonstrate flaws in its regulation and operation. If the sub-prime crisis continues to spread, the reputation of the U.S. market could impair its ability to attract investment. U.S. MBS received large amounts of foreign investment this paper has suggested they may have been manipulated by domestic issuers. If this claim is substantiated by foreign claimants through securities litigation it would demonstrate the failure of U.S. regulation to protect foreign investors. Securitization of U.S. real estate assets perpetuated a housing bubble in part because international investors did not have the information to accurately assess the worth of these investments. If foreign institutional investors end up suffering a disproportionate share of the loss, it would further damage the reputation of the U.S. market.

The prospect of the U.S. securities regime governing the international market is unrealistic. The U.S. Securities Exchange Commission (SEC) is the watchdog charged with regulating over 10,000 publicly traded companies, investment advisers that manage more than $32 trillion in assets, and $44-trillion worth of trading conducted yearly on America's
even with a budget of $905.3 million and a staff of 3,600 it is impossible for the SEC to prevent major abuses domestically, let alone police the international market. Therefore, international resources must be devoted to improving regulation and oversight.

Disclosure requirements are the greatest source of transparency and accountability in the securities market. In order for the international market to function safely disclosure must provide market participants with accurate information by which to make investment decisions. However, the internationalization of the capital market provides impediments to the creation of a comprehensive and rigorous disclosure standard. If standards are too costly to comply with or require a level of transparency enterprises are not willing to meet, this can dissuade issuers from listing on an exchange. The danger is that a race to the bottom may ensue, with national regimes offering lax disclosure requirements as a means to attract foreign investment. This slippery slope can be avoided through the international coordination of disclosure standards. This could ensure countries are not punished for protecting investors, and firms would bear the burden of proving their accountability. With regards to the unregulated sectors of the capital market, there is a crucial need for greater disclosure; however, the international nature of these firms could allow them to circumvent any domestic attempt at forcing disclosure.

The investment industry operates at the international level and is a prime beneficiary of the shortcomings of the national approach to securities regulation. There are large gaps between domestic regimes which provide ample opportunity for firms to adopt marginal practices in pursuit of profits. Thriving firms, such as investment banks, should be made accountable to investors and the overall market. The exporting of mortgage risk is an example of widespread malfeasance perpetrated in a regulatory void. Unfortunately, the risks associated with investing in securitized assets were not adequately disclosed and this is the major cause of difficulties surrounding the U.S. MBS market.

The domestic approach to international capital market regulation does not reflect the realities, a fact long realized by the investment industry. The current international infrastructure has no hope of providing meaningful regulation. It may require a large market failure like the Great Depression to spur action, but the opportunity exists now to prevent such failures. This can only be achieved by coordinated international initiatives.

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B. THE INTERNATIONAL SECURITIES FRAMEWORK

Governance of the international capital market involves a patchy framework of domestic laws, proposed initiatives, and limited agreements. This system has thus far served its purpose in facilitating cross border investments. However, the current focus on regulation and enforcement at the national level neglects the reality that the international trade in securities has long since outgrown domestic borders. The regulation of the international debt market can be analogized to a nation governed at the state level without a federal level to determine the interaction between these states or guide the country as a whole. Greene, a leading scholar on international securities regulation, describes the situation as follows:

Securities regulatory regimes around the world, largely developed on the conceptual basis of segregated national markets, are fast being outpaced by market developments and are finding themselves unable to address effectively the realities of the accelerating integration of global capital markets.\(^{124}\)

The general objectives of securities regulation are to create market efficiency, protect investors, enforce regulation and ensure the stability of the overall market.\(^{125}\) Currently initiatives are aimed at improving efficiency and reducing agency costs, while, protection of investors and stability of the overall market remain largely unregulated at the international level. The fact that the debt market, of crucial importance to the global economy, has not been the focus of any meaningful international initiative is curious indeed. There is a conception within the international community that coordinated regulation is too immense a task and therefore international initiatives have been limited in scope. The current state of affairs favors countries with established securities markets, such as the U.S., and allows them to attract high levels of capital and spread economic risks outside national borders. However, the greatest beneficiary of the absence of international regulation has been the investment industry, which has flourished in this unregulated climate. This section will focus on what constitutes the international framework for the trade of securities by examining coordination at the intergovernmental level, through agreements between domestic industry regulators and private regulation of the market. It will conclude with how the regulation of international capital markets could evolve to provide effective protection to participants and protect against macroeconomic dangers.

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\(^{124}\) Greene, supra note 53, at 13.

Achievements in regulation at the intergovernmental level have been elusive and insufficient to make any real impact on the international capital market. Bureaucrats feel that reaching a consensus in the domain of securities law is unachievable because of the variance in domestic regimes and associated fields such as corporate, bankruptcy, and tax law. While a range of bilateral and multilateral agreements exist between nations they deal mostly with issues of cross border enforcement and assistance with securities investigations. There is currently no international treaty in force which specifically focuses on the global capital market. More positively, international initiatives have been undertaken in recognition of an urgent need to develop uniformity and international consensus in the securities market. 2006’s Hague Convention and UNIDROIT’s proposed convention dealing with intermediated securities represent a first step towards the development of an international framework. However, both conventions do little to address the two most vital objectives of securities regulation: protection of investors and stability of the overall market. Furthermore, these initiatives demonstrate the difficulties of drafting specific legislation and suggest that international treaty making may not be a feasible approach to developing the regulation of the international capital market.

A. The Hague Convention on Indirectly Held Securities

The central role of securities intermediaries is one of the most important developments of the internationalization of capital markets. Traditionally, share certificates acted as proof of ownership and individual investors took possession of these certificates. However, today most

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127 In absence of any substantive international securities law a variety of bilateral and multi-lateral agreements have been undertaken in order to ensure that some enforceable law governs securities transactions. These agreements have created some bridges between domestic regulatory regimes. However, these efforts at cross-border regulation have been largely restricted to responsive measures such as information sharing, assistance with investigations, and enforcement of foreign judgments. See Mann, supra note 96, for a description of Mutual Legal Assistance Treaties, and Memorandums of Understanding between national governments and securities regulators.


investors maintain accounts with intermediaries, such as investment brokers or banks, and purchase securities through them. Both brokers and banks generally hold securities through other intermediaries which utilize central securities depositories to take possession of share certificates. The growth of shares held through intermediaries is the result of the market’s internationalization and demonstrates the deficiencies of applying domestic laws to transactions typically involving multiple jurisdictions. The development of uniform rules governing securities held through intermediaries is extremely important to enhancing legal certainty and market efficiency. These holdings are often used as security to creditors and it is essential that the law governing these pledges is clearly ascertainable to ensure they are effective in the relevant legal jurisdiction. The Hague "Convention on the Law Applicable to Certain Rights in Respect of Securities Held with an Intermediary" concluded July 5, 2006, and attempted to develop a legally binding international instrument to regulate a portion of the capital market. The preamble of the agreement states the convention’s purpose as follows:

Aware of the urgent practical need in a large and growing global financial market to provide legal certainty and predictability as to the law applicable to securities that are now commonly held through clearing and settlement systems or other intermediaries.

The convention created a set of conflict rules to govern transactions known as the “agreement plus reality test,” designed to provide consistency in the application of conflict of laws rules dealing with securities held through intermediaries.

According to the test, “the law governing a transaction effected on the books of an intermediary is, in general, determined by the relationship between the investor and intermediary.” The notion of allowing parties unrestricted selection of governing law was mentioned but did not attract sufficient levels of support. Instead the convention gives precedence to the law selected by the intermediary and customer as long as it meets certain criteria. Under this approach an agreement specifying the governing law is effective so long as the jurisdiction bears a sufficient connection to the activities of the intermediary. The formulation of this

130. An intermediary is defined as “a person that in the course of business or other regular activity maintains securities accounts for others . . .” Hague Convention, supra note 134, Article 1.
132. Hague Convention, Supra note 128.
133. Id., Preamble.
134. Rogers, Supra note 131, at 286.
135. Id. at 308.
136. Id. at 288.
137. Id. at 308. The convention has expressly dismissed the approach which is currently in operation for directly held securities. Article 6 of the Convention explains that the place of
rule came as a compromise between differing legal regimes and replaces the traditional conflict of law rules which rely on place of incorporation, or location of share certificates, to determine applicable law.

Although agreement was reached between the drafters of the convention, it can not be considered a true victory for international convergence in securities law. The subject matter of the convention was extremely narrow and did not affect the scope of domestic regulatory jurisdiction of securities, and the activities of intermediaries clearly remain within the ambit of domestic authorities. Furthermore, it did not impose obligations on national securities regimes or require any substantive changes of law. Essentially the convention's aim was to provide one uniform rule that could be applied to securities pledged through intermediaries in order to reduce agency costs and improve legal certainty. The substance of the convention does not provide material advantage to any nation and therefore, on the surface, competing national interests should not have played a role in the treaties negotiations. Nonetheless, at this point it has failed to be widely adopted and this highlights the immense difficulties of reaching international consensus in securities coordination. Currently, the treaty bears the signatures of Switzerland and the United States alone.

The Hague Convention is a starting point and its significance lies in the fact that it is potentially the first legally binding multi-lateral treaty to govern the securities market. At this stage it is equally plausible the treaty represents a global will to regulate the securities industry or a global reluctance to commence such effort. The adoption of the "agreement plus reality" test demonstrates a movement towards giving deference to freedom of contract and represents an emerging international norm of significance to the securities industry. However, the Hague Convention does little to protect investors or ensure accountability of intermediaries operating on the international plane. At best the treaty represents a movement towards greater coordination in the regulation of capital markets.

The progress of the Hague Convention demonstrates that treaty making is becoming obstructed by politics particularly within the EU where achieving consensus is increasingly elusive. The success or incorporation of the issuer of shares, and the location of the register are both factors which are to be disregarded in analyzing the law to be applied. However, the convention includes a set of fall back rules in the event that the agreement between the parties does not select the applicable law to govern the contract. In this case Article 5(2) holds that the applicable law will be determined by the intermediaries' place of incorporation.

138. *Id.* at 317.
140. It has been suggested by insiders that decisions regarding ratification of treaties within the EU often are made based on considerations which have little to do with the substance of a convention.
failure of the Hague Convention will shed light on whether intergovernmental treaties are a viable means to create a securities framework.

B. The UNIDROIT Proposed Convention on Substantive Law

The first major inter-governmental attempt at developing a substantive international securities framework is currently being developed by UNIDROIT. Their proposed convention on “Substantive Rules Regarding Intermediated Securities” represents an international effort to harmonize the global capital market.\textsuperscript{141} Whereas the Hague Convention focused on conflict of law rules, UNIDROIT’s initiative aims to create uniform operational rules to govern intermediated securities.\textsuperscript{142} According to the convention’s drafters the aims of international securities initiatives should be: the protection of market participants, such as investors, collateral takers and intermediaries; the protection of the financial system in the event of major institutional failure; and gains in economic efficiency.\textsuperscript{143} However, as the project has taken shape the emphasis has been placed on facilitating investment and efficiency, while overall market and investor protection has taken a back seat. The primary focus has been restricted to promoting legal certainty in international transactions and this demonstrates the lack of international will to target the true dangers of the market.

The project arose from the recognition that applying domestic rules to the international securities market is not an efficient regulation of global investment. While the Hague Convention and traditional private international law aim to provide uniform rules identifying the appropriate domestic law to apply to securities, this law may not be effective in governing international securities transactions. National laws vary greatly in substance and quality and this represents a drag on certainty and efficiency. The UNIDROIT study group identifies two principles which the convention’s substantive rules should address. First, rules governing cross-border securities must be internally sound.\textsuperscript{144} In order for this to be achieved all applicable national laws must be clear and justified. Second, these rules must be compatible with the international market.\textsuperscript{145} Even when

\textsuperscript{141} UNIDROIT, supra note 129.
\textsuperscript{142} The Convention is intended to apply where conflict of law rules designate the law of a contracting state as applicable law or where the applicable law is that of a contracting state without reference to conflict of law principles. UNIDROIT, supra note 135, at Article 2.
\textsuperscript{143} Phillip Paech, Legal Risk and Market Efficiency, in UNIDROIT Seminar on Harmonized Substantive Rule Regarding Securities Held With an Intermediary 1(2004) ("Paech")
\textsuperscript{145} Id.
all nations possess sound rules it is possible that these systems may conflict, creating market inefficiencies. The project’s objective is to encourage uniformity and convergence by ensuring only rational and compatible rules are applied to securities held through intermediaries.

The founders of the UNIDROIT project believed it could be a forum in which to develop a comprehensive global regime for securities regulation. At its conception this project was guided by the lofty goal of creating unified investor rights. However, political differences quickly rendered this unachievable. It was argued that other related areas such as tax, insolvency and corporate law were too domestically entrenched to permit global securities harmonization. The result of this political opposition was a severe curtailing of the initiative’s scope, with the adoption of the functional approach advocating unification only where “absolutely necessary.” Clearly, this illustrates a lack of international will to develop a functioning substantive framework. As a result, it is likely that the convention will comprise a set of mandatory baseline rules, as well as an optional annex with a more ambitious set of harmonized rules.

The initial vision of sweeping harmonization has now been reduced to a set of nine issues which largely aim to improve market efficiency. The UNIDROIT project now focuses on achieving legal certainty but does not impose any obligations on intermediaries such as creating disclosure standards or prohibiting unethical behaviors.

The limited agenda of the UNIDROIT initiative demonstrates the continued reluctance of the global community to achieve meaningful convergence in securities regulation. The subject matter of the proposed convention lends more to the facilitation of cross border investment than to its regulation. As this initiative is in the beginning stages if, when, or how it will affect the international capital market is a mystery. However, if the current track record of international securities initiatives is any indication, it will not be any time in the near future.

147. Id.
150. Id., The Scope of the proposed Convention includes the following: 1) Recognition of book entries as only condition for a disposition 2) Role of Uniform Dispositions 3) Clear and simple rule for creation and realization of collateral 4) Good faith acquisition 5) Net settlement 6) Finality and irrevocability 7) Possibility of provisional credits 8) Loss allocation 9) Preclusion of Upper Tier Attachment.
C. Outlook

Government initiatives to develop international laws governing the securities industry have failed to produce any meaningful results. Although there are significant obstacles to the convergence of international securities laws, the realities of the global capital market make it essential. Administrative problems at domestic levels are no excuse for maintaining an ineffective system of regulation and market discipline. Capital markets will continue to lose their domestic character and the current system of regulation will become less and less effective. The global community should not wait for a market failure to take action.

The current initiatives we have discussed are limited in nature and will do little to address the systemic problems facing the global capital market. Essentially the international community is reluctant to take actions which may constrain capital markets despite the fact that this is precisely what is needed.

The Hague Convention and UNIDROIT demonstrate the infantile state of the international securities regime. They also raise serious questions regarding the viability of relying on bureaucrats to develop a legal framework through treaty agreements. However, history has demonstrated that such a feat is possible, and agencies like the WTO and IMF have been instrumental to the international economy. The need for international oversight may be better met by the development of an international agency with regulatory powers. Although this would require a sacrifice of sovereignty, it is perhaps the only way in which true achievements can be made.

II. AGREEMENTS BETWEEN DOMESTIC REGULATORS

Whereas international consensus at the governmental level is rarely achieved, domestic regulators have been successful in making some important steps towards harmonizing the investment industry. While these initiatives have been effectively negotiated, they lack the legal power of an international treaty. As a result they have had varying success in their implementation, and currently serve more as recommended standards than binding legal instruments. This section examines the International Organization of Securities Commissions and Similar Organizations (IOSCO) and its development of uniform disclosure standards and the Bank for International Settlements (BIS) regulation of the financial industry. Both organizations have important implications for the protection of investors and the health of the capital market. They have achieved legal status within specific domestic regimes and compliance with their
standards is a key signal of transparency and accountability within private industry and both. Furthermore, these organizations have the potential to create uniform international policies which could form a basis or model for regulation of the capital market.

A. The IOSCO

The IOSCO is composed of one hundred and ten national securities regulators. It was once described as the most important organization attempting to influence international securities regulation. This has proven to be somewhat of a dubious distinction in light of the failures of international regulation. The IOSCO does not possess binding authority over its members and consensus within the organization is often obscure. Nonetheless, the IOSCO has made advancements in the field of securities disclosure and has the potential to serve as a model for convergence of international standards.

The IOSCO proposed the development of a single disclosure document in multi jurisdictional offerings through the harmonization of global disclosure standards. The commission also urged the creation of international accounting and auditing standards upon which such disclosure could be based. Foreign issuers who comply with this standard would have an “international passport” allowing them access to the domestic securities exchanges of other members. These uniform standards have received international support and were incorporated into the national laws of some member countries. In September of 1999 the U.S. SEC incorporated the IOSCO standards into domestic law.

As with most international securities initiatives, the IOSCO disclosure standards for multi jurisdictional offerings are limited, and only cross border offerings by foreign issuers fall within their scope. Nonetheless, it could represent an excellent opportunity to improve general capital market disclosure. As we have discussed, the reduction of regulatory requirements can be a tool used by national governments to attract issuers looking to avoid the burdens of complying with rigorous disclosure standards. A uniform international standard could prevent this race to the

151. For a list please see IOSCO website available at: http://www.iosco.org/.
153. Id.
154. Id.
155. Id.
Disclosure is perhaps the most effective protector of investors and the coordinated effort of international regulators should impose high standards on the issuers of securities and the investment industry. This would improve the dissemination of information to investors and help prevent fraud and other market manipulations.

If uniform disclosure was combined with international accounting standards it would create an efficient system where issuers of securities worldwide could be measured according to objective standards. Such uniformity would greatly improve the transparency of the international capital market. The International Accounting Standards Board has developed a model set of financial reporting rules for the global market known as the International Financial Reporting Standards. Convergence in international accounting standards will make the interpretation of financial statements easier and improve the effectiveness of disclosure.

The creation of uniform disclosure and accounting standards could address one of the most significant weaknesses of the capital market, which is the lack of transparency and imbalance of information. It is vital that disclosure standards are applied to all financial instruments, including those marketed to sophisticated investors. As with all international instruments we have encountered these standards are non-binding, however they do influence the policy of a substantial number of nations.

B. The Bank for International Settlements

The Bank for International Settlements is an organization currently composed of fifty-five central banks. It has played an important role in devising framework rules to govern the banking industry that are highly relevant to the international securities market. The “International Convergence of Capital Measurement and Capital Standards - A Revised Framework,” or “Basel II,” is an effort of international banking regulators to establish uniform rules for financial institutions. Basel II has had an important impact on the international finance industry and was recently incorporated into EU law.

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157. For more information see the International Accounting Standards Board website available at http://www.iasb.org/Home.htm.
158. Formerly known as the International Accounting Standards (IAS).
159. According to the IASB website nearly 100 countries currently require or permit the use of, or have a policy of convergence with, IFRSs.
The Basel committee developed a framework to build stability in the international banking system by regulating risk management practices of financial institutions. The most significant and well known measure is the general requirement that banks hold the capital equivalent to 8% of their risk weighted assets. This requirement was agreed to in the first Basel Accord; however, Basel II has sought to adopt a more sophisticated approach in determining the risk weight of assets which allows two methods of calculating regulatory capital required for credit risk. The first technique known as the “standardized approach” is reliant upon external credit rating agencies to determine the risks associated with a financial institution’s holdings. For these ratings to be accepted they must be from agencies recognized by domestic banking regulators. The second method, known as the “internal ratings based approach,” allows financial institutions to develop their own internal rating system based on certain guidelines.

Basel II also increases transparency through supervisory review giving regulators greater means of inspection and access to information. This is known as the “second pillar”, and requires high standards of disclosure by financial institutions to ensure market participants have an accurate picture of risk levels. The international acceptance of the Basel standards is an important step towards ensuring market stability and preventing disruptions.

An unfortunate limitation of the accord is that it is not law but rather a model which has been described by the Basel Committee as “being circulated to supervisory authorities worldwide with a view to encouraging them to consider adopting this revised Framework at such time as they believe is consistent with their broader supervisory priorities.” The lack of legal force behind Basel and Basel II has lead to varied implementation of the initiatives. Nonetheless, Basel II has direct implications on the international debt market as it creates a global standard and acts as an oversight agency. Its success demonstrates that domestic regulators can

and credit institutions (recast) (June 14, 2006).


164. As we shall see in the following section, credit agencies have not been effective or reliable providers of market information. Therefore, it is highly problematic to allow these ratings to determine the capital requirements of the finance industry.


167. As mentioned the EU has adopted the Basel II requirements as law. However, the Basel requirements have also been manipulated. Please see Dan W. Puchniak, Perverse Main Bank Rescue in the Lost Decade: Proof that Unique Institutional Incentives Drive Japanese Corporate Governance, Pacific Rim Law & Policy Journal, V.16, no. 2 39 (March 2007), for an example of the regulatory avoidance of the Basel Accord in Japan.
achieve consensus at an international level.

Although the major objective of the Basel Committee is to improve global financial stability, the Basel Accord also contributed to the growth of securitization, which, as discussed previously, can lead to economic dangers. Compliance with Basel II's minimum capital requirements has encouraged financial institutions to decrease their risk exposures. Under Basel II the holding of assets with attached risks, such as mortgages, requires banks to maintain certain levels of capital to ensure financial stability if those assets fail to materialize (if a mortgagor defaults on loans payments). Securitization of debt allows banks to transfer risk to third parties by converting risk-bearing assets into cash. By selling this risk banks can comply with Basel II more easily. However, this detachment of risk can lead to reckless behavior on the part of financial institutions. This can be particularly dangerous if the risks associated with these assets are disguised.

Although Basel II should improve the stability of the finance industry, it does not deal with the economic risks which are transferred to investors. It is essential to recognize that risks do not disappear and if they accumulate in other unregulated sectors of the market its stability may be at risk. This is a hazard of the current patchwork approach; although the banking system may be insulated from the risks it creates, these risks do not vanish but are rather transferred to other sectors of the market.

C. Outlook

Agreements between national regulators have been more successful than governmental initiatives largely because as they have less force they are not as politicized. The IOSCO and the Basel Committee have helped improve the transparency and accountability of the market. However, these agreements do not fully achieve their respective goals because of the many gaps in international capital market regulation. Market risks, such as the demise of the U.S. sub-prime market, were hidden from regulators and investors until it was too late. This was because disclosure of information regarding MBS was insufficient. If we consider the application of the Basel Minimum Capital requirements, financial institutions heavily involved in the market were able to achieve compliance by transferring risks to unwitting investors. The complexity of the capital market prevents regulators and investors from comprehending the true value of securities and until this is remedied through better disclosure of information, standards can easily be avoided.

168. Glukhovsky, supra note 1, at 655.
III. CREDIT RATING AGENCIES

In absence of effective global regulation of capital markets, private credit rating agencies play a vital role in overseeing the flow of global capital. Their importance to the operation of the international capital market dwarfs that of any international regulatory initiative. These agencies are integral to the global debt market as a source of information and market transparency. Their valuation of securities, manifested in the ratings they assign, have a tremendous impact on trading prices as well as market confidence. Investors worldwide rely on these ratings to make financial decisions, as they provide some of the only information available regarding market instruments, particularly those related to securitization. They act as market incentives to ensure industry performance by signaling investors as to the value of a given investment.

A. The Importance of Credit Ratings

The importance of credit ratings to the debt market cannot be overstated and many factors give them overwhelming power and control over the investment industry. Far from being restricted to providing information to investors, ratings can in fact compel investors to act. Ratings assigned by these agencies can influence the behavior of investors and financial institutions because they effectively determine what constitutes an investment grade security. There are credit rating benchmarks for certain market investors, which prohibit investment in securities that do not meet the standard. For example, institutional investors such as pension funds are often prohibited from holding securities that do not achieve minimum rating scores. Therefore, if an investment holding of a pension fund is downgraded below the minimum credit rating it must be sold. Conversely, these investors may continue to hold deteriorating assets provided they have not been downgraded. Therefore, credit ratings can be more influential than the actual value of a security in determining the behavior of institutional investors.

Similarly, insurance companies are huge investors whose investment behavior is reliant upon credit ratings. Insurance regulators use credit ratings to evaluate and influence the holdings of these companies.

171. Rosner, supra note 13, at 64.
American insurance companies are regulated by the National Association of Insurance Commissioners (NAIC) who monitors the credit quality and value of insurers' investments. The NAIC discourages holdings of riskier investments by attaching high capital charges to non-investment grade holdings. This makes it more expensive to hold riskier investments and it is the evaluation by the rating agency which determines that cost.

At the international level ratings are used by the Basel Committee to determine the financial position of banking institutions. Under the "standard approach" Basel II relies on credit ratings to determine financial institutions' minimum capital requirements. The only assurance of the integrity of ratings is that they are from a credit rating agency accepted by national regulators where it is based. As a result, credit ratings are relied upon to determine the capital requirements of international financial institutions worldwide.

Perhaps the most vital role played by credit agencies is within the derivatives market. In our earlier discussion of credit default swaps, we noted that pre-identified credit events determine whether a protection buyer is entitled to collect payment from the seller of credit risk protection. Credit downgrades are often what triggers payment in a credit default swap. Therefore, the implication of a change in credit rating can be increased exponentially through the derivatives market. Derivatives are often misunderstood instruments that do not provide investors with sufficient information regarding the credit quality of the underlying borrowers. Credit rating agencies are one of the few sources of information regarding this enormous and potentially volatile market. The IOSCO has expressed concern with derivatives explaining, "Because of the opacity and complexity of these debt instruments, investors such as pension schemes are more dependent on guidance from rating agencies." Unfortunately, it is becoming increasingly evident that credit ratings agencies have provided misinformation regarding the value of securitized assets and derivatives.

### B. Failures of the Rating Industry

The extraordinarily important role assumed by credit ratings creates an expectation that only the highest levels of quality and integrity will be acceptable from the agencies, which provide these ratings. However, the credit rating industry is failing to remedy information imbalances between debt issuers and investors and there is growing consensus that the ratings

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172. Partnoy, supra note 44, at 700.
174. Id
175. Rosner, supra note 13, at 31.
provided by these agencies are of little informational value.\textsuperscript{176} The world’s most influential credit agencies failed to predict the largest bankruptcy in U.S. history, rating Enron as investment grade until four days before it filed for bankruptcy. They were also unaware of the imminent collapse of the massive American dotcom company, WorldCom, until forty-two days before it filed for bankruptcy.\textsuperscript{177} Furthermore, on October 30, 2006, Fitch ratings a globally recognized agency increased the rating of New Century Financial, a now defunct mortgage lender, commending the firm for its “competent management team, established servicing platform, capable default technology, and enhanced cross-functional training platform.”\textsuperscript{178} These monumental failings are indicative of the poor health of the ratings industry and demonstrate that they are more reactive than predictive.\textsuperscript{179} There is a growing concern that the entire rating industry suffers from inherent conflicts of interest and has failed to provide the global market with accurate information and ratings analysis. This is a cause for serious concern in light of the power and influence they hold.

The ratings industry is dominated by a small number of firms, giving them tremendous power in the international market. In the U.S. and internationally, three agencies, Moody’s, S&P and Fitch, dominate the ratings market.\textsuperscript{180} This is largely attributable to their statutory monopoly granted by the government as Nationally Recognized Statistical Rating Organizations (NRSROs).\textsuperscript{181} Protected by this state sanctioned monopoly they have made billions in profits, however, the integrity of the information they provide is highly suspect. Allowing a small number of private firms to oversee the operation of the international market combined with the nature of the ratings industry gives rise to inherent conflicts of interest. Rating agencies receive the majority of their income from the corporations they rate,\textsuperscript{182} raising obvious questions regarding their motivations. Furthermore, as discussed, certain investors are limited to holding investment grade securities and therefore a rating change can force them to sell at a disadvantageous time. There is speculation that rating agencies will inflate ratings for a fee, granting investment grade status, allowing investors to circumvent quality restriction, and purchase or hold more risky

\textsuperscript{176} Please see Partnoy, supra note 44, Rosner, supra note 13.
\textsuperscript{178} Rosner, supra note 13, at 27.
\textsuperscript{180} Only Moody’s, S&P and Fitch are recognized by all of the member countries of the Basel Committee.
\textsuperscript{181} Fitch rating is also a NRSRO but does not have the same market share.
\textsuperscript{182} Partnoy, supra note 44, at 652.
Agencies have been accused of inflating ratings for issuers in return for the payment of higher premiums. These conflicts of interest expose the innate problems of allowing private industry to act as gatekeeper of the securities market. It also raises doubts regarding the integrity of the information provided by these agencies.

The failure of rating agencies to provide accurate information played an important role in perpetuating the U.S. housing bubble. Their assignment of artificially high ratings to secondary market instruments contributed to the influx of investment and mispricing of these assets. Furthermore, the importance of ratings increases with more complicated structures such as CDOs, as less information is available and their value is more difficult to determine. A major difficulty with interpreting ratings is that they are often as opaque as the derivatives market itself. Recent studies have determined that the methodologies used are flawed and attach ratings, which are higher than the sum of the parts. It is argued that the traditional credit risk models used by credit rating firms are unsuitable for MBS because the servicing and payment obligations are continuously changing. As it becomes increasingly clear that rating agencies have overvalued MBS, it is likely they will be forced to implement widespread ratings downgrades. This could in turn force institutional investors to sell their holdings exacerbating the situation.

U.S. rating agencies enjoy tremendous market power with their ratings determining market behavior at many levels. However, the U.S. judiciary has failed to recognize their de facto regulatory power within the market, equating their ratings to mere opinions. The leading global rating agencies have been immune from liability for issuing negligent, false, or misleading ratings. Judicial treatment of NRSROs has equated them to journalists, offering them first amendment protection as free speech. This is clearly an erroneous analogy because of the market’s overwhelming reliance on their ratings. The U.S. Senate Commerce Committee describes the issue as follows:

The credit rating agencies seem to be trying to walk a fine line between maintaining their enormous market power through both official and unofficial uses of their ratings, and insisting their ratings are purely their

183. *Id*
184. *Id.* at 701.
186. Rosner, *supra note 13*, at 47.
187. MBS rating downgrades have begun with Moody’s downgrade of $5.2 billion of MBS on July 10, 2007. It is likely that this is the tip of the iceberg. A recent S&P report stated that changes “will be implemented with respect to the methodology for rating new transactions” involving CDOs Please see Barnes, *supra note 78*.
“opinion,” and therefore pure speech under a First Amendment analysis.189

Judicial characterization of NRSROs as mere opinion providers is naive and significantly reduces accountability within the industry.

U.S. legislators aware of the failings of this industry have passed a bill that may fundamentally change its nature. The Credit Rating Agency Reform Act of 2006,190 targets the credit rating industry and will open it to competition as well as introduce more transparency and accountability. The bill empowers the SEC to require rating agencies to maintain books and records, conduct examinations, and initiate enforcement against credit raters. This legislation should significantly improve the industry’s operation. However, it may also force a re-evaluation of securitized assets, the results of which may not be welcome news.

The most recent IMF Global Financial Stability Report warns that one of the greatest risks to the international economy is: “rating agencies continue to expand the application of their ratings beyond the traditional credit risk domain.”191 However, rating agencies are allowed, if not encouraged, to extend their influence because of the lack of regulation and transparency in the international capital market. Although it is apparent that credit raters are failing to provide reliable information, it is equally evident that they are a vital and irreplaceable component of the international investment infrastructure. The need to establish an international organization to regulate and evaluate capital markets has never been so imperative.

IV. FREEDOM OF PARTIES

The ineffectiveness and uncertainties of the international securities framework has inspired a market response whereby private parties use contractual agreements to specify choice of law and venue. This important provides an alternative to reliance on the domestic approach to securities law and is a means of gaining predictability in choice of law issues. The principle of freedom of contract and rise of international commercial arbitration represent a market solution to the lack of international regulation.

National courts recognize the importance of allowing parties the freedom to determine the laws and jurisdiction that will govern their relationship. The United States Supreme Court, a traditionally vigilant

defender of domestic jurisdiction, recognizes the growing international tend
towards party autonomy. In Bremen, the Supreme Court explained the
importance of freedom of contract to international business transactions.
Justice Stewart ruled that:

A contractual provision specifying in advance the forum in which a
dispute shall be litigated and the law to be applied is, therefore, an almost
indispensable precondition to achievement of the orderliness and
predictability essential to any business transaction.192

The Supreme Court in Scherk also explained that parties of
international securities transactions are free to choose the law they see
fit.193 The supremacy of freedom of contract is becoming an international
norm.194 This principle is an important step in gleaning some certainty in
this borderless industry, as it allows parties to choose arbitration over
court.195

Private party agreements can enhance predictability and fill gaps in
the international securities framework. Although contractual agreements
regarding securities transactions have been focused on establishing
jurisdiction and choice of law for disputes, they also represent an
opportunity to regulate issuer behavior. Contractual terms which define
misrepresentation, and specifies recourse in such case, could be an
effective means of improving the accountability of the investment industry.
Institutional investors have the market power to demand conditions when
dealing with the investment industry. As discussed, these investors
invested heavily in the U.S. MBS market and the decline of this market
should alert them to the risks of an unregulated market which lacks
transparency.

V. THE FUTURE OF CAPITAL MARKET REGULATION

International initiatives aimed to provide a comprehensive framework
for regulating the global capital market are at a juvenile stage of
development. The consequence of lack of regulation and oversight is that
individual domestic regimes remain charged with governing activity
outside their borders. As most domestic securities laws were designed in a
different era it is unrealistic to expect them to effectively adapt to a

(1972), the case was cited extensively in the recent decision of Richards v Lloyds of London, 135 F.3d
1289 (9th Cir 1998).
194. See for example Article 3 of the Convention of Rome on the Law Applicable to Contractual
Obligations, 80/934/EEC (June 19, 1980).
195. See for example Hong-Lin You, From Arbitrability to A-National Principles – The U.S
financial landscape designed by sophisticated practitioners who exploit opportunities of the global market. This current patchwork approach does not effectively close the gaps between regulatory regimes and often misses the bigger picture; capital markets are not confined within domestic borders. This model has been outgrown and the current approach neglects the larger global implications of international debt flows. This has allowed financial institutions such as investment banks to operate unhindered on the global scale. The result is a proliferation of new financial instruments and markets. These developments have not been accompanied by regulatory advances and endanger international investors and the global economy.

The private sector is beginning to seek alternatives to the traditional systems of securities regulation and dispute resolution and this development has the potential to play an important role in securities markets. Furthermore, coordinated efforts by domestic regulators, particularly in the field of disclosure, represents a vital means of providing protection to investors and the overall market. However, in order to achieve a truly sustainable framework to govern global capital markets, an organization of governments should form to oversee and regulate international debt flows. The potential of these mechanisms to improve the international debt market will be explored in this final section.

A. Contractual Agreements

Private contractual relationships will play an important role in lieu of effective international regulation in establishing the rights and duties attached to investment relationships. International commercial arbitration is now a well accepted alternative in dealing with disputes arising out of securities transactions. The growing recognition of the validity of arbitration and choice of law agreements make private contracts an attractive alternative to the current domestic framework. The benefits of arbitration include increased legal certainty and the confidential nature of proceedings. Another major advantage is that arbitrators specializing in international securities disputes can be utilized.

Although these attempts by private parties will not remedy broad economic dangers, they do provide potential for improving investor protection. Not only do arbitration and choice of law agreements improve legal predictability, they could also stimulate higher standards within the investment industry. This is particularly applicable to "sophisticated" investors who are inclined to opt for arbitration rather than publicize their

196. A prime example is London, England, a center for global securities arbitration, which is well equipped to handle complex, multiparty disputes arising from securities deals. For more information please see the London Court of International Arbitration website at http://www.lcia-arbitration.com/.
investment failings through litigation. Large scale investors often do not share in the protections afforded to individual investors because they are believed to have the skills and resources to fend for themselves. Within this unregulated market there is an opportunity for these powerful investors to contractually oblige investment firms to raise disclosure standards. Furthermore, standards of negligence and misrepresentation could be contractually agreed upon between parties.

There is a great deal of information failure in the international capital market. Within the U.S. MBS industry it is likely that institutional investors were mislead by securitizers and rating agencies with regards to the underlying value of their investments. Through contractual agreements a number of measures could be introduced to avoid this situation. First, issuers could be obligated to provide complete and continuous disclosure of the assets underlying their securities. Second, contractually agreed performance requirements could be introduced. Investments by their nature are speculative and include risk. However, it would not be unreasonable to demand minimum protections when MBS issuers profit so greatly. The massive capital held by institutional investors gives them the leverage to demand disclosure and results. This would improve the incentive structure within the investment industry.

The rise of international commercial arbitration allows parties to circumvent the limitations of domestic systems ill-suited to international capital markets. However, private contracts not subject to state scrutiny are susceptible to power and information imbalances. Arbitration is not a viable option for the average investor. Using private contracts to regulate international capital relationships will only protect powerful investors and does little to remedy market vulnerability as a whole.

B. Uniform Global Disclosure Standards

There is a direct correlation between levels of information held by participants and the successful operation of the market. Unfortunately, information failures are responsible for market distortions and investor losses all too often. As we have seen, information provided by the investment industry through investment banks, credit rating agencies, and other institutions is often flawed if not downright negligent. Financial regulators are unable to effectively monitor secondary markets where only "qualified investors" have access to performance reports and other information regarding these financial instruments. Shockingly, U.S. banking regulators are not considered to be "qualified investors" and even

197. Rosner, supra note 13, at 83.
after designation must receive permission to inspect securities prospectuses and deal information. The opacity and complexity of securitization and derivative instruments leaves a select few with a virtual monopoly of information.

The failure of the U.S. MBS market is an example of how information deficiencies create artificial economies and perpetuate malfeasance. Subprime loans were an important part of the U.S. MBS market rise, with loan packages attracting a great deal of investment worldwide. Investors clearly did not understand the risks involved primarily because of the complex structures, which packaged sub-prime loans with reliable mortgages and understated the aggregate risks. Furthermore, CDO structures were designed and marketed as instruments insulated from risk through derivatives such as credit default swaps. With mortgage defaults now sweeping the U.S. it is clear that these instruments are not the safe investments they were represented to be. More shocking than these unethical behaviors is that victims of these improprieties may not even know they have suffered losses. As widespread losses continue to be incurred, it is unclear how far and to whom they will affect. There is a shocking lack of information regarding who holds the risk of mortgage defaults in the U.S. market. According to one prominent market researcher, "It's pathetic, but it is almost impossible to find out, which is no good for the system or anyone really . . . . On the CDO side we know even less and regulators know even less because there aren't even clear reporting standards." There are concerns that unsuspecting holders like pension funds may have significant exposure. Clearly there are severe problems with the flow of information within the capital market. As the complexity and range of financial instruments continue to expand, something must be done to remedy this.

An inherent difficulty with the global capital market is that information is a commodity and imbalances are exploited for profit. The failure of the U.S. sub-prime market did not take everyone by surprise and it has been reported that many hedge funds made significant gains from the collapse through options markets. It would not be surprising to discover that the same firms singing the praises of higher yields through the MBS market were shorting these securities. Lack of disclosure is a catalyst for malfeasance and can lead to market failures. Currently, issuers can easily avoid disclosure obligations by choosing lenient jurisdictions or operating

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198. Id.


200. Id.
in unregulated sectors. The international community cannot afford to wait to improve the flow and quality of information in the capital market. The MBS market is but one example of a continuous cycle of information failures and as the derivatives market continues to expand the stakes have become very high.

Transparency needs to be improved in the market and coordinated efforts at the international level must be undertaken. The implementation of rigid global disclosure standards is of extreme importance to improving regulation, investor protection, and ensuring stability of the overall market. These standards would lead to far greater market transparency and could prevent the large scale abuses which characterize today’s market.

The IOSCO has been relatively successful in proposing uniform standards and in the short term could be a forum for reaching international agreement on disclosure and accounting by facilitating convergence between domestic regulators. However, the IOSCO may lack the power of compulsion necessary to achieve meaningful reform. Unless incorporated into domestic law IOSCO standards act more as a guide than a source of law. In order to have meaningful impact disclosure must have the force of law either at the domestic or international level.

There are also two major shortcomings which detract from the effective flow of market information. First, the current system of disclosure is overly reliant on rating agencies without providing sufficient oversight or constraints upon the industry. Rating agencies must be made more accountable. The U.S. Credit Rating Agency Reform Act is an important step to improving the operation of the credit industry and reducing information imbalances. However, in order to be successful the oversight powers granted to the SEC must be vigilantly applied and U.S. courts must develop a more rational understanding of the role of rating agencies. Second, it is crucial that disclosure standards are extended to the derivatives market and to investments offered to sophisticated investors. The derivatives market currently allows securities to be valued at the whim of private industry with only credit rating agencies providing information. Transparency reforms should include publicized performance reports and creating rules and regulations for structured securities. Improving disclosure with regards to securitized assets and derivatives will create a more economically sound capital market allowing investors to accurately price investments. Furthermore, it is essential that disclosure standards are applied to transactions involving sophisticated investors and that they register their investments. Sophisticated investors are often representatives of large groups who should be aware of their investments. There is no justification for allowing these transactions to occur behind closed doors.

The key to a successful global capital market is widespread knowledge and information. The current system is unacceptable and poses
dangers to the international economy. We must not wait for a system failure to begin analyzing the shortcomings and dangers which currently exist. Uniform disclosure standards are achievable and could significantly improve the flow of market information reducing the risk of misfeasance and market distortions. Initiatives of this nature are currently being undertaken between national securities regulators. However, eventually disclosure requirements should be assumed by an international organization with the power to regulate the global financial system.

C. International Credit Organization

This paper has repeatedly stressed the importance of substantive intergovernmental action to regulate the global capital market. The market currently faces huge debt imbalances and holds a large proportion of the world’s wealth in foggy sectors. It is no longer sufficient that each country is regulated; we must focus on interactions between economies with regard to savings and investment. Political realities indicate that treaty-making will not create an effective regulatory framework any time soon. However, there remains a need for the development of a multi-lateral organization to set baseline regulations for securities markets and to oversee its operation. An International Capital Organization (ICO) should be created and empowered to regulate the investment industry and monitor global debt flows. Such an organization is the only feasible way to protect global financial stability in this era of international markets. This organization should have widespread supervisory and inspection powers over private industry and enforce uniform disclosure and accounting standards. Crucially, it must be able to regulate all sectors and members of the investment industry, including transactions involving sophisticated investors and the trade of derivatives. It should also monitor and report on macroeconomic developments and trends of concern to capital market operation.

World-famous economist Henry Kaufman has proposed the creation of a world financial regulator composed of investment professionals from all major industrialized countries.\(^{201}\) Kaufman’s proposal would have this organization provide public credit ratings of financial market participants. This is a brilliant concept, which could improve information flows and the current biased nature of credit ratings. The role of credit ratings in the international capital market is paramount and should not be entrusted to private firms. Furthermore, bestowing this function on an international organization would be an excellent way to conquer current political

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obstacles to uniform regulation. On the surface this development would not require the sacrifice of national sovereignty in the way a treaty requires concrete obligations and adherence to rules. The ICO would not need the power of legal compulsion to achieve its regulatory goals as market realities would more than compensate. As discussed, the only meaningful regulation of securities at the international level is provided by credit agencies whose ratings determine the ability to attract capital and the cost of borrowing. While no country would allow their economic policies to be governed by an international organization, this would allow the ICO to ensure responsibility and transparency at the national and international level or face a dreaded credit downgrade. Currently, private rating firms have assumed a primary position in the international capital market and though they have profited greatly, they have failed to effectively evaluate the market. This position and the power it entails should be controlled at an international level by an ICO. This would be a great achievement in global regulation and fundamentally improve the operation of capital markets.

The major obstacle to the development of an ICO will be its inability to acquire sufficient operational resources. The task of overseeing and evaluating the global capital market is a monumental one, which requires international coordination. The organization must attract leading financial minds to fulfill its mandate and large capital contributions would be required from nations worldwide. In the short term, these functions could be undertaken by an organization formed under the auspices of the IMF, which is already involved in the study of capital markets. However this may limit the potential of the organization and potentially damage its perception. Instead, nations of the world should establish a fresh organization through cooperation and consensus.

International coordination in securities regulation has been unsuccessful to this point and a great deal of political will and conciliation will be necessary to accomplish it. However, the fate of the international economy may depend on such an achievement.

VI. CONCLUSION

The international securities market has flourished, improving global prosperity but also creating risks for market participants and the global economy. The traditional conception of capital markets as domestic no longer reflects the reality of international finance. We have entered an era in which the lifetime savings of a Japanese grandmother can contribute to home ownership half a world away. It is clear that regulation of the capital market has not kept pace with these developments and still retains a domestic focus. This has been very profitable for the investment industry
and large importers of capital like the U.S. However, this unregulated climate is dangerous to parties that lack the information to make informed investments and the international economy as a whole. The first part of this paper demonstrated how our first time homebuyer Hiro, and his grandmother, Kayori, a pension fund contributor could be harmed by the market. Millions of these debt relationships exist and their cumulative effects could be dire. Uninformed or misrepresented investments also distort the market, creating asset bubbles, inefficient allocations of capital and huge debt imbalances.

The lack of international regulation has not harmed the short-term interests of developed capital markets. The U.S.’s success in attracting a disproportionately large sum of international investment is due in part to the lack of efficient regulation elsewhere in the world. This infusion of capital reduces borrowing costs and risks and fuels their high levels of domestic spending. However, it has also created the most indebted nation in world history, owing around $4.9 trillion. The U.S. debt imbalance has allowed the country to enjoy consecutive asset bubbles (stock market, housing) but the time will come when it will have to repay its debts.

The U.S. housing market has been described as the global economic wildcard and securitization has transferred a significant portion of this risk to foreign investors. The sub-prime industry is an example of market distortion perpetuated through securitization. The crash of this market has damaged the global economy and caused widespread losses to investors. With the recent failure of American Home Mortgage Investment Corp., and bankruptcy concerns for Countrywide Financial Corp. the largest U.S. mortgage lender it is clear that damage is no longer restricted to the sub-prime industry. It is too early to say how long or severe the economic slump will be, but it is already taking its toll on the international financial market. If the U.S. housing market is the global economic wild card, the derivatives market is the joker and could exacerbate the crisis. The U.S. mortgage crisis exposed enormous deficiencies in the operation of finance

203. American Home is not a sub-prime lender and specializes in providing mortgages to borrowers who fall just short of top credit scores, known as Alt-A mortgages. Please see Steven Church and Bradley Keoun, American Home Files for Bankruptcy After Shutdown (Update7), (August 6, 2007), http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aRWAL_a9xlM. Merrill Lynch & Co. has raised the prospect of bankruptcy for Countrywide Financial Corp., who has been forced to draw upon its entire $11.5 billion line of credit. Shannon D. Harrington and Hamish Risk, Corporate Bond Risk Rises Worldwide as Credit Concerns Escalate, (August 16, 2007), http://www.bloomberg.com/apps/news?pid=newsarchive&sid=a.cxwILMECo4.
204. In a move that leading to global market turmoil, BNP Paribas SA, France’s largest bank, was forced to stop withdrawals from three investment funds with high exposure to the sub-prime market. Sebastian Boyd, BNP Paribas Freezes Funds as Loan Losses Roil Markets (Update5), (August 9, 2007), http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aW1wj5i.vyOg.
markets yet, according to Rosner, "there is still no focus on monitoring bank funding markets. The feared outcome is nothing more than a 21st century bank run, this time from CDO investors rather than depositors." The recent failure of two Bear Stern CDO hedge funds indicates this is already under way. Global markets have seized on fears of an international credit crisis, requiring government intervention in North America, Europe and Asia. Whether or not this intervention is effective it cannot be regarded as more than a short term fix.

The continuous cycle of international financial crises is a warning signal that the global debt market is not functioning properly. Coordinated international effort must target the failings of the market before it is too late. International regulation will occur; it is a matter of hoping that the catalyst for such development is not a financial catastrophe.

205. Rosner, supra note 10, at 83.
206. The two Bear Stearns funds, the High-Grade Structured Credit Strategies Enhanced Leverage Fund and High-Grade Structured Credit Strategies Fund, are reported to have little to no value left. The two funds were formerly worth well over a billion dollars. Yalman Onaran, Bear Stearns Tells Fund Investors 'No Value Left' (Update6), (July 18, 2007), http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aiMUHwcgLDKI.
207. The central banks of the U.S., Europe, Japan, Australia and Canada injected over $136 billion into the banking system during the week of August 6, 2007, in attempt to relieve the global liquidity crisis. Scott Lanman and Christian Vits, Central Banks Add Cash to Avert Crisis of Confidence (Update9), (August 10, 2007), http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aBHNFmbsWcY.