

INTERNATIONAL LAW ASSOCIATION
RIO DE JANEIRO CONFERENCE (2008)
INTERNATIONAL SECURITIES REGULATION

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EIGHTH INTERIM REPORT

Part I – Overview

The pace of developments in the Committee’s assigned field during the biennium between the Association’s 72nd (Toronto, 2006) and 73rd (Rio, 2008) Conferences has been rapid indeed. The introduction and spread of new securities and securities-like instruments, and the appearance and utilization of new market instrumentalities, have posed extraordinary challenges, with the result (among others) that attention of the Committee has been diverted in some part from the cataloguing of developments to the analysing, anew, of regulatory fundamentals across markets and across borders. Due to this trend, this Report opens with a description of ‘principles-based’ regulation (Part II), and follows with a review of selected corporate governance developments in different national contexts (Part III). Part IV provides a global overview of *sukuk* rooted in Islamic law principles, while Part V analyses potential impact of ‘sovereign wealth funds’ on cross-border capital markets. The Report then explores the emergence of ‘mutual recognition’ as a possible framework for international securities regulation (Part VI), and concludes with a rehearsal of themes that have been the repetitive objects of the Committee’s attention since its establishment two decades ago.

Readers may justly inquire why the extraordinary market events emanating from the global credit crisis of 2007-2008 are omitted from this Report. The Committee has taken the view that we are simply too close in time to those events to place them properly in the spectrum of the developments that are here described. Concerned readers are referred to a forthcoming article by the Committee’s Rapporteur analysing and proposing solutions for the global credit crisis.¹

¹ E Avgouleas, *The Global Credit Crisis, Behavioural Finance, and Financial Regulation: In Search of a New Orthodoxy*, 8 J Corp L Studies (forthcoming).

Officials of the Association, other participants in the Association's activities through their respective national Branches, and unaffiliated readers of this Report are invited to consider its contents in the light of a set of contrapuntal themes that appear to the Committee to underlie the discrete issues discussed in this Report: first, the impact – beneficial but also constrictive – of convergence in national responses to market issues; second, the presence or absence of structures for accountability by securities market regulators to the markets their regulation serves; third, the implications – for market interaction and also for the ability of individual financial markets to perform their necessary functions – of adherence by different market regulators to varying fundamental regulatory principles; and finally, the extent to which national and international 'law' in the securities regulatory arena is now created by transnational regulatory networks such as CESR and IOSCO rather than by States or by Supra-National Entities to which States adhere.

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The Committee functioned during this most recent biennium through e-mail correspondence and a series of conference telephone calls in the European, Asian and American time zones in which topics for study and reporting were discussed and evaluated. Subsequent to this dialogue, initial drafts were completed by the following: Part II by Ms Ida Levine in London (who expresses thanks for assistance to her colleague James Browning and acknowledges that Part II also benefitted from review and suggestions by former British Columbia Securities Commissioner Robin E. Ford); Part III by Professor Etsuro Kuronuma in Tokyo (examining statutory developments in Japanese corporate law), Dr Dittmar Hagedorn in Stuttgart (addressing developments in German corporate law and European Union exploration of proportionality between capital and control), and Dr Friedrich Schwank in Vienna (discussing matters relating to embedded control systems under Austrian law); Part IV by Dr Nik Norzrul Thani in Kuala Lumpur (who expresses thanks to his associate Shamsul Qamar Abd Rani and his pupil Fadhlul Adnin Abdul Karim for their assistance); Part V by Professor Iain MacNeil in Glasgow (who acknowledges the research of Professor Justin O'Brien of the Centre for Applied Philosophy and Public Ethics at Australian National University as a principal source for Part V); and Part VI by the Committee's Chairman. Part VII reflects an effort by the Chairman to sketch themes for consideration by the Committee at its working session in Rio and, to the extent justified during the working session and approved by the Director of Studies and the Advisory Committee on Research, for extended study during the next biennium. Editing and compilation was done by the Rapporteur and the Chairman, prior to submission of the Report in draft form to the Committee members and alternates and thereafter in response to comments received from those members and alternates.

Part II – Principles-Based Regulation

National and international securities regulation has at least since the Great Depression been constructed on a rules-based model. Detailed prescriptions of desired or prohibited conduct have been written to govern the activities of market professionals vis-à-vis one another and vis-à-vis their non-professional customers. Enforcement by regulatory or judicial bodies has proceeded from perceived violations of those detailed rules..

Market participants themselves have often called for the clarity that detailed rules are thought to bring. Reassessment of ruled-based regulation and a turn to 'principles-based regulation' ('PBR') is of relatively recent vintage and is often associated with the UK's Financial Services Authority ('FSA'). As described by the FSA:

Principles-based regulation means placing greater reliance on principles and outcome-focused, high-level rules as a means to drive at the regulatory aims we [the FSA] want to achieve, and less reliance on prescriptive rules....Principles-based regulation also means a different approach to how we [the FSA] deal with regulated entities, whether in the context of day-to-day supervisory contact, the information we request or, when necessary, the way we use our enforcement powers. It also means different expectations of firms and how they engage with the regulatory issues they face. Our aim is to focus more clearly on the outcomes we as regulators want to achieve, leaving

more of the judgement calls on how to achieve those outcomes to the senior management of the firms.²

Using that description as a touchstone, recent actions by US financial regulators become more easily comprehensible. Recent actions include the publication of *The Department of the Treasury Blueprint for a Modernised Financial Regulatory Structure*³, and the gradual movement by the US Securities & Exchange Commission ('SEC') to modify some facets of its traditionally rules-based regime. Nonetheless, market events in both countries (characterised in the media as regulatory lapses) suggest that the future heralds a regulatory approach that appropriately combines aspects of both rules-based and principles-based regulation without accepting either approach in its entirety.

A. The UK Experience

1. *The Financial Services Authority and PBR*. In April 2007, FSA issued a paper setting out the increasing role that PBR would have in UK regulation.⁴ PBR was not new – FSA's Rules had been constructed around eleven high level Principles⁵ and four statutory objectives⁶ since 2001⁷ – but in the PBR Paper FSA suggested that the balance between prescriptive rules and high level principles would tip even further towards the latter. This emerged, in part, out of a realization by FSA that detailed rules had not been sufficient to address regulatory failings such as major mis-selling episodes.⁸ Other key themes from the PBR Paper included:

- *Regulatory outcomes*: An increased focus on high level principles to achieve regulatory *outcomes*; not detailed rules governing regulatory *process*. A recent example of this is the relaxation of the UK's previously detailed rules on financial promotions in that the desired outcome of 'fair, clear and not misleading' promotions remains the same, but there is now greater flexibility in how to achieve this goal.⁹
- *Senior Management Responsibility*: Increased involvement and responsibility of senior management and board directors in achieving the regulatory outcomes.
- *Engagement*: Encouragement of positive and open engagement by firms with FSA which would in turn provide a greater range of guidance to assist regulated firms in achieving their regulatory goals.

² Financial Services Authority, *Principles-Based Regulation: Focusing on the Outcomes that Matter*, April 2007, 6, available at <http://www.fsa.gov.uk/pubs/other/principles.pdf> ('PBR Paper').

³ US Department of the Treasury, Office of Domestic Finance, *The Department of the Treasury Blueprint for a Modernised Financial Regulatory Structure*, 31 Mar. 2008, available at <http://www.treas.gov/press/releases/reports/Blueprint.pdf> ('US Treasury Blueprint').

⁴ The PBR Paper, *supra* note 2.

⁵ See *FSA Handbook of Rules*, Principles for Business Sourcebook, 2.1.1, available at <http://fsahandbook.info/FSA/html/handbook/PRIN/2/1>.

⁶ Financial Services and Markets Act 2000, Ch 8, Part I, §§ 3, 4, 5 and 6.

⁷ C Briault, Managing Dir. of Retail Markets, FSA, Speech at the Australian Securities and Investment Commission Summer School: More Principles-Based Regulation and Treating Customers Fairly, 7 Mar. 2007, available at http://fsa.gov.uk/pages/library/communication/speeches/2007/0307_cb.shtml.

⁸ *Id.*

⁹ Financial Services Authority, *FSA Handbook of Rules*, New Conduct of Business Rules Sourcebook, 4.2 and 5, available at <http://fsahandbook.info/FSA/html/handbook/COBS>; see also Financial Services Authority, *Financial Promotion and Other Communications*, Consultation Paper 06/20, Oct. 2006, 12-31, available at http://www.fsa.gov.uk/pubs/cp/cp06_20.pdf; Financial Services Authority, *Implementing the Markets in Financial Instruments Directive (MiFID)*, Policy Statement 07/02, Jan. 2007, 124-129, available at http://www.fsa.gov.uk/pubs/policy/ps07_02.pdf; Financial Services Authority, *Reforming Conduct of Business Regulation*, Policy Statement 07/06, May 2007, 109-116, available at http://www.fsa.gov.uk/pubs/policy/ps07_06.pdf.

2. A *'Regulatory Dividend'*. The PBR approach aims to allow firms increased flexibility in managing their businesses to meet their regulatory objectives and in responding to changes and innovations in the marketplace. FSA stressed that it expected the PBR approach to result in a 'regulatory dividend' citing relatively lower levels of regulatory capital, less frequent assessments and greater reliance on firms' senior management. However, the 'regulatory dividend' has not been without its price. It is now incumbent on firms to ensure that regulatory compliance is embedded in a firm's decision making process from the 'top down', and senior management must work with the firms' compliance departments in making judgements as to the best way to achieve a given regulatory outcome. This requires additional senior management attention, and more effort from legal and compliance departments as they seek to support senior management.

3. *The Challenges of PBR*. The PBR approach in the UK can be much more challenging for firms than a rules-based approach scrutinising process according to a static set of rules. In particular, PBR raises the following issues:

- *Guidance*: The length of the FSA Handbook of Rules has been significantly reduced as a result of PBR. Industry participants are now left with other sources of what they view as 'soft guidance' which they use in their efforts to achieve regulatory outcomes. Examples include speeches, 'Dear CEO letters', case studies, consultation papers, discussion papers, the FSA website, press releases and sector-specific industry codes (such as the UK's Pension Fund Disclosure Code for broking commissions¹⁰). Without a contained set of rules, keeping up with the different materials is an onerous task, especially for small firms and firms new to the sector. Engagement with a firm's own monitoring team for interpretive guidance may be ineffective, or may be undesirable due to potential inconsistencies between its interpretation and that of the FSA enforcement team in the event of a future problem.
- *Uncertainty*: As a result, firms can no longer be as certain that they have met their regulatory obligations. While FSA claims that firms will be able to rely on information produced by FSA, and that the status of the material will affect its significance in an enforcement context, the guidance may lack specificity and clarity. 'Sturdy breakwater' as opposed to 'safe harbour' may be the better way to view this guidance.¹¹
- *Enforcement*: The risk is that enforcement action may become less predictable. Despite using reasonable care to devise appropriate processes to meet regulatory outcomes, firms may find themselves subject to enforcement action on the basis of having breached a principle, especially if the breach has led to a risk to any of FSA's statutory objectives. Currently, FSA routinely brings enforcement action on this basis.¹² There is the risk of firms' actions being viewed with hindsight; as a result, for self-protection from legal risk, firms must carefully document the reasons why judgements are made under circumstances prevailing at the time.

4. *The EU Influence*. PBR has its limits, not least due to the provisions of MiFID¹³ and the Capital Requirements Directive ('CRD'),¹⁴ both implemented and in effect in the UK. Unlike earlier directives,

¹⁰ Investment Management Association, The Investment Management Association's Pension Fund Disclosure Code, Sept. 2007, available at <http://www.investmentuk.org/news/standards/pfdc3.pdf> (endorsed by the National Association of Pension Funds).

¹¹ See Briault, *supra* note 7.

¹² See 'Final Notices' published on <http://www.fsa.gov.uk> (frequently citing breach of a Principle as a ground for enforcement action).

¹³ Directive 2004/39/EC of the European Parliament and of the Council of 21 Apr. 2004 on Markets in Financial Instruments Amending Council Directives 85/611/EEC and 93/6/EEC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC ('MiFID'), Official Journal of the European Union, available at <http://eur-lex.europa.eu/LexUriServ/Le xUriServ.do?uri=CONSLEG:2004L0039:20060428:EN:PDF>.

¹⁴ The Capital Requirements Directive, comprising Directive 2006/48/EC of the European Parliament and of the Council of 14 Jun. 2006 Relating to the Taking up and Pursuit of the Business of Credit Institutions, Official Journal of the European Union, 30 Jun. 2006, available at http://eur-lex.europa.eu/LexUriServ/site/en/oj/2006/1_17/77/1_17720060630en00010200.pdf and Directive 2006/49/EC of the European Parliament and of the Council of 14 Jun.

MiFID suggests that additional detailed prescriptive rules (as opposed to principles-based rules) are the way toward greater regulatory convergence and compliance. Furthermore, certain areas simply do not lend themselves to PBR, such as the rules governing disclosure that firms must provide to retail customers – which must be consistent to promote comparability across Europe.

Based on the Basel II regime, the Capital Requirements Directive imposes minimum capital requirements on EU financial firms and incorporates a risk-based approach to determining capital adequacy. While base capital requirements are grounded on prescribed formulae, firms are also required to undertake a further assessment of the adequacy of their capital levels, an exercise referred to as the Independent Capital Adequacy Assessment Process or ‘ICAAP’. More than ever before, ICAAP challenges firms’ risk management departments and senior management to consider and scrutinise the risks facing their firms in more firm-specific detail.

5. *Progress Report*. In the light of recent events, it might be fair to say that in the UK the jury is still out on the success of PBR as a fundamental approach to regulation. It is clear that PBR presents a steep learning curve not only for firms, but also for regulators.¹⁵ It must be remembered, however, that in the UK the increasing emphasis on PBR is just that; it is not an outright rejection of the detailed rules-based approach to regulation. Instead, FSA combines the two approaches so that it may have the best of both in its regulatory armoury. If deployed effectively, PBR could foster a more far-reaching and effective regulatory structure: regulatory issues would be elevated to the forefront of firms’ governance structures and the regulatory framework would become more nimble and adaptable to market innovations. For firms, this could bring greater commercial flexibility and perhaps even a ‘regulatory dividend’, but also requires increased vigilance in reviewing FSA ‘soft guidance’ and in monitoring and implementing compliance processes. For the unprepared, the breadth of PBR provides a broad platform for exposure to enforcement.

B. The US Experience

1. *The SEC and PBR*. The US financial services market differs from that in the UK or Europe.¹⁶ The US regulatory system has developed to accommodate its retail investor sector and prevalent litigation. While primary legislation in the US may in some major instances provide broad principles (consider, for example, the US anti-fraud provisions¹⁷), the regulatory regime that has developed around it is detailed and rules-based. Accordingly, transactions with retail investors are governed by more specific rules, and regulated firms are provided with clearer boundaries of their responsibilities so that they may avoid regulatory enforcement action. In the past, the rules-based approach has been considered a more appropriate method of providing this certainty.¹⁸

Nonetheless, the US is beginning to move toward PBR partly perhaps as a response to a perceived diminution of competitiveness with the UK financial services industry and a concomitant perceived superiority of the UK regulatory regime. New York City Mayor Michael Bloomberg and former New York

2006 of the Capital Adequacy of Investment Firms and Credit Institutions, Official Journal of the European Union (30 Jun. 2006), available at http://eur-lex.europa.eu/LexUriServ/site/en/oj/2006/l_177/l_17720060630en0201_0255.pdf.

¹⁵ Financial Services Authority, *Executive Summary of FSA’s Internal Audit Review on the Handling of the Northern Rock Crisis*, 26 Mar. 2008, noted at 12 (explaining that ‘changes to the capital adequacy framework stemming from the reform of the Basel accord created a heavy workload’), available at http://www.fsa.gov.uk/pages/library/other_publications/miscellaneous/2008/nr.shtml.

¹⁶ See R C Campos, SEC Commissioner, US Securities and Exchange Commission, Speech at Luxembourg Fund Industry Association and the American Chamber of Commerce: Principles v. Rules, 14 Jun. 2007, available at <http://www.sec.gov/news/speech/2007/spch061407rcc.htm>.

¹⁷ 15 U.S.C. § 78j(b) (2007); 17 C.F.R. 240.10b-5 (2007).

¹⁸ The Institute of Chartered Accountants of Scotland, *Principles into Practice: Key Points from the Too Late for Principles? Conference October 2006*, http://www.icas.org.uk/site/cms/download/principlesintopractice_key_points.pdf.

State Governor Eliot Spitzer have both called for a UK-style system for regulating New York's financial services industry.¹⁹

Recently, the SEC announced that it intends to focus more on mid-sized broker-dealers' risk management controls through its existing risk management program²⁰ and proposed rule amendments that would require well-documented risk management controls from larger broker-dealers.²¹ Additionally, in its proposing release on amendments to the financial responsibility rules, the SEC noted that its regulatory objective is that firms have internal controls designed to manage material risk exposures to enable them to identify, analyse, and manage the risks inherent in the firm's business activities with a view to preventing significant losses.²² Currently, no specific rule mandates risk management controls for broker-dealers (except with respect to OTC derivatives and consolidated supervised entities); therefore, existing risk management programs are already carried out according to a principles-based approach. The increased focus on this will require more broker-dealers to assess their risk management controls along these principles-based lines. The proposed documentation requirement would further formalise this principles-based approach, increase its stringency and require many firms to devote more resources.

This approach takes into consideration many factors, not just compliance with the strict letter of financial responsibility and capital rules. In many respects, this approach to prudential supervision is very similar to the new approach required by the CRD in Europe. The SEC has also acknowledged, however, that risk management examinations are not intended to result in enforcement action but instead are intended to be constructive in terms of addressing risk.

2. *The Treasury's Blueprint for a Modernised Financial Regulatory Structure.* Following publication of the US Treasury Blueprint, a much more significant shift to PBR may be on the horizon in the US. The Blueprint is divided into short and medium-term recommendations and a long-term 'optimal regulatory structure' recommendation.

The short and medium-term measures focus primarily on consolidating the fragmented US regulatory landscape by establishing federal oversight of the mortgage, insurance and banking sectors and improving co-ordination between regulatory agencies and the process for accessing Federal Reserve liquidity. There is one notable exception in the medium-term: it is proposed that the SEC and the Commodity Futures Trading Commission ('CFTC') should merge. In connection with this agency merger, the US Treasury Blueprint recommended the adoption of 'core principles,' similar to those in use by the CFTC, for governance of exchanges and clearing agencies.²³ This structure, operating by reference to core principles, is similar to that of the FSA.

However, the long-term recommendation contains the most far reaching proposals for structural change and embraces a principles-based approach to regulation as a core feature of the 'optimal regulatory structure'. The key recommendations are to:

- Move away from functional regulation split across banking, insurance, securities and futures to a system where the same regulators regulate all financial services institutions.

¹⁹ The New York State Commission to Modernise the Regulation of the Financial Services Industry was established on 29 May 2007 and was expected to report by 30 June 2008; see *Panel to Help New York Retain Status as World Financial Capital*, Press Release, 29 May 2007, available at <http://www.state.ny.us/governor/press/0529072.html>.

²⁰ See M A Gadziala, Assoc. Dir., Office of Compliance Inspections and Examinations, 2007 AICPA/FMD National Conference on the Securities Industry: Risk Management for Broker-Dealers, 28 Nov. 2007, available at <http://www.sec.gov/news/speech/2007/spch112807mag.htm>.

²¹ Proposed Amendments to Financial Responsibility Rules for Broker-Dealers, Exchange Act Release No. 34-55431, 72 Fed. Reg. 12862 (19 Mar. 2007).

²² *Id.* at 12870.

²³ US Treasury Blueprint, *supra* note 3 at 111.

- Implement an objectives-based approach to address three core areas: (i) market stability; (ii) prudential supervision; and (iii) conduct of business, with an emphasis on consumer protection.
- Establish three distinct regulators: (i) a market stability regulator; (ii) a new prudential financial regulator; and (iii) a new conduct-of-business regulator.²⁴

The Federal Reserve would take on the role of market stability regulator, expanding its traditional role as supervisor of certain banks and their holding companies. The prudential regulator would focus on firms with federal guarantees, imposing capital adequacy requirements, investment and activity limits, and on-site risk management supervision. The business conduct regulator would monitor business conduct across all financial institutions with a view to providing more effective consumer and investor protection.

This is analogous to the UK system where FSA, the Bank of England and H.M. Treasury are responsible for different aspects of financial services regulation. Although their roles overlap, FSA discharges the roles of prudential and conduct of business regulator and supervisor of financial markets. While the Bank of England is responsible for market, financial and monetary stability affecting the financial system as a whole,²⁵ H.M. Treasury sets the legislative and institutional framework for financial system regulation.²⁶

C. Conclusion

PBR is becoming an increasingly significant component of the regulators' armoury. There are some signs that this may ease the way to greater regulatory convergence. PBR is, however, not a panacea and is likely to continue to be associated with detailed rules and requirements. The challenge for regulators will be to determine which areas should be subject to which type of approach, taking into account the particular commercial and cultural context being addressed. For these reasons, national regulators are likely to position themselves at very different points on the PBR spectrum, and a single or unified approach to PBR remains unlikely.

For firms, there are obvious challenges ahead. Senior management and boards will have to allocate sufficient resources to regulatory issues to absorb 'soft guidance' and to embed regulatory decision-making in firms' corporate governance structures. There may be a 'regulatory dividend' for those firms that embrace the challenge. Firms that fail to do so may attract principles-based enforcement actions. If these challenges are successfully met, the adoption of PBR should result in a more sophisticated and responsive approach to regulation, creating tangible benefits for the financial system generally and, equally, providing stronger protection for investors and consumers.

Part III – Selected Developments in Corporate Governance

Subpart First: The New Corporation Law in Japan

A. Corporate Structure under the New Corporation Law

1. *Enlarged Freedom in Designing Corporate Organs.* The new Japanese Corporation Law ('JCL'), replacing Corporate Law Chapters in the Japanese Commercial Code, was enacted in 2005 and implemented in 2006. JCL enlarged enterprise flexibility in designing corporate organs. By specification in its certificate of incorporation, a company can adopt a board of directors, auditors, a board of auditors, an accounting auditor, an accounting officer, and committees. Every company must have a shareholders' meeting and one

²⁴ US Treasury Blueprint, *supra* note 3 at 137.

²⁵ *Memorandum of Understanding Between the Bank of England, HM Treasury and FSA*, 22 Mar. 2006, 1-2, available at <http://www.bankofengland.co.uk/about/legislation/mou.pdf>.

²⁶ *Id.* at 3.

or more directors. Appointment and removal of directors, auditors, accounting auditors, and accounting officers is made by a resolution of the shareholders of each company.

2. Definitions.

To understand corporate governance issues under the JCL, it is important to understand the following definitions and rules for governance structure.

Closely held company: a company that restricts transfer of all of the classes of its shares by the certificate of incorporation. *Publicly held company*: a company other than a closely held company.

Large company: a company whose legal capital is more than 500 million yen (4.3 million US dollars) or whose liability is more than 20 billion yen (170 million US dollars). *Small company*: a company other than a large company. Some listed companies belong to the category of small company.

Director: the corporate organ in charge of operation of a company. Only a natural person is qualified to be a director. The director has corporate representative power except when the certificate of incorporation states otherwise or a board of directors is formed. *Board of directors*: the corporate organ that decides important corporate operations and monitors the operation of a company by the individual director. It appoints and removes the representative director. Three or more directors are required to form a board of directors.

Auditor: the corporate organ that has the power and duty to supervise the operation and accounting of a company. Only a natural person is qualified to be an auditor. Accounting knowledge is not required. *Board of auditors*: the corporate organ that has the power and duty to supervise the operation and accounting of a company. Three or more auditors are required to form a board of auditors. At least half of its members must be outside auditors.

Accounting officer: the corporate organ that helps the director prepare financial statements of a company and make the financial statements public on behalf of the company. The accounting officer must be appointed from among certified public accountants, accounting firms, certified tax accountants, or tax accounting firms. *Accounting auditor*: the corporate organ that has the power and duty to audit corporate accounting. The accounting auditor must be appointed from among certified public accountants or accounting firms. Any company can let certified public accountants or accounting firms audit corporate accounting voluntarily without adopting an accounting auditor as a corporate organ.

Committees: sub-bodies of the board of directors. If a company chooses to be a committee-type company, it must form a nominating committee, audit committee, and compensation committee. The nominating committee appoints candidates for director positions. The audit committee has the same power and duty as the board of auditors. The compensation committee decides the compensation of directors without a shareholders' meeting. Each committee consists of three or more directors and more than half of the members must be outside directors. A company with committees cannot appoint auditors. In the committee-type company, the board of directors appoints and removes representative and non-representative officers and delegates operational power to officers. The same person can be a director and an officer. The director, auditor, accounting auditor, accounting officer, and officer of a committee-type company owe fiduciary duty to the company and are liable to the company for the damage caused by any breach of their duties. Their liabilities to the company can be pursued by shareholder derivative suits.

3. Rules and Reasons for Governance Structure.

Rule on small closely held companies

Rule 1: Since the governance of small closely held companies is in the nature of a private contract, shareholders of a small closely held company can choose any combination of corporate organs in accordance with Rules 5 through 8 below, except that the combination of director(s) and board of auditors is not allowed.

Rules on larger companies

Rule 2: Large companies must have an accounting auditor because the number of creditors is large and creditors need audits by professionals.

Rule 3: Publicly held companies must have a board of directors and auditor(s) or must be a committee-type company. Since the composition of shareholders is unstable in publicly held companies, a corporate organ that monitors officers and directors on behalf of shareholders is needed.

Rule 4: Large publicly held companies must have a board of auditors or must be a committee-type company. Since monitoring by shareholders is ineffective in large publicly held companies, enhanced monitoring by a board of auditors is needed. Accounting audits by professionals are also needed (under Rule 2).

Rules attached to selection of corporate organs

Rule 5: When a board of directors is formed, the company must have either auditor(s) or committees. Because shareholders delegate power to operate the business to the board of directors by operation of law, an organ which monitors management is thought to be needed. For small companies, (i) the auditor's power can be restricted to accounting audits and (ii) the accounting officer can be an alternative to the auditor. When a board of directors is not formed, shareholders as a body have supreme powers to decide corporate affairs through their resolutions.

Rule 6: When the power of an auditor is restricted to accounting audits or when no auditor is adopted, the shareholders' power to monitor management is enhanced by law. Each shareholder has power similar to that of an auditor. In certain cases, each shareholder can call a directors' meeting, attend the meeting, and inspect minutes of the meeting without a court's approval. Each shareholder can also suspend illegal acts of directors with or without court approval. This rule is based on the perceived need for someone to supervise management in order to assure that the business is operated in compliance with laws and regulations.

Rule 7: Every company can be a committee-type company. If a company chooses to be a committee-type, it must also adopt an accounting auditor. Monitoring management in a committee-type company is done through 'internal control'. The internal control system is difficult to create and maintain without help from an accounting auditor.

Rule 8: When a company adopts an accounting auditor, it must either adopt an auditor or be a committee-type company. An auditor or audit committee is thought to be needed to secure independence of the accounting auditor.

B. The Powers of Corporate Auditors in Japan

While quite common among Asian countries, the corporate auditor system in Japan is hard for Europeans and Americans to understand. Before 2002, the history of corporate governance reform meant reform of the provisions concerning corporate auditors. In contrast, recent corporate governance reforms in Japan have been stimulated by failure of the auditor system.

In 1890, the Japanese Commercial Code adopted, from the German Corporation Law of 1870, the concept of auditors who have audit power over business operations and accounting. Monitoring by an auditor was thought to be necessary not for the shareholders but for governmental control of private companies. The 1950 Amendment of the Commercial Code introduced the board of directors. Because the board of directors monitored business operations, the range of monitoring by the auditor was restricted to the accounting by the corporation. After several large corporate accounting scandals, the 1974 Amendment of the Commercial Code extended the auditors' power to include audits on corporate business operations. The difference between the board of directors and the auditor is that the former monitors the efficiency of business operations while the latter monitors the legality of business operations. Measures of monitoring are also different. The most powerful weapon of the board of directors is to remove representative power from individual directors, while for the auditor it is the right to suspend illegal conduct by a director.

In parliamentary consideration of the 2002 Commercial Code Amendment, disagreement arose regarding which type of corporate governance is more effective to monitor corporate management. Generally speaking,

the business community tended to oppose the mandatory introduction of committee-type corporations. Thus, the 2002 amendment allowed large corporations to select either a board of auditors or a committee model, under the rubric ‘Competition among Institutions.’ In comparison to committee-type corporations, auditor-type corporations had both an advantage and a disadvantage in a practical sense. The advantage was that the auditor-type corporations were not required by law to have an internal control system. The disadvantage was that they could not distribute dividends without a shareholders’ resolution. These differences have diminished in the new JCL in the name of equal footing for ‘Competition among Institutions.’

C. Independent or Outside Directors under JCL

1. Legal Source of the Independent Director Mechanism

The concept of an ‘outside’ or ‘independent’ director is grounded in the conclusion that a director who does not have any direct relationship with the company’s top executive officers or with the company itself is able to make business decisions without undue influence from the executive officers. In Art. 2 of the JCL, an independent director is defined as a director who does not concurrently carry on any other business behaviour for the corporation directly. In other words, the director is not involved in the execution of business decisions and is not and has not been an employee of the company (or any subsidiary of the company) in which he or she serves as director. For this purpose, the term ‘employee’ includes director and any form of employee that is under the direction of the corporate chain.

2. Committee-Type Company

The 2002 Commercial Code Amendment (relevant rules were carried over into the JCL in 2005) first introduced the committee-type company. JCL Art. 400 (3) requires that more than half of the members of each committee in a committee-type company be independent directors. This amendment allows the boards of large companies (those most likely to be recipients of foreign investment) either to operate using the US-style single tier structure or to maintain their traditional Japanese-style structure. Those opting for the new system are required to establish three committees of the board of directors: a nominating committee, an audit committee and a compensation committee.

One of the reasons why the 2002 Amendment divided the board of directors into three committees was that it was practically impossible to require a majority of board members to be independent directors. By requiring a majority of committee members to be independent directors and giving each committee some decisive power on behalf of the board, a board of directors can function if only two board members are independent. Similarly, under the auditor board system, at least two outside auditors are needed. Therefore, two outside members are sufficient both for committee-type corporations and for auditor board-type corporations.

The executive officer is a mandated organ in a committee-type company. Executive officers have a one-year term, are elected by the board of directors and are delegated the power to carry out business (JCL Art. 402).

3. Purposes

The introduction of independent directors is thought to enhance the boards’ function of monitoring and prevent corporate misconduct. Traditionally in Japan, the representative director maintained the power to nominate the other directors and the auditors while at the same time being able to control corporate offices through a chain of command. This situation effectively restricted the efficacy of the monitoring function by the auditor and, since most directors are concurrently high-ranking officers, by the directors. Therefore, the key idea was to break the representative director’s dominance over the board of directors and allow the independent directors to play a more important role in corporate governance.

4. Current Implementation

The Tokyo Stock Exchange does not require listed companies to provide a certain number of independent directors nor does it impose certain qualifications for independent directors. Since 2006, the Tokyo Stock Exchange Listing Rules require listed companies to submit an annual Corporate Governance Report. The

Corporate Governance Report aims to improve the corporate governance of listed companies, in part by making public the backgrounds and other relationships of outside directors and outside auditors.²⁷

5. *Special Committee*

Following a wave of hostile takeovers in Japan, many listed companies have introduced defensive measures like shareholder rights plans adopted well before any hostile bidder appeared. Because defensive measures are exercised for the purpose of protecting shareholder value or corporate value, judgment as to the exercise of rights under shareholder rights plans is often vested in a special committee comprised of independent persons. On occasion, outside directors participate in the committee. Although there is no case on the issue, the independence of the members of such a committee is considered an important factor in any court proceeding assessing whether to reject a complaint by a bidder. Most members of such special committees owe no fiduciary duties to the target company. Therefore, some commentators argue that directors of the company are better-suited to determine whether to exercise defensive measures than are outside persons like lawyers and academics. Nonetheless, no case law or statute holds that a special committee is effective for the rejection of shareholder derivative suits seeking to hold directors liable toward their company.

D. Internal Control Systems

1. *Case Law Developments.* The Daiwa Bank Case in 2000 was a turning point for listed companies to build internal control systems. A judgment on the case by the Osaka district court required a former representative director of Daiwa Bank to pay US\$775,000,000 in damages to the company for failing to establish and implement a proper risk management system. Although the case was settled at the appellate court level, many academics and lawyers agree with the judgment that directors of a company have a fiduciary duty to construct internal control systems within the company. Such a duty was stipulated in the Commercial Code in 2004 and was implanted in JCL Art. 326 (6).

Since 1993 shareholder derivative suits have made major impacts on corporate governance. In 2008, the Supreme Court of Japan ordered approximately US\$50,000,000 damages against corporate directors who failed to assure compliance with regulations governing food safety.

2. *Internal Control Reporting under FIEL*

In 2005 the Japanese Financial Instruments and Exchange Law ('FIEL') replaced the former Securities and Exchange Law. FIEL requires listed companies to file internal control reports together with annual and quarterly financial reports. Internal control reports must be accompanied by an audit opinion by a certified public accountant or an auditing firm. FIEL also mandates that companies file a certification letter by the issuer's representative and CFO.

Rules and regulations on internal control over financial reporting are called 'J-SOX' and are applied for each fiscal year starting on or after April 1, 2008. Most listed companies have finished constructing their internal control systems in cooperation with their accountants. The J-SOX internal control report represents management's assessment of the efficacy of the company's internal control system. The Japanese report differs from its US counterpart in that the former adopts so-called indirect reporting. Nonetheless, listed companies are very sensitive to material weaknesses which might be pointed out by their accounting firms.

The J-SOX internal control report sheds light on the relationship between each company's internal auditors and its accounting firms. According to the auditing standards on internal control reports, accounting firms must assess the efficacy of corporate auditors in order to audit the reports. However, under the JCL, corporate auditors also assess financial auditing by accounting auditors. Such a discrepancy between FIEL and JCL is causing confusion in auditing practice.

²⁷ See generally Tokyo Stock Exchange, *TSE-Listed Companies: White Paper of Corporate Governance 2007*, Mar. 2007, available at <http://www.tse.or.jp/rules/cg/white-paper/white-paper07e.pdf>.

Subpart Second: Proportionality between Capital and Control in the EU

A. Definition

The principle of proportionality between capital and control ('one share – one vote') requires proportionality between economic risk and control in the sense that shared capital, which carries the right to participate in the profit of a company, should also carry proportionate control rights. If economic and control rights are separated, then certain shareholders, carrying more control rights than shares, might have an incentive to extract value from the company at the expense of non-controlling shareholders.²⁸ Non-controlling shareholders have to be protected against such abuse in order to guaranty the fair functioning of the financial markets. Nonetheless, there are many deviations from the principle of 'one share – one vote,' some of which are outlined below.

B. Background

In the 1920s, after a long period of accepting limited voting rights (particularly of individual shareholders in the United States), the New York Stock Exchange prohibited listings of firms with non-voting stocks. Since then, corporations in the United States have largely been committed to the 'one share-one vote' system, whereas the European countries have permitted a variety of deviations.

In 2001, the High Level Group of Company Law Experts appointed by the European Commission expressly determined that the holder of the majority of risk-bearing capital should be able to exercise control, and it suggested restoration of the 'one share-one vote' principle. This was followed by a period of consultations between 2001 and 2006 at the EU Commission. In 2006, the EU Commission mandated a consortium led by ISS Europe to identify existing deviations from the principle of proportionality in the EU member states, to analyse the role of the regulatory framework, and to evaluate its economic significance as well as its impact on investors.²⁹

C. The EU Deliberation

1. *ISS-Study*. Analysing thirteen Control Enhancing Mechanisms ('CEMs') in nineteen countries, the EC-mandated study was delivered to and discussed within the EU between May and December 2007. The CEMs analysed were multiple voting right shares, non-voting shares, non-voting preference shares, priority shares, voting right ceilings, depositary certificates, ownership ceilings, super majority provisions, golden shares, partnerships limited by shares, cross-share-holdings, shareholders' agreements, and pyramid structures. The countries analysed may be divided into different categories: those tending to constrain CEMs and those emphasising the 'freedom of contract' principle, which stipulates that corporations should organise themselves in the way they think is the best. None of the surveyed jurisdictions opted for either a pure 'one share-one vote' system or a pure 'right of self-organisation' principle. Most countries have implemented between five and eleven CEMs but the degree of unitisation of CEMs varies substantially from country to country.

Of the 464 analysed companies, 40% use CEMs. France, Sweden and Spain are the countries with the highest proportion of companies applying CEMs.³⁰ Fifty-two percent of all companies analysed are large companies; only 26% were listed recently.³¹ Pyramid structures and multiple voting right shares are the

²⁸ Commission of the European Communities, *Commission Staff Working Document: Impact Assessment on the Proportionality between Capital and Control in Listed Companies*, Brussels, SEC (2007) 1705, 12 Dec. 2007, 4, available at http://ec.europa.eu/internal_market/company/docs/shareholders/impact_assessment_122007.pdf.

²⁹ *Report on the Proportionality Principle in the European Union*, External Study commissioned by the European Commission, 5, available at http://ec.europa.eu/internal_market/company/docs/shareholders/study/final_report_en.pdf.

³⁰ *Id.* at 6.

³¹ *Id.*

CEMs with the highest proportion of use (27% and 21%, respectively) followed by shareholders' agreements (14%).³²

The majority of 445 institutional investors worldwide, with assets under management of €4.900 billion (of which 13% are attributed to Europe) have declared that they hold a negative view of CEMs generally. Most negatively perceived are priority shares, multiple voting right shares, voting right ceilings and golden shares. The majority of institutional investors take CEMs into account when making investment decisions, and calculate a discount on the share prices of between 10% and 30%.

2. *Options for action.* The *EU Commission's Staff Working Document: the Impact Assessment on the Proportionality between Capital and Control in Listed Companies*³³ outlined three options:

- (a) *Prohibition of CEMs created by companies.* Apart from the fact that not all CEMs (for example, pyramids and shareholders' agreements) are under the control of companies, the prohibition of CEMs may have negative consequences for companies' ability to access the capital markets or to establish long term policies.
- (b) *Enhancing transparency regarding CEMs.* The European Corporate Governance Forum ('ECGF') made three suggestions to enhance transparency: listed companies should explain the reasons, objectives and effects of their CEMs; shareholders should in certain cases be required to disclose the size and nature of their shareholdings as well as the policy they have on the exercise of powers attached to their holdings; and companies and shareholders should be required to provide more transparency on the recourse to non-proportional mechanisms.
- (c) *Doing nothing.* This would imply reliance on existing regulations, on the ground that they are dealing sufficiently with the issue. The existing legal framework, established at the EU-level, can be divided into four categories:
 - Recognition of the exercise of present control rights.
 - Prevention of conflicts of interests.
 - Transparency obligations, particularly under Directive 2006/46/EC on corporate government disclosures³⁴ and the Transparency Directive 2004/109/EC.³⁵
 - Recognition of the exercise of voting rights (and facilitation of the market for corporate control) under Directive 2007/36/EC³⁶ and Directive 2004/25/EC.³⁷

³² *Id.*

³³ See Commission of the European Communities, *supra* note 28 at 5.

³⁴ Directive 2006/46/EC of the European Parliament and of the Council of 14 June 2006 Amending Council Directives 78/660/EEC on the Annual Accounts and Consolidated, 86/635/EEC on the Annual Accounts and Consolidated Accounts of Banks and Other Financial Institutions and 91/674/EEC on the Annual Accounts and Consolidated Accounts of Insurance Undertakings, Official Journal of the European Union, 16 Aug. 2006, available at http://eur-lex.europa.eu/LexUriServ/site/en/oj/2006/l_224/l_22420060816en00010007.pdf.

³⁵ Directive 2004/109/EC of the European Parliament and of the Council of 15 December 2004 on the Harmonization of Transparency Requirements in Relation to Information about Issuers Whose Securities are Admitted to Trading on a Regulated Market and Amending Directive 2001/34/EC, Official Journal of the European Union, 31 Dec. 2004, available at <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2004:390:0038:0057:EN:PDF>.

³⁶ Directive 2007/36/EC of the European Parliament and of the Council of 11 July 2007 on the Exercise of Certain Rights of Shareholders in Listed Companies, Official Journal of the European Union, 17 Jul. 2007, available at <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2007:184:0017:0024:EN:PDF>

³⁷ Directive 2004/39/EC of the European Parliament and of the Council, *supra* note 13.

3. *The EU decision.* The EU Commission decided in December 2007 to choose in principle the ‘doing nothing’ option, for three main reasons:

- The Commission expected high monitoring costs under the first option and high disclosure costs for investors under the second option.
- There appeared to be no sufficient evidence of the benefits for the market under the first or second option. To the contrary, the risks of action appeared to be disproportionate to the likely benefits.
- Action would affect only a limited group of shareholders (minority shareholders) and would not affect all stakeholders that could have residual claims on the company (for example, creditors when the company defaults on covenants, or employees in countries which require that employees be represented on the board of directors).

D. Reaction, and Possible Future Treatment

Members of the ECGF expressed disappointment that the EU Commission dropped further exploration of proportionality and that it did not accept ECGF’s proposal to increase transparency. In ECGF’s opinion, the fragmentary systems within the European Community are obstacles to the creation of an integrated European financial market.

As a consequence of the Commission’s decision, ECGF decided to focus once again on its original mandate to monitor the convergence of the national Corporate Governance Codes. When more detailed information on existing national codes is available, the problem of shareholders’ rights may be put on the agenda again. Increasing market pressure enhances the probability that this subject will be crucial in the future, either directly or via the discussion of the revision of the Takeover Bids Directive or the protection of minority shareholders. Commissioner McCreevy has expressly pointed out that the actual decision was not meant to disregard minority shareholders’ protection.³⁸

The European Commission, however, continues to consider improving the effectiveness of the existing framework by enhancing (i) transparency on and around CEMs, notably on the actual use of CEMs by companies/voting right holders, their reasons for using them and the effects of their use, and (ii) disclosure requirements regarding related-party transactions involving persons benefiting from CEMs.³⁹ One relevant subject specifically addressed by the European Commission is the increasing use of less transparent financial instruments to acquire control of voting rights (for example, stock lending and related techniques) that separate ownership from control.⁴⁰ Nonetheless, it remains unclear which type of regulatory instrument—directive, regulation or recommendation—might be chosen in the case of further EC action.

Subpart Third: The German Corporate Governance Code (‘GCGC’)

The GCGC, implemented in 2002, has been amended by the Government Commission during its session of June 14th, 2007 mainly with regard to issues regarding the management board and the supervisory board.⁴¹

A. Management Board

The allocation of duties within the management board and especially the question of which duties should be allocated to the board as a whole have been discussed extensively in the German business community. The GCGC now requires that by-laws govern ‘the allocation of duties among individual Management Board

³⁸ European Corporate Governance Forum, Minutes of the meeting of 22 Nov. 2007, European Commission, 2, available at http://ec.europa.eu/internal_market/company/docs/ecgforum/minutes_22_11_2007_en.pdf.

³⁹ Commission of the European Communities, *supra* note 28 at 25.

⁴⁰ Commission of the European Communities, *supra* note 28 at 24.

⁴¹ German Corporate Governance Code (‘GCGC’), 14 Jun. 2007, available at <http://www.corporate-governance-code.de/eng/kodex/index.html>.

members, matters reserved for the Management Board as a whole and the required majority for Management Board resolutions (unanimity or resolution by majority vote).⁴²

Furthermore, the amended Code provides that ‘payments made to a Management Board member on premature termination of his contract without serious cause do not exceed the value of two years compensation (severance payment cap) and compensate no more than the remaining term of the contract.’⁴³ The severance payment cap is to be calculated on the basis of the member’s total compensation for the past full financial year and, if appropriate, the expected total compensation for the current financial year. Payments promised in the event of premature termination of a management board member’s contract due to a change of control may not exceed 150% of the severance payment cap. This provision implies that no severance payment should be granted if serious causes justify the termination of a board member’s appointment.

B. Supervisory Board

As the procedure for selecting the shareholders’ representatives has not been very transparent, GCGC now stipulates that the supervisory board should set up a nominating committee ‘composed exclusively of shareholder representatives, which propose suitable candidates to the Supervisory Board for recommendation to the General Meeting.’⁴⁴ Such a committee could define a distinct profile of the qualifications a company expects from its supervisory board members and continuously search for qualified and competent candidates who might be available in the market.

The duties of the Audit Committee have been extended by adding ‘compliance’ as a process falling within the committee’s purview.⁴⁵ In addition, the Audit Committee is also charged with obtaining information on the compliance program introduced by the management board and assessing whether the compliance program properly addresses the legal requirements and the company’s risk situation.

Subpart Fourth: Independent Embedded Control Systems in Austria

After the collapse of Enron and WorldCom in 2001 and 2002, some European systems that had been functioning under the two-tier corporate governance structure—a board of managing directors appointed by and under close control of a supervisory board—that had been traditional in various civil law jurisdictions, were strengthened in their conclusion that the two-tier structure was superior and, in particular, less susceptible to corporate fraud and deception than the unitary board of directors. Appreciation for this two-tier structure diminished, however, as Europe was shaken by the collapse of Italy’s Parmalat Group and the news of irregular diversion of funds in the Siemens Group. The result has been an ongoing search for improved tools of corporate supervision, scrutiny and audit.

Two-tier corporate governance structures have in practice demonstrated various flaws, particularly the following:

- Although combined with welcome compensation, serving on a supervisory board is often seen as a tedious job. Retired managing directors are often ‘pushed upstairs’ by appointment to membership on supervisory boards, partly as a tribute to their prior corporate careers and partly to provide a supplement to their old age pensions. Austrian legislation seeks to curtail this practice by requiring a two-year waiting period between retirement from a management board and appointment to membership on the same company’s supervisory board.

⁴² *Id.* § 4.2.1.

⁴³ *Id.* § 4.2.3.

⁴⁴ *Id.* § 5.3.3.

⁴⁵ *Id.* § 5.3.2.

- In some European countries, it is quite common for a person to serve on a number of supervisory boards. The benefit of cross-fertilization of knowledge and experience is, however, frequently outweighed by the lack of time and dedication to the supervisory board of any one particular company.
- As members of the supervisory board have frequently been managing directors of the company during the more active part of their corporate lives, there is a real danger that they may be too lenient with the current managing directors. In turn, the current managing directors may hesitate to probe past actions and policies of former managing directors. An alliance of wrongdoers on both boards could hide their mistakes from shareholders and the public.
- Some supervisory boards have too many members. This can result in no single member having responsibility for anything in particular. It is a common experience that individuals acting jointly in a group with other individuals act with less care and concern than an individual who must rely on his or her own discretion and be held individually accountable for making decisions.
- The participation of representatives of the works council on supervisory boards does have its benefits, but experience has shown that this participation can result in reluctance by the managing directors to provide full and frank information to the supervisory board.

In those companies where the two-tier corporate governance structure has failed, corporate fraud and deception would not likely have been prevented by internal scrutiny and external audit. The managing directors who engaged in fraud and deception were able to circumvent the traditional safeguards of corporate control and reporting. Legislators are seeking to create constraints that would be more difficult to circumvent. One such constraint is the independent embedded control system.

Austria has amended its corporate legislation with a view to having companies implement embedded control systems.⁴⁶ Article 82 of the Austrian Corporation Act was amended to provide that ‘the board of managing directors shall ensure the existence of both an accounting system and an embedded control system commensurate with the requirements of the enterprise.’⁴⁷ It should be noted that the legislature placed the embedded control system on the same level of importance as the accounting system.

The features of such an embedded control system are as follows:

- The embedded control system is an internal building block of the corporate enterprise. It is built into the organisation of the enterprise and therefore has immediate and intimate access to information quite different from access available to an external audit.
- The embedded control system is independent to the extent that it neither reports to nor is subject to supervision and instructions from the board of managing directors, the supervisory board or any audit committee established within the organization of the enterprise.
- The embedded control system is responsible for adapting and developing suitable means of control in line with the particular organisation and requirements of the enterprise. The system itself is a dynamic process that requires the individuals in charge of the system to develop and tighten the tools of control in line with the development of the enterprise, changing business practices and a changing business environment.
- The embedded control system is required to document its mechanisms, procedures, results and findings. This documentation becomes a part of the corporate books of the enterprise.
- The embedded control system is in turn subject to external audit. The auditor’s report has to evaluate both the results of the embedded control system and its effectiveness. In addition, the auditor will have to make a judgment as to the independence of the embedded control system.

⁴⁶ E.g. Austria: Article 82 Corporation Act (Aktengesetz) and Article 22 Limited Liability Company Act (GmbH-gesetz).

⁴⁷ Compare Article 22 Limited Liability Company Act with GCGC *supra* note 45 (Austrian limited liability companies are required to have an embedded control system).

Embedded control systems have become the subject of great scrutiny by organizations and legislatures, particularly as these systems are themselves works in progress that continuously change and improve in the effort to promote their effectiveness. A well-functioning embedded control system supports good corporate governance, seeks to assure that an enterprise will stay on track in pursuit of its business goals, assists in policing compliance, protects the assets of an enterprise, and helps to secure completeness and reliability of enterprise information, documents, data and corporate procedures.

Guidance and encouragement for further development of embedded control systems have been provided by, among others, the Institute of Internal Auditors⁴⁸, the International Organization of Supreme Audit Institutions⁴⁹, and the Committee of Sponsoring Organizations of the Treadway Commission⁵⁰ (in particular by its Enterprise Risk Management Framework). The European Union Directive 2006/43/EC,⁵¹ which includes specific reference to the duty of external auditors to evaluate the effectiveness of internal controls including internal revision and risk management of companies, and Directive 2004/109/EC,⁵² requiring member states to create institutions tasked with subsequent controls of external audits of public companies, have been relevant to legislative efforts.

Part IV – GLOBAL OVERVIEW ON SUKUK

A. Definition

Sukuk is a document or certificate that represents the value of an asset. The Auditing and Accounting Organization for Islamic Financial Institutions ('AAOIFI') refers to sukuk as 'certificates of equal value representing undivided shares in ownership of tangible assets, usufruct and services (or in the ownership) of the assets of particular projects or special investment authority, however, this is true after receipt of the value of the sukuk, the closing of subscription and the employment of funds received for the purpose for which the sukuk were issued.'⁵³

Sukuk is distinguished from shares, bonds, and notes as sukuk must have an intrinsic value. The AAOIFI defines 14 types of Sukuk, among others: Ijarah Sukuk (leasing certificates), certificates of ownership of usufructs (including Sukuk Manfa'at Al-Ijarah), Salam Sukuk (deferred commodity delivery certificates), Istisna' Sukuk (manufacturing or project finance certificates), Mudharabah Sukuk (partnership/finance trusteeship certificates), Murabahah Sukuk (purchase order documents) and Musharakah certificates (Joint Venture certificates).⁵⁴

AAOIFI states that investment sukuk does not represent debts owed by the issuer or certificate holder. Consequently, sukuk cannot be issued from *dayn* (debt) or debt receivables.⁵⁵ The standard outlined by AAOIFI has been reflected in numerous regulations in various jurisdictions. For instance, Article 1 of the *Kuwait Executive Regulation of Securities and Foundation of Investment Funds* defines sukuk as

⁴⁸ See www.theiia.org.

⁴⁹ See www.intosai.org.

⁵⁰ See www.coso.org.

⁵¹ Directive 2006/43/EC of the European Parliament and of the Council, of 17 May 2006, on Statutory Audits of Annual Accounts and Consolidated Accounts Amending Council Directives 78/660/EEC and 83/349/EEC and Repealing Council Directive 84/253/EEC, Official Journal of the European Union, 9 Jun. 2006, available at http://eur-lex.europa.eu/LexUriServ/site/en/oj/2006/l_157/l_15720060609en00870107.pdf.

⁵² Directive 2004/109/EC of the European Parliament and of the Council, *supra* note 35.

⁵³ 17th Shariah Standards of AAOIFI, Article 2.

⁵⁴ AAOIFI Shariah Standards.

⁵⁵ Badlisyah Abdul Ghani, Probing Creative and Successful Sukuk Issues (Islamic Bonds), Developing Islamic Banking & Capital Market: New Opportunities, New Market & New Frontier in Islamic Banking & Finance, Kuala Lumpur, Asian Strategy and Leadership Institute (ASLI), 2 (2004).

'instruments that have equal value issued by companies under certain types of contract which comply with the Islamic Shariah such as Musharakah, Mudharabah, ijarah or an investment agency in certain investment project or activity, subject to the provisions of the relevant laws'.

The position is different under Malaysian regulations. Since the contracts of Ba'i al-dayn and Ba'i Inah are acceptable to the Shariah Advisory Council ('SAC') in Malaysia, the Malaysian Securities Commission ('SC') applies sukuk to all types of securities including shares, bonds or notes.⁵⁶ The same adoption also can be found in *Central Bank of Bahrain (CBB) Debt Securities Guidelines*, which refers to sukuk as debt securities, consisting of debentures, loan stock, bonds, sukuk, subordinated debt, notes and other securities or instruments acknowledging, evidencing or creating indebtedness, whether secured or unsecured, conventional or Islamic, and options, warrants or similar rights to subscribe or purchase any of the foregoing, and convertible debt securities.

B. Current Trends of Sukuk Issuances in Different Jurisdictions

The past five years have seen a rapid surge in the global issuance of sukuk securities all over the globe. As a result of the strong finish, 2006 issuances were 2.36 times greater than the 2005 new issuance volume, and the gross market size doubled from US\$25.9 billion to US\$52.6 billion. Total Islamic assets held under sukuk management are worth approximately US\$500 billion.⁵⁷

According to Standard & Poor's, after more than doubling in 2007 to over US\$60 billion, the global market for sukuk is on track to top the US\$100 billion mark in the next few years. Moody's reported last year that the main Shariah principle used for sukuk structure was sukuk-al Musharakah, worth about US\$12.9 billion and followed by sukuk Al-Ijarah of US\$10.3 billion. Both Shariah principles are gaining acceptance worldwide as those principles are recognised by Middle Eastern scholars, whereas Ba'i Inah or Ba'i al-dayn (widely accepted in Malaysia) are deemed controversial in Middle Eastern jurisdictions.

The year 2006 saw the issuance in Malaysia of more globally accepted sukuk employing the concepts of Mudharabah, Musharakah and Ijarah. Government-linked companies also demonstrated their commitment and support in this regard with several sukuk issues being benchmarked to globally acceptable structures. These included the Khazanah exchangeable sukuk, the world's first Islamic exchangeable sukuk, worth US\$850 million. In terms of value, sukuk structured using Musharakah in 2006 contributed RM 29.4 billion or 70% of the total amount of sukuk approved.⁵⁸

On the other hand, the Gulf Cooperation Council ('GCC') market may be expected to overtake Malaysia as the predominant sukuk market in years to come. With the rise of corporate sukuk issuance from 13 to 21 last year and the friendly sukuk regulations (especially in the United Arab Emirates ('UAE')), the GCC market is expanding quite rapidly. Listed sukuk on the Dubai International Financial Exchange alone amounted to about US\$16.1 billion at year-end 2007, up from \$7.6 billion in 2006, recording more than 100% growth. Qatar and Bahrain have adopted comprehensive legal frameworks and are said to compete with the pace of UAE to increase the size of their sukuk market in the near future.

The rapidly growing GCC market has entirely changed the trend of global sukuk. South East Asia – and Malaysia in particular – is currently a friendlier market than the GCC for small and medium-sized sukuk. GCC-issued mega-sukuks tend to be valued in hundreds of millions or even billions of dollars with little room for smaller investors. The 55 sukuk issued in South East Asia during 2007 were worth between US\$1 million and US\$10 million whereas not a single sukuk in the GCC fell within that range. The Islamic Finance Information Service has concluded that the GCC is 'inhospitable' to small and medium-sized

⁵⁶ S A Rosly, *Critical Issues on Islamic Banking and Financial Markets*, (Dinamas Publishing 2005), 473.

⁵⁷ American Journal of Islamic Finance & Fitch Ratings (Mar. 2007).

⁵⁸ Z Anwar, Securities Comm'n Chairman, Welcome Address at the Securities Commission and Citibank Global Shariah Dialogue: Recent Trends in the Sukuk Market, Kuala Lumpur, 6 Mar. 2007, available at http://www.sc.com.my/eng/html/resources/speech/sp_20070306.html.

borrowers with only five corporate sukuk issuances worth less than US\$100 million throughout the life of the market so far.⁵⁹

Issuing sukuk has been on the agenda of the UK Government for some time. The introduction of new measures for sukuk in the 2007 UK Government Budget enables sukuk, or ‘alternative bonds’ as the Government calls them, to be issued, held and traded in the same way as corporate bonds. Bahrain Sovereign Sukuk is already listed on the London Stock Exchange, and London’s secondary sukuk market is experiencing growth. Deals are already structured out of London and Islamic bonds will likely be issued out of London as well. In fact, issuance of sovereign sukuk is also expected in Japan, Hong Kong and Indonesia in 2008.

C. Characteristics of an Effective Legal and Regulatory Framework for the Islamic Financial Services Industry (‘IFSI’)⁶⁰

The success and rapid growth of the sukuk market in Malaysia and GCC is owed to the effective legal and regulatory framework provided by the respective regulators. A legal and regulatory framework which is effective for ensuring a resilient development of IFSI would be characterised by: (a) an enabling environment that accommodates and facilitates the development of the industry; (b) a clear and efficient system that preserves enforceability of Islamic financial contracts; and (c) a credible and reliable forum for settlement of legal disputes arising from Islamic finance transactions.

1. The Creation of an Enabling Environment

Different countries are now at different stages of developing the sukuk regulations in their respective jurisdictions. The Government of Malaysia has taken a proactive step in introducing a comprehensive regulatory scheme under the Capital Market Services Act 2007 (‘CMSA’), catering for Islamic securities including sukuk. The CMSA is supported by the Capital Markets and Services Regulations 2007, the Licensing Handbook and the Guidelines on Regulation of Markets. All of these documents came into effect concurrently with the CMSA. Section 212 of the CMSA sets out the procedures to obtain approval from the Shariah Advisory Council for SC providing their Shariah compliance sign-off before such products are offered in the market.

In the GCC, the Bahrain Monetary Agency (‘BMA’) has established ‘The Prudential Information and Regulatory Framework’ (‘PIRI’) – regulations which cover capital adequacy, asset quality, management of investment accounts, corporate governance and liquidity management. PIRI was the first comprehensive framework created specifically to deal with Islamic banks. PIRI has facilitated the growth of a sukuk market in Bahrain and met its requirement to achieve Shariah compliance.

The cumulative country experiences show that the following factors are keys to moulding an enabling legal environment for IFSI: (i) clear policy decisions and directions coordinated by local financial regulations; (ii) legislation providing for the licensing and supervision of Institutions offering Islamic Financial Services (‘IIFS’) and confirming the establishment of IFSI and its qualitative differences from conventional systems; (iii) a comprehensive and precise mechanism to ensure systemic Shariah-compliance, supervised by qualified Shariah scholars who advise the institution either as a sole Islamic authority or as part of a Shariah committee; (iv) a friendly and neutral taxation system that makes Shariah-compliant products stand parallel and competitive with conventional ones; (v) supporting infrastructures such as accounting standards and human resource development and any other necessary non-fiscal initiatives; and (vi) participation in global initiatives, such as the Islamic Financial Services Board. Since lack of standardization of religious opinion becomes a hindrance and prevents widespread acceptance of Islamic financial products and services,

⁵⁹ www.alwaba.com, 26 Feb. 2008.

⁶⁰ See The Effectiveness Of The Legal And Regulatory Framework For Islamic Financial Services, presented by Dato Dr Nik Norzrul Thani at the 3rd Seminar on Legal Issues in the Islamic Financial Services Industry, organised by the Islamic Financial Services Board, Kuala Lumpur, 28-29 Mar. 2007 (awaiting publication).

thorough research, followed by innovative legal opinions, ensures that the products and services offered do not contravene Islamic law and that new instruments are formulated on the basis of Islamic legal heritage.

2. The Enforceability of Contracts

In most countries in the world, English law has become the primary legal reference. English courts are chosen as a proper forum to deal with transactional matters, particularly those involving enforcement of contracts. When, however, the IIFS introduce Islamic financial instruments and services, indirectly those courts are called to implement Islamic law, specifically but not limited to Islamic law of contract and commerce.

The legal difficulties that arise from the introduction of Islamic financial services in various jurisdictions relate to the classic problem associated with dualism or pluralism. When the classical Islamic law of contract is applied into an alien environment, the English or other law governing its interpretation and enforcement usually ignores that form even if the parties create their agreements according to Islamic legal form. It is not practical for parties to incorporate all the rules of Islamic law in their agreements, but many of the rules, such as the ban on interest and excessive risk (*riba* and *gharar*), that are omitted are fundamental to Islamic principles. Therefore, documents and instruments used in Islamic financial transactions not only have to be in accord with Islamic law, but must also comply with the standard of national law in force and must be structured to be enforceable in the state civil courts. Even if the Shariah advisory or supervisory councils have approved those instruments as being Shariah-compliant, the hybrid nature of these enforcement proceedings may result in conflicts between Islamic law and civil law, making the Shariah-compliant instruments vulnerable to judicial challenge in the national courts. The judges in such cases may not refer to Shariah experts for clarification, but may directly apply local law principles to decide the matter.

3. Settlement of Legal Disputes

Resolution of disputes arising from Islamic financial transactions according to Islamic law as well as the applicable national law necessitates a concrete legal framework. Transaction-specific solutions and experimenting in drafting clauses in Islamic contracts are insufficient for IFSI for the long term; there needs to be a carefully-planned program that ensures continuous improvement in competency of judges and lawyers, transparency and predictability of court decisions based on precedents and law reports, as well as the development of alternative methods of dispute resolution such as mediation and arbitration.

The following measures should be studied and considered for meeting future legal infrastructural challenges: (i) the establishment of special courts to try all cases arising from Islamic financial transactions, or special benches within the local judiciary comprised of judges trained in Islamic law, in either case accompanied by efforts to publish quality law reports that ensure the availability of precedents for IFSI's guidance; (ii) the establishment of an international adjudicating body (i.e., an international Islamic court or an international Islamic arbitration tribunal) to deal with disputes arising in cross border transactions where the law applicable is Islamic law; and (iii) the establishment of a comprehensive code of Islamic commercial law to provide the general guidelines for satisfactory dispute resolution for IIFS. In addition, consideration should be given to greater use of arbitration (*tahkim*) and mediation (*sulh*) by Shariah experts, rather than litigation in cases of dispute, since that would be in line with the Shariah principles to resolve the dispute in the best manner. Other methods that could be explored to the advantage of the IFSI are mini-trials and a hybrid of arbitration and mediation (*arb-med*).⁶¹

D. Conclusion

The sukuk market is expected to grow rapidly as part of the systemic Middle Eastern growth in long-term conventional debt financing combined with a drive to tap the deep pool of Islamic liquidity. Malaysia, where approximately 75% of corporate issuance was Islamic in 2005, may provide some indication of future demand. In this regard, the Government of Malaysia has been the leading example as a regulator providing

⁶¹ Dr N Norzrul Thani, *Islamic Law Implementation for Global Finance, Leadership in Global Finance: The Emerging Islamic Horizon 4-11*, INCEIF Global Forum 2007, Kuala Lumpur (2007).

an extensive Capital Market Masterplan and a Financial Sector Masterplan that resulted in the country's present industrial growth and advancement. A strong legal infrastructure is the means through which governments and the industry apply and achieve their policy objectives in relation to the sukuk market.

With industry initiative, clear policy direction and market demand, the requisite legal measures can be implemented to create a conducive environment that facilitates a more harmonious interface between Shariah principles and the respective national legal frameworks, ensures transparency, and minimises commercial risk and uncertainty.

Part V – SOVEREIGN WEALTH FUNDS IN THE CAPITAL MARKETS

To a previously unexpected extent, academic and public discourse on capital market dynamics in the Biennium 2006-2008 focused on the potential impact on market integrity stemming first from hedge funds, second from private equity funds and most recently from sovereign wealth funds ('SWFs').⁶² It is particularly sovereign wealth funds operating out of Asia and the Middle East from which, in the present 'largest ever peacetime liquidity crisis,'⁶³ leading western financial houses have turned to seek fresh funds in the course of their recapitalisation (see Table 1). The European Union Commissioner for Internal Markets, Charlie McCreevy, noted the 'irony that the entities that were being demonised [by vested interests in Europe]...have in recent months been the saviours rather than the demons'.⁶⁴

Table 1: Sovereign Wealth Fund Investments in Major Western Banks⁶⁵

BANK	SUB-PRIME LOSSES (US\$ BILLIONS)	SOVEREIGN WEALTH FUND INVESTMENT (US\$ BILLIONS)
Merrill Lynch	31.7	11 including: 4.4 (Temasek Holdings, Singapore) 2.0 (Korea Investment Fund) 2.0 (Kuwaiti Investment Fund) 0.3 (New Jersey Division of Investment)
Citigroup	40.7	20.0 including: 7.5 (Abu Dhabi Investment Corporation) 6.8 (Singapore Investment Corporation)

⁶² See Financial Services Authority, *Private Equity: A Discussion of Risk and Regulatory Engagement*, Feedback Statement 07/3, Feedback on DP06/6, Jun. 2007, available at http://www.fsa.gov.uk/pubs/discussion/fs07_03.pdf; Financial Services Authority, *Private Equity: A Discussion of Risk and Regulatory Engagement*, Discussion Paper 06/6, Nov. 2006, available at http://www.fsa.gov.uk/pubs/discussion/dp06_06.pdf; see Walker Working Group, *Guidelines for Disclosure and Transparency in Private Equity*, Nov. 2007, available at http://walkerworkinggroup.com/sites/10051/files/wwg_report_final.pdf (indicating that the private equity industry itself proposed voluntary guidelines); see generally Justin O'Brien (ed.), *Private Equity, Corporate Governance and the Dynamics of Capital Market Regulation* (London: World Scientific Publishing Co. Inc., 2007).

⁶³ R Lomax, Deputy Governor, Bank of Eng., Speech at the Institute of Economic Affairs 25th Anniversary Conference: The State of the Economy, 26 Feb. 2008, 5, available at <http://www.bankofengland.co.uk/publications/speeches/2008/speech337.pdf>.

⁶⁴ C McCreevy, Speech at Society of Business Economists Annual Dinner: Credit Crisis and the Aftermath, 6 Feb. 2008, 2, available at <http://209.85.135.104/search?q=cache:z5kfotUzBuAJ:europa.eu/rapid/pressReleasesAction.do%3Freference%3DSPEECH/08/60%26format%3DPDF%26aged%3D0%26language%3DEN%26guiLanguage%3Den+Cr edit+Crisis+and+the+Aftermath%E2%80%99&hl=en&ct=clnk&cd=2&gl=us>.

⁶⁵ Principal elements of Table 1 are attributable to J O'Brien, *When the Music Stops: Sovereign Wealth Funds and the Limits of Financial Capitalism*, available at <http://www2.ku.edu/~kupa/kettering/pdfs/OBrien.pdf>.

BANK	SUB-PRIME LOSSES (US\$ BILLIONS)	SOVEREIGN WEALTH FUND INVESTMENT (US\$ BILLIONS)
		3.0 (Kuwait Investment Authority)
		0.4 (New Jersey Division of Investment)
UBS	38.0	9.7 (Singapore Investment Corporation)
Morgan Stanley	12.6	5 (China Investment Corporation)
Barclays	3.2	2.98 (China Development Bank)
Standard Chartered.....	0.3	8 (Temasek Holdings, Singapore)
Deutsche Bank	7.5	2 (Investment Corporation of Dubai)
Credit Suisse	6.3	2 (Qatar Investment Authority)

In the first two months of 2008, SWFs invested US\$24.8 billion, just under half the total amount dispersed in the whole of 2007. Since January 2007, more than US\$60.7 billion has been invested, primarily in the financial sector. Singapore has been the most aggressive, with portfolio enhancements of US\$41.7 billion.⁶⁶ The pressing need for investment may, as Commissioner McGreevy suggests, reflect poor risk management at the corporate level in the relevant banks. At the same time, much wider geopolitical issues are also at play, focusing on the perceived transparency and accountability deficit associated with the governance of sovereign wealth funds, particularly those emanating from China and the countries of the Persian Gulf. It is an open question, however, whether the risks identified – financial contagion, the extension of foreign policy through exercise of soft power, and governance deficiencies – represent a pressing danger or an attempt to justify economic protectionism.

A. The Rise of Sovereign Wealth Funds

SWFs are investment vehicles used by governments to manage current account surpluses. These can derive from one-off windfalls, such as the proceeds from privatisation; recurring foreign exchange receipts from natural resource exploitation; or the investment of profits accruing from adroit trading strategies. Unlike traditional stabilisation funds, which tend to invest conservatively to ensure immediate access in the event of a sudden deterioration in critical export markets, SWFs pursue longer-term investment horizons. Investment portfolios are typically diversified along geographic and sectoral dimensions, with an increasing propensity to diversify beyond equities into a range of alternative asset classes. Asset holdings by SWFs have now eclipsed hedge funds and private equity funds in terms of funds under management, and it is estimated that the total assets under management by SWFs could reach as much as US\$12 trillion by 2015.⁶⁷ At that level, SWF assets would exceed central bank reserves and would reach the level of conventional pension funds.⁶⁸

Policymakers across developed markets have flagged the possibility that increased foreign investment in strategic sectors – particularly from SWFs domiciled in China, Russia and the Gulf – could trigger a revival of economic protectionism. The European Commission, for example, has recognised that, while SWFs form an essential transmission belt within the engine of financial globalisation, the relative opacity in SWF governance arrangements makes it difficult to gauge whether investment expansion could threaten legitimate national interests. Separate and several focus on what is deemed to be the individual national interest gives

⁶⁶ J Burton, *Wealth Funds Exploit Credit Squeeze*, Financial Times, 18, 23 Mar. 2008.

⁶⁷ Commission of the European Communities, *A Common European Approach to Sovereign Wealth Funds*, 4, note 3, 27 Feb. 2008, available at http://ec.europa.eu/internal_market/finances/docs/sovereign_en.pdf.

⁶⁸ See Deutsche Bank Research, *Sovereign wealth funds – state investments on the rise*, 10 Sept. 2007, available at http://www.dbresearch.de/PROD/DBR_INTERNET_DE-PROD/PROD000000000215270.pdf.

rise to a constant risk that foreign investment review processes could be excessively politicised by forces of economic populism and protectionism.⁶⁹

To forestall these nascent but growing protectionist impulses from gaining further traction, the European Commission's preferred response has been to persuade SWFs to adopt a voluntary code of practice.⁷⁰ The proposed code introduces common disclosure standards, which are designed to ensure policy coherence in defining what constitutes the public interest in blocking potential investments.⁷¹ The European Union proposals follow the visit of a US Treasury delegation to Abu Dhabi in February 2008 for discussions with the emirate's Investment Authority, which, with more than US\$900 billion under management, is the world's largest sovereign wealth fund. The meeting was also attended by the Government of Singapore Investment Corporation, the third largest SWF. Both have been active in acquiring strategic (but passive) stakes in US investment banks. The funds agreed a set of principles that require an explicit commitment that investment decisions should be based solely on commercial grounds rather than to advance, directly or indirectly, the geopolitical goals of the controlling Government. According to the US Treasury, 'greater information disclosure in areas such as purpose, investment objectives, institutional arrangements and financial information...can reduce uncertainty and build trust in recipient countries.'⁷² Moreover, the other leading Singaporean fund, Temasek Holdings, sent its executive director to a Congressional hearing in Washington to impress upon lawmakers its internal checks and balances on undue political influence,⁷³ and the ranking civil servant responsible for the oversight of the Norwegian Government Pension Fund – Global, Europe's largest SWF, emphasised to Congress its own well developed controls and the desirability of legislative restraint.⁷⁴ These steps, designed to narrow the perception of an accountability and transparency deficit, are likely to be instrumental in framing trans-national regulatory discourse, particularly at the International Monetary Fund ('IMF').

The IMF is exceptionally cognisant of the diplomatic sensitivities inherent in limitations on SWFs.⁷⁵ Its Deputy Managing Director has argued that 'if there were a sense that somehow "best practices" were decided by someone else and dictated [to the SWFs], that could be extremely counterproductive.'⁷⁶ There are, nevertheless, signs of bristling at a partial rewriting of the rules governing financial globalisation. The chairman of Dubai World, for example, has warned that the introduction of formal regulatory oversight is both unwarranted and contrary to the interests of recipient corporations and states,⁷⁷ and the vice president of

⁶⁹ For a review of recent regulatory developments in France and Germany, see U.S. Government Accountability Office, *Foreign Investment: Laws and Policies Regulating Foreign Investment in 10 Countries*, Report to the Honorable Richard Shelby, Feb 2008, available at <http://www.gao.gov/new.items/d08320.pdf>.

⁷⁰ T Barber, *Europe Pushes Wealth Funds to Sign Code*, Financial Times (London), 27 Feb. 2008 (Online Edition).

⁷¹ These issues also inform recently released guidelines regarding the management of the Australian foreign investment review; see *infra* note 92.

⁷² Y Otaiba, *Our Sovereign Wealth Plans*, Wall Street Journal A16 (New York), 19 Mar. 2008.

⁷³ Testimony of Simon C. Israel, Executive Director, Temasek Holdings, before the Financial Services Committee of the United States House of Representatives, Washington DC, 5 March 2008, available at http://www.house.gov/apps/list/hearing/financialsvcs_dem/Israel/030508.pdf.

⁷⁴ Testimony of M Skancke, Director General, Asset Management Department, Norwegian Ministry of Finance before the Financial Services Committee of the US House of Representatives, Washington DC, 5 March 2008, available at http://www.house.gov/apps/list/hearing/financialsvcs_dem/skancke/030508.pdf. The Norwegian Government Pension Fund – Global details all of its investments, places self-imposed limits on portfolio size and conforms to an ethical code of practice. Its precise governance rules are published online and are available at http://www.mbin.no/Templates/Article___42531.aspx.

⁷⁵ See IMF, *Sovereign Wealth Funds – A Work Agenda*, 29 Feb. 2008, available at <http://www.imf.org/external/np/pp/eng/2008/022908.pdf>.

⁷⁶ B Davies, *US Pushes Sovereign Funds to Open to Outside Scrutiny*, Wall Street Journal (New York) A1, 26, Feb. 2008.

⁷⁷ See British Broadcasting Corporation, *Dubai Fund Hits Back at Criticism*, BBC News, 29 Feb. 2008, available at <http://news.bbc.co.uk/1/hi/business/7271007.stm>.

the China Investment Corporation has expressed irritation at the call for a code of conduct, saying it was ‘unfair’ and that ‘the claims that sovereign wealth funds are causing threats to state security and economic security are groundless. We don’t need outsiders to come tell us how we should act.’⁷⁸

B. Risks Associated With Sovereign Wealth Funds

The potential risks associated with SWFs can be usefully broken into four core areas: the risk of financial contagion; the extension of foreign policy through exercise of soft political power; national security considerations; and uneven transformative potential of transparency and accountability on improving corporate governance procedures within individual corporations and within the market as a whole.

1. *The Risk of Financial Contagion.* As noted in Table 1 above, three of the most significant US investment banks have secured survival by turning to SWFs operating out of the Middle East and South East Asia. The presence of SWFs as operators in the financial market is unlikely in itself to represent a threat to financial stability since risk-taking and leverage are in principle controlled by (domestic) regulators through capital adequacy rules. However, other aspects of the *modus operandi* of SWFs do raise concerns relating to financial stability.⁷⁹ In the first place, SWFs do not normally fall under the regulatory control of domestic financial authorities and are therefore not subject to the same capital adequacy requirements or controls over risk-taking. Second, there is a general lack of transparency in relation to SWF investment strategy, fund allocation and shareholding;⁸⁰ this makes the SWFs relatively opaque market participants and can trigger uncertainty in financial markets. Third, market discipline may be damaged if creditors and counterparties simply assume that SWFs enjoy an implicit sovereign guarantee when, in reality, they do not.

Some SWFs have sought to head-off potential criticism by developing more indirect conduits, most notably through a deepening of collaborative ventures with private equity consortia. There are precedents for this in the Government of China’s investment in the initial public offering by Blackstone Group L.P. in June 2007, in Chinese Investment Corporation’s contribution to a major fund established by JC Flowers & Co. LLC, to invest in distressed financial stocks, and in the Government Investment Corporation of Singapore’s taking a lead investor role in a similar fund established by Texas Pacific Group.⁸¹ An inevitable consequence is that many of the risks associated with private equity funds and hedge funds in the past may be exponentially amplified, in particular the risks of insider trading and market manipulation.⁸² Fears over the former may of course be tempered by the generally passive investment approach of the SWFs, which is likely to mean that access to any non-public information (whether or not material) through engagement with management will be limited. Market manipulation is probably the greater concern, especially when private equity is used as a

⁷⁸ V Ruan, *China’s Investment Fund Pushes Back*, Wall Street Journal (New York) A6, 7 Mar. 2008.

⁷⁹ Clear exceptions are the Norwegian Government Pension Fund – Global, Temasek Holdings (Singapore) and GIC (the Government of Singapore Investment Corporation).

⁸⁰ See C Lowery, Remarks delivered at the Asian Financial Crisis Revisited Conference Series: Sovereign Wealth Funds and the International Financial System, Federal Reserve Bank of San Francisco, 21 Jun. 2007, available at <http://www.treas.gov/press/releases/hp471.htm>.

⁸¹ See, respectively, British Broadcasting Corporation, *China Buys \$3bn Blackstone Stake*, BBC News, 21 May 2007, available at <http://news.bbc.co.uk/2/hi/business/6675453.stm>; H Sender, *CIC Close to Fund Deal with JC Flowers*, Financial Times (London), Feb. 8, 2008, available at <http://www.ft.com/cms/s/0/aeaf55dc-d5b1-11dc-8b56-0000779fd2ac,dwp-uuid=b03d580a-4ff0-11dc-a6b0-0000779fd2ac.html>; and H Sender, *Singapore to be Top Investor in TPG Fund*, Financial Times (London), 14 Feb. 2008, available at <http://www.ft.com/cms/s/0/3/a129a0-da69-11dc-9bb9-0000779fd2ac.html>.

⁸² See Financial Services Authority, *supra* note 61. The US Securities and Exchange Commission has flagged the asymmetrical informational issue and its application to SWFs as well as other state-controlled funds with privileged access to market sensitive information; see E Tafara, Testimony Concerning Foreign Government Investment in the US Economy and Financial Sector, before the Financial Services Subcommittee on Domestic and International Monetary Policy, Trade and Technology and the Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises, 5 Mar. 2008, available at <http://www.sec.gov/news/testimony/2008/ts030508et.htm>.

conduit, since in those circumstances transactions are much more likely to be heavily leveraged and there may be a double barrier to transparency arising from the largely unregulated nature of both investor and investee.

There is also some concern over the potentially disruptive effect on companies and financial markets of the inward/outward flow of portfolio investments made by SWFs. In this respect, the EU proposals for a code of conduct for SWFs mirror the approach adopted by Australia;⁸³ both are based on the transformative potential of enhanced disclosure. Greater disclosure could provide an early warning system of volatile build-ups of capital within particular sectors, and could reduce the potential of sudden capital withdrawals causing or amplifying financial crises. In addition, the explicit articulation of investment strategies offers the opportunity to reduce any perception that SWF investments are being used to further foreign policy objectives, and provides a mechanism for holding Government owners to account.

2. *The Exercise of Soft Power.* The growing role of SWFs represents a fundamental shift in market dynamics precisely because SWFs potentially fuse political and commercial imperatives in ways that are not always transparent. While their investment strategies do not differ in substance from those of traditional pension funds, the sheer scale of SWFs allows for the potential extension of foreign policy aims through the exercise of ‘soft power’.⁸⁴ The systematic acquisition of direct and indirect investment does raise as yet unresolved questions of whether, and if so, how, these developments threaten ‘the public interest’. SWFs reject any suggestion of a threat. The Abu Dhabi Investment Authority has, for example, stated explicitly that ‘the Abu Dhabi government has never and will never use its investment organizations or individual investments as a foreign policy tool’.⁸⁵ It also emphasises that financial experts manage 80% of its investments. It cautions, however, that ‘in a world thirsty for liquidity, receiving nations should be mindful of the signals sent through protectionist rhetoric and rash regulation.’⁸⁶

3. *Threats to National Interest.* Many countries impose restrictions on foreign direct investment.⁸⁷ Concerns over national security issues, for example, were central to the controversy in the United States over the aborted acquisition of Unocal by China National Offshore Oil Corporation in 2005 and a planned investment by state-owned Dubai Ports World in P&O’s stevedore operations on the US eastern seaboard in 2006.⁸⁸ While these two examples involved proposed acquisitions by state-owned enterprises rather than SWFs, similar considerations apply. The passage of the Foreign Investment and National Security Act of 2007⁸⁹ was designed to introduce more certainty into the foreign investment review process in the United States. Although designed to clarify matters and reduce controversy, the Committee on Foreign Investment (referred to as ‘CFIUS’) remains a politically charged arena. This is particularly the case for China-domiciled investors, as the abortive attempt by Bain Capital Partners LLC and its partner Huawei Technologies Co., Ltd. to gain control of 3Com Corporation demonstrated in recent months.⁹⁰

⁸³ See Barber, *supra* 70; see *infra* note 92.

⁸⁴ See J Nye, *Soft Power: The Means to Success in World Politics*, (New York: Public Affairs Books, 2005).

⁸⁵ See Otaiba, *supra* note 72.

⁸⁶ See Otaiba, *supra* note 72.

⁸⁷ For an index of national foreign direct investment restrictions, see *Sovereign Wealth Funds – A Position Paper by the Swiss Bankers Association*, 11 May 2008, available at http://www.swissbanking.org/en/999978_e.pdf.

⁸⁸ See generally, E Graham and D Marchick, *US National Security and Foreign Direct Investment* (Washington DC: Institute for International Economics, 2006).

⁸⁹ PL 110-49, 121 Stat 246 (110th Congress, 1st Session).

⁹⁰ S Kirchgaessner, *US Insiders Point to Bain Errors over 3Com*, Financial Times (London), 30, 4 Mar. 2008, available at http://us.ft.com/ftgateway/superpage.ft?news_id=fto030320081848181711; S Kirchgaessner, *Washington Obstacle Course sees Chinese Companies Re-Examine Their US Ambitions*, Financial Times (London), 30, Mar. 4, 2008, available at <http://search.ft.com/nonFtArticle?id=080304000045&ct=0>.

There are important structural and policy differences, however, between the 3Com proposal and those investments consummated within the financial sector (reflected in Table I above). The recent financial acquisitions have been structured to ensure that they remain below mandatory government review thresholds. In the United States, for example, passive investments of less than 10% do not generally elicit CFIUS review (although there are circumstances in which investments below 10% may be subject to evaluation).⁹¹

Similar issues pertain to the procedures governing the Foreign Investment Review Board in Australia. In order to tame xenophobic impulses and keep the door open to Chinese investment, the Australian federal government stated that Foreign Investment Review Board deliberations would be governed by six operating principles (while making clear that ultimate decision-making authority would remain with the Treasurer).⁹² The UK on the other hand has historically adopted a liberal approach towards foreign investment and has no specific legal framework comparable to that of either the United States or Australia. The Government is empowered to prohibit or limit mergers or acquisitions that are against the public interest, but SWF investments do not normally reach the level at which the system of merger control is triggered. Of greater potential relevance is the possibility that the FSA may review the licensing arrangements in respect of a bank when the shareholding of an SWF reaches 20%, on the basis that effective supervision may be compromised by the legal or administrative framework under which the SWF operates.

4. *The Changing Dynamics of Corporate Governance.* The emergence of SWFs as substantial shareholders in listed companies across the world poses challenges for corporate governance. On the one hand, the generally passive approach⁹³ adopted by SWFs tends to mitigate concerns related to the possibility that they will exercise soft political power. On the other hand, the emergence of such a powerful but passive class of shareholder poses a challenge to the emergence worldwide of a more active model of corporate governance in recent years. That trend has been particularly evident in Europe, where widespread adoption of Codes of Corporate Governance has been premised, at least in part, on an agenda of promoting activism and accountability on the part of boards of directors. On one reading, SWFs would not pose a threat to the activist model (even if they opted out of it), but on another they might be viewed in a less benign way if, through links with private equity and hedge funds, they were to become involved in the more aggressive forms of activism which have come to the fore in recent years.⁹⁴ The outcome is difficult to predict because, even if SWFs were to move towards a generally more active approach, the agenda that they might bring with them remains uncertain. As illustrated by the Norwegian Government Pension Fund – Global, the long-term horizons under which SWFs operate allows them some freedom to pursue approaches to governance and corporate responsibility that may not be viable for private sector funds operating under shorter time horizons and with a narrower profit-based objective. Viewed from this perspective, proposals to limit SWFs to non-voting shares⁹⁵ recognise the risks associated with SWF activism but not the potential benefits.

⁹¹ China's investment in Blackstone provides a paradigmatic example. The investment was limited to 9.9% of the value of the company and the China Investment Corporation did not demand a board seat. See B Davis and D Berman, *Lobbyists Smoothed Way For A Spate Of Foreign Deals*, Wall Street Journal (New York) A1, 25 Jan. 2008, available at http://online.wsj.com/article/SB120120895483414521.html?mod=googlenews_wsj.

⁹² Guidelines for Foreign Government Investment Proposals, Attachment A to *Summary of Australia's Foreign Investment Policy*, Treasury of the Government of Australia, April 2008, available at http://www.firb.gov.au/content/_downloads/General_Policy_Summary_April_2008.pdf.

⁹³ There are some exceptions to this, such as the Norwegian Government Pension Fund – Global which has a policy of engaging with portfolio companies especially with regard to ethical considerations; see http://www.regjeringen.no/en/sub/Styrer-rad-utvalg/ethics_council/Government-Pension-Fund-Global.html?id=440567.

⁹⁴ See *Shareholder Activism Debate: a Force for Good or Bad?*, Euromoney, Oct. 2007, available at <http://www.euromoney.com/Article/1445991/Debates/763/ChannelPage/8949/Shareholder-activism-debate-A-force-for-good-or-bad.html>.

⁹⁵ See R Gilson and C Milhaupt, *Sovereign Wealth Funds and Corporate Governance: A Minimalist Response to the New Mercantilism*, 18 Feb. 2008, available at <http://ssrn.com/abstract=1095023>.

C Conclusion

While SWFs may bristle at the rewriting of the rules of financial globalisation, legitimate concerns over the impact of SWF investment in individual national markets elicit debate on whether and how to strengthen mechanisms of transparency and procedures for accountability. Given their increasing role in providing liquidity, it is inevitable that SWFs have entered onto the political radar, like private equity funds and hedge funds before them. Here a useful precedent can be found in the indirect ways in which private equity was persuaded to enhance its accountability. As the industry-sponsored review into its operations in the United Kingdom acknowledged: ‘The context for this enquiry is that a position that full disclosures and reporting to limited partners, the ultimate owners of private equity, are alone sufficient is no longer politically and otherwise sustainable, at least in respect of the largest portfolio companies.’⁹⁶ A similar dynamic is now facing the SWFs. Thus, although their development is largely due to trade imbalances, their global acceptance is likely, to a great extent, to be subject to their voluntary embrace of the disclosure imperative.

Part VI – RECOGNISING THE VIRTUES OF MUTUAL RECOGNITION

The subject matter of this Part VI reverts to material discussed in the Committee’s early Reports, reflecting the insights of its initial Rapporteurs Professor Cynthia Lichtenstein and Mr Peter Willis.⁹⁷

In the ‘hierarchy of approaches’ to address inconsistencies arising out of separate national legislative and regulatory treatment of securities law issues, one ordering of approaches was as follows: ‘autochthony; common heritage; mutual recognition; technical harmonization; virtual uniformity; and uniformity.’ Alternatively, per one of the then Committee members: national treatment; international harmonization, mutual recognition, and common international standards.

Taken for itself, mutual recognition was perceived to ‘allow[] non-conforming foreign laws, procedures or documents to be treated as if they conformed to the domestic standard. As a matter of process, mutual recognition is often achieved by the use of a regulatory agency’s power to exempt or dispense with full compliance, rather than by formal amendment by the legislature.’

The fundamental justification for mutual recognition was that ‘major countries have recognized that foreign jurisdictions offer [virtually] the same degree of disclosure to investors and regulatory supervision of issuers, to enable them to “relax” the technical registration standards in their own jurisdiction.’⁹⁸

For much of the intervening time, however, mutual recognition was a concept out of favor, at least in the United States. When in 1997, for example, the SEC published a concept Release⁹⁹ reviewing issues of cross-border trading, the first option it listed was ‘Sole Reliance on Foreign Markets’ Home Country Regulation.’ Despite the advantages of certainty, control of additional regulatory expense, and provision of market service to US investors at lower cost, all recited in the Release, however, the ‘significant drawbacks’ of this option as perceived by the SEC, overwhelmed those advantages. The drawbacks included (i) less protection for

⁹⁶ Walker Working Group, *supra* note 62; see generally I MacNeil, *Private equity: the UK regulatory response*, 3(1) *Capital Markets Law Journal* 18 (2008).

⁹⁷ See International Law Association, *Mutual Recognition and Harmonization of Securities Laws, Report of the 65th Conference* (Cairo 1992), Part II, Subdivision 5, 97; Key Theme—Harmonization and Related Concepts, *Report of the 67th Conference* (Helsinki 1996), Part II, Subdivision 2.2, 483.

⁹⁸ Key Theme—Harmonization and Related Concepts, *Report of the 67th Conference* (Helsinki 1996), Part II, Subdivision 2.2, 486.

⁹⁹ SEC Concept Release No. 34-38672, 64 SEC Docket (CCH) 1631 (23 May 1997), 62 *Federal Register* 30485 (4 Jun. 1997).

investors than when trading on US markets, in terms of less issuer-oriented disclosure and less reliable market information; (ii) lower market integrity than when trading on US markets, in terms of potential for market manipulation, lack of firm quotes, absence of rapid dissemination of trading data, and lack of access to sources allowing for evaluation of the currency of published data; (iii) lower mandates for maintenance and preservation of trading information than when compared to US markets, in terms of support for subsequent regulatory investigations or subsequent suits for vindication of private rights, and (iv) greater likelihood, than when trading in US markets, of prevention of access to US courts to serve process, to claim damages or to enforce judgments.¹⁰⁰ The substance of that Release could be construed as a statement of the long-time SEC institutional view that may (not unfairly) be paraphrased as ‘if it (whatever ‘it’ may be) didn’t originate here, in the SEC, it can’t be reliable for investors.’

Only in the last two years has the view changed, under the stimulus of persuasive articles by two well-respected securities lawyers, one in the investment banking and brokerage community (who is a former SEC official) and one high-ranking within the SEC, Edward F Greene and Ethiopis Tafara.¹⁰¹ Whatever the intra-SEC dynamics initiated by those articles,¹⁰² or perhaps simply because the time was propitious, in June 2007 the SEC convened a public roundtable for discussion on the topic¹⁰³ and by February 2008 felt sufficiently convinced to publish a Joint Statement with the EC stating their ‘common interest in developing a cooperative approach to reducing regulatory friction and increasing investor access to investment diversification opportunities....The concept of mutual recognition offers significant promise....’¹⁰⁴ In the Joint Statement, SEC Chairman Cox and EC Commissioner McCreedy ‘mandated their respective staffs to intensify work on a possible framework for EU-US mutual recognition for securities in 2008.’¹⁰⁵ The Joint Statement was followed only a few weeks later by the announcement by Chairman Cox and Australian

¹⁰⁰ *Id.* at 1693-4 and 30522-3.

¹⁰¹ E Tafara, Director of the SEC’s Office of International Affairs, and R J Peterson, Senior Counsel of the SEC’s Office of International Affairs, co-authored an article reinitiating the discussion: *A Blueprint for Cross-Border Access to U.S. Investors: A New International Framework*, 48 *Harvard Int’l L J* 31 (Winter 2007). The Tafara/Peterson article was accompanied by four pieces commenting on the principal text, one of which was E F Greene, *Beyond Borders: Time to Tear down the Barriers to Global Investing*, 48 *Harvard Int’l L J* 85 (Winter 2007). Greene, former Director of the SEC’s Division of Corporation Finance and former General Counsel of the SEC, currently serves as General Counsel, Citi Markets and Banking within Citigroup Inc., New York City. He subsequently pursued the discussion in *Resolving Regulatory Conflicts Between the Capital Markets of the United States and Europe*, 2 *Capital Markets L J* 5 (Jan. 2007), and *Beyond Borders Part II: A New Approach to the Regulation of Global Securities Offerings*, available at http://www.sechistorical.org/collection/papers/2000/2007_05_01_GreeneBeyondT.pdf.

¹⁰² See E R Sirri, Dir SEC Div’n of Market Reg’n, Speech by SEC Staff: Trading Foreign Shares, Boston, 1 Mar. 2007, available at <http://www.sec.gov/news/speech/2007/spch030107ers.htm>; R C Campos, Speech by SEC Commissioner: SEC Regulation Outside the United States, London, 8 March 2007, Section VII, available at <http://www.sec.gov/news/speech/2007/spch030807rcc.htm#7>; A L Nazareth, Speech by SEC Commissioner: Remarks before the ABA Section of International Law, Washington, 4 May 2007, available at <http://www.sec.gov/news/speech/2007/spch050407aln.htm>; C Cox, Speech by SEC Chairman: Learning from the Shogun – Toward IOSCO’s Vision of a Global Market, Tokyo, 8 Nov, 2007, available at <http://www.sec.gov/news/speech/2007/spch110807cc.htm>; and J W White, Dir, SEC Div’n of Corp Finance, Speech by SEC Staff: Corporation Finance in 2008 – A Focus on Financial Reporting, San Diego, 23 Jan. 2008), available at <http://www.sec.gov/news/speech/2008/spch012308jww.htm>.

¹⁰³ See SEC Spotlight on: Roundtable Discussion Regarding Mutual Recognition, US Securities and Exchange Commission, available at <http://www.sec.gov/spotlight/mutualrecognition.htm>. for the archived webcast, unofficial transcript, and related materials.

¹⁰⁴ *Statement of the European Commission and the U.S. Securities and Exchange Commission on Mutual Recognition in Securities Markets*, Washington, 1 Feb. 2008, available at <http://www.sec.gov/news/press/2008/2008-9.htm>.

¹⁰⁵ *Id.*

Prime Minister Rudd of the initiation of ‘formal discussions to develop a mutual recognition arrangement for the two nations’ securities markets.’¹⁰⁶

The fundamentals of this ‘concept of mutual recognition’ as they are generally understood are:

1. *Comparability*. Exemption from domestic (that is, host country) registration requirements for market participants whose home country regulatory regimes have been determined by the host country regulator to offer ‘comparable regulatory oversight’ in terms of systemic objectives and systemic reliability, even though particular regulatory means used for the achievement of those objectives may differ.
2. *Regulatory Cooperation*. Exemption for market participants whose home and host country regulators have entered into formal agreements on exchange of information relevant to prudential market supervision as well as enforcement activity.
3. *Substituted Compliance*. Compliance by exempt market participants with the regulatory scheme administered by their home country regulators (enforcement being conducted by those home country regulators and not by the host country regulator), except that host country anti-fraud provisions would be administered and enforced by the host country regulators.

A variety of additional conditions fills out the discussion, including but by no means limited to the desirability vel non of (i) notice to investors of the differences in protection under different regulatory regimes; (ii) prohibition of unfair discrimination in access to products and services; (iii) reciprocity in treatment of market participants in home and host countries; (iv) separate treatment of participants in retail and wholesale markets; (v) reliance on electronic technologies, not only in trading, but in disclosure as well as clearance and settlement; and (vi) perhaps most important of all, commonality in standards for assessing comparability. The discussion varies, also, depending on the market sector under consideration. Access to exchange markets seems to present far fewer problems than access to vehicles for common investment whether dubbed UCITS or mutual funds; similarly, access to market intermediaries seems to present far fewer problems than access to issuers engaged in raising capital. The US Commodity Futures Trading Commission allowance of access by US traders to trading data from futures exchanges overseas¹⁰⁷ stands as an example, albeit in a limited and somewhat different trading context, of how a form of mutual recognition can in fact work.

In a presentation in April 2008 in New York, Eddy Wymeersch, the Chairman of the Committee of European Securities Regulators (‘CESR’), suggested that a comparison of US and EU securities regulatory regimes would evidence that the ‘essential objectives on both sides are [already] met’, especially in terms of reliability of the respective regulatory systems, clearance and settlement, investor protection, disclosure, treatment of market abuse, and fairness of the respective markets.¹⁰⁸ One of the slides that accompanied his presentation reads:

- ‘The regulations on both sides are largely equivalent: no need to add host regulation
- ‘The supervision is largely comparable also in terms of efficiency: hence home supervision
- ‘Enforcement: clear differences due to different traditions – strengthening is under way – mechanism [is] needed for dealing with differences in sanctioning.’¹⁰⁹

¹⁰⁶ SEC Chairman Cox, *Prime Minister Rudd Meet Amid U.S.-Australia Mutual Recognition Talks*, Washington, 29 Mar. 2008, available at <http://www.sec.gov/news/press/2008/2008-52.htm>.

¹⁰⁷ See no-action letters beginning with CFTC Interpretative Letter No. 96-28 (1996-1997 Transfer Binder) Comm. Fut. L. Rep. (CCH) para. 26,669, 29 Feb. 1996.

¹⁰⁸ E Wymeersch, slides accompanying presentation entitled *US-EU Mutual recognition: The Way Forward*, Practising Law Institute: Foreign Issuers & the U.S. Securities Laws 2008: Best Practices in Cross-Border Offerings and Reforms, New York, 30 Apr. 2008.

¹⁰⁹ *Id.* at 17.

If Mr Wymeersch is correct, then the substantive problems on the road to US-EU mutual recognition may be surmounted in the reasonably near future. That will leave the political issues: bilateral comparability assessment (as in the case of Australia) or multilateral comparability assessment (as seems to be the position of the EU); accountability to the host country legislative body or outsourcing accountability to a home country government structure; and adaptive regulation and cross-border enforcement in the name of market competitiveness or rigid rules and national treatment in the name of investor protection. To none of these is there a single response determinable without debate. Continuing globalization of markets is unlikely to await the result.

Part VII – CONCLUSION

Although this Report (in Part I) refers readers to our Rapporteur’s forthcoming article on the global credit crisis, the Committee does not believe it yet has the perspective for proper analysis of the impacts of the extraordinary market events that the crisis generated. While the ‘credit crunch’ appears to have originated in the rapid deflation of a multi-year housing market ‘bubble’ in the United States, it then spread across the globe both by virtue of concomitant housing price deflation elsewhere and losses on direct and derivative housing-related investments suffered by international financial institutions on all continents. As we observe market and regulatory reactions to the crisis, we on the Committee are afforded the ‘opportunity for...reflection’ that was the cornerstone of the Conclusion to our Seventh Interim Report:

Reflexive adaptation of regulation to the rapidity and extent of change in international securities markets has at times taken on an aura of *saue qui peut*; the Association, happily, is afforded the opportunity for more considered reflection.¹¹⁰

Regulatory reaction to the ‘credit crunch’ will in any event be but one facet of the developments that can be expected to impact the international securities markets, and therefore to elicit the Committee’s attention in the biennium about to begin. The “Interim” nature of this Eighth Report comes bright and clear in each of its several Parts: to what extent, in the next biennium and beyond, will principles-based regulation (Part II) and mutual recognition (Part VI) fulfill the goals and perform the role envisioned by their expositors for these novel approaches to regulation? How, in the next biennium and beyond, will sovereign wealth funds (Part V) self-limit their use of ‘soft power’ to dispel the reaction of economic populism that their very wealth produces? Will Sukuk (Part IV) be able, in the next biennium and beyond, to continue to adapt to the evolving 21st Century financial instruments with which it deals to realise the prophetic precepts on which it is based? What will be the success, in the next biennium and beyond, of the rapid evolution in corporate governance (Part III) whether in Japan, on the European continent, or elsewhere in nations with developed or developing securities markets?

And on another plane: Throughout this Report can be distinguished, like the muffled notes introducing the Chorale, the under-score of questions about the accountability of the regulators—both those vested with responsibility or who take to themselves responsibility for market oversight and those exercising market oversight at one or two removes from political discipline within transnational regulatory networks such as IOSCO, Basle, or CESR. Two years ago, this Committee observed that ‘[a]ccountability of governors is a critical issue and almost by default has emerged as a new focus of academic study in the context of international securities markets.’ While we failed to explore this issue in the biennium just past, it is certainly appropriate and timely to consider doing so in the biennium about to begin.

With the permission of the Committee membership and of the Director of Studies, this Eighth Interim Report will conclude by repeating the ‘challenge’ articulated in its immediate predecessor: Taken together, the themes/issues/matters reflected in this Part VII present more than mere topics for discussion at the Committee’s workshop in Rio de Janeiro. Taken together, they provide more than sufficient grist for the Committee’s work in the next biennium. Taken together, they pose a challenge to the conventional notions

¹¹⁰ See The International Law Association, *Seventh Interim Report of the Seventy-Second Conference* (Toronto 2006), 827, 858.

of appropriate principles for international securities regulation, not an affront or an interdiction, but a challenge to reconsider, to reinforce, and reaffirm, or to seek reform as and where the Committee and the Association find these courses justified.