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

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Introduction

The idea of the state lies at the core of international relations and international law. The concept of sovereignty is also central to the notion of the state. Indeed, inherent in the existing system of states are the principles of political independence and sovereign equality that form the underpinnings of sovereignty. Thus, it is unsurprising that the United Nations Charter specifically declares that:

Nothing contained in the present Charter shall authorize the United Nations to intervene in matters which are essentially within the domestic jurisdiction of any state or shall require the Members to submit such matters to settlement under the present Charter; but this principle shall not prejudice the application of enforcement measures under Chapter V.

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

This devotion to sovereignty appears to be inconsistent with the increasing trend toward the establishment of international agreements and institutions, since they involve a surrender of some

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1 See BARRY E. CARTER & PHILLIP R. TRIMBLE, INTERNATIONAL LAW 1366 (2d ed. 1995).
2 U.N. CHARTER art. 2, ¶ 7.
3 See CARTER & TRIMBLE, supra note 1, at 1366-67.
degree of sovereignty. After all, "[s]ince governments put a high value on the maintenance of their own autonomy, it is usually impossible to establish international institutions that exercise authority over states."4

This paper attempts to reconcile this apparent inconsistency by examining the trend toward international agreements from a public choice perspective. In order to provide focus and context to the inquiry, we concentrate on the field of corporate finance—in particular, the areas of banking and securities law. The starting point for the analysis is that nations do not decide to cooperate or forge international agreements, rather the regulators, bureaucrats, and politicians within nations do. And regulators will not agree to enter into international agreements unless it is in their (private) interest to do so. Furthermore, regulators are political-support-maximizing actors; they respond to political pressure and to self-interest.

All else equal, regulators would prefer not to cede or to share authority with their counterparts from other countries. Thus, regulators in a particular country generally will not sacrifice autonomy by coordinating their activities with regulators from other countries. The thesis of this Article, however, is that technological change, market processes, and other exogenous variables may deprive the regulators in a particular country of the power to act unilaterally. Such change can cause regulators acting alone to become irrelevant. When this happens, the regulators in a particular country will have strong incentives to engage in activities such as international coordination in order to survive.

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

In this Article, we will apply this theory to the Basle Accords, the historic documents which standardize minimum capital requirements among the world's banks. In the context of the negotiations leading up to those agreements, our theory explains why an agreement to coordinate capital levels was reached. Japanese regulators appeared to be reluctant to compromise with their bureaucratic colleagues from other nations, while the regulators from the

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United States were quite eager to reach an agreement about capital levels. Unlike their United States counterparts, the Japanese bureaucrats representing Japan's Ministry of Finance were quite powerful. Their autonomy was not being threatened by internal or external sources, and therefore, they felt little need to reach an international accord in order to protect either their autonomy or their bureaucratic turf. By contrast, the U.S. banking regulators were faced with serious challenges to their own power at home, and therefore had strong private incentives to reach an agreement.

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

Part I of this Article describes the public choice theory of international regulatory competition and coordination in more detail. It begins by briefly distinguishing two competing views of government regulation, public-interest theory and public choice theory, to illustrate why public choice theory provides a useful perspective on recent international coordination in financial regulation. Next, the Article lays out the framework of a public choice theory for financial regulation. In Part II, we apply the insights of public choice theory for financial regulation to the recent efforts to coordinate banking and securities law. First, we examine the Basle Accord on minimum capital requirements for financial institutions and demonstrate that coordination of such requirements makes little sense from a public-interest perspective. However, we show that international coordination can easily be explained from a public choice view. Next, we examine recent international agreements on insider trading regulations. In this area, where the United

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5 For a more in-depth application of public choice theory to international financial regulation, see Edward J. Kane, Tension Between Competition and Coordination in International Financial Regulation, in Governing Bank's Future: Markets vs. Regulation 33 (Catherine England ed., 1991).
States was also facing serious threats to its autonomy, we will see that the United States successfully pressured other countries into adopting insider trading regulations that have helped the United States maintain its autonomy in those areas. Again, public-interest theory provides little guidance in explaining this activity, while a public choice view provides a useful explanation.

I. PUBLIC CHOICE THEORY AND THE DECLINE OF THE NATION STATE

Political science and economics provide competing theories to explain the role of government in regulating society. The traditional view of political scientists, formally known as the public-interest theory, generally posits that legal institutions and bureaucracies regulate in order to further the common good. Adherents to the public-interest theory assert that a government seeks to achieve this basic goal of serving the public by solving collective action problems and intervening when private markets fail to allocate resources properly. "Public-interest theory maintains that government should correct these failures through regulation, for example, through taxes or subsidies designed to push markets toward a 'socially optimal' equilibrium."7

A. An Introduction to Public Choice Theory

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

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8 See Butler & Macey, supra note 7, at 1436; see also McCormick & Tollison, supra note 7, at 3-4.
9 McCormick & Tollison, supra note 7, at 4.
Not surprisingly, the public-interest theory has been criticized as "not a very believable theory of government."\(^{10}\) Even more problematic, given its objective of explaining government regulation, is that the public-interest theory fails to explain much of what is observed in the real world. Contrary to the predictions of public-interest theory, one often observes regulation where there is little, if any, evidence of market failure. One also finds governmentally-coerced wealth transfers that benefit powerful, discrete interest groups at the expense of the general public.\(^{11}\)

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

The critical advantage of public choice theory over public-interest theory is its superior predictive powers. For example, as Kenneth Scott has noted, "[i]n [public choice theory's] light, much of banking regulation (such as restraints on entry or price fixing through the late and unlamented Regulation Q) can be explained as successful efforts by banks to obtain monopoly rents through a cartel administered by the government."\(^{15}\) Similarly, as one of us has demonstrated elsewhere (in a joint work with Geoffrey Miller),

\(^{10}\) Id. at 3.


\(^{12}\) See Butler & Macey, supra note 7, at 1436-37 ("Thus, [public choice theory] analyzes decisions made by politicians, bureaucrats, and interest-groups in accordance with generally accepted principles of rational economic behavior.").

\(^{13}\) See id. at 1436.

\(^{14}\) Richard A. Posner, Economics, Politics, and the Reading of Statutes and the Constitution, 49 U. Chi. L. Rev. 263, 265 (1982); see also Butler & Macey, supra note 7, at 1436.

\(^{15}\) Scott, supra note 11, at 387.
the real beneficiaries of deposit insurance are financial institutions, because deposit insurance minimizes their cost of funds, and not the public's, which pays for deposit insurance with foregone interest.\footnote{16}{Jonathan R. Macey \& Geoffrey P. Miller, Banking Law \& Regulation (1992).}

Regime theory is an important school of thought about international relations that can best be viewed as an application of the public-interest theory that uses some aspects of public choice theory in its analysis.\footnote{17}{For two classic works in regime theory, see International Regimes (Stephen D. Krasner ed., 1983); and Keohane, supra note 4.} Because regime theory, like the theory presented here, generates predictions about the contours and timing of international cooperation based on certain tools of economics, the theory will be discussed briefly.\footnote{18}{Realism, liberalism, and Marxism generally are considered to be the three major contending schools of thought into which the competing theories of political scientists who focus on international relations can be divided. Robert Gilpin, The Political Economy of International Relations 24-25 (1987); 5 International Political Economy (Jeffrey Frieden \& David Lake eds., 2d ed. 1991). See generally The Theoretical Evaluation of International Political Economy: A Reader (George T. Cran \& Abla Amawi eds., 1991); David A. Lake, The International Political Economy of Trade (1993). However, the realist approach and the liberal approach are basically variants of the public-interest approach. The Marxist approach is not worth discussing seriously.}

Although there is some ambiguity about the precise definition of a regime, regimes can be loosely defined as "sets of implicit or explicit principles, norms, rules and decision-making procedures around which actors' expectations converge in a given area of international relations."\footnote{19}{Stephen Krasner, Structural Causes and Regime Consequences: Regimes as Intervening Variables, in International Regimes, supra note 17, at 1-2.} Regimes are also "man-made arrangements (social institutions) for managing conflict in a setting of interdependence."\footnote{20}{Ernst B. Haas, Words Can Hurt You; or, Who Said What to Whom About Regimes, in id. at 23, 26.}

**B. Regime Theory and International Cooperation**

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

Thus, regime theory, like the public-interest theory generally,
predicts that “public goods problems affect the . . . demand for
international regimes, which can ameliorate problems of transac-
tions costs and information imperfections that hinder effective
decentralized responses to problems of providing public goods.” By
contrast, public choice theory predicts that international regimes
do not respond to public goods problems, but rather to the needs
of politicians, bureaucrats, and interest groups of the countries that
constitute the relevant decision-makers within the regimes.

One critical prediction of regime theory that sharply contrasts
with the theory developed in this paper is that the pace of conflict
will increase as markets develop and the world becomes more
interdependent.

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

There are several flaws with this analysis. The first is the assump-
tion that governments have preferences. Institutions in general,
and governments in particular, do not have preferences, people do.
Governmental policy reflects the preferences of powerful constitu-
ents, not some mystically determined set of preferences that might

21 Anne-Marie Slaughter, International Law in a World of Liberal States, 6 EUR. J.
22 Robert O. Keohane, The Demand for International Regimes, in INTERNATIONAL RE-
GIMES, supra note 17, at 141, 170.
23 Keohane, supra note 4, at 243.
be described as the "national interest." Second, unlike the public choice theory, regime theory presumes that governmental policy is made without regard to the preferences of the policymakers who are formulating and implementing that policy. This presumption is false and is inconsistent with our theory. As the following section explains, it is implausible that regulators and policymakers will enact policies that threaten their own authority and autonomy, much less their very existence merely because such policies are consistent with the national interest.

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

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

In a nutshell, regime theory posits that international institutions (called "regimes") are vehicles through which states attempt to further their own interests. Public choice theory rejects the idea that states have interests, and instead posits that international institutions are vehicles through which politicians, bureaucrats, and interest groups reflect their own interests.

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24 See id. at 246.
C. Public Choice Theory and Financial Regulation

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

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

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

25 Kane, supra note 5, at 34 (citing Kenneth E. Scott, The Dual-Banking System: A Model of Competition in Regulation, 30 Stan. L. Rev. 1 (1977)).
26 Id. at 36.
27 Id. at 37.
28 Id.
29 Id.
30 Id.
31 Id.
The recent global acceleration of financial and regulatory change reflects the response of regulatees and regulators to exogenous and endogenous decreases in the costs of entry and exit from various financial product markets. The microeconomic view is that product line and geographic market expansion by suppliers of financial regulatory services follow and support rivalry between client financial services firms within and across countries, regions, and various kinds of administrative boundaries. Supplementing strictly bureaucratic theories of regulatory behavior (e.g., Niskansen 1971), my conception is based on the premise that regulators attempt, subject to bureaucratic, market, and technological constraints, to extend or to defend their share of the market for regulatory services in the face of exogenous and endogenous disturbances in the economy.\textsuperscript{32}

One of us has made an argument analogous to Kane’s in a recent article discussing administrative agency obsolescence.\textsuperscript{33} In that article, Macey applied principles of firm or industry failure in a market economy to administrative agencies. In a competitive market when “a firm misuses scarce resources by ‘producing unwanted products, or overproducing, or using inefficient production techniques, at the extreme it will fail, and the resources will find more socially desirable resources.”\textsuperscript{34} The argument there was that “just as technological innovations in markets often cause whole industries to become obsolete—for example, the introduction of the automobile had disastrous consequences for the buggy whip industry—so too can technological innovation render administrative agencies obsolete.”\textsuperscript{35} This argument concluded that while a competitive market permits firm or industry failure so that resources will flow to more efficient uses:

[W]hen administrative agencies become obsolete, they are likely to respond to their obsolescence in ways that impose very heavy costs on the firms they are supposed to regulate, or on society generally, or both. As obsolescence sets in, administrative agencies are likely to replace the publicly articulated goals that provided the initial justification for the creation of the agency with self-serving goals designed to insure that the agency will remain

\textsuperscript{32} Id.


\textsuperscript{34} Id. at 910 (quoting A. Dale Tussing, The Case for Bank Failure, 10 J.L. & Econ. 129, 129 (1967)).

\textsuperscript{35} Id. at 911.
a secure place of employment for the officials who comprise its staff.\textsuperscript{36}

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

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

A. The Basle Capital Accords

1. Background

In theory, the purpose of capital adequacy rules is to protect depositors from the damage caused by excessive risk taking by financial institutions.\textsuperscript{37} Generally speaking, a bank's capital is the difference between the bank's assets and liabilities. This sum is often characterized as a bank's "cushion" against insolvency.\textsuperscript{38} The higher a bank's level of capital, the larger the cushion that protects depositors in case of financial stress. Likewise, so long as a bank has a positive capital level, it is solvent: it has sufficient assets to pay all of its outstanding liabilities, and the risk of loss in case of failure falls solely on the shareholders' shoulders.\textsuperscript{39} Thus, the presence of adequate capital provides protection for depositors, or in the context of federal deposit insurance, for the federal deposit insurance system.

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

\textsuperscript{36} Id. at 913.
\textsuperscript{37} See Macey & Miller, supra note 16, at 284.
\textsuperscript{38} See id.
\textsuperscript{39} See id.
Even more problematic is the problem of asset risk. Any rational system of capital adequacy rules must account in some meaningful way for the risk present in the financial institution's asset portfolio. This is because the riskier the firm's assets, the greater the risk of bankruptcy. For example, a bank that simply accepts time deposits and invests the proceeds in short-term government debt of matching maturities does not run any risk of insolvency (so long as the return on the notes can cover the interest on the deposits plus the bank's expenses). By contrast, a bank that takes deposits and invests the proceeds in speculative assets such as real estate loans or derivatives runs a significantly higher risk of insolvency.

For these reasons, simple, bright-line capital rules are inappropriate and ineffective. Ironically, for a long time, such crude, bright-line rules were exactly what financial institutions in the United States operated under. The original capital adequacy rules, known as leverage ratio, simply required that banks meet a gross ratio of capital to assets with no accounting for the risk of assets. This allowed banks to operate at widely disparate levels of risk while remaining in compliance with the leverage ratio guidelines.

The inadequacy of the leverage ratio framework became increasingly apparent with the dramatic growth in banks' international and cross-border activities during the 1970s. The greatly varied capital adequacy rules throughout the world caused major banking nations to be concerned that countries with relatively strict capital guidelines were being placed at a competitive disadvantage as compared to those with more lenient guidelines.

To illustrate, take two banks, Bank A and Bank B. Assume that the cost of debt funding (e.g., what it must pay depositors or other creditors for the use of their money) for both banks is 7%

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

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

42 This example is drawn from Hal S. Scott & Shinsaku Iwashara, In Search of a Level Playing Field: The Implementation of the Basle Capital Accord in Japan and the United States 5-6 (1994).
and that the cost of equity funding is 10%. This is consistent with observed reality, since the cost of equity funding is higher than the cost of debt funding.

Next, assume that Bank A is subject to a 4% capital ratio and Bank B is subject to a 6% capital ratio and that in all other respects the banks are identical. This would mean that Bank A can fund up to 96% of any given loan with deposits or other debt and must fund only 4% of the loan with some form of equity that meets the minimum capital requirements. Bank B, on the other hand, can only fund 94% of the loan with deposits or other debt, and must fund 6% of the loan with some form of equity that meets the capital requirements.

The cost to each bank of making a loan can be determined using the following equation:

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\text{Loan Cost} = \left(\%\text{ of loan funded by debt} \times \text{cost of debt}\right) + \left(\%\text{ of loan from funded by equity} \times \text{cost of equity}\right)
\]

Applying this formula, one can easily calculate what it would cost each bank to make a loan of $100:

- Bank A's Loan Cost = (96)(.07) + (4)(.1) = 7.12%
- Bank B's Loan Cost = (94)(.07) + (6)(.1) = 7.18%

Thus, Bank A's lower capital requirements enable it to finance its lending activities more cheaply than Bank B, giving Bank A a competitive advantage. Put another way, because it faces lower capital requirements, Bank A can lend out more money for a given level of equity than Bank B. And, all else equal, Bank A will be more profitable than Bank B.

It was widely understood that the competitive advantage to be gained from more lenient capital standards was responsible for a reduction in the capital levels of international banks. This reduction became a source of concern for regulators, which "was exacerbated by the emerging debt crisis in the major developing countries."43

In addition to competitive inequality concern, regulators expressed concern over the striking development and growth in off-

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43 Peter Cooke, Excerpts from Bank Capital Adequacy, in HAL SCOTT & PHILIP WELLONs, INTERNATIONAL FINANCE: TRANSACTIONS, POLICY AND REGULATION 214, 216 (1995); see also David Shirreff, The Fearsome Growth of Swaps, EUROMONEY, Oct. 1985, at 247, 253 (quoting Charles Lucas of the Federal Reserve Bank of New York as stating that central banks must harmonize their regulation of swaps, for "[o]therwise the business will simply be driven to the least regulated markets").
balance sheet activities by banks (e.g., standby letters of credit and
derivatives such as currency and interest rate swaps). These activi-
ties raised a new set of risks for financial institutions that were
completely different from the traditional risk associated with the
institution’s loan portfolio.\textsuperscript{44}

The concerns about banks becoming increasingly risky as a re-
result of dangerously low capital levels and off-balance sheet activi-
ties made banks increasingly difficult to monitor. This initially led
to a joint initiative between the United States and the United King-
dom in 1986, which was designed to achieve a common risk-
weighted capital measuring system.\textsuperscript{45} This initiative was followed
in December 1987 with the Basle Capital Adequacy Accords.\textsuperscript{46}
The Basle Accords are essentially a “gentleman’s agreement”
among central bankers in the countries that make up the Basle Su-
previsors Committee of the Bank for International Settlements
(“BIS”).\textsuperscript{47} In 1989, when the European Union adopted its own
capital guidelines based on the Basle structure, the Accord was ex-
tended to several non-G-10 European Union countries.\textsuperscript{48} In addi-
tion to these countries, many other nations have adopted the Basle
Accord in order to enhance their international reputation, and to
“enable them to operate in countries like the United States that
require conformity with the Basle standards as a condition for
entry.”\textsuperscript{49}

Before looking at the Basle Accords from a public-interest
and public choice perspective, it will be helpful to provide a brief
summary of how the Basle’s risk-adjusted capital ratio framework
operates. Under the Basle Accords, a bank’s asset portfolio is di-
vided into four categories. Each category is assigned a risk-weight
percentage which in theory reflects the risk level of the assets
within that category.\textsuperscript{50} The higher the risk-weight percentage, the
riskier the asset category. For example, the risk-weight percentage
for private loans is 100%, while the risk-weight percentage for gov-

\textsuperscript{44} See Cooke, supra note 43, at 216.
\textsuperscript{45} See id. at 217.
\textsuperscript{46} See Ethan B. Kapstein, Resolving the Regulator’s Dilemma: International Coordina-
\textsuperscript{47} See Hal S. Scott, The Competitive Implications of the Basle Capital Accord, 39 St.
Louis U. L.J. 885, 888 (1995). The BIS Committee includes the Group of Ten (G-10)
countries (Belgium, Canada, France, Germany, Italy, Japan, Netherlands, Sweden, United
Kingdom, and United States) plus Switzerland and Luxembourg. Id. at 885.
\textsuperscript{48} See id. This brought in Denmark, Greece, Ireland, Portugal, and Spain.
\textsuperscript{49} Id.
\textsuperscript{50} Macey & Miller, supra note 16, at 285.
ernment securities is 0%. Thus, no capital is necessary to offset government securities, while 100% of the specified minimum capital levels must be held against a bank’s loan portfolio because the total assets in each category are then multiplied by the appropriate risk-weight, and these products are summed.

The Basle guidelines also seek to account for the risks associated with financial institutions’ off-balance sheet activities. Each off-balance sheet activity is multiplied by a credit conversion factor to determine a “credit equivalent value” for the particular activity. The “credit equivalent value” is then adjusted for risk based on the identity of the borrower. The result is known as the bank’s “adjusted credit equivalent value.” The sum of the risk-weighted assets is added to the adjusted credit equivalent value to reach the bank’s “total risk-adjusted assets.”

The next step is to calculate the bank’s capital. The Basle Accords divide the bank’s capital into two categories, called “tiers.” Tier 1, commonly known as the bank’s “core” capital, generally consists of common stock, qualifying noncumulative preferred stock, and minority interests in equity accounts of subsidiaries. However, Tier 1 does not include goodwill.

Tier 2, commonly known as the bank’s “supplementary” capital, generally includes allowances for loan and lease losses, perpetual preferred stock not in Tier 1, subordinated debt, intermediate term preferred stock, and certain other hybrid capital instruments and notes. Essentially, Tier 2 capital consists of items that have less certain or less permanent value than Tier 1 capital. Tier 1 is then added to Tier 2 (with the exception that the Tier 2 level cannot exceed the Tier 1 level), and this sum is reduced by certain deductions. The result is the financial institution’s total capital.

The final step is to determine whether the bank’s ratio of total capital to total risk-adjusted assets meets the Basle requirement, which is currently 8%. Additionally, because a bank’s Tier 2 capital cannot exceed its Tier 1 capital, the Basle guidelines effectively impose a separate Tier 1 capital to risk-adjusted assets ratio of 4% of assets.

51 Id.
52 Id. at 286.
53 Id.
54 Id.
55 Id.
56 Id.
57 Id.
58 Id. at 287.
2. The Basle Accords from the Public-Interest Perspective

The public-interest based explanation for the Basle Accords is easily summarized. The globalization of financial markets that began in the 1970s brought a substantial increase in international competition. This increased competition, combined with the explosion in banks' use of off-balance sheet activities, is supposed to produce a need for international regulatory coordination. Coordinating internal regulations would provide for the safety and soundness of the banking industry and would promote competitive equality within the banking industry. It is argued that without the Basle Accords, banks operating in countries with weak capital requirements would have a competitive advantage over banks operating in countries with stringent capital requirements. This competitive advantage would put pressure on bank regulators. A competition among regulators results in a "race to the bottom" where regulators try to benefit their own constituents by lowering capital requirements. International coordination in the form of the Basle Accords solves this problem.

There are at least two problems with the public-interest analysis. First, the Basle Accords did not improve the safety and soundness of the financial system. Nor have they "leveled the regulatory playing field" by eliminating the competitive inequities that can theoretically arise from differing capital guidelines. Second, the public-interest approach presumes that "harmonization" or "cooperation" is beneficial to the public without offering a believable explanation as to why a country such as the United States would be eager to sacrifice at least some of its national autonomy in the area of financial regulation.

Hal Scott and Shinsaku Iwahara have effectively demonstrated that there was never a realistic chance that the Basle Accords could level the international playing field. Scott and Iwahara explain that "[c]ompetitive advantages between banks in two countries are caused primarily not by differences in capital ratios but by differences in comparative advantage, the fundamentals of each economy, and governmental support in the form of safety net policies."
One of the principal reasons for Scott and Iwahara's conclusion arises from the existence of a "bailout differential" between nations.\textsuperscript{62} In an efficient market, the risk of debtor default would lead creditors of highly leveraged firms to demand higher interest payments than creditors of less leveraged firms. This does not occur in the banking industry because of the presence of a governmental "safety net."\textsuperscript{63} All major banking countries have some form of implicit or explicit guarantee/deposit insurance that the depositors in financial institutions will be protected if the financial institution defaults.\textsuperscript{64} The presence of this guarantee generally makes creditors indifferent to a financial institution's leverage ratio.\textsuperscript{65}

However, the strength of this safety net varies from country to country.\textsuperscript{66} For example, there is strong evidence to support the fact that the Japanese and European safety nets are stronger than that of the United States.\textsuperscript{67} The implication of this is that creditors will demand higher interest rates from United States banks than they do from European or Japanese banks with the same leverage because the overall risk of lending to United States banks is higher. . . . United States banks must have more capital to make up for the weaker government guarantees.\textsuperscript{68}

The available data appear to confirm Scott and Iwahara's position. The average capital ratio for the ten largest United States banks in 1993 was 13.6\%, as compared to 9.67\% for the ten largest Japanese banks.\textsuperscript{69} Similarly, the average capital ratio for the ten largest European banks in 1993 was 10.12\%, also lower than the United States's 13.6\%.\textsuperscript{70} Moreover, neither the capital ratio differentials between the United States and Japan nor those between the United States and Europe have narrowed since the inception of the Basle Accords.\textsuperscript{71}

\textsuperscript{62} Scott, supra note 47, at 886.
\textsuperscript{63} Id. at 887.
\textsuperscript{64} See Macey & Miller, supra note 16, at 745.
\textsuperscript{65} See Scott, supra, at 886-87.
\textsuperscript{66} See id. at 887.
\textsuperscript{67} See id. Scott noted that "[n]o depositor in Japan has lost a single Yen due to bank failure since the end of World War II," while U.S. depositors have often been required to absorb significant losses. Id. In addition, the safety net of European countries is also stronger than that of the U.S. because the European countries have either "fewer but larger banks (too big to fail), or [they] have state-owned banks." Id.
\textsuperscript{68} Id. at 887-88.
\textsuperscript{69} See id. at 888 (citing Federal Reserve, Japanese Securities Report).
\textsuperscript{70} Id. at 889 (citing American Banker).
\textsuperscript{71} Id.
Not only have the Basle Accords not leveled the international playing field with respect to capital, "it would be a total accident if it did so given the disparate effects of regulatory, market, accounting and tax differences among countries." Moreover, the Basle Accords's risk-weight categories create competitive distortions based upon differences between domestic economies. Japanese banks typically have higher levels of private loans relative to the U.S., which are risk-weighted at 100%. The U.S., by contrast, has relatively higher levels of residential mortgages, which carry a risk-weight of 50%. Thus, the Basle standards themselves place Japanese banks at a competitive disadvantage relative to the U.S. banks. Residential mortgages, which are favored by the Accords, are a more important part of the U.S. banking market than the Japanese banking market, while private loans, which are disfavored, are more important to Japanese banks.

What about safety and soundness of the Basle Accords? While no systematic analysis has yet provided a clear answer as to whether the Basle Accords have achieved this objective, Robert Litan has shown that their framework can contribute to credit crunches in periods of economic downturn. Litan's analysis casts a strong shadow over any claim that the Accords have improved the safety and soundness of the banking system. The Basle Accords have this effect because their "risk weights tilted the incentives of banks heavily toward investing in government bonds [risk-weight of 0%] rather than making loans." Assuming a bank must pay 3% to attract deposits and 10% for equity, the implication of these risk-weights is that a bank's cost of funding to invest in government bonds is 3%, while its cost of funding for a private loan is 3.56%.

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

It is no doubt true that weak demand for commercial loans has contributed to this situation. But the undeniable fact re-
mains that before the Basle Accord . . . the cost of funding both
government bonds and loans were the same. . . .

Moreover, by pushing banks into playing the government
bond yield curve, the risk weights are impelling banks to take on
greater interest rate risk, which may come to haunt them when
the yield flattens, as it eventually will.79

Thus, the public-interest theory’s safety, soundness, and com-
petitive equality arguments fall short. Moreover, public-interest
theory fails to explain why a country would be willing to sacrifice
its autonomy in order to take part in the Basle Accords.

3. The Basle Accord from the Public Choice Perspective

The public choice model provides a much more useful per-
spective on the Basle Accords. Consistent with the public-interest
view, the public choice perspective traces the regulatory innova-
tions culminating in the Basle Accords to the market and techno-
logical innovations of the past twenty years. These exogenous
market and technological forces posed a significant threat to the
national regulatory structure of countries like the United States
and the United Kingdom. In response to this threat, the bank reg-
ulators in those countries pushed the Basle agenda in an attempt to
protect their autonomy in the face of international competition.
Indeed, the Accords are entirely consistent with the desire on the
part of regulators to avoid regulatory obsolescence.

The principal effect of the technological change and the
globalization of markets over the past two decades has been to re-
duce the entry and exit barriers which had maintained financial in-
stitutions within domestic boundaries.80 This, in turn, has made it
easier for regulated firms to migrate to more sympathetic regula-
tors, and has caused increased competition among national regula-
tory authorities. In this competition, the United States has “been
losing market share in securities and banking to foreign regulators,
particularly to the Japanese.”81

This emerging loss of market share to the Japanese has forced
nations such as the United States and the United Kingdom to re-
spond with demands for “harmonization” in order to maintain
some degree of autonomy.82 From their position of relative
strength, regulators in Japan’s Ministry of Finance saw little need

79 Id. at 8-9.
80 See Kane, supra note 5, at 44.
81 Id.
82 Id. at 45.
to enter into an international accord. Moreover, Japanese banks were not undercapitalized when the Basle Accords were being discussed. Rather the reverse: Japanese banks were solidly capitalized.83

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

In this context, it is important to note that it was only after United States regulators threatened to exclude Japanese banks from United States markets that the Japanese were drawn into the fold.84 In other words, Japanese regulators could report back to their bank clientele that they had no choice but to enter into the Accords, or else the consequences for Japanese banks would be even worse. The Japanese regulators at Basle probably could have resisted the threat of exclusion from the United States markets by promising to protect depositors against loss. But they most likely did not want to do so because signing the Basle Accords increased the power and autonomy of Japanese regulators.

**B. Insider Trading Regulation**

1. **Background**

The recent trend toward international regulation of insider trading provides another example of how the trend in internationalization is consistent with the desire of the nation to maintain its autonomy.85 As recently as the mid-1980s, actual enforcement of insider trading regulations was largely confined to the United States. Most other major financial center nations either did not

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83 We are grateful to Raghuram G. Rajan of the University of Chicago for reminding us of this historical fact.
84 See Kapstein, supra note 46.
have insider trading regulation (e.g., Germany) or, if they did, did not actively enforce the regulations (e.g., Japan). Today, "[v]irtually every country with a major stock market has adopted, or is actively considering, provisions outlawing insider trading." For example, in 1989, the European Community adopted a directive calling for the coordination of regulations on insider trading. Even more striking is the fact that in June 1994 the German Parliament authorized legislation making insider trading a crime for the first time in that country's history.

Given the fact that many of these nations, especially Germany, historically failed, and even still fail, to view insider trading with the same hostility that Americans do, this recent global regulation appears to contradict the theory that the nation state would act to maintain its autonomy. However, as was the case with the Basle Accords, this recent trend reflects the response of a nation confronted with obsolescence in a regulatory arena that is faced with technological change, market processes, and exogenous variables. In particular, the recent trend toward globalization of insider trading regulations represents a response by the Securities and Exchange Commission ("SEC" or the "Commission") to protect its own power through international accords, and through pressuring other nations to adopt an insider trading framework analogous to that of the United States.

2. The United States's Insider Trading Framework

The SEC's power to regulate insider trading derives from the existence of domestic federal statutes prohibiting insider trading and allocating the power to enforce the prohibition to the Commission. Current insider trading laws forbid the purchase or sale of corporate stock by employees or other closely associated individuals based on information that is not publicly available. The source of these laws derives primarily from Section 16(b) of the Securities and Exchange Act of 1934, and judicial interpretation
of both Section 10(b) of the Exchange Act and Rule 10b-5 promulgated by the SEC under authority granted to it by Section 10(b). Section 16(b) of the Exchange Act requires corporate officers, directors, and other statutorily defined insiders to disgorge profits made from the purchase and sale of equity in their firm within any six month period. This statute, however, is minimally effective against insider trading since penalties are easily avoided by holding onto securities for longer than the required six months.

Section 10(b) of the Exchange Act, however, is far broader than Section 16. It prohibits "any deceptive or manipulative device or contrivance in contravention of such rules and regulations as the Commission may prescribe" relating to securities trading. Under this congressional grant of authority, the SEC crafted Rule 10b-5, which requires an individual who possesses material inside information to either refrain from trading or publicly disclose that information well before trading in the relevant stock. Specifically, Rule 10b-5 makes it unlawful:

(a) To employ any device, scheme, or artifice to defraud; (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading; or (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

This regulation serves as the basis for the prohibition against insider trading.

The language of Section 10(b) and Rule 10b-5, however, is not facially limited to insiders. "The term 'insider' is not even de-
fined in the statute[s]." In fact, the Supreme Court greatly narrowed the scope of the regulations in \textit{Chiarella v. United States},\textsuperscript{101} and \textit{Dirks v. SEC},\textsuperscript{102} two opinions that dealt considerable blows to the SEC's power and prestige.

In \textit{Chiarella}, a financial printer made stock purchases based on confidential information regarding client companies obtained through his employment with Pandick Press.\textsuperscript{103} The printing company produced mandatory filings for tender offers on target company securities.\textsuperscript{104} Chiarella used the information submitted to Pandick to purchase stock in the target companies prior to public disclosure of the offers.\textsuperscript{105} The defendant was subsequently charged with violating Section 10(b) of the Exchange Act and Rule 10b-5.\textsuperscript{106} The Second Circuit found that Chiarella did not violate the statute, stating that possession of nonpublic information does not by itself establish an affirmative duty to disclose or refrain from trading the pertinent security.\textsuperscript{107} The Court held that a fiduciary duty, arising from a contractual or quasi-contractual relationship, must be present to establish liability under Rule 10b-5.\textsuperscript{108} Since Chiarella had neither a contractual relationship nor a position of trust with the client companies, he did not have a fiduciary duty to disclose.\textsuperscript{109} The Court's ruling in \textit{Chiarella} was reaffirmed several years later in \textit{Dirks v. SEC},\textsuperscript{110} another landmark insider trading decision. In this case, Raymond Dirks, an investment analyst, sold to his investment clients insider tips which he received from a former officer of Equity Funding of America concerning a massive fraud within the company.\textsuperscript{111} He advised his clients to sell stock in Equity Funding based upon the damaging information he received directly from the corporation.\textsuperscript{112} The Court held that since Dirks had no connection with Equity Funding, he could not possibly owe a fiduciary duty to the corporation. According to the Court, absent

\textsuperscript{100} Mann & Lustgarten, \textit{supra} note 93, at 14.
\textsuperscript{101} 445 U.S. 222 (1980).
\textsuperscript{102} 463 U.S. 646 (1983).
\textsuperscript{103} 445 U.S. at 224.
\textsuperscript{104} \textit{Id.}; see also Mann & Lustgarten, \textit{supra} note 93, at 14.
\textsuperscript{105} \textit{Chiarella}, 445 U.S. at 224; see also Mann & Lustgarten, \textit{supra} note 93, at 14.
\textsuperscript{106} \textit{Chiarella}, 445 U.S. at 225; see also Haddock & Macey, \textit{supra} note 90, at 157-58 (discussing \textit{Chiarella}).
\textsuperscript{107} \textit{Chiarella}, 445 U.S. at 235.
\textsuperscript{108} \textit{Id.} at 228.
\textsuperscript{109} \textit{Id.} at 232-33.
\textsuperscript{110} 463 U.S. 646 (1983).
\textsuperscript{111} \textit{Id.} at 648-49; see also Haddock & Macey, \textit{supra} note 90, at 158 (discussing \textit{Dirks}).
\textsuperscript{112} \textit{Dirks}, 463 U.S. at 648-49 ("[S]enior management denied any wrongdoing, but certain corporation employees corroborated the charges of fraud.").
a fiduciary duty, there could be no liability under SEC Rule 10b-5.\textsuperscript{113}

These cases rejected the equal information requirement for all traders that had been the prevailing interpretation of Rule 10b-5, and the interpretation favored by the SEC for decades.\textsuperscript{114} The "equal access to information" doctrine declared that:

all members of the investing public should be subject to identical market risks,—which market risks include . . . the risk that one's evaluative capacity or one's capital available to put at risk may exceed another's capacity or capital . . . . Such inequalities based upon unequal access to knowledge should not be shrugged off as inevitable in our way of life . . . . \textsuperscript{115}

Following Chiarella and Dirks, the equal access theory to information was replaced by the theory that no duty to disclose arises "where the person who has traded on inside information 'was not [the corporation's] agent, . . . was not a fiduciary, [or] was not a person in whom the sellers [of the securities] had placed their trust and confidence.'"\textsuperscript{116} The duty to disclose is, therefore, now limited solely to true insiders.\textsuperscript{117}

3. International Insider Trading Regulation from a Public-Interest Perspective

According to the public-interest theory, insider trading laws were enacted to protect investors from unfair competition in financial markets.\textsuperscript{118} Unfortunately for the SEC, although insider trading was long prohibited in the United States, in most other countries it has been legal for years.\textsuperscript{119} This immediately calls into question the legitimacy of the often summarily accepted proposition that insider trading is, in fact, bad for both markets and investors in light of the robust capital markets that exist in trading forums like Japan, Hong Kong, Singapore, and Germany, where insider trading has long been either \textit{de facto} or \textit{de jure} legal.

In order to determine whether the public-interest theory explains the SEC's pursuit of international insider trading agree-

\textsuperscript{113} Id. at 664-67.
\textsuperscript{114} See Haddock & Macey, supra note 90, at 155 (citing Chiarella, 445 U.S. at 232-33).
\textsuperscript{116} Dirks v. SEC, 463 U.S. at 654 (quoting Chiarella, 445 U.S. at 232). \textit{See also} Haddock & Macey, supra note 90, at 155.
\textsuperscript{117} See Haddock & Macey, supra note 90, at 155.
\textsuperscript{119} See Haddock & Macey, supra note 90, at 149.
ments, some insight into the benefit accorded to the public by the promulgation of regulations against insider trading is required. Investors in capital markets can earn significant returns by obtaining information relating to a firm's future prospect that is not already reflected in the firm's share price. Profiting from investments requires two things: first, the ability to acquire information not already reflected in the share price and, second, the ability to access the market with this information through the purchase or sale of shares. To determine whether insider trading laws truly serve the public interest, their effect on various types of investors must be examined.

There are three primary groups of stock market investors: (1) true insiders, (2) quasi-insiders, and (3) outsiders. True insiders are individuals who are closely associated to a particular firm and have instant access to firm-specific information not readily available to others. This group includes corporate officers and directors, legal counsel, employees, and others who may reasonably be expected to have privileged access to information about the future value of the firm by reason of their employment status.

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

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120 See id. at 151.
121 See id.
122 See id.
123 See id.
124 See id. at 151-52.
125 See id. at 152.
126 See id.
127 See id.
128 See id.
mitigates against the natural advantage enjoyed by true insiders.\textsuperscript{129} In light of existing insider trading laws in the United States, which prevent true insiders from trading in firms with which they have a professional affiliation, quasi-insiders, the next best information processors permitted to trade, will benefit from the insider trading laws because they will be able to take advantage of new-found information about the share values and translate that information into an effective trading strategy.\textsuperscript{130}

Outsiders comprise the third group of market investors. Members of this group include ordinary shareholders and the general public.\textsuperscript{131} Outsiders are at a tremendous competitive disadvantage in acquiring new information vis-à-vis true insiders and quasi-insiders since they do not have a personal connection to the firm like true insiders.\textsuperscript{132} Moreover, they lack the ability to analyze and utilize firm-specific information as quickly as quasi-insiders.\textsuperscript{133} Outsiders are, therefore, the least likely group to profit from new information. Even in the absence of trading by true insiders, by the time the true outsiders get new information that will affect share prices it will be too late for them to profit from it because market professionals already will have caused share prices to adjust to their correct levels.

Current insider trading laws in the United States apply only to true insiders.\textsuperscript{134} In the absence of these restrictions, true insiders would have a clear advantage over the remaining two groups. Rather, insider trading laws work to the advantage of quasi-insiders, like Chiarella and Dirks, at the expense of true insiders.\textsuperscript{135} The vast majority of the American public, however, are not quasi-insiders. It is, therefore, not necessarily true that these regulations benefit most Americans. Moreover, it has been argued that insider trading is not necessarily bad for markets.\textsuperscript{136} At a minimum, no one has clearly articulated why firms should not be allowed to vol-

\textsuperscript{129} See id. True insiders, by contrast, do not have an equal incentive to invest resources in applying information to trading markets. See id.
\textsuperscript{130} See id.
\textsuperscript{131} See id. at 152-53.
\textsuperscript{132} See id. at 153.
\textsuperscript{133} See id.
\textsuperscript{134} See id.
\textsuperscript{135} See id. at 153.
\textsuperscript{136} See Henry G. Manne, Insider Trading and the Stock Market 166 (1966); Haddock & Macey, supra note 90, at 154.
untarily exempt themselves from insider trading laws if the shareholders deem it to be in the best interests of the corporation.\textsuperscript{137}

If domestic insider trading laws do not benefit the general public, then expanding the ban on insider trading internationally cannot be consistent with public-interest theory. Consequently, public-interest theory does not accurately explain the motivation behind the SEC's pursuit of international insider trading agreements. Moreover, even if insider trading were found to be harmful to the capital markets in a particular nature, it is by no means clear why the government would want to export insider trading prohibitions to other countries. Why would any rational country want to help rival nations develop competing capital markets in light of the global competition for capital?

4. \textit{International Insider Trading Regulation from a Public Choice Perspective}

Public choice theory provides a more persuasive explanation of the SEC's pursuit of international insider trading agreements. The SEC faced the problem that few countries had similar laws.\textsuperscript{138} This created an incentive for insider traders to conduct their transactions in any one of the numerous countries that were not subject to similar prohibitions. This exogenous factor undermines the power of the SEC's enforcement authority, threatening to make the agency irrelevant in this area. The battle for self-preservation, however, cannot be won in the domestic arena. Thus, the agency is forced to engage in the second-best alternative, which involves cooperation and assistance from abroad. The agency's willingness to enter into international agreements is consistent with its desire to consolidate its own power.\textsuperscript{139}

Within the insider trading context, the SEC's power to enforce its regulations disappears if the Commission cannot successfully prevent insider trading abroad. As capital markets become more global, people with inside information can easily use it in trading markets outside of the United States. Within these foreign markets meaningful insider trading regulations may simply not exist, and if they do, regulators may be unwilling to enforce them. Moreover, the bank secrecy laws of several European countries add to the


\textsuperscript{138} See Haddock & Macey, \textit{supra} note 90, at 149.

\textsuperscript{139} See Macey, \textit{supra} note 33, at 912-14.
difficulty of enforcing local rules in the United States.\textsuperscript{140} These aspects of overseas markets are useful tools for nonresidents wishing to circumvent domestic insider trading laws here in the United States.\textsuperscript{141}

In response to these threats, the SEC not only expended significant resources in investigating and prosecuting transnational insider trading cases, but also “exerted pressure in countries to prohibit insider dealing and to provide the Commission with information on insider trading cases.”\textsuperscript{142} For example, Switzerland enacted article 161 of its Penal Code in 1988 criminalizing insider trading largely in response to pressure from the United States.\textsuperscript{143} Likewise, Japan stepped up enforcement of its previously ignored insider trading regulations due to the United States’s pressure.\textsuperscript{144} The SEC’s influence can also be seen behind the European Community’s 1989 Council Directive obligating member nations of the Community to adopt insider trading regulations by 1992.\textsuperscript{145}

Perhaps the most telling example of the SEC’s influence is Germany’s recent adoption of insider trading legislation in July 1994, making insider trading a crime for the first time in Germany’s history.\textsuperscript{146} Obviously, “the SEC cannot dictate Germany’s insider trading rules . . . nonetheless [the SEC] made its disapproval of [Germany’s] current system known both directly and indirectly through the prosecution of high-profile cases involving transactions originating in Germany that violate United States insider trading laws.”\textsuperscript{147}

It is important to note that the SEC’s “lobbying” to get other nations to adopt insider trading regulations is an even more power-

\textsuperscript{140} See Haddock & Macey, supra note 90, at 150.
\textsuperscript{141} See C. Edward Fletcher, MATERIALS ON THE LAW OF INSIDER TRADING 554 (1991).
\textsuperscript{142} Pitt & Hardison, supra note 85, at 204 n.26. See Reauthorization for the Securities and Exchange Commission, 1992-94, Hearing before the Subcommittee on Securities and Senate Committee on Banking, Housing and Urban Affairs, 102d Cong., 1st Sess. 22 (July 25, 1991) (testimony of Richard Breeden, Chairman of the United States Securities and Exchange Commission, requesting further increases in resources available to the SEC for international enforcement and assistance initiatives).
\textsuperscript{143} See id. at 204 n.29. See also Haddock & Macey, supra note 90, at 150.
\textsuperscript{144} See Pitt & Hardison, supra note 85, at 205 n.36 (citing Michael Hughes, Insider Trading Like Polygamy—Depends Where You Do It, REUTERS BUS. REP. (March 27, 1989) (quoting Japanese broker as stating that Japan upgraded criminal penalties for insider trading in response to pressure from the United States)).
\textsuperscript{146} See Standen, supra note 89, at 177.
\textsuperscript{147} Id. at 200. Notably, by focusing on the possession of inside information as opposed to the existence of a fiduciary duty, the Council Directive and German regulations have a much broader scope than their United States counterparts.
ful form of "coordination" than merely working to obtain an international agreement relating to insider trading. An international agreement lacks the enforcement authority of a domestic regulation and can be easily side-stepped or ignored.

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

Finally, the SEC has negotiated bilateral agreements, treaties, or memoranda of understanding with its counterparts in other nations. These negotiations have resulted in enhanced procedures to access international information pertaining to SEC investigations. The SEC has successfully reached accords to deal with the problem of insider trading through secret bank accounts with several nations, including Switzerland, the Cayman Islands, Brazil, the United Kingdom, Canada, Japan, France, and the Netherlands.

In 1988, Congress supplemented existing SEC authority to reciprocate exchanges of information by providing that:

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

148 See id.
149 See id. at 554-55.
150 See id. at 555.
151 See id.
matters to the Commission; and (B) compliance with the re-
quest would prejudice the public interest of the United States.\textsuperscript{152}

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

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

CONCLUSION

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

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

Local bureaucracies will enter international agreements that
sacrifice some of their national sovereignty in order to avoid the
specter of becoming irrelevant. This thesis, as exemplified in both
the Basle Accords and efforts by the SEC to internationalize in-
side trading laws, provides a new way to explain international eco-
monic coordination in an era of increasing global competition.

In sum, the purpose of this Article has been to view interna-
tional cooperation from a public choice perspective. The hypothe-
sis is that the behavior of politicians, interest groups, and
bureaucrats in the international arena is no different than their be-

\textsuperscript{152} Id. See Insider Trading and Securities Fraud Enforcement Act of 1988, Pub. L. No.
of the 1934 Securities and Exchange Act).
behavior elsewhere. We live in a rent-seeking society and international agreements reflect this. This Article has applied this perspective to two important sources of international cooperation: insider trading on securities markets and capital requirements for banks. In these settings, international cooperation was driven by concerns on the part of regulators that the increasingly internationalization of capital markets was eroding their ability to regulate. Financial market regulators are concerned about their ability to regulate in a world in which capital can be transferred around the world quickly, business can be conducted across borders at very low cost, and institutional structures can be changed in order to avoid regulation.

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

We can expect an international accord among financial regulators whenever the agreement involves a smaller sacrifice of autonomy than the autonomy that would be lost by normal market processes as firms migrated to the most liberal regulatory environment. This Article explains that the increasing globalization of markets, brought about largely through exogenous technological developments, has increased the regulators' incentives to enter into international accords by raising the loss of power to bureaucrats who do not enter into them.

Moreover, this Article does not claim that all international accords are fueled by concerns about losing regulatory turf. In many contexts, regulators, politicians, and interest groups have other concerns. The point here is that technological change has made concerns about relevance very important in the area of global corporate finance. In other areas where international accords are discussed, such as the environment, national security, aid to developing nations, and monetary policy, other concerns are likely
to dominate (however, the particular analysis used here would seem to apply with particular force to the desire of European countries to bind themselves together more closely into the European Union, in order to avoid irrelevance on the world stage—but that broad topic should be the subject of future research).

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